Model Tax Convention on Income and on Capital

(Updated as of 29 April 2000)

OECD Committee on Fiscal Affairs

VOLUME I

Introduction

Model Convention

Commentary

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
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INTRODUCTION

1. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods. Its harmful effects on the exchange of goods and services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.

2. It has long been recognized among the Member countries of the Organisation for Economic Co-operation and Development that it is desirable to clarify, standardize, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation.

3. This is the main purpose of the OECD Model Tax Convention on Income and on Capital, which provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation. As recommended by the Council of the OECD,[1] Member countries, when concluding or revising bilateral conventions, should conform to this Model Convention as interpreted by the Commentaries thereon and having regard to the reservations contained therein and their tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention.

A. Historical background

4. Progress had already been made towards the elimination of double taxation through bilateral conventions or unilateral measures when the Council

1. Cf. Appendix II in Volume II.

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of the Organisation for European Economic Co-operation (OEEC) adopted its first Recommendation concerning double taxation on 25 February 1955. At that time, 70 bilateral general conventions had been signed between countries that are now Members of the OECD. This was to a large extent due to the work commenced in 1921 by the League of Nations. This work led to the drawing up in 1928 of the first model bilateral convention and, finally, to the Model Conventions of Mexico (1943) and London (1946), the principles of which were followed with certain variants in many of the bilateral conventions concluded or revised during the following decade. Neither of these Model Conventions, however, was fully and unanimously accepted. Moreover, in respect of several essential questions, they presented considerable dissimilarities and certain gaps.

5. The increasing economic interdependence and co-operation of the Member countries of the OEEC in the post-war period showed increasingly clearly the importance of measures for preventing international double taxation. The need was recognised for extending the network of bilateral tax conventions to all Member countries of the OEEC, and subsequently of the OECD, several of which had so far concluded only very few conventions and some none at all. At the same time, harmonization of these conventions in accordance with uniform principles, definitions, rules, and methods, and agreement on a common interpretation, became increasingly desirable.

6. It was against this new background that the Fiscal Committee set to work in 1956 to establish a draft convention that would effectively resolve the double taxation problems existing between OECD Member countries and that would be acceptable to all Member countries. From 1958 to 1961, the Fiscal Committee prepared four interim Reports, before submitting in 1963 its final Report entitled "Draft Double Taxation Convention on Income and Capital".[2] The Council of the OECD adopted, on 30 July 1963, a Recommendation concerning the avoidance of double taxation and called upon the Governments of Member countries, when concluding or revising bilateral conventions between them, to conform to that Draft Convention.

7. The Fiscal Committee of the OECD had envisaged, when presenting its Report in 1963, that the Draft Convention might be revised at a later stage

2. *Draft Double Taxation Convention on Income and Capital*, OECD, Paris, 1963.

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following further study. Such a revision was also needed to take account of the experience gained by Member countries in the negotiation and practical application of bilateral conventions, of changes in the tax systems of Member countries, of the increase in international fiscal relations, and of the development of new sectors of business activity and the emergence of new complex business organisations at the international level. For all these reasons, the Fiscal Committee and, after 1971, its successor the Committee on Fiscal Affairs, undertook the revision of the 1963 Draft Convention and of the commentaries thereon. This resulted in the publication in 1977 of a new Model Convention and Commentaries.[3]

8. The factors that had led to the revision of the 1963 Draft Convention continued to exert their influence and, in many ways, the pressure to update and adapt the Model Convention to changing economic conditions progressively increased. New technologies were developed and, at the same time, there were fundamental changes taking place in the ways in which cross-borders transactions were undertaken. Methods of tax avoidance and evasion became more sophisticated. The globalisation and liberalisation of OECD economies also accelerated rapidly in the 1980s. Consequently, in the course of its regular work programme, the Committee on Fiscal Affairs and, in particular, its Working Party No. 1, continued after 1977 to examine various issues directly or indirectly related to the 1977 Model Convention. This work resulted in a number of reports, some of which recommended amendments to the Model Convention and its Commentaries.[4]

9. In 1991, recognizing that the revision of the Model Convention and the Commentaries had become an ongoing process, the Committee on Fiscal Affairs adopted the concept of an ambulatory Model Convention providing periodic and more timely updates and amendments without waiting for a complete revision. It was therefore decided to publish a revised updated version of the Model Convention which would take into account the work done since 1977 by integrating many of the recommendations made in the above-mentioned reports.

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3. *Model Double Taxation Convention on Income and on Capital*, OECD, Paris, 1977.

4. A number of these reports were published and appear in Volume II.

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10. Because the influence of the Model Convention had extended far beyond the OECD Member countries, the Committee also decided that the revision process should be opened up to benefit from the input of non-Member countries, other international organisations and other interested parties. It was felt that such outside contributions would assist the Committee on Fiscal Affairs in its continuing task of updating the Model Convention to conform with the evolution of international tax rules and principles.

11. This led to the publication in 1992 of the Model Convention in a loose-leaf format. Unlike the 1963 Draft Convention and the 1977 Model Convention, the revised Model was not the culmination of a comprehensive revision, but rather the first step of an ongoing revision process intended to produce periodic updates and thereby ensure that the Model Convention continues to reflect accurately the views of Member countries at any point in time.

11.1 Through one of these updates, produced in 1997, the positions of a number of non-member countries on the Model Convention were added in a second volume in recognition of the growing influence of the Model Convention outside the OECD countries (see below). At the same time, reprints of a number of previous reports of the Committee which had resulted in changes to the Model Convention were also added.

B. Influence of the OECD Model Convention

12. Since 1963, the OECD Model Convention has had wide repercussions on the negotiation, application, and interpretation of tax conventions.

13. First, OECD Member countries have largely conformed to the Model Convention when concluding or revising bilateral conventions. The progress made towards eliminating double taxation between Member countries can be measured by the increasing number of conventions concluded or revised since 1957 in accordance with the Recommendations of the Council of the OECD. But the importance of the Model Convention should be measured not only by the number of conventions concluded between Member countries[5] but also by the fact that, in

5. Cf. Appendix I in Volume II for the list of these conventions.

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accordance with the Recommendations of the Council of the OECD, these conventions follow the pattern and, in most cases, the main provisions of the Model Convention. The existence of the Model Convention has facilitated bilateral negotiations between OECD Member countries and made possible a desirable harmonization between their bilateral conventions for the benefit of both taxpayers and national administrations.

14. Second, the impact of the Model Convention has extended far beyond the OECD area. It has been used as a basic document of reference in negotiations between Member and non-Member countries and even between non-Member countries, as well as in the work of other worldwide or regional international organisations in the field of double taxation and related problems. Most notably, it has been used as the basis for the United Nations Model Double Taxation Convention between Developed and Developing Countries,[6] which reproduces a significant part of the provisions and Commentaries of the OECD Model Convention. It is in recognition of this growing influence of the Model Convention in non-member countries that it was agreed, in 1997, to add to the Model Convention the positions of a number of these countries on its provisions and Commentaries.

15. Third, the worldwide recognition of the provisions of the Model Convention and their incorporation into a majority of bilateral conventions have helped make the Commentaries on the provisions of the Model Convention a widely-accepted guide to the interpretation and application of the provisions of existing bilateral conventions. This has facilitated the interpretation and the enforcement of these bilateral conventions along common lines. As the network of tax conventions continues to expand, the importance of such a generally accepted guide becomes all the greater.

6. *United Nations Model Double Taxation Convention between Developed and Developing Countries, United Nations Publications,* New York, 1980.

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C. Presentation of the Model Convention

Title of the Model Convention

16. In both the 1963 Draft Convention and the 1977 Model Convention, the title of the Model Convention included a reference to the elimination of double taxation. In recognition of the fact that the Model Convention does not deal exclusively with the elimination of double taxation but also addresses other issues, such as the prevention of tax evasion and non-discrimination, it was subsequently decided to use a shorter title which did not include this reference. This change has been made both on the cover page of this publication and in the Model Convention itself. However, it is understood that the practice of many Member countries is still to include in the title a reference to either the elimination of double taxation or to both the elimination of double taxation and the prevention of fiscal evasion.

Broad lines of the Model Convention

17. The Model Convention first describes its scope (Chapter I) and defines some terms (Chapter II). The main part is made up of Chapters III to V, which settle to what extent each of the two Contracting States may tax income and capital and how international juridical double taxation is to be eliminated. Then follow the Special Provisions (Chapter VI) and the Final Provisions (entry into force and termination, Chapter VII).

Scope and definitions

18. The Convention applies to all persons who are residents of one or both of the Contracting States (Article 1). It deals with taxes on income and on capital, which are described in a general way in Article 2. In Chapter II, some terms used in more than one Article of the Convention are defined. Other terms such as "dividends", "interest", "royalties" and "immovable property" are defined in the Articles that deal with these matters.

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Taxation of income and capital

19. For the purpose of eliminating double taxation, the Convention establishes two categories of rules. First, Articles 6 to 21 determine, with regard to different classes of income, the respective rights to tax of the State of source or situs and of the State of residence, and Article 22 does the same with regard to capital. In the case of a number of items of income and capital, an exclusive right to tax is conferred on one of the Contracting States. The other Contracting State is thereby prevented from taxing those items and double taxation is avoided. As a rule, this exclusive right to tax is conferred on the State of residence. In the case of other items of income and capital, the right to tax is not an exclusive one. As regards two classes of income (dividends and interest), although both States are given the right to tax, the amount of tax that may be imposed in the State of source is limited. Second, insofar as these provisions confer on the State of source or situs a full or limited right to tax, the State of residence must allow relief so as to avoid double taxation; this is the purpose of Articles 23 A and 23 B. The Convention leaves it to the Contracting States to choose between two methods of relief, i.e. the exemption method and the credit method.

20. Income and capital may be classified into three classes, depending on the treatment applicable to each class in the State of source or situs:

— income and capital that may be taxed without any limitation in the State of source or situs,
— income that may be subjected to limited taxation in the State of source, and
— income and capital that may not be taxed in the State of source or situs.

21. The following are the classes of income and capital that may be taxed without any limitation in the State of source or situs:

— 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);
— profits of a permanent establishment situated in that State, gains from the alienation of such a permanent establishment, and capital representing movable property forming part of the business property of such a permanent establishment (Article 7 and paragraph 2 of Articles 13

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and 22); an exception is made, however, if the permanent establishment is maintained for the purposes of international shipping, inland waterways transport, and international air transport (cf. paragraph 23 below);
— income from the activities of artistes and sportsmen exercised in that State, irrespective of whether such income accrues to the artiste or sportsman himself or to another person (Article 17);
— directors' fees paid by a company that is a resident of that State (Article 16);
— remuneration in respect of an employment in the private sector, exercised in that State, unless the employee is present therein for a period not exceeding 183 days in any twelve month period commencing or ending in the fiscal year concerned and certain conditions are met; and remuneration in respect of an employment exercised aboard a ship or aircraft operated internationally or aboard a boat, if the place of effective management of the enterprise is situated in that State (Article 15);
— subject to certain conditions, remuneration and pensions paid in respect of government service (Article 19).

22. The following are the classes of income that may be subjected to limited taxation in the State of source:

— dividends: provided the holding in respect of which the dividends are paid is not effectively connected with a permanent establishment or fixed base in the State of source, that State must limit its tax to 5 per cent of the gross amount of the dividends, where the beneficial owner is a company that holds directly at least 25 per cent of the capital of the company paying the dividends, and to 15 per cent of their gross amount in other cases (Article 10);
— interest: subject to the same proviso as in the case of dividends, the State of source must limit its tax to 10 per cent of the gross amount of the interest, except for any interest in excess of a normal amount (Article 11).

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 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

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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).

24. Where a resident of a Contracting State receives income from sources in the other Contracting State, or owns capital situated therein, that in accordance with the Convention is taxable only in the State of residence, no problem of double taxation arises, since the State of source or situs must refrain from taxing that income or capital.

25. Where, on the contrary, income or capital may, in accordance with the Convention, be taxed with or without limitation in the State of source or situs, the State of residence has the obligation to eliminate double taxation. This can be accomplished by one of the following two methods:

— exemption method: income or capital that is taxable in the State of source or situs is exempted in the State of residence, but it may be taken into account in determining the rate of tax applicable to the taxpayer's remaining income or capital;
— credit method: income or capital that is taxable in the State of source or situs is subject to tax in the State of residence, but the tax levied in the State of source or situs is credited against the tax levied by the State of residence on such income or capital.

Special provisions

26. There are a number of special provisions in the Convention. These provisions concern:

— the elimination of tax discrimination in various circumstances (Article 24);
— the establishment of a mutual agreement procedure for eliminating double taxation and resolving conflicts of interpretation of the Convention (Article 25);
— the exchange of information between the tax authorities of the Contracting States (Article 26);

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— the tax treatment of members of diplomatic missions and consular posts in accordance with international law (Article 27);
— the territorial extension of the Convention (Article 28).

General remarks on the Model Convention

27. The Model Convention seeks, wherever possible, to specify for each situation a single rule. On certain points, however, it was thought necessary to leave in the Convention a certain degree of flexibility, compatible with the efficient implementation of the Model Convention. Member countries therefore enjoy a certain latitude, for example, with regard to fixing the rate of tax at source on dividends and interest, the choice of method for eliminating double taxation and, subject to certain conditions, the allocation of profits to a permanent establishment by apportionment of the total profits of the enterprise. Moreover, for some cases, alternative or additional provisions are mentioned in the Commentaries.

Commentaries on the Articles

28. For each Article in the Convention, there is a detailed Commentary that is intended to illustrate or interpret its provisions.

29. As the Commentaries have been drafted and agreed upon by the experts appointed to the Committee on Fiscal Affairs by the Governments of Member countries, they are of special importance in the development of international fiscal law. Although the Commentaries are not designed to be annexed in any manner to the conventions signed by Member countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes.

29.1 The tax administrations of Member countries routinely consult the Commentaries in their interpretation of bilateral tax treaties. The Commentaries are useful both in deciding day-to-day questions of detail and in resolving larger issues involving the policies and purposes behind various provisions. Tax officials give great weight to the guidance contained in the Commentaries.

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29.2 Similarly, taxpayers make extensive use of the Commentaries in conducting their businesses and planning their business transactions and investments. The Commentaries are of particular importance in countries that do not have a procedure for obtaining an advance ruling on tax matters from the tax administration as the Commentaries may be the only available source of interpretation in that case.

29.3 Bilateral tax treaties are receiving more and more judicial attention as well. The courts are increasingly using the Commentaries in reaching their decisions. Information collected by the Committee on Fiscal Affairs shows that the Commentaries have been cited in the published decisions of the courts of the great majority of Member countries. In many decisions, the Commentaries have been extensively quoted and analysed, and have frequently played a key role in the judge's deliberations. The Committee expects this trend to continue as the world-wide network of tax treaties continues to grow and as the Commentaries gain even more widespread acceptance as an important interpretative reference**.**

30. Observations on the Commentaries have sometimes been inserted at the request of Member countries that are unable to concur in the interpretation given in the Commentary on the Article concerned. These observations thus do not express any disagreement with the text of the Convention, but usefully indicate the way in which those countries will apply the provisions of the Article in question.

Reservations of certain Member countries on some provisions of the Convention

31. Although all Member countries are in agreement with the aims and the main provisions of the Model Convention, nearly all have entered reservations on some provisions, which are recorded in the Commentaries on the Articles concerned. There has been no need for countries to make reservations indicating their intent to use the alternative or additional provisions that the Commentaries allow countries to include in their bilateral conventions. It is understood that insofar as a Member country has entered reservations, the other Member countries, in negotiating bilateral conventions with the former, will retain their freedom of action in accordance with the principle of reciprocity.

32. The Committee on Fiscal Affairs considers that these reservations should be viewed against the background of the very wide areas of agreement that has been achieved in drafting this Convention.

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Relation with previous versions

33. When drafting the 1977 Model Convention, the Committee on Fiscal Affairs examined the problems of conflicts of interpretation that might arise as a result of changes in the Articles and Commentaries of the 1963 Draft Convention. At that time, the Committee considered that existing conventions should, as far as possible, be interpreted in the spirit of the revised Commentaries, even though the provisions of these conventions did not yet include the more precise wording of the 1977 Model Convention. It was also indicated that Member countries wishing to clarify their positions in this respect could do so by means of an exchange of letters between competent authorities in accordance with the mutual agreement procedure and that, even in the absence of such an exchange of letters, these authorities could use mutual agreement procedures to confirm this interpretation in particular cases.

34. The Committee believes that the changes to the Articles of the Model Convention and the Commentaries that have been made since 1977 should be similarly interpreted.

35. Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles. However, other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific situations.

36. Whilst the Committee considers that changes to the Commentaries should be relevant in interpreting and applying conventions concluded before the adoption of these changes, it disagrees with any form of *a contrario* interpretation that would necessarily infer from a change to an Article of the Model Convention or to the Commentaries that the previous wording resulted in consequences different from those of the modified wording. Many amendments are intended to simply clarify, not change, the meaning of the Articles or the Commentaries, and such *a contrario* interpretations would clearly be wrong in those cases.

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36.1 Tax authorities in Member countries follow the general principles enunciated in the preceding four paragraphs. Accordingly, the Committee on Fiscal Affairs considers that taxpayers may also find it useful to consult later versions of the Commentaries in interpreting earlier treaties.

Multilateral convention

37. When preparing the 1963 Draft Convention and the 1977 Model Convention, the Committee on Fiscal Affairs considered whether the conclusion of a multilateral tax convention would be feasible and came to the conclusion that this would meet with great difficulties. It recognized, however, that it might be possible for certain groups of Member countries to study the possibility of concluding such a convention among themselves on the basis of the Model Convention, subject to certain adaptations they might consider necessary to suit their particular purposes.

38. The Nordic Convention on Income and Capital entered into by Denmark, Finland, Iceland, Norway and Sweden, which was concluded in 1983 and replaced in 1987, 1989 and 1996,[7] provides a practical example of such a multilateral convention between a group of Member countries and follows closely the provisions of the Model Convention.

39. Also relevant is the Convention on Mutual Administrative Assistance in Tax Matters, which was drawn up within the Council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs. This Convention entered into force on 1 April 1995.

40. Despite these two conventions, there are no reasons to believe that the conclusion of a multilateral tax convention involving all Member countries could now be considered practicable. The Committee therefore considers that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.

7. The Faroe Islands is also a signatory of the 1989 and 1996 Conventions.

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Tax avoidance and evasion; improper use of conventions

41. The Committee on Fiscal Affairs continues to examine both the improper use of tax conventions and international tax evasion. The problem is referred to in the Commentaries on several Articles. In particular, Article 26, as clarified in the Commentary, enables States to exchange information to combat these abuses.

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TITLE OF THE CONVENTION

**Convention between (State A) and (State B)
with respect to taxes on income and on capital**[1]

PREAMBLE TO THE CONVENTION[2]

1. States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.

2. The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

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CHAPTER I

SCOPE OF THE CONVENTION

Article 1

PERSONS COVERED

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

HISTORY: Included in the 1963 Draft Convention.

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Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

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

4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the words "a Contracting State" for "each Contracting State".

Paragraph 2: Included in the 1963 Draft Convention.

Paragraph 3: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by deleting the comma before "in particular" and deleting the words "In the case of" at the beginning of sub-paragraphs *a*) and *b*).

Paragraph 4: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Convention and until 29 April 2000, paragraph 4 read as follows:

"4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of

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changes which have been made in their respective taxation laws."

Paragraph 4 had previously been amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 4 read as follows:

"4. The Convention shall also apply to any identical or substantially similar taxes which are subsequently imposed in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify to each other any changes which have been made in their respective taxation laws."

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CHAPTER II

DEFINITIONS

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 that is treated as a body corporate for tax purposes;
c) the term "enterprise" applies to the carrying on of any business;
d) 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;
e) 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;
f) the term "competent authority" means:
(*i*) (in State A): .....
(*ii*) (in State B): .....
g) 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;
h) the term "business" includes the performance of professional services and of other activities of an independent character.

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the

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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.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. The preamble of the paragraph was amended by the 1977 Model Convention by substituting the words "For the purposes of this Convention" for "In this Convention".

Subparagraph *a*) corresponds to sub-paragraph *b*) of the 1963 Draft Convention. Amended by the 1977 Model Convention by redesignating it as sub-paragraph *a)* and by substituting the word "includes" for "comprises". Sub-paragraph *a)* of the 1963 Draft Convention was not included in the 1977 Model Convention; in the 1963 Draft Convention, sub-paragraph *a*) read as follows:

> "*a)* the terms "a Contracting State" and "the other Contracting State" mean (State A) or (State B), as the context requires;".

Sub-paragraph *b)* was amended, by replacing the words "entity which" by the words "entity that", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Sub-paragraph *b)* corresponds to sub-paragraph *c)* of the 1963 Draft Convention which was amended by the 1977 Model Convention by redesignating it as sub-paragraph *b)*.

Sub-paragraph c*)* was replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Sub-paragraph *c*), as it read in the 1977 Model Convention and until 29 April 2000, was then redesignated as sub-paragraph *d*).

Sub-paragraph *d)* corresponds to sub-paragraph *c)* as it read in the 1977 Model Convention and until 29 April 2000. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000, by redesignating it as sub-paragraph *d*). Sub-paragraph *c*) of the 1977 Model Convention corresponded to sub-paragraph *d*) of the 1963 Draft Convention, which had been amended by the 1977 Model Convention by redesignating it as sub-paragraph *c)*.

Sub-paragraph *e)* corresponds to sub-paragraph *d)* as it read before 29 April 2000. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000, by redesignating it as sub-paragraph *e*). Sub-paragraph *d*), as it read before then, had been previously amended by replacing the words "enterprise which" by the words "enterprise that", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Sub-paragraph *d)* was originally added by the 1977 Model Convention.

Sub-paragraph *f)* corresponds to sub-paragraph *e)* as it read before 29 April 2000. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000, by redesignating it as sub-paragraph *f*). Sub-paragraph *e*), as it

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read before 29 April 2000, was identical to sub-paragraph *e)* of the 1963 Draft Convention except that its subdivisions 1. and 2. were redesignated as (*i*) and (*ii*).

Sub-paragraph *g)* corresponds to sub-paragraph *f)* as it read before 29 April 2000. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000, by redesignating it as sub-paragraph *g*). Sub-paragraph *f*), as it read before then, corresponded to paragraph 2 of Article 24 of the 1977 Model Convention. Paragraph 2 of Article 24 was redesignated as sub-paragraph *f*) and amended by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 2 of Article 24 read as follows:

> "2. The term "nationals" means:
> *a*) all individuals possessing the nationality of a Contracting State;
> *b*) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State."

Paragraph 2 of Article 24 of the 1977 Model Convention was included in the 1963 Draft Convention. It was amended by the 1977 Model Convention by substituting the word "laws" for "law" in sub-paragraph *b*).

Sub-paragraph *h)* was added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 2: Amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. In the 1977 Model Convention and until 21 September 1995, paragraph 2 read as follows:

> "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 which it has under the law of that State concerning the taxes to which the Convention applies."

Paragraph 2 had previously been amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

> "2. As regards the application of the Convention by a Contracting State any term not otherwise defined shall, unless the context otherwise requires, have the meaning which it has under the laws of that Contracting State relating to the taxes which are the subject of the Convention."

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Article 4

RESIDENT

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;

c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;

d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

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HISTORY: The title of Article 4 was changed by the 1977 Model Convention. In the 1963 Draft Convention, it read "FISCAL DOMICILE".

Paragraph 1: Amended, by adding to the first sentence the words "and also includes that State and any political subdivision or local authority thereof" and by replacing in the second sentence the words "But this term" with "This term, however,", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. In the 1977 Model Convention and until 21 September 1995, paragraph 1 read as follows:

> "1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. But this 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."

Paragraph 1 had been previously amended by the 1977 Model Convention, notably by the addition of the second sentence. In the 1963 Draft Convention, paragraph 1 read as follows:

> "1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the law of that State, is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature."

Paragraph 2: Amended, by adding the word "only" after the word "resident" in the third line of subparagraph *a)* to correct an omission that was made when similar changes were made to sub-paragraphs *a), b)* and *c)* as part of the 1995 update (see below), by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Sub-paragraphs *a*), *b*), and *c*) had been previously amended by adding the word "only" after the word "resident" (except in the third line of sub-paragraph *a*)), by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 2 had been previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

> "2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then this case shall be determined in accordance with the following rules:
>
> *a*) He shall be deemed to be a resident of the Contracting State in which he has a permanent home available to him. If he has a permanent home available to him in both Contracting States, he shall be deemed to be a resident of the Contracting State with which his personal and economic relations are closest (centre of vital interests);
>
> *b*) If the Contracting State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either Contracting State, he shall be deemed to be a resident of the Contracting State in which he has an habitual abode;
>
> *c*) If he has an habitual abode in both Contracting States or in neither of them, he shall be deemed to be a resident of the Contracting State of which he is a national;
>
> *d*) If he is a national of both Contracting States or of neither of them, the competent authorities of the Con-

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tracting States shall settle the question by mutual agreement."

Paragraph 3: Amended, by adding the word "only" after the words "shall be deemed to be a resident", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 3 had been previously amended by the 1977 Model Convention by substituting the words "the State in which" for "the Contracting State in which".

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

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

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, display or delivery 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, display or delivery;
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;

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f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs *a*) to *e*), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. 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.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the words "through which the business of an enterprise" for "in which the business of the enterprise".

Paragraph 2: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the words "includes" in the first line for "shall include". At the same time, the word "and" was added at the end of subparagraph *e*), sub-paragraph *f*) was modified and sub-paragraph *g*) was deleted. In the 1963 Draft Convention, sub-paragraphs *f*) and *g*) read as follows:

"*f*) a mine, quarry or other place of extraction of natural resources;

g) a building site or construction or assembly project which exists for more than twelve months."

Paragraph 3: Added by the 1977 Model Convention.

Paragraph 4: Corresponds to paragraph 3 of the 1963 Draft Convention. Amended by the 1977 Model Convention by renumbering it as

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paragraph 4, modifying its preamble and sub-paragraph *e*) and adding sub-paragraph *f*). In the 1963 Draft Convention, paragraph 3 read as follows:

"3. The term "permanent establishment" shall not be deemed to include:

a) the use of facilities solely for the purpose of storage, display or delivery 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, display or delivery;

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 for collecting information, for the enterprise;

e) the maintenance of a fixed place of business solely for the purpose of advertising, for the supply of information, for scientific research or for similar activities which have a preparatory or auxiliary character, for the enterprise."

Paragraph 5: Corresponds to paragraph 4 of the 1963 Draft Convention. Renumbered as paragraph 5 and amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 4 read as follows:

"4. A person acting in a Contracting State on behalf of an enterprise of the other Contracting State—other than an agent of an independent status to whom paragraph 5 applies—shall be deemed to be a permanent establishment in the first-mentioned State if he has, and habitually exercises in that State, an authority to conclude contracts in the name of the enterprise, unless his activities are limited to the purchase of goods or merchandise for the enterprise."

Paragraph 6: Corresponds to paragraph 5 of the 1963 Draft Convention. Renumbered as paragraph 6 and amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 5 read as follows:

"5. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business."

Paragraph 7: Corresponds to paragraph 6 of the 1963 Draft Convention. Renumbered as paragraph 7 in the 1977 Model Convention.

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CHAPTER III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

"1. Income from immovable property may be taxed in the Contracting State in which such property is situated."

Paragraph 2: Included in the 1963 Draft Convention. The first sentence of the paragraph was amended by the 1977 Model Convention. In the 1963 Draft Convention, the first sentence of paragraph 2 read as follows:

"2. The term "immovable property" shall be defined in accordance with the law of

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the Contracting State in which the property in question is situated."

Paragraph 3: Included in the 1963 Draft Convention.

Paragraph 4: Paragraph 4 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and until 29 April 2000, paragraph 4 read as follows:

"4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services."

Paragraph 4 had been previously amended by the 1977 Model Convention by substituting the words "independent personal services" for "professional services". Paragraph 4 was originally included in the 1963 Draft Convention.

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Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to 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 determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes 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.

4. Insofar 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. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

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6. For the purposes 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.

7. 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 provisions of this Article.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by adding the words "Subject to the provisions of paragraph 3" at the beginning of the paragraph.

Paragraph 3: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the words "In determining" for "In the determination of" at the beginning of the paragraph.

Paragraph 4: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the word "contained" in the last line for "laid down".

Paragraph 5: Included in the 1963 Draft Convention.

Paragraph 6: Included in the 1963 Draft Convention.

Paragraph 7: Included in the 1963 Draft Convention.

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Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

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 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.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Included in the 1963 Draft Convention.

Paragraph 3: Included in the 1963 Draft Convention.

Paragraph 4: Added by the 1977 Model Convention.

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Article 9

ASSOCIATED ENTERPRISES

1. Where

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 this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

HISTORY: Paragraph 1: Paragraph 1 was included as Article 9 in the 1963 Draft Convention. Designated as paragraph 1 by the 1977 Model Convention.

Paragraph 2: Added by the 1977 Model Convention.

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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) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) 15 per cent 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 and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 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

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tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment 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.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Amended, by replacing the words "if the recipient is the beneficial owner of the dividends" with "if the beneficial owner of the dividends is a resident of the other Contracting State,", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 2 had been previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

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

a) 5 per cent of the gross amount of the dividends if the recipient is a company (excluding partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) in all other cases, 15 per cent of the gross amount of the dividends.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

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

Paragraph 3: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the words "which is subjected to the same taxation treatment as income from shares by the laws of the State" for "assimilated to income from shares by the taxation law of the State".

Paragraph 4: Paragraph 4 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and until 29 April 2000, paragraph 4 read as follows:

"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."

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Paragraph 4 was previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 4 read as follows:

"4. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the dividends, being a resident of a Contracting State, has in the other Contracting State, of which the company paying the dividends is a resident, a permanent establishment with which the holding by virtue of which the dividends are paid is effectively connected. In such a case, the provisions of Article 7 shall apply."

Paragraph 5: Paragraph 5 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and until 29 April 2000, paragraph 5 read as follows:

"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 insofar as such dividends are paid to a resident of that other State or insofar 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."

Paragraph 5 was previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 5 read as follows:

"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 to persons who are not residents of that other State, or subject the company's undistributed profits to a tax on undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State."

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Article 11

INTEREST

1. Interest 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 interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

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. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.

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6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the 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.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Amended, by replacing the words "if the recipient is the beneficial owner of the interest" with "if the beneficial owner of the interest is a resident of the other Contracting State,", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 2 had been previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

> "2. However, such interest may be taxed in the Contracting State in which it arises, and according to the law of that State, but the tax so charged shall not exceed 10 per cent of the amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation."

Paragraph 3: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 3 read as follows:

> "3. The term "interest" as used in this Article means income from Government securities, bonds or debentures, whether or not secured by mortgage and whether or not carrying a right to participate in profits, and debt-claims of every kind as well as all other income assimilated to income from money lent by the taxation law of the State in which the income arises."

Paragraph 4: Paragraph 4 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and until 29 April 2000, paragraph 4 read as follows:

> "4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is 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."

Paragraph 4 was previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 4 read as follows:

> "4. The provisions of paragraphs 1 and 2 shall not apply if the recipient of the

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interest, being a resident of a Contracting State, has in the other Contracting State in which the interest arises a permanent establishment with which the debt-claim from which the interest arises is effectively connected. In such a case, the provisions of Article 7 shall apply."

Paragraph 5: Paragraph 5 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Between 21 September 1995 and 29 April 2000, paragraph 5 read as follows:

"5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

Paragraph 5 was previously amended, by deleting the words "that State itself, a political subdivision, a local authority or", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. In the 1977 Model Convention and until 21 September 1995, paragraph 5 read as follows:

"5. Interest shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."

Paragraph 5 had been previously amended by the 1977 Model Convention by substituting "permanent establishment or fixed base" for "permanent establishment" in the three different places where these words appeared. Paragraph 5 was originally included in the 1963 Draft Convention.

Paragraph 6: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 6 read as follows:

"6. Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the interest paid, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention."

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Article 12

ROYALTIES

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. 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, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 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 and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the 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.

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HISTORY: Paragraph 1: Paragraph 1 was replaced by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 1 previously read as follows:

> "1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties."

Paragraph 1, as it read before 23 October 1997, had been included in the 1963 Draft Convention but amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

> "1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State."

Paragraph 2: Included in the 1963 Draft Convention. Paragraph 2 was amended by deleting the words "or for the use of, or the right to use, industrial, commercial or scientific equipment" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 23 of the Report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983). Prior to this amendment, paragraph 2 read as follows:

> "2. 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, 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."

Paragraph 3: Paragraph 3 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and until 29 April 2000, paragraph 3 read as follows:

> "3. The provisions of paragraph 1 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 such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply."

Paragraph 3 was previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 3 read as follows:

> "3. The provisions of paragraph 1 shall not apply if the recipient of the royalties, being a resident of a Contracting State, has in the other Contracting State in which the royalties arise a permanent establishment with which the right or property giving rise to the royalties is effectively connected. In such a case, the provisions of Article 7 shall apply."

Paragraph 4: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 4 read as follows:

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"4. Where, owing to a special relationship between the payer and the recipient or between both of them and some other person, the amount of the royalties paid, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the recipient in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In that case, the excess part of the payments shall remain taxable according to the law of each Contracting State, due regard being had to the other provisions of this Convention."

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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, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), 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 any property other than that referred to in paragraphs 1, 2 and 3, shall be taxable only in the Contracting State of which the alienator is a resident.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

"1. Gains from the alienation of immovable property, as defined in paragraph 2 of Article 6, may be taxed in the Contracting State in which such property is situated."

Paragraph 2: Paragraph 2 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and until 29 April 2000, paragraph 2 read as follows:

"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

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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."

Paragraph 2 was previously amended by the 1977 Model Convention, notably by deleting the last sentence, the principle of which has been taken up in paragraph 3. In the 1963 Draft Convention, paragraph 2 read as follows:

"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 professional services, including such gains from the alienation of such a permanent establishment (alone or together with the whole enterprise) or of such a fixed base, may be taxed in the other State. However, gains from the alienation of movable property of the kind referred to in paragraph 3 of Article 22 shall be taxable only in the Contracting State in which such movable property is taxable according to the said Article."

Paragraph 3: Added by the 1977 Model Convention; it corresponds generally to the last sentence of paragraph 2 of the 1963 Draft Convention.

Paragraph 4: Corresponds to paragraph 3 of the 1963 Draft Convention. Renumbered as paragraph 4 and amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 3 read as follows:

"3. Gains from the alienation of any property other than those mentioned in paragraphs 1 and 2, shall be taxable only in the Contracting State of which the alienator is a resident."

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[Article 14 - INDEPENDENT PERSONAL SERVICES]

[Deleted]

HISTORY: Article 14 was deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention and until 29 April 2000, Article 14 read as follows:

"*Article 14*

INDEPENDENT PERSONAL SERVICES

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other State but only so much of it as is attributable to that fixed base.

2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

Paragraph 1 was previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

"1. Income derived by a resident of a Contracting State in respect of professional services or other independent activities of a similar character shall be taxable only in that State unless he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income may be taxed in the other Contracting State but only so much of it as is attributable to that fixed base."

Before being deleted on 29 April 2000, paragraph 2 was unchanged from the 1963 Draft Convention.

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Article 15

INCOME FROM EMPLOYMENT

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international 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.

HISTORY: The title of Article 15 was changed by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Prior to that amendment, the title of the Article was "DEPENDENT PERSONAL SERVICES".

Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Included in the 1963 Draft Convention. Sub-paragraph *a*) was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 80 of the Report entitled "Taxation

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Issues Relating to the International Hiring-out of Labour" (adopted by the Council of the OECD on 24 August 1984). Prior to this amendment, sub-paragraph *a*) read as follows:

"*a*) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned, and".

Sub-paragraph *c*) was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Prior to that amendment, sub-paragraph *c*) read as follows:

"c) the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State."

Before these amendments, paragraph 2 was unchanged from the 1963 Draft Convention.

Paragraph 3: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 3 read as follows:

"3. Notwithstanding the preceding provisions of this Article, remuneration in respect of an employment exercised aboard a ship or aircraft in international 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."

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Article 16

DIRECTORS' FEES

Directors' fees and other similar payments derived by a resident of a 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.

HISTORY: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by adding the word "other" immediately before "similar payments".

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Article 17

ARTISTES AND SPORTSMEN

1. Notwithstanding the provisions of Articles 7 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised.

HISTORY: The title of Article 17 was changed by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 5 of the Report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987). Prior to that amendment, the title of the Article was "ARTISTES AND ATHLETES".

Paragraph 1: Paragraph 1 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Between 23 July 1992 and 29 April 2000, paragraph 1 read as follows:

> "1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State."

Paragraph 1 was previously amended by substituting the word "sportsman" for "athlete" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 5 of the Report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 1 was included as Article 17 in the 1963 Draft Convention. Designated as paragraph 1 and amended by the 1977 Model Convention. In the 1963 Draft Convention, Article 17 read as follows:

> "Notwithstanding the provisions of Articles 14 and 15, income derived by public entertainers, such as theatre, motion pic-

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ture, radio or television artistes, and musicians, and by athletes, from their personal activities as such may be taxed in the Contracting State in which these activities are exercised."

Paragraph 2: Paragraph 2 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Between 23 July 1992 and 29 April 2000, paragraph 2 read as follows:

"2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised."

Paragraph 2 was originally added by the 1977 Model Convention. Paragraph 2 was amended by substituting the word "sportsman" for "athlete" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 5 of the Report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

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Article 18

PENSIONS

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

HISTORY: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention by substituting the words "paragraph 2 of Article 19" for "paragraph 1 of Article 19".

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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 pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that State.

3. The provisions of Articles 15, 16, 17, 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.

HISTORY: The title of Article 19 was changed by the 1977 Model Convention. In the 1963 Draft Convention, it read "GOVERNMENTAL FUNCTIONS".

Paragraph 1: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. In the 1977 Model Convention and until 31 March 1994, paragraph 1 read as follows:

"1. *a*) 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 remuneration shall be taxable only in the other Contracting State if the services are

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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."

Paragraph 1 had previously been amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

"1. Remuneration, including pensions, paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to any individual in respect of services rendered to that State or subdivision or local authority thereof in the discharge of functions of a governmental nature may be taxed in that State."

Paragraph 2: Replaced paragraph 2 of the 1963 Draft Convention. Paragraph 2 of the 1963 Draft Convention was amended and renumbered as paragraph 3 (cf. history of paragraph 3) and new paragraph 2 was added by the 1977 Model Convention.

Paragraph 3: Amended, by adding ", 17,", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 3 had been previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. In the 1977 Model Convention and until 31 March 1994, paragraph 3 read as follows:

"3. The provisions of Articles 15, 16 and 18 shall apply to remuneration and 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."

Paragraph 3 of the 1977 Model Convention corresponded to paragraph 2 of the 1963 Draft Convention. Renumbered as paragraph 3 and amended by the 1977 Model Convention by substituting "remuneration and pensions" for "remuneration or pensions" and by substituting "a business" for "any trade or business". In the 1963 Draft Convention, paragraph 2 read as follows:

"2. The provisions of Articles 15, 16 and 18 shall apply to remuneration or pensions in respect of services rendered in connection with a trade or business carried on by one of the Contracting States or a political subdivision or a local authority thereof."

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Article 20

STUDENTS

Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

HISTORY: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, Article 20 read as follows:

> "Payments which a student or business apprentice who is or was formerly a resident of a Contracting State and who is present in the other Contracting State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that other State, provided that such payments are made to him from sources outside that other State."

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Article 21

OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

HISTORY: The title of Article 21 was changed by the 1977 Model Convention. In the 1963 Draft Convention, it read "INCOME NOT EXPRESSLY MENTIONED".

Paragraph 1: Corresponds to Article 21 of the 1963 Draft Convention. Designated as paragraph 1 and amended by the 1977 Model Convention. In the 1963 Draft Convention, Article 21 read as follows:

> "Items of income of a resident of a Contracting State which are not expressly mentioned in the foregoing Articles of this Convention shall be taxable only in that State."

Paragraph 2: Paragraph 2 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and before 29 April 2000, paragraph 2 read as follows:

> "2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State 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 income is 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."

Paragraph 2 was originally added by the 1977 Model Convention.

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CHAPTER IV

TAXATION OF CAPITAL

Article 22

CAPITAL

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by 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 may be taxed in that other State.

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

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

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

> "1. Capital represented by immovable property, as defined in paragraph 2 of Article 6, may be taxed in the Contracting State in which such property is situated."

Paragraph 2: Paragraph 2 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Convention and before 29 April 2000, paragraph 2 read as follows:

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"2. Capital represented by 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 by 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, may be taxed in that other State."

Paragraph 2 was previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

"2. Capital represented by movable property forming part of the business property of a permanent establishment of an enterprise, or by movable property pertaining to a fixed base used for the performance of professional services, may be taxed in the Contracting State in which the permanent establishment or fixed base is situated."

Paragraph 3: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 3 read as follows:

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

Paragraph 4: Included in the 1963 Draft Convention.

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CHAPTER V

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

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"1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraph 2, exempt such income or capital from tax but may, in calculating tax on the remaining income or capital of that person, apply the rate of tax which would have been applicable if the exempted income or capital had not been so exempted."

Paragraph 2: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

"2. Where a resident of a Contracting State derives income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that person an amount equal to the tax paid in that other Contracting State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is appropriate to the income derived from that other Contracting State."

Paragraph 3: Added by the 1977 Model Convention.

Paragraph 4: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000, on the basis of paragraph 113 of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

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Article 23 B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;

b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

HISTORY: Paragraph 1: Corresponds to paragraphs 1 and 2 of the 1963 Draft Convention. These paragraphs were merged and amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraphs 1 and 2 read as follows:

"1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that person, an amount equal to the income tax paid in that other Contracting State;

b) as a deduction from the tax on the capital of that person, an amount equal to the capital tax paid in that other Contracting State.

2. The deduction in either case shall not, however, exceed that part of the income tax or capital tax, respectively, as computed before the deduction is given, which is appropriate, as the case may be, to the income or the capital which may be taxed in the other Contracting State."

Paragraph 2: Replaced paragraph 2 of the 1963 Draft Convention. Paragraph 2 of the 1963 Draft Convention was merged with paragraph 1 (cf. history of paragraph 1) and new paragraph 2 was added by the 1977 Model Convention.

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CHAPTER VI

SPECIAL PROVISIONS

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 Contracting State shall not be subjected in either 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 the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.

3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

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4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

HISTORY: Paragraph 1: Paragraph 1 was amended by adding the words "in particular with respect to residence" in the first sentence by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 1 read as follows:

> "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 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."

Paragraph 1 had previously been amended by the 1977 Model Convention, notably by adding the second sentence. In the 1963 Draft Convention, paragraph 1 read as follows:

> "1. The 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 are or may be subjected."

Paragraph 2: Paragraph 2 was amended by adding the words "in particular with respect to residence" after the words "in the same circumstances" by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. In the 1977 Model Convention, paragraph 1 read as follows:

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"2. Stateless persons who are residents of a Contracting State shall not be subjected in either 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 the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.

Paragraph 2 corresponds to paragraph 3 of the 1977 Model Convention. Paragraph 2 of the 1977 Model Convention was amended and redesignated as sub-paragraph 1 *f*) of Article 3 (cf. history of Article 3) and paragraph 3 was renumbered as paragraph 2 by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 2 read as follows:

"2. The term "nationals" means:

a) all individuals possessing the nationality of a Contracting State;

b) all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State."

Paragraph 3 of the 1977 Model Convention was included in the 1963 Draft Convention. It was amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 3 read as follows:

"3. Stateless persons shall not be subjected in a 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 State in the same circumstances are or may be subjected."

Paragraph 3: Paragraph 3 corresponds to paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was renumbered as paragraph 3 by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992.

Paragraph 4 of the 1977 Model Convention was included in the 1963 Draft Convention. Its presentation was modified by the 1977 Model Convention. In the 1963 Draft Convention, the second sentence was presented as a second paragraph.

Paragraph 4: Paragraph 4 corresponds to paragraph 5 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was renumbered as paragraph 4 by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992.

Paragraph 5 of the 1977 Model Convention did not appear in the 1963 Draft Convention.

Paragraph 5: Paragraph 5 corresponds to paragraph 6 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was renumbered as paragraph 5 by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992.

Paragraph 6 of the 1977 Model Convention corresponded to paragraph 5 of the 1963 Draft Convention. Paragraph 5 of the 1963 Draft Convention was renumbered as paragraph 6 and amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 5 read as follows:

"5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of that first-mentioned State are or may be subjected."

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Paragraph 6: Paragraph 6 corresponds to paragraph 7 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was renumbered as paragraph 6 by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992.

Paragraph 7 of the 1977 Model Convention corresponded to paragraph 6 of the 1963 Draft Convention. Paragraph 6 of the 1963 Draft Convention was renumbered as paragraph 7 and amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 6 read as follows:

> "6. In this Article the term "taxation" means taxes of every kind and description."

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Article 25

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

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 the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention, notably by adding the second sentence. In the 1963 Draft Convention, paragraph 1 read as follows:

"1. Where a resident of a Contracting State considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with this Convention, he may, notwithstanding the remedies provided by

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the national laws of those States, present his case to the competent authority of the Contracting State of which he is a resident."

Paragraph 2: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention, notably by adding the second sentence. In the 1963 Draft Convention, paragraph 2 read as follows:

"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 an appropriate 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 not in accordance with the Convention."

Paragraph 3: Included in the 1963 Draft Convention.

Paragraph 4: Included in the 1963 Draft Convention. Amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Prior to that amendment, paragraph 4 read as follows:

"4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States."

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Article 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes referred to in the first sentence. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

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).

HISTORY: Paragraph 1: Paragraph 1 was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April. Between 21 September 1995 and 29 April 2000, paragraph 1 read as follows:

"1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out

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the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions."

Paragraph 1 had been previously amended, by replacing the words "involved in" with "concerned with", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 1 had been previously amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 1 read as follows:

"1. The competent authorities of the Contracting States shall exchange such information as is necessary for the carrying out of this Convention and of the domestic laws of the Contracting States concerning taxes covered by this Convention insofar as the taxation thereunder is in accordance with this Convention. Any information so exchanged shall be treated as secret and shall not be disclosed to any persons or authorities other than those concerned with the assessment or collection of the taxes which are the subject of the Convention."

Paragraph 2: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

"2. In no case shall the provisions of paragraph 1 be construed so as to impose on one of the Contracting States the obligation:

a) to carry out administrative measures at variance with the laws or the administrative practice of that or of the other Contracting State;

b) to supply particulars which are 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)."

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Article 27

MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

HISTORY: The title of Article 27 and the Article itself were amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. In the 1977 Model Convention and until 31 March 1994, the title and the Article read as follows:

"DIPLOMATIC AGENTS
AND CONSULAR OFFICERS

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements."

The title and the Article had previously been amended by the 1977 Model Convention. In the 1963 Draft Convention, they read as follows:

"DIPLOMATIC AND CONSULAR
OFFICIALS

Nothing in this Convention shall affect the fiscal privileges of diplomatic or consular officials under the general rules of international law or under the provisions of special agreements."

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Article 28

TERRITORIAL EXTENSION[1]

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 international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 30 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.

HISTORY: Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, paragraph 2 read as follows:

"2. Unless otherwise agreed by both Contracting States, the denunciation of the Convention by one of them under Article 30 shall terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article."

1. The words between brackets are of relevance when, by special provision, a part of the territory of a Contracting State is excluded from the application of the Convention.

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CHAPTER VII

FINAL PROVISIONS

Article 29

ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at ..... as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

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

HISTORY: Paragraph 1: Included in the 1963 Draft Convention.

Paragraph 2: Included in the 1963 Draft Convention.

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Article 30

TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ..... In such event, the Convention shall cease to have effect:

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

HISTORY: Included in the 1963 Draft Convention. Amended by the 1977 Model Convention. In the 1963 Draft Convention, Article 30 read as follows:

"This Convention shall remain in force until denounced by one of the Contracting States. Either Contracting State may denounce the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year ..... In such event, the Convention shall cease to have effect:

a) in (State A): .....
b) in (State B): ....."

TERMINAL CLAUSE[1]

1. The terminal clause concerning the signing shall be drafted in accordance with the constitutional procedure of both Contracting States.

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COMMENTARY ON ARTICLE 1
CONCERNING THE PERSONS COVERED BY THE CONVENTION

1. Whereas the earliest conventions in general were applicable to "citizens" of the Contracting States, more recent conventions usually apply to "residents" of one or both of the Contracting States irrespective of nationality. Some conventions are of even wider scope because they apply more generally to "taxpayers" of the Contracting States; they are, therefore, also applicable to persons, who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. It has been deemed preferable for practical reasons to provide that the Convention is to apply to persons who are residents of one or both of the Contracting States. The term "resident" is defined in Article 4.

Application of the Convention to partnerships

2. Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships. These difficulties are analysed in the report by the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships",[1] the conclusions of which have been incorporated below and in the Commentary on various other provisions of the Model Tax Convention.

(Replaced on 29 April 2000; see HISTORY)

3. As discussed in that report, a main source of difficulties is the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries adopt what may be referred to as the fiscally transparent approach, under which the partnership is ignored for tax purposes and the individual partners are taxed on their respective share of the partnership's income.

(Replaced on 29 April 2000; see HISTORY)

4. A first difficulty is the extent to which a partnership is entitled as such to the benefits of the provisions of the Convention. Under Article 1, only persons

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who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. While paragraph 2 of the Commentary on Article 3 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4.

(Replaced on 29 April 2000; see HISTORY)

5. Where a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention. Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners should be entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence (cf. paragraph 8.4 of the Commentary on Article 4).

(Replaced on 29 April 2000; see HISTORY)

6. The relationship between the partnership's entitlement to the benefits of a tax Convention and that of the partners raises other questions.

(Replaced on 29 April 2000; see HISTORY)

6.1 One issue is the effect that the application of the provisions of the Convention to a partnership can have on the taxation of the partners. Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State.

(Added on 29 April 2000; see HISTORY)

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6.2 Another issue is that of the effect of the provisions of the Convention on a Contracting State's right to tax income arising on its territory where the entitlement to the benefits of one, or more than one, Conventions is different for the partners and the partnership. Where, for instance, the State of source treats a domestic partnership as fiscally transparent and therefore taxes the partners on their share of the income of the partnership, a partner that is resident of a State that taxes partnerships as companies would not be able to claim the benefits of the Convention between the two States with respect to the share of the partnership's income that the State of source taxes in his hands since that income, though allocated to the person claiming the benefits of the Convention under the laws of the State of source, is not similarly allocated for purposes of determining the liability to tax on that item of income in the State of residence of that person.

(Added on 29 April 2000; see HISTORY)

6.3 The results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of source. This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

(Added on 29 April 2000; see HISTORY)

6.4 Where, as described in paragraphs 6.2, income has "flowed through" a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as "paid" to the partners since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in their State of residence. Hence the partners, in these circumstances, satisfy the condition, imposed in several Articles, that the income concerned is "paid to a resident of the other Contracting State". Similarly the requirement, imposed by some other Articles, that income or gains

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are "derived by a resident of the other Contracting State" is met in the circumstances described above. This interpretation avoids denying the benefits of tax Conventions to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them, can claim the benefits of the Convention with respect to that income. Following from the principle discussed in paragraph 6.3, the conditions that the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.

(Added on 29 April 2000; see HISTORY)

6.5 Partnership cases involving three States pose difficult problems with respect to the determination of entitlement to benefits under Conventions. However, many problems may be solved through the application of the principles described in paragraphs 6.2 to 6.4. Where a partner is a resident of one State, the partnership is established in another State and the partner shares in partnership income arising in a third State then the partner may claim the benefits of the Convention between his State of residence and the State of source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his State of residence. If, in addition, the partnership is taxed as a resident of the State in which it is established then the partnership may itself claim the benefits of the Convention between the State in which it is established and the State of source. In such a case of "double benefits", the State of source may not impose taxation which is inconsistent with the terms of either applicable Convention therefore, where different rates are provided for in the two Conventions, the lower will be applied. However, Contracting States may wish to consider special provisions to deal with the administration of benefits under Conventions in situations such as these, so that the partnership may claim benefits but partners could not present concurrent claims. Such provisions could ensure appropriate and simplified administration of the giving of benefits. No benefits will be available under the Convention between the State in which the partnership is established and the State of source if the partnership is regarded as transparent for tax purposes by the State in which it is established. Similarly no benefits will be available under the Convention between the State of residence of the partner and the State of source if the income of the partnership is not allocated to the

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partner under the taxation law of the State of residence. If the partnership is regarded as transparent for tax purposes by the State in which it is established and the income of the partnership is not allocated to the partner under the taxation law of the State of residence of the partner, the State of source may tax partnership income allocable to the partner without restriction.

(Added on 29 April 2000; see HISTORY)

6.6 Differences in how countries apply the fiscally transparent approach may create other difficulties for the application of tax Conventions. Where a State considers that a partnership does not qualify as a resident of a Contracting State because it is not liable to tax and the partners are liable to tax in their State of residence on their share of the partnership's income, it is expected that that State will apply the provisions of the Convention as if the partners had earned the income directly so that the classification of the income for purposes of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows-through the partnership. Difficulties may arise, however, in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and another party to a transaction. Some of these difficulties are discussed in paragraphs 19.1 of the Commentary on Article 5 and paragraphs 6.1 and 6.2 of the Commentary on Article 15.

(Added on 29 April 2000; see HISTORY)

6.7 Finally, a number of other difficulties arise where different rules of the Convention are applied by the Contracting States to income derived by a partnership or its partners, depending on the domestic laws of these States or their interpretation of the provisions of the Convention or of the relevant facts. These difficulties relate to the broader issue of conflicts of qualification, which is dealt with in paragraphs 32.1 ff. and 56.1 ff. of the Commentary on Article 23.

(Added on 29 April 2000; see HISTORY)

Improper use of the Convention

7. The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, irrespective of double taxation

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conventions, to exploit differences in tax levels between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.

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

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

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

11. Improper uses of the Convention are discussed in two reports from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Base Companies" and "Double Taxation Conventions and the Use of Conduit

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Companies".[1] As indicated in these reports, the concern expressed in paragraph 9 above has proved to be valid as there has been a growing tendency toward the use of conduit companies to obtain treaty benefits not intended by the Contracting States in their bilateral negotiations. This has led an increasing number of Member countries to implement treaty provisions (both general and specific) to counter abuse and to preserve anti-avoidance legislation in their domestic laws.

(Replaced on 23 July 1992; see HISTORY)

12. Several solutions have been considered but, for the reasons set out in the above-mentioned reports, no definitive texts have been drafted, no strict recommendations as to the circumstances in which they should be applied made, and no exhaustive list of such possible counter-measures given. The texts quoted below are merely intended as suggested benchmarks that treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:

— the degree to which tax advantages may actually be obtained by conduit companies;
— the legal context in both Contracting States, and
— the extent to which *bona fide* economic activities might be unintentionally disqualified by such provisions.

(Added on 23 July 1992; see HISTORY)

13. A solution to the problem of conduit companies would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a "look-through" provision might have the following wording:

> "A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State."

1. These two reports are reproduced in Volume II at pages R(5)-1 and R(6)-1.

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Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.

(Amended on 31 March 1994; see HISTORY)

14. The "look-through approach" seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard *bona fide* business activities.

(Added on 23 July 1992; see HISTORY)

15. Conduit situations can be created by the use of tax-exempt (or nearly tax-exempt) companies that may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies (the exclusion approach). The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident. As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause such as the following:

> "No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under Section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

(Amended on 23 October 1997; see HISTORY)

16. Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an

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important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

(Added on 23 July 1992; see HISTORY)

17. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. While this seems adequate with respect to a normal international relationship, a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

> "Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State
>
> *a*) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
> *b*) exercise directly or indirectly, alone or together, the management or control of such company,
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law."

The concept of "substantial interest" may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.

(Amended on 23 October 1997; see HISTORY)

18. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting *bona fide* provisions in the treaty to provide for the necessary flexibility (cf. paragraph 21 below); moreover, such an approach does not offer adequate

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protection against advanced tax avoidance schemes such as "stepping-stone strategies."

(Added on 23 July 1992; see HISTORY)

19. The approaches referred to above are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use of conventions. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

> "Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State
>
> *a*) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
> *b*) exercise directly or indirectly, alone or together, the management or control of such company
>
> any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)."

(Amended on 23 October 1997; see HISTORY)

20. A provision of this kind appears to be the only effective way of combatting "stepping-stone" devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underly the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in

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their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a *bona fide* clause.

(Added on 23 July 1992; see HISTORY)

21. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in *bona fide* cases. Such provisions could have the following wording:

a) General bona fide provision

"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention."

b) Activity provision

"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations."

c) Amount of tax provision

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

d) Stock exchange provision

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned — directly or through one or more companies each of which is a resident of the first-mentioned State — by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

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e) Alternative relief provision

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention".

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

25. While these and the other counteracting measures described in the reports mentioned in paragraph 11 above are not inconsistent with the spirit of tax treaties, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be appropriate to grant him the protection of the treaty network.

(Added on 23 July 1992; see HISTORY)

26. The majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, but believe that such measures should be used only for this purpose. It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be

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suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer.

(Added on 23 July 1992; see HISTORY)

Observations on the Commentary

27. The *United States* believes that the business activities referred to in sub-paragraph *b*) of paragraph 21 of the Commentary should exclude "the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company." Absent this language, a third-country resident could set up a classic treaty shopping conduit operation — a personal investment company — and argue that the company is engaged in a substantive business operation (the managing of the third-country owner's personal portfolio) and the income in respect of which benefits are claimed (dividends and interest) is connected with those business operations.

(Added on 23 July 1992; see HISTORY)

27.1 The *Netherlands* will adhere to the conclusions on the application of the Convention to partnerships incorporated in the Commentary on Article 1 and in the Commentaries on the other relevant provisions of the Convention only, and to the extent to which, it is explicitly so confirmed in a specific tax treaty, as a result of mutual agreement between competent authorities as meant in Article 25 of the Convention or as unilateral policy.

(Added on 29 April 2000; see HISTORY)

27.2 *France* has expressed a number of reservations on the report on "The Application of the OECD Model Tax Convention to Partnerships". In particular, France does not agree with the interpretation put forward in paragraphs 5 and 6 above according to which if a partnership is denied the benefits of a tax convention, its members are entitled to the benefits of the tax conventions entered into by their State of residence. France believes that this result is only possible, to a certain extent, if provisions to that effect are included in the convention entered into with the State where the partnership is situated.

(Added on 29 April 2000; see HISTORY)

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27.3 *Portugal*, where all partnerships are taxed as such, has expressed a number of reservations on the report on "The Application of the OECD Model Tax Convention to Partnerships" and considers that the solutions put forward in that report should be incorporated in special provisions only applicable when included in tax conventions. This is the case, for example, of the treatment of the situation of partners of partnerships — a concept which is considerably fluid given the differences between States — that are fiscally transparent, including the situation where a third State is inserted between the State of source and the State of residence of the partners. The administrative difficulties resulting from some of the solutions put forward should also be noted, as indicated in the report itself in certain cases.

(Added on 29 April 2000; see HISTORY)

Reservation on the Article

28. The *United States* reserves the right, with certain exceptions, to tax its citizens and residents, including certain former citizens and long-term residents, without regard to the Convention.

(Amended on 29 April 2000; see HISTORY)

29. [Deleted on 31 March 1994; see HISTORY]

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HISTORY

[In 1995, a number of minor drafting improvements that did not affect the meaning of the text were made to the Commentary on Article 1. These minor changes are not described in this section.]

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Replaced paragraph 2 of the 1977 Model Convention. The second sentence of paragraph 2 of the 1977 Model was incorporated into an amended paragraph 3 and a new paragraph 2 was added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). In the 1977 Model Convention and until 29 April 2000, paragraph 2 read as follows:

> "2. The domestic laws of the various OECD Member countries differ in the treatment of partnerships. The main issue of such differences is founded on the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries disregard the partnership and tax only the individual partners on their shares of the partnership income."

Paragraph 3: Replaced paragraph 3 of the 1977 Model Convention. Part of paragraph 3 of the 1977 Model was included in paragraph 5 (cf. history of paragraph 5) and a new paragraph 3 was added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). In the 1977 Model Convention and until 29 April 2000, paragraph 3 read as follows:

> "3. These differences in views have many effects on the application of the Convention in the case of partnerships, especially where one or more partners are not residents of the State in which the partnership was created or organised. First, the question arises whether a partnership as such may invoke the provisions of the Convention. Where a partnership is treated as a company or taxed in the same way, it may reasonably be argued that the partnership is a resident of the Contracting State taxing the partnership on the grounds mentioned in paragraph 1 of Article 4 and therefore, falling under the scope of the Convention, is entitled to the benefits of the Convention. In the other instances mentioned in para-graph 2 above, the application of the Convention to the partnership as such might be refused, at least if no special rule covering partnerships is provided for in the Convention."

Paragraph 4: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). In the 1977 Model Convention and until 29 April 2000, paragraph 4 read as follows:

> "4. Moreover, different rules of the Convention may be applied in the Contracting States to income derived by a partner from the partnership, depending on the approach of such States. In States where partnerships are treated as companies, distributions of profits to the partners may be considered to be dividends (paragraph 3 of Article 10), whilst for other

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States all profits of a partnership, whether distributed or not, are considered as business profits of the partners (Article 7). In many States, business profits of partnerships include, for tax purposes, all or some special remuneration paid by a partnership to its partners (such as rents, interest, royalties, remuneration for services), whilst in other States such payments are not dealt with as business profits (Article 7) but under other headings (in the above-mentioned examples: Articles 6, 11, 12, 14 and 15, respectively)."

Paragraph 5: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). New paragraph 5 includes an amended version of the second sentence of paragraph 3 of the 1977 Model Convention. In the 1977 Model Convention and until 29 April 2000, paragraph 5 read as follows:

"5. Finally the capital invested in a partnership or the alienation of a participation in a partnership may be treated, depending on the approach, under paragraph 2 of Articles 22 and 13 (permanent establishment) or paragraph 4 of Articles 22 and 13 (other movable property)."

Paragraph 6: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). Prior to 29 April 2000, paragraph 6 read as follows:

"6. The concurrent application of different Articles of the Convention in the two Contracting States (or even the non-application of the Convention in one of them) may result not only in double taxation, but also in non-taxation. However the practical application of double taxation conventions, whether or not based on the Model Convention, and discussions in the Committee on Fiscal Affairs when the 1977 Model Convention was being drafted have shown that the opinions of the OECD Member countries differ too much and that it is extremely difficult to find a uniform solution that would be acceptable to all or even to the great majority of Member countries. The Convention does not, therefore, contain any special provisions relating to partnerships. Contracting States are however left free to examine the problems of partnerships in their bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate."

Paragraph 6 was included in the 1977 Model Convention but was subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 6 read as follows:

"6. The concurrent application of different Articles of the Convention in the two Contracting States (or even the non-application of the Convention in one of them) may not only result in double taxation, but also in non-taxation. However the practical application of double taxation conventions, whether or not based on the 1963 Draft Convention, and the discussions on the revision of the 1963 Draft Convention have shown that the opinions of the OECD Member countries differ too much and that it is extremely difficult to find a uniform solution which would be acceptable to all or even to the great majority of Member countries. The Convention does not, therefore, contain any special provisions relating to partnerships. Contracting States are however left free to examine the problems of partnerships in their

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bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate."

Paragraph 6.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.4: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.5: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.6: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.7: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Unchanged from the 1977 Model Convention.

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Amended, by replacing the footnote to the paragraph, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. The footnote previously read as follows:

"1. These and two other reports were published in 1987 under the joint title *International Tax Avoidance and Evasion — Four Related Studies*, in "Issues of International Taxation" No. 1, OECD, Paris, 1987."

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Paragraph 11 replaced paragraph 11 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was renumbered as paragraph 28 (cf. history of paragraph 28) and new paragraph 11 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 22 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 13: Amended, by replacing the words "the first-mentioned State" by "a Contracting State" at the end of the suggested provision, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 13 previously read as follows:

> "13. A solution to the problem of conduit companies would be to disallow treaty benefits to a company insofar as the company is not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a "look-through" provision might have the following wording:
>
> > "A company which is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits unless it is neither owned nor controlled directly or through one or more companies, wherever resident, by persons who are not residents of the first mentioned State."
>
> Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents."

Paragraph 13 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 23 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 14: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 25 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 15: Amended, by deleting the words "as far as the income paid by the company is concerned" in the first line of the last part of the paragraph, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. The last part of paragraph 15 previously read as follows:

> "The scope of this provision, as far as the income paid by the company is concerned, could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information)."

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Paragraph 15 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 26 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 16: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 28 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 17: Amended, by replacing the word "and" by "or" at the end of sub-paragraph *a)* of the suggested provision included in the paragraph, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Sub-paragraph *a)* of the suggested provision included in paragraph 17 previously read as follows:

> "*a*) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and".

Paragraph 17 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 29 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 18: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 36 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 19: Amended, by replacing the word "and" by "or" at the end of sub-paragraph *a)* of the suggested provision included in the paragraph, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Sub-paragraph *a)* of the suggested provision included in paragraph 19 previously read as follows:

> "*a*) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and".

Paragraph 19 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 37 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 20: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 41 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 21: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 42 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 22: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 23: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 39 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 24: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 40 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 25: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 46 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 26: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 47 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 27: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 27.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 27.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 27.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 28: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 28 read as follows:

> "28. The *United States* reserves the right to tax its citizens and residents (with certain exceptions) without regard to the Convention."

Paragraph 28 corresponds to paragraph 11 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was renumbered as paragraph 28 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Deleted by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 29 previously read as follows:

> "29. The United States reserves the right to limit the benefits of the Convention to certain persons."

Paragraph 29 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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COMMENTARY ON ARTICLE 2
CONCERNING TAXES COVERED
BY THE CONVENTION

1. This Article is intended to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise, to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, and to ensure for each Contracting State notification of significant changes in the taxation laws of the other State.

(Amended on 29 April 2000; see HISTORY)

Paragraph 1

2. This paragraph defines the scope of application of the Convention: taxes on income and on capital; the term "direct taxes" which is far too imprecise has therefore been avoided. It is immaterial on behalf of which authorities such taxes are imposed; it may be the State itself or its political subdivisions or local authorities (constituent States, regions, provinces, *départements*, cantons, districts, *arrondissements*, *Kreise*, municipalities or groups of municipalities, etc.). The method of levying the taxes is equally immaterial: by direct assessment or by deduction at the source, in the form of surtaxes or surcharges, or as additional taxes (*centimes additionnels*), etc.

Paragraph 2

3. This paragraph gives a definition of taxes on income and on capital. Such taxes comprise taxes on total income and on elements of income, on total capital and on elements of capital. They also include taxes on profits and gains derived from the alienation of movable or immovable property, as well as taxes on capital appreciation. Finally, the definition extends to taxes on the total amounts of wages or salaries paid by undertakings ("payroll taxes"; in Germany, "*Lohn-summensteuer*"; in France, "*taxe sur les salaires*"). Social security charges, or any other charges paid where there is a direct connection between the levy and

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the individual benefits to be received, shall not be regarded as "taxes on the total amount of wages".

4. Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty. Practice among Member countries varies with respect to the treatment of interest and penalties. Some countries never treat such items as taxes covered by the Article. Others take the opposite approach, especially in cases where the additional charge is computed with reference to the amount of the underlying tax. Countries are free to clarify this point in their bilateral negotiations.

(Amended on 29 April 2000; see HISTORY)

5. The Article does not mention "ordinary taxes" or "extraordinary taxes". Normally, it might be considered justifiable to include extraordinary taxes in a model convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

Paragraph 3

6. This paragraph lists the taxes in force at the time of signature of the Convention. The list is not exhaustive. It serves to illustrate the preceding paragraphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the Convention.

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6.1. Some Member countries do not include paragraphs 1 and 2 in their bilateral conventions. These countries prefer simply to list exhaustively the taxes in each country to which the Convention will apply, and clarify that the Convention will also apply to subsequent taxes that are similar to those listed. Countries that wish to follow this approach might use the following wording:

> "1. The taxes to which the Convention shall apply are:
>
> *a*) (in State A): .....
> *b*) (in State B): .....
>
> 2. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the taxes listed in paragraph 1. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws."

As mentioned in paragraph 3 above, social security charges and similar charges should be excluded from the list of taxes covered.

(Added on 29 April 2000; see HISTORY)

Paragraph 4

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identical or substantially similar taxes that are imposed in a Contracting State after the date of signature of the Convention in addition to, or in place of, the existing taxes in that State.

(Amended on 29 April 2000; see HISTORY)

8. Each State undertakes to notify the other of any significant changes made to its taxation laws by communicating to it, for example, details of new or substituted taxes. Member countries are encouraged to communicate other significant developments as well, such as new regulations or judicial decisions; many countries already follow this practice. Contracting States are also free to extend the notification requirement to cover any significant changes in other laws that have an impact on their obligations under the convention; Contracting states wishing to do so may replace the last sentence of the paragraph by the following:

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"The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws affecting their obligations under the Convention."

(Amended on 29 April 2000; see HISTORY)

Observation on the Commentary

9. In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term "tax" does not include penalties, or interest on overpayment or underpayment of tax.

(Amended on 21 September 1995; see HISTORY)

Reservations on the Article

10. *Australia*, *Canada* and the *United States* reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

11. *Japan* and *Korea* reserve their position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital.

(Amended on 23 October 1997; see HISTORY)

12. *Greece* holds the view that "taxes on the total amounts of wages or salaries paid by enterprises" should not be regarded as taxes on income and therefore will not be covered by the Convention.

(Added on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 1 read as follows:

> "1. This Article is intended to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise, to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, by means of the periodical exchange of lists and through a procedure for mutual consultation."

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 4 read as follows:

> "4. Clearly a State possessing taxing powers — and it alone — may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty."

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 6.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 7: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 7 read as follows:

> "7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. This provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its taxation laws."

Paragraph 8: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 8 read as follows:

> "8. Each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes imposed during that year."

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Paragraph 9: Included in the 1977 Model Convention. Amended, by adding the words ", or interest on overpayment or underpayment of tax", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 9 previously read as follows:

> "9 . In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term "tax" does not include penalties."

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Included in the 1977 Model Convention. Amended, by adding Korea and to the country making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 11 previously read as follows:

> "11. *Japan* reserves its position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital."

Paragraph 12: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

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COMMENTARY ON ARTICLE 3
CONCERNING GENERAL DEFINITIONS

1. This Article groups together a number of general provisions required for the interpretation of the terms used in the Convention. The meaning of some important terms, however, is explained elsewhere in the Convention. Thus, the terms "resident" and "permanent establishment" are defined in Articles 4 and 5 respectively, while the interpretation of certain terms appearing in the Articles on special categories of income ("income from immovable property", "dividends", etc.) is clarified by provisions embodied in those Articles. In addition to the definitions contained in the Article, Contracting States are free to agree bilaterally on definitions of the terms "a Contracting State" and "the other Contracting State". Furthermore, Contracting States are free to agree bilaterally to include in the possible definitions of "Contracting States" a reference to continental shelves.

Paragraph 1

THE TERM "PERSON"

2. The definition of the term "person" given in sub-paragraph *a*) is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense (cf. especially Articles 1 and 4). The definition explicitly mentions individuals, companies and other bodies of persons. From the meaning assigned to the term "company" by the definition contained in sub-paragraph *b*) it follows that, in addition, the term "person" includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation, Stiftung*) may fall within the meaning of the term "person". Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons.

(Amended on 29 April 2000; see HISTORY)

THE TERM "COMPANY"

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 according to the tax laws of the Contracting State in which it is organised. The

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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.

THE TERM "ENTERPRISE"

4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term "enterprise" has therefore been attempted in this Article. However, it is provided that the term “enterprise” applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary are free to omit the definition of the term "enterprise" from their bilateral conventions.

(Amended on 29 April 2000; see HISTORY)

THE TERM "INTERNATIONAL TRAFFIC"

5. The definition of the term "international traffic" is based on the principle set forth in paragraph 1 of Article 8 that the right to tax profits from the operation of ships or aircraft in international traffic resides only in the Contracting State in which the place of effective management is situated in view of the special nature of the international traffic business. However, as stated in the Commentary on paragraph 1 of Article 8, the Contracting States are free on a bilateral basis to insert in sub-paragraph *d*) a reference to residence, in order to be consistent with the general pattern of the other Articles. In such a case, the words "an enterprise that has its place of effective management in a Contracting State" should be replaced, by "an enterprise of a Contracting State" or "a resident of a Contracting State".

6. The definition of the term "international traffic" is broader than is normally understood. The broader definition is intended to preserve for the State of the place of effective management the right to tax purely domestic traffic as well as

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international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders. This intention may be clarified by the following illustration. Suppose an enterprise of a Contracting State or an enterprise that has its place of effective management in a Contracting State, through an agent in the other Contracting State, sells tickets for a passage that is confined wholly within the first-mentioned State or alternatively, within a third State. The Article does not permit the other State to tax the profits of either voyage. The other State is allowed to tax such an enterprise of the first-mentioned State only where the operations are confined solely to places in that other State.

6.1 A ship or aircraft is operated solely between places in the other Contracting State in relation to a particular voyage if the place of departure and the place of arrival of the ship or aircraft are both in that other Contracting State. However, the definition applies where the journey of a ship or aircraft between places in the other Contracting State forms part of a longer voyage of that ship or aircraft involving a place of departure or a place of arrival which is outside that other Contracting State. For example, where, as part of the same voyage, an aircraft first flies between a place in one Contracting State to a place in the other Contracting State and then continues to another destination also located in that other Contracting State, the first and second legs of that trip will both be part of a voyage regarded as falling within the definition of "international traffic".

(Added on 29 April 2000; see HISTORY)

6.2 Some States take the view that the definition of "international traffic" should rather refer to a transport as being the journey of a passenger or cargo so that any voyage of a passenger or cargo solely between two places in the same Contracting State should not be considered as covered by the definition even if that voyage is made on a ship or plane that is used for a voyage in international traffic. Contracting States having that view may agree bilaterally to delete the reference to "the ship or aircraft" in the exception included in the definition, so as to use the following definition:

> "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 such transport is solely between places in the other Contracting State;"

(Added on 29 April 2000; see HISTORY)

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6.3 The definition of "international traffic" does not apply to any transport when the ship is operated between two places in the same Contracting State, even if part of the transport takes place outside that State. Thus, for example, a cruise beginning and ending in the same Contracting State without a stop in a foreign port does not constitute a transport of passengers in international traffic. Contracting States wishing to expressly clarify that point in their conventions may agree bilaterally to amend the definition accordingly.

(Added on 29 April 2000; see HISTORY)

THE TERM "COMPETENT AUTHORITY"

7. The definition of the term "competent authority" recognizes that in some OECD Member countries the execution of double taxation conventions does not exclusively fall within the competence of the highest tax authorities; some matters are reserved or may be delegated to other authorities. The present definition enables each Contracting State to designate one or more authorities as being competent.

THE TERM "NATIONAL"

8. The definition of the term "national" merely stipulates that the term applies to any individual possessing the nationality of a Contracting State. It was not judged necessary to include in the text of the Convention any more precise definition of nationality, nor did it seem indispensable to make any special comment on the meaning and application of the word. Obviously, in determining what is meant by "the nationals of a Contracting State" in relation to individuals, reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.

(Replaced on 23 July 1992; see HISTORY)

9. Sub-paragraph *f*) is more specific as to legal persons, partnerships and associations. By declaring that any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State is considered to be a national, the provision disposes of a difficulty that often arises. In defining the nationality of companies, certain States have regard less to the law

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that governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

(Replaced on 23 July 1992; see HISTORY)

10. Moreover, in view of the legal relationship created between a company and the State under whose law it is organised, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term "national".

(Replaced on 23 July 1992; see HISTORY)

10.1 The separate mention of partnerships in sub-paragraph 1 *g*) is not inconsistent with the status of a partnership as a person under sub-paragraph 1 *a*). Under the domestic laws of some countries, it is possible for an entity to be a "person" but not a "legal person" for tax purposes. The explicit statement is necessary to avoid confusion.

(Added on 29 April 2000; see HISTORY)

THE TERM "BUSINESS"

10.2 The Convention does not contain an exhaustive definition of the term "business", which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies the Convention. Sub-paragraph *h*), however, provides expressly that the term includes the performance of professional services and of other activities of an independent character. This provision was added in 2000 at the same time as Article 14, which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term "business" includes the performance of the activities which were previously covered by Article 14, was intended to prevent that the term "business" be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting States for which this is not the case are free to agree bilaterally to omit the definition.

(Added on 29 April 2000; see HISTORY)

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Paragraph 2

11. This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly.

(Amended on 21 September 1995; see HISTORY)

12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. 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 (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

(Added on 23 July 1992; see HISTORY)

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).

(Added on 23 July 1992; see HISTORY)

13.1 Paragraph 2 was amended in 1995 to conform its text more closely to the general and consistent understanding of Member states. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws

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imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws. States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms.

(Added on 21 September 1995; see HISTORY)

Reservations on the Article

14. *Italy* and *Portugal* reserve the right not to include the definitions in subparagraphs 1 *c*) and *h*) ("enterprise" and "business") because they reserve the right to include an article concerning the taxation of independent personal services.

(Replaced on 29 April 2000; see HISTORY)

15. The *United States* reserves the right to omit the phrase "operated by an enterprise that has its place of effective management in a Contracting State" from the definition of "international traffic" in subparagraph *e*) of paragraph 1.

(Added on 29 April 2000; see HISTORY)

16. *Ireland* reserves the right to omit the final phrase of paragraph 2, which gives tax law precedence over other laws.

(Added on 21 September 1995; see HISTORY)

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HISTORY

[In 1995, a number of minor drafting improvements that did not affect the meaning of the text were made to the Commentary on Article 3. These minor changes are not described in this section.]

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). In the 1977 Model Convention, paragraph 2 read as follows:

> "2. The definition of the term "person" given in sub-paragraph *a*) is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense (cf. especially Articles 1 and 4). The definition explicitly mentions individuals, companies and other bodies of persons. From the meaning assigned to the term "company" by the definition contained in sub-paragraph *b*) it follows that, in addition, the term "person" includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation*, *Stiftung*) may fall within the meaning of the term "person". Special considerations for the application of the Convention to partnerships are found in paragraphs 2 to 6 of the Commentary on Article 1."

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 4 read as follows:

> "4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No definition of the term "enterprise" has therefore been attempted in this Article."

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 6.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 6.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 6.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Replaced paragraph 8 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was amended and renumbered as paragraph 11 (cf. history of paragraph 11) and

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paragraph 11 of the Commentary on Article 24 in the 1977 Model Convention was amended and, as a consequence of the redesignation of paragraph 2 of Article 24 as sub-paragraph 1 *f*) of Article 3 (cf. history of sub-paragraph 1 *f*) of Article 3 of the Model Convention), renumbered as paragraph 8 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 11 of the Commentary on Article 24 read as follows:

> "11. Paragraph 2 merely stipulates that the term "nationals" applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the Article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by "the nationals of a Contracting State", reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality."

Paragraph 9: Replaced paragraph 9 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was renumbered as paragraph 14 (cf. history of paragraph 14) and paragraph 12 of the Commentary on Article 24 in the 1977 Model Convention was amended and, as a consequence of the redesignation of paragraph 2 of Article 24 as sub-paragraph 1 *f*) of Article 3 (cf. history of sub-paragraph 1 *f*) of Article 3 of the Model Convention), renumbered as paragraph 9 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 12 of the Commentary on Article 24 read as follows:

> "12. But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it."

Paragraph 10: Replaced paragraph 10 of the 1977 Model Convention. Paragraph 10 of the 1977 Model Convention was deleted by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 10 read as follows:

> "10. Belgium reserves the right to vary, in its conventions, sub-paragraph b) of paragraph 1 of Article 3, and paragraph 1 of Article 4, so as to make it clear that partnerships constituted under Belgian law must be treated as residents of Belgium, in view of the twofold fact that they are legal persons and that their world income is in all cases subject to tax in Belgium."

New paragraph 10 corresponds to paragraph 13 of the Commentary on Article 24 in the 1977 Model Convention, which was amended and renumbered by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, as a consequence of the redesignation of paragraph 2 of Article 24 as sub-paragraph 1 *f*) of Article 3 (cf. history of sub-paragraph 1 *f*) of Article 3 of the Model Convention). In the 1977 Model Convention, paragraph 13 of the Commentary on Article 24 read as follows:

> "13. Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to

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the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term "nationals"."

Paragraph 10.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 10.2: Added, together with the heading preceding it, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 11: Amended, by adding the words ", and in 1995 amended the Model to make this point explicitly", by OECD Council Recommendation C(95)132/FINAL, adopted on 21 September 1995, which amended the Appendix to Recommendation C(94)11/FINAL in order to reflect a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 11 corresponded to paragraph 8 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was renumbered as paragraph 11 and amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 8 read as follows:

"8. This paragraph provides a general rule of interpretation in respect of terms used in the Convention but not defined therein."

Paragraph 12: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13.1: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 14: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 14 previously read as follows:

"14. For the purposes of Articles 10, 11 and 12, *New Zealand* would wish to treat dividends, interest and royalties in respect of which a trustee is subject to tax in the State of which he is a resident as being beneficially owned by that trustee."

Paragraph 14 as it read before 29 April 2000, corresponded to paragraph 9 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was renumbered as paragraph 14 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 15: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

An earlier reservation under paragraph 15 was deleted by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 15,

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which had been added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, previously read as follows:

> "15. *France* reserves the right to specify in paragraph 2 that for the purposes of the Convention, the meaning that a term or expression has under taxation law will prevail over any other meanings that the term or the expression may have under other branches of the law."

Paragraph 16: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

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COMMENTARY ON ARTICLE 4
CONCERNING THE DEFINITION OF RESIDENT

I. Preliminary remarks

1. The concept of "resident of a Contracting State" has various functions and is of importance in three cases:

a) in determining a convention's personal scope of application;

b) in solving cases where double taxation arises in consequence of double residence;

c) in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs.

2. The Article is intended to define the meaning of the term "resident of a Contracting State" and to solve cases of double residence. To clarify the scope of the Article some general comments are made below referring to the two typical cases of conflict, i.e. between two residences and between residence and source or situs. In both cases the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory.

3. Generally the domestic laws of the various States impose a comprehensive liability to tax — "full tax liability" — based on the taxpayers' personal attachment to the State concerned (the "State of residence"). This liability to tax is not imposed only on persons who are "domiciled" in a State in the sense in which "domicile" is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.

4. Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on "residence" have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.

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5. This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or situs. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference.

6. An example will elucidate the case. An individual has his permanent home in State A, where his wife and children live. He has had a stay of more than six months in State B and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being a resident of that State. Thus, both States claim that he is fully liable to tax. This conflict has to be solved by the Convention.

7. In this particular case the Article (under paragraph 2) gives preference to the claim of State A. This does not, however, imply that the Article lays down special rules on "residence" and that the domestic laws of State B are ignored because they are incompatible with such rules. The fact is quite simply that in the case of such a conflict a choice must necessarily be made between the two claims, and it is on this point that the Article proposes special rules.

II. Commentary on the provisions of the Article

Paragraph 1

8. Paragraph 1 provides a definition of the expression "resident of a Contracting State" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws (cf. Preliminary remarks). As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g.

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diplomats or other persons in government service). In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory. According to its wording and spirit the provision would also exclude from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. This, however, has inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended. The exclusion of certain companies from the definition would not of course prevent Contracting States from exchanging information about their activities (cf. paragraph 2 of the Commentary on Article 26). Indeed States may feel it appropriate to develop spontaneous exchanges of information about companies which seek to obtain treaty benefits unintended by the Model Convention.

(Amended on 23 July 1992; see HISTORY)

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

(Added on 21 September 1995; see HISTORY)

8.2 Paragraph 1 refers to persons who are "liable to tax" in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for

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purposes of the Convention (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11).

(Added on 29 April 2000; see HISTORY)

8.3 In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

(Added on 29 April 2000; see HISTORY)

8.4 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

(Added on 29 April 2000; see HISTORY)

Paragraph 2

9. This paragraph relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States.

10. To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the

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right to tax devolves upon that particular State. The facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.

(Amended on 21 September 1995; see HISTORY)

11. The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.

12. Sub-paragraph *a*) means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.

13. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).

14. If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital

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interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.

15. If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

16. Sub-paragraph *b*) establishes a secondary criterion for two quite distinct and different situations:

a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
b) the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

17. In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

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18. The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

19. In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, sub-paragraph *b*) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

20. Where, in the two situations referred to in sub-paragraph *b*) the individual has an habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them, sub-paragraph *d)* assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25.

Paragraph 3

21. This paragraph concerns companies and other bodies of persons, irrespective of whether they are or not legal persons. It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course, possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc., also, special rules as to the preference must be established.

22. It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed.

23. The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the "place of management" of the enterprise

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is situated; other conventions attach importance to its "place of effective management", others again to the "fiscal domicile of the operator".

(Amended on 23 July 1992; see HISTORY)

24. As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business are in substance made. The place of effective management will ordinarily be the place where the most senior person or group of persons (for example a board of directors) makes its decisions, the place where the actions to be taken by the entity as a whole are determined; however, no definitive rule can be given and all relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

(Amended on 29 April 2000; see HISTORY)

Observations on the Commentary

25. *Italy* does not adhere to the interpretation given in paragraph 24 above concerning "the most senior person or group of persons (for example, a board of directors)" as the sole criterion to identify the place of effective management of an entity. In its opinion the place where the main and substantial activity of the entity is carried on is also to be taken into account when determining the place of effective management.

(Replaced on 29 April 2000; see HISTORY)

26. *Spain*, due to the fact that according to its internal law the fiscal year coincides with the calendar year and there is no possibility of concluding the fiscal period by reason of the taxpayer's change of residence, will not be able to proceed in accordance with paragraph 10 of the Commentary on Article 4. In this case, a mutual agreement procedure will be needed to ascertain the date from which the taxpayer will be deemed to be a resident of one of the Contracting States.

(Added on 21 September 1995; see HISTORY)

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Reservations on the Article

27. *Canada* reserves the right to use as the test for paragraph 3 the place of incorporation or organisation with respect to a company and, failing that, to deny dual resident companies the benefits under the Convention.

(Amended on 29 April 2000; see HISTORY)

28. *Japan* and *Korea* reserve their position on the provisions in this and other Articles in the Model Tax Convention which refer directly or indirectly to the place of effective management. Instead of the term "place of effective management", these countries wish to use in their conventions the term "head or main office".

(Amended on 23 October 1997; see HISTORY)

29. *France* does not agree with the general principle according to which if tax owed by a partnership is determined on the basis of the personal characteristics of the partners, these partners are entitled to the benefits of tax conventions entered into by the States of which they are residents as regards income that "flows-through" that partnership. Under French domestic law, a partnership is considered to be liable to tax even though, technically, that tax is collected from the partners; for that reason, France reserves the right to amend the Article in its tax conventions in order to specify that French partnerships must be considered as residents of France in view of their legal and tax characteristics.

(Amended on 29 April 2000; see HISTORY)

30. *Turkey* reserves the right to use the "registered office" criterion (legal head office) as well as the "place of effective management" criterion for determining the residence of a person, other than an individual, which is a resident of both Contracting States because of the provisions of paragraph 1 of the Article.

(Renumbered on 21 September 1995; see HISTORY)

31. *Mexico* and the *United States* reserve the right to use a place of incorporation test for determining the residence of a corporation, and, failing that, to deny dual resident companies certain benefits under the Convention.

(Amended on 29 April 2000; see HISTORY)

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32. *Germany* reserves the right to include a provision under which a partnership that is not a resident of a Contracting State according to the provisions of paragraph 1 is deemed to be a resident of the Contracting State where the place of its effective management is situated, but only to the extent that the income derived from the other Contracting State or the capital situated in that other State is liable to tax in the first-mentioned State.

(Replaced on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992 on the basis of paragraph 14 of a previous report entitled "Double Taxation Conventions and the Use of Conduit Companies" (adopted by the Council of the OECD on 27 November 1986). In the 1977 Model Convention, paragraph 8 read as follows:

> "8. Paragraph 1 provides a definition of the expression "resident of a Contracting State" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws (cf. Preliminary Remarks). As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service). In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory."

Paragraph 8.1: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 8.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 8.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 8.4: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 9: Unchanged from the 1977 Model Convention.

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Paragraph 10: Included in the 1977 Model Convention. Amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. In the 1977 Model Convention, paragraph 10 read as follows:

> "10. To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State."

Paragraph 11: Unchanged from the 1977 Model Convention.

Paragraph 12: Unchanged from the 1977 Model Convention.

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Unchanged from the 1977 Model Convention.

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Unchanged from the 1977 Model Convention.

Paragraph 19: Unchanged from the 1977 Model Convention.

Paragraph 20: Unchanged from the 1977 Model Convention.

Paragraph 21: Unchanged from the 1977 Model Convention.

Paragraph 22: Unchanged from the 1977 Model Convention.

Paragraph 23: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting the last sentence of the paragraph. In the 1977 Model Convention, paragraph 23 read as follows:

> "23. The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the "place of management" of the enterprise is situated; other conventions attach importance to its "place of effective management", others again to the "fiscal domicile of the operator". Concerning conventions concluded by the United Kingdom which provide that a company shall be regarded as resident in the State in which "its business is managed and controlled", it has been made clear, on the United Kingdom side, that this expression means the "effective management" of the enterprise."

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Paragraph 24: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 24 read as follows:

> "24. As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals."

Paragraph 25: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention and until 29 April 2000, paragraph 25 read as follows:

> "25. *New Zealand's* interpretation of the term "effective management" is practical day to day management, irrespective of where the overriding control is exercised."

Paragraph 26: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 27: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 27 read as follows:

> "27. *Canada* reserves the right to use as the test for paragraph 3 the place of incorporation or organisation with respect to a company."

Paragraph 27 corresponds to paragraph 26 as it read after 23 July 1992 but before 21 September 1995. Paragraph 26 was renumbered as paragraph 27 by the Report entitled "The 1995 Update to the Model Tax Convention", which was adopted by the Council of the OECD on 21 September 1995.

Paragraph 26 had been previously amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting the reference to the United States (cf. history of paragraph 30). In the 1977 Model Convention, paragraph 26 read as follows:

> "26. *Canada* and the *United States* reserve the right to use as the test for paragraph 3 the place of incorporation or organisation with respect to a company."

Paragraph 28: Amended, by adding Korea to the country making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 28 previously read as follows:

> "28. *Japan* reserves its position on the provisions in this and other Articles in the Model Tax Convention which refer directly or indirectly to the place of effective management. Instead of the term "place of effective management", Japan wishes to use in its conventions the term "head or main office"."

Paragraph 28 corresponds to paragraph 27 as it read before 21 September 1995. Paragraph 27 was renumbered as paragraph 28 by the Report entitled "The 1995 Update to the Model Tax Convention", which was adopted by the Council of the OECD on 21 September 1995.

Paragraph 27 had been previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 27 previously read as follows:

> "27. *Japan* reserves its position on the provisions in this and other Articles in the Model Convention which refer directly or indirectly to the place of effective management."

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Paragraph 27 corresponded to paragraph 28 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was deleted and paragraph 28 was renumbered as paragraph 27 and amended by deleting the word "also" immediately after "Japan" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 27 read as follows:

> "27. *Japan* wishes to be free to conclude a bilateral convention which provides that the fiscal domicile of a resident of both Contracting States is to be determined through consultation between competent authorities. When entering into such consultation, Japan is prepared to take into consideration the rules set out in paragraph 2 of this Article as far as practicable."

Paragraph 29: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 29 read as follows:

> "29. *France* reserves the right to amend the Article in its tax conventions in order to specify that French partnerships must be considered as residents of France in view of their legal and tax characteristics."

Paragraph 29 corresponds to paragraph 28 as it read after 23 July 1992 but before 21 September 1995. Paragraph 28 was renumbered as paragraph 29 by the Report entitled "The 1995 Update to the Model Tax Convention", which was adopted by the Council of the OECD on 21 September 1995.

Paragraph 28 replaced paragraph 28 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was amended and renumbered as paragraph 27 (cf. history of paragraph 27) and new paragraph 28 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 30: Paragraph 30 corresponds to paragraph 29 as it read before 21 September 1995. Paragraph 29 was renumbered as paragraph 30 by the Report entitled "The 1995 Update to the Model Tax Convention", which was adopted by the Council of the OECD on 21 September 1995.

Paragraph 29 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 31: Amended, by adding Mexico as a country making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 31 previously read as follows:

> "31. The *United States* reserves the right to use a place of incorporation test for determining the residence of a corporation, and, failing that, to deny dual resident companies certain benefits under the Convention."

Paragraph 31 corresponds to paragraph 30 as it read before 21 September 1995. Paragraph 30 was renumbered as paragraph 31 by the Report entitled "The 1995 Update to the Model Tax Convention", which was adopted by the Council of the OECD on 21 September 1995.

Paragraph 30 had been previously amended, by adding the word "certain" before the word "benefits", by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. After 23 July 1992, but before 31 March 1994, paragraph 30 read as follows:

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> "30. The *United States* reserves the right to use a place of incorporation test for determining the residence of a corporation, and, failing that, to deny dual resident companies benefits under the Convention."

Paragraph 30 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. It corresponded in part to paragraph 26 of the 1977 Model Convention.

Paragraph 32: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 32 previously read as follows:

> "32. *Mexico* reserves the right to be excluded from the application of the portion of sub-paragraph *d*) of paragraph 2 that addresses double nationality, because the Mexican Constitution does not allow Mexican nationals to be nationals of any other State. "

Paragraph 32, as it read before 29 April 2000, was added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the OECD Council on 21 September 1995.

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COMMENTARY ON ARTICLE 5 CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT

1. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

1.1 Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.

(Added on 29 April 2000; see HISTORY)

Paragraph 1

2. Paragraph 1 gives a general definition of the term "permanent establishment" which brings out its essential characteristics of a permanent establishment in the sense of the Convention, i.e. a distinct "situs", a "fixed place of business". The paragraph defines the term "permanent establishment" as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

— the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;
— this place of business must be "fixed", i.e. it must be established at a distinct place with a certain degree of permanence;
— the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another,

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are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a "productive character" it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4. The term "place of business" covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 20 below).

(Amended on 23 July 1992; see HISTORY)

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6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment.

7. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibili-ties, for example, participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may

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go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances.

(Amended on 23 July 1992; see HISTORY)

9. The leasing of containers is one particular case of the leasing of industrial or commercial equipment which does, however, have specific features. The question of determining the circumstances in which an enterprise involved in the leasing of containers should be considered as having a permanent establishment in another State is more fully discussed in a report entitled "The Taxation of Income Derived from the Leasing of Containers".[1]

(Replaced on 23 July 1992; see HISTORY)

10. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business (cf. paragraph 35 below). But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines

1. Reproduced in Volume II at page R(3)-1.

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also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

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

11. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 2

12. This paragraph contains a list, by no means exhaustive, of examples, each of which can be regarded, *prima facie*, as constituting a permanent establishment. As these examples are to be seen against the background of the general definition given in paragraph 1, it is assumed that the Contracting States interpret the terms listed, "a place of management", "a branch", "an office", etc. in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1.

(Renumbered on 23 July 1992; see HISTORY)

13. The term "place of management" has been mentioned separately because it is not necessarily an "office". However, where the laws of the two Contracting States do not contain the concept of "a place of management" as distinct from an

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"office", there will be no need to refer to the former term in their bilateral convention.

(Renumbered on 23 July 1992; see HISTORY)

14. Sub-paragraph *f*) provides that mines, oil or gas wells, quarries or any other place of extraction of natural resources are permanent establishments. The term "any other place of extraction of natural resources" should be interpreted broadly. It includes, for example, all places of extraction of hydrocarbons whether on or off-shore.

(Renumbered on 23 July 1992; see HISTORY)

15. Sub-paragraph *f*) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off-shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

a) shall be deemed not to have a permanent establishment in that other State; or
b) shall be deemed to carry on such activities through a permanent establishment in that other State, or
c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 3

16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more

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than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.

(Renumbered on 23 July 1992; see HISTORY)

17. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.

(Renumbered on 23 July 1992; see HISTORY)

18. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses). The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries

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concerned with this issue can adopt solutions in the framework of bilateral negotiations.

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

19. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of bad weather conditions or a lack of materials but resumed work on 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.

(Renumbered on 23 July 1992; see HISTORY)

19.1 In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve month, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.

(Added on 29 April 2000; see HISTORY)

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20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 4

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in sub-paragraph *e)*, which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover sub paragraph *f*) provides that combinations of activities mentioned in sub-paragraphs *a*) to *e*) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

(Renumbered on 23 July 1992; see HISTORY)

22. Sub-paragraph *a*) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Sub-paragraph *b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Sub-paragraph *c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph *d*) is intended to include the case of the newspaper bureau which has

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no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase" .

(Renumbered on 23 July 1992; see HISTORY)

23. Sub-paragraph *e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this sub-paragraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this sub-paragraph provides a generalised exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

(Renumbered on 23 July 1992; see HISTORY)

24. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of sub-paragraph *e).* A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level.

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If enterprises with international ramifications establish a so-called "management office" in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a "place of management" within the meaning of sub-paragraph *a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of sub-paragraph *e*) of paragraph 4.

(Renumbered on 23 July 1992; see HISTORY)

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, or to maintain or repair such machinery, as this goes beyond the pure delivery mentioned in sub-paragraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Sub-paragraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

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

26. Moreover, sub-paragraph *e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company

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owning the fixed place belongs, would not fall within the scope of sub-paragraph *e*).

(Renumbered on 23 July 1992; see HISTORY)

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to sub-paragraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the sub-paragraphs *a*) to *e*) of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of sub-paragraph *e*) (cf. paragraphs 24 and 25 above). Sub-paragraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of the sub-paragraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding the question whether or not a permanent establishment exists. States which want to allow any combination of the items mentioned in sub-paragraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in sub-paragraph *f*).

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

28. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises

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this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is main-tained.

(Renumbered on 23 July 1992; see HISTORY)

29. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (cf. paragraph 11 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under sub-paragraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

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

30. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 5

31. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. The

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paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.

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

32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a perma-nent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases. Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise.

(Amended on 31 March 1994; see HISTORY)

33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed

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by another person in the State in which the enterprise is situated. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

(Renumbered on 23 July 1992; see HISTORY)

34. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e. not only to the extent that such a person exercises the authority to conclude contracts in the name of the enterprise.

(Renumbered on 23 July 1992; see HISTORY)

35. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 6

36. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business (cf. paragraph 32 above). Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

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

37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

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a) he is independent of the enterprise both legally and economically, and
b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

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

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital. Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

(Renumbered on 23 July 1992; see HISTORY)

39. According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD Member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by

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virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The 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. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 7

40. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

(Renumbered on 23 July 1992; see HISTORY)

41. However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.

(Renumbered on 23 July 1992; see HISTORY)

42. The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company.

(Renumbered on 23 July 1992; see HISTORY)

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Observations on the Commentary

43. *Italy* does not adhere to the interpretation given in paragraph 12 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting *a priori* permanent establishments.

(Amended on 23 July 1992; see HISTORY)

44. The *Czech Republic* would add to paragraph 25 its view that when an enterprise has established an office (such as a commercial representation office) in a country, and the employees working at that office are substantially involved in the negotiation of contracts for the import of products or services into that country, the office will in most cases not fall within paragraph 4 of Article 5. Substantial involvement in the negotiations exists when the essential parts of the contract — the type, quality, and amount of goods, for example, and the time and terms of delivery — are determined by the office. These activities form a separate and indispensable part of the business activities of the foreign enterprise, and are not simply activities of an auxiliary or preparatory character.

(Added on 23 October 1997; see HISTORY)

45. *Mexico* wishes to include some wording in its conventions to emphasize that the arm's length principle should be considered in determining whether or not an agent is of independent status.

(Replaced on 21 September 1995; see HISTORY)

45.1 *Hungary* is of the opinion that an agent, whether commission agent or not, should be of an independent status within the sense of the Convention**.**

(Added on 23 October 1997; see HISTORY)

45.2 *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the third sentence of paragraph 1.1 — as far as the method for computing taxes is concerned, national systems are not affected by the new wording of the model, i.e. by the elimination of Article 14.

(Added on 29 April 2000; see HISTORY)

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Reservations on the Article

46. *Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if the enterprise carries on designated supervisory activities in that State for more than twelve months, if substantial equipment is used in that State for more than twelve months by, for or under contract with the enterprise in the exploration for or exploitation of natural resources, or if a person — acting in that State on behalf of the enterprise — manufactures or processes there goods or merchandise belonging to the enterprise.

(Renumbered on 23 July 1992; see HISTORY)

47. *Greece, Korea, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

(Amended on 23 October 1997; see HISTORY)

48. The *United States* reserves the right to add "a drilling rig or ship used for the exploration of natural resources" to the activities covered by the 12 month threshold test in paragraph 3.

(Replaced on 29 April 2000; see HISTORY)

49. *Spain* reserves its position on paragraph 3 so as to be able to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2. Spain also reserves its right to tax an enterprise as having a permanent establishment in Spain when such an enterprise carries on supervisory activities in Spain for more than 12 months in connection with a building site or construction or installation project also lasting more than 12 months.

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

50. *Greece* reserves the right to treat an enterprise as having a permanent establishment in Greece if the enterprise carries on planning, supervisory or consultancy activities in connection with a building site or construction or installation project lasting more than six months, if scientific equipment or

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machinery is used in Greece for more than three months by the enterprise in the exploration or extraction of natural resources or if the enterprise carries out more than one separate project, each one lasting less than six months, in the same period of time (i.e. within a calendar year).

(Added on 23 July 1992; see HISTORY)

51. *Greece* reserves the right to include paragraph 2 of Article 5 as it was drafted in the 1963 Draft Convention.

(Amended on 23 October 1997; see HISTORY)

52. Considering the special problems in applying the provisions of the Model Convention to offshore hydrocarbon exploration and exploitation and related activities, *Denmark*, *Ireland*, *Norway* and the *United Kingdom* reserve the right to insert in a special article provisions relating to such activities.

(Amended on 21 September 1995; see HISTORY)

53. *Norway* also reserves the right to include connected supervisory or consultancy activities in paragraph 3 of the Article.

(Added on 23 July 1992; see HISTORY)

54. *Portugal* reserves the right to treat an enterprise as having a permanent establishment in Portugal if the enterprise carries on an activity consisting of planning, supervising, consulting, any auxiliary work or any other activity in connection with a building site or construction or installation project lasting more than six months, if such activities or work also last more than six months. Portugal also reserves the right to consider that a permanent establishment exists if the activity of the enterprise is carried on with a certain degree of continuity by employees or any other personnel under contract.

(Added on 23 July 1992; see HISTORY)

55. *Turkey* reserves the right to treat a person as having a permanent establishment in Turkey if the person performs professional services and other activities of independent character, including planning, supervisory or consultancy activities, with a certain degree of continuity.

(Amended on 29 April 2000; see HISTORY)

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56. *New Zealand* reserves the right to insert provisions that deem a permanent establishment to exist if, for more than six months, an enterprise conducts activities relating to the exploration or exploitation of natural resources, uses or leases substantial equipment or furnishes services (including consultancy and independent personal services).

(Amended on 29 April 2000; see HISTORY)

57. *Greece* reserves the right to insert special provisions relating to offshore activities.

(Added on 21 September 1995; see HISTORY)

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

(Added on 21 September 1995; see HISTORY)

59. *Mexico* reserves the right to tax an enterprise that carries on supervisory activities for more than six months in connection with a building site or a construction, assembly, or installation project.

(Added on 21 September 1995; see HISTORY)

60. The *Czech Republic*, while agreeing with the "fixed place of business" requirement of paragraph 1, reserves the right to propose in bilateral negotiations specific provisions clarifying the application of this principle to arrangements for the performance of services over a substantial period of time.

(Added on 23 October 1997; see HISTORY)

61. *Poland* reserves the right to replace "construction or installation project" with "construction, assembly, or installation project".

(Added on 23 October 1997; see HISTORY)

62. *Korea* reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months.

(Added on 23 October 1997; see HISTORY**)**

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63. *Canada* reserves the right in sub-paragraph 2(f) to replace the words "of extraction" with the words "relating to the exploration for or the exploitation.

(Added on 29 April 2000; see HISTORY)

64. *Mexico* reserves the right to tax individuals performing professional services or other activities of an independent character if they are present in Mexico for a period or periods exceeding in the aggregate 183 days in any twelve month period.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 1.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by replacing, at the end, the reference to paragraph 19 by a reference to paragraph 20 (cf. history of paragraph 20).

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992 on the basis of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983). In the 1977 Model Convention, paragraph 8 read as follows:

> "8. Where tangible property such as facilities, equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, the activity of the lessor may go beyond the mere leasing of equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances."

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Paragraph 9: Replaced paragraph 9 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was amended and renumbered as paragraph 10 (cf. history of paragraph 10) and new paragraph 9 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 10: Corresponds to paragraph 9 of the 1977 Model Convention. Paragraph 10 of the 1977 Model Convention was renumbered as paragraph 11 (cf. history of paragraph 11) and paragraph 9 was renumbered as paragraph 10, and amended by replacing the reference therein to paragraph 34 by a reference to paragraph 35, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 11: Corresponds to paragraph 10 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was renumbered as paragraph 12 (cf. history of paragraph 12) and paragraph 10 was renumbered as paragraph 11 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12: Corresponds to paragraph 11 of the 1977 Model Convention. Paragraph 12 of the 1977 Model Convention was renumbered as paragraph 13 (cf. history of paragraph 13) and paragraph 11 was renumbered as paragraph 12 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13: Corresponds to paragraph 12 of the 1977 Model Convention. Paragraph 13 of the 1977 Model Convention was renumbered as paragraph 14 (cf. history of paragraph 14) and paragraph 12 was renumbered as paragraph 13 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14: Corresponds to paragraph 13 of the 1977 Model Convention. Paragraph 14 of the 1977 Model Convention was renumbered as paragraph 15 (cf. history of paragraph 15) and paragraph 13 was renumbered as paragraph 14 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 15: Corresponds to paragraph 14 of the 1977 Model Convention. Paragraph 15 of the 1977 Model Convention was renumbered as paragraph 16 (cf. history of paragraph 16) and paragraph 14 was renumbered as paragraph 15 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 16: Corresponds to paragraph 15 of the 1977 Model Convention. Paragraph 16 of the 1977 Model Convention was renumbered as paragraph 17 (cf. history of paragraph 17) and paragraph 15 was renumbered as paragraph 16 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 17: Corresponds to paragraph 16 of the 1977 Model Convention. Paragraph 17 of the 1977 Model Convention was amended and renumbered as paragraph 18 (cf. history of paragraph 18) and paragraph 16 was renumbered as paragraph 17 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 18: Corresponds to paragraph 17 of the 1977 Model Convention. Paragraph 18 of the 1977 Model Convention was renumbered as paragraph 19 (cf. history of paragraph 19) and paragraph 17 was amended and renumbered as paragraph 18 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 17 read as follows:

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> "17. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses)."

Paragraph 19: Corresponds to paragraph 18 of the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was renumbered as paragraph 20 (cf. history of paragraph 20) and paragraph 18 was renumbered as paragraph 19 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 19.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 20: Corresponds to paragraph 19 of the 1977 Model Convention. Paragraph 20 of the 1977 Model Convention was renumbered as paragraph 21 (cf. history of paragraph 21) and paragraph 19 was renumbered as paragraph 20 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Corresponds to paragraph 20 of the 1977 Model Convention. Paragraph 21 of the 1977 Model Convention was renumbered as paragraph 22 (cf. history of paragraph 22) and paragraph 20 was renumbered as paragraph 21 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 22: Corresponds to paragraph 21 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention was renumbered as paragraph 23 (cf. history of paragraph 23) and paragraph 21 was renumbered as paragraph 22 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 23: Corresponds to paragraph 22 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 22 was renumbered as paragraph 23 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 24: Corresponds to paragraph 23 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was amended and renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 23 was renumbered as paragraph 24 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 25: Corresponds to paragraph 24 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and paragraph 24 renumbered as paragraph 25 and amended by substituting the words "or to maintain or repair" for "and to maintain and repair" in the first sentence, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 26: Corresponds to paragraph 25 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was amended and renumbered as paragraph 27 (cf. history of paragraph 27) and

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paragraph 25 was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 27: Corresponds to paragraph 26 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was renumbered as paragraph 28 (cf. history of paragraph 28) and paragraph 26 was renumbered as paragraph 27, and amended by replacing the reference therein to paragraphs 20, 23 and 24 by a reference to paragraphs 21, 24 and 25, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Corresponds to paragraph 27 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was amended and renumbered as paragraph 29 (cf. history of paragraph 29) and paragraph 27 was renumbered as paragraph 28 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Corresponds to paragraph 28 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was renumbered as paragraph 30 (cf. history of paragraph 30) and paragraph 28 was renumbered as paragraph 29, and amended by replacing the reference therein to paragraph 10 by a reference to paragraph 11, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 30: Corresponds to paragraph 29 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was amended and renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 29 was renumbered as paragraph 30 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 31: Corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was renumbered as paragraph 32 (cf. history of paragraph 32) and paragraph 30 was renumbered as paragraph 31, and amended by substituting the words "was redrafted in the 1977 Model Convention" for "has been redrafted" in the last sentence, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 32: Amended, by adding a sentence at the end of the paragraph, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 32 previously read as follows:

> "32. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether employees or not, who are not independent agents falling under paragraph 6. Such persons may be either individuals or companies. It would not have been in the interest of international economic relations to provide that the maintenance of any dependent person would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of the scope of their authority or the nature of their activity involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons having the authority to conclude contracts can lead to a permanent establishment for the enterprise maintaining them. In such a case the person has sufficient authority to bind the enterprise's participation in the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that that person makes use of this authority repeatedly and not merely in isolated cases."

Paragraph 32 corresponds to paragraph 31 of the 1977 Model Convention. Paragraph 32 of the 1977 Model Convention was renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 31

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was renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 33: Corresponds to paragraph 32 of the 1977 Model Convention. Paragraph 33 of the 1977 Model Convention was renumbered as paragraph 34 (cf. history of paragraph 34) and paragraph 32 was renumbered as paragraph 33 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 34: Corresponds to paragraph 33 of the 1977 Model Convention. Paragraph 34 of the 1977 Model Convention was renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 33 was renumbered as paragraph 34 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 35: Corresponds to paragraph 34 of the 1977 Model Convention. Paragraph 35 of the 1977 Model Convention was amended and renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 34 was renumbered as paragraph 35 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 36: Corresponds to paragraph 35 of the 1977 Model Convention. Paragraph 36 of the 1977 Model Convention was amended and renumbered as paragraph 37 (cf. history of paragraph 37) and paragraph 35 was renumbered as paragraph 36, and amended by replacing the reference therein to paragraph 31 by a reference to paragraph 32, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 37: Corresponds to paragraph 36 of the 1977 Model Convention. Paragraph 37 of the 1977 Model Convention was renumbered as paragraph 38 (cf. history of paragraph 38) and paragraph 36 was renumbered as paragraph 37 and amended by substituting the word "his" for the word "this" in sub-paragraph *b*) thereof by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 38: Corresponds to paragraph 37 of the 1977 Model Convention. Paragraph 38 of the 1977 Model Convention was renumbered as paragraph 39 (cf. history of paragraph 39) and paragraph 37 was renumbered as paragraph 38 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 39: Corresponds to paragraph 38 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was renumbered as paragraph 40 (cf. history of paragraph 40) and paragraph 38 was renumbered as paragraph 39 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 40: Corresponds to paragraph 39 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was renumbered as paragraph 41 (cf. history of paragraph 41) and paragraph 39 was renumbered as paragraph 40 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 41: Corresponds to paragraph 40 of the 1977 Model Convention. Paragraph 41 of the 1977 Model Convention was renumbered as paragraph 42 (cf. history of paragraph 42) and paragraph 40 was renumbered as paragraph 41 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Corresponds to paragraph 41 of the 1977 Model Convention. Paragraph 42 of the 1977 Model Convention was deleted and paragraph 41 was renumbered as paragraph 42 by the Report

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entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. Paragraph 42 of the 1977 Model Convention read as follows:

> "42. Treatment in Irish tax law of non-resident operators in *Ireland* and in the Irish continental shelf area. Profits arising to a person not resident in Ireland from exploration or exploitation activities in Ireland or in the Irish continental shelf area as well as profits from exploration or exploitation rights are treated as the profits of a trade carried on in Ireland through a branch or agency and are, in consequence, taxable in Ireland. This includes non-resident contractors who supply well-drilling, pipe-laying and similar services in Ireland or in the Irish continental shelf area. In addition, capital gains accruing on the disposal of exploration or exploitation rights in Ireland or in the Irish continental shelf area are treated as gains accruing on the disposal of assets situated in Ireland. When negotiating conventions with other Member countries, Ireland would wish sub-paragraph *f*) of paragraph 2 to be so drafted and interpreted as to reflect the Irish position."

Paragraph 43: Included in the 1977 Model Convention. Paragraph 43 of the 1977 Model Convention was amended by replacing the reference therein to paragraph 11 by a reference to paragraph 12 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 44, as it read before 31 March 1994, was amended and renumbered as paragraph 56 (cf. history of paragraph 56) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 45: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

An earlier Observation numbered paragraph 45 was deleted, as a consequence of the amendment made to paragraph 32 (cf. history of paragraph 32), by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 45 previously read as follows:

> "45. The *United Kingdom* considers that an agent who is not an agent of independent status within paragraph 6 of this Article and who has the characteristics described in paragraphs 32 and 33 above will represent a permanent establishment of an enterprise if he has the authority to conclude contracts on behalf of that enterprise whether in his own name or that of the enterprise."

Paragraph 45, as it read after 23 July 1992 but before 31 March 1994, replaced paragraph 45 of the 1977 Model Convention. Paragraph 45 of the 1977 Model Convention was renumbered as paragraph 46 (cf. history of paragraph 46) and a new paragraph 45 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45.1: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 45.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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Paragraph 46: Corresponds to paragraph 45 of the 1977 Model Convention. Paragraph 46 of the 1977 Model Convention was renumbered as paragraph 47 (cf. history of paragraph 47) and paragraph 45 was renumbered as paragraph 46 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 47: Amended, by adding Korea to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 47 previously read as follows:

> "47. *Greece, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

Paragraph 47 corresponds to paragraph 46 of the 1977 Model Convention. Paragraph 47 of the 1977 Model Convention was renumbered as paragraph 48 (cf. history of paragraph 48) and paragraph 46 was renumbered as paragraph 47 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 48: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 48 read as follows:

> "48. *Korea* and *New Zealand* also reserve the right to tax an enterprise that carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also, in the case of New Zealand, an enterprise where substantial equipment or machinery is being used by, for, or under contract with the enterprise."

Paragraph 48 had been previously amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 21 September 1995, but before 23 October 1997, paragraph 48 read as follows:

> "48. *New Zealand* also reserves the right to tax an enterprise that carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is being used by, for, or under contract with the enterprise."

Paragraph 48 had been previously amended on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Prior to that amendment, paragraph 48 read as follows:

> "48. *New Zealand* also reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is for more than six months being used by, for or under contract with the enterprise."

Paragraph 48 corresponded to paragraph 47 of the 1977 Model Convention. Paragraph 48 of the 1977 Model Convention was amended and renumbered as paragraph 49 (cf. history of paragraph 49) and paragraph 47 was renumbered as paragraph 48 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 49: Corresponds to paragraph 48 of the 1977 Model Convention. Paragraph 48 was renumbered as paragraph 49 and amended by the Report entitled "The Revision of the Model

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Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 48 read as follows:

> "48. *Spain* reserves its position on paragraph 3 so as to be able to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2."

Paragraph 50: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 51: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 51 previously read as follows:

> "51. *Greece* for the purpose of negotiating Conventions with other Member countries would wish to be free to propose paragraph 2 of Article 5 as it is drafted in the 1963 Draft Convention."

Paragraph 51 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 52: Amended, by adding Ireland to the list of countries making the reservation, on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 52 had been previously amended, by adding United Kingdom to the list of countries making the reservation, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 52 previously read as follows:

> "52. Considering the special problems in applying the provisions of the Model Convention to offshore hydrocarbon exploration and exploitation and related activities, *Denmark* and *Norway* reserve the right to insert in a special article provisions relating to such activities."

Paragraph 52 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 53: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 54: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 55: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 55 read as follows:

> "55. *Turkey* reserves the right to treat an enterprise as having a permanent establishment in Turkey if the enterprise carries on planning, supervisory or consultancy activities in connection with a building site or construction or installation project lasting more than six months."

Paragraph 55 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 56: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 56 read as follows:

> "56. New Zealand reserves the right to negotiate the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand."

Paragraph 56 corresponds to paragraph 44, as it read after 23 July 1992 but before 31 March 1994. Paragraph 44 was amended and renumbered as paragraph 56 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 44 previously read as follows:

> "44. While, subject to its reservations in relation to this Article, *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article, it would wish to be free to negotiate for the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand."

Paragraph 57: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 58: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 59: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 60: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 61: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 62: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 63: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 64: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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COMMENTARY ON ARTICLE 6
CONCERNING THE TAXATION OF INCOME FROM IMMOVABLE PROPERTY

1. Paragraph 1 gives the right to tax income from immovable property to the State of source, that is, the State in which the property producing such income is situated. This is due to the fact that there is always a very close economic connection between the source of this income and the State of source. Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income.

2. Defining the concept of immovable property by reference to the law of the State in which the property is situated, as is provided in paragraph 2, will help to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not. The paragraph, however, specifically mentions the assets and rights which must always be regarded as immovable property. In fact such assets and rights are already treated as immovable property according to the laws or the taxation rules of most OECD Member countries. Conversely, the paragraph stipulates that ships, boats and aircraft shall never be considered as immovable property. No special provision has been included as regards income from indebtedness secured by immovable property, as this question is settled by Article 11.

3. Paragraph 3 indicates that the general rule applies irrespective of the form of exploitation of the immovable property. Paragraph 4 makes it clear that the provisions of paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises.

(Amended on 29 April 2000; see HISTORY)

4. It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise, income is only indirectly derived from immovable

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property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner.

(Amended on 29 April 2000; see HISTORY)

Reservations on the Article

5. *Finland* reserves the right to tax income of shareholders in Finnish companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in Finland and held by the company, where such right is based on the ownership of shares or other corporate rights in the company.

(Amended on 23 July 1992; see HISTORY)

6. *France* wishes to retain the possibility of applying the provisions in its domestic laws relative to the taxation of income from shares or rights, which are treated therein as income from immovable property.

7. *Spain* reserves its right to tax income from any form of use of a right to enjoyment of immovable property situated in Spain when such right derives from the holding of shares or other corporate rights in the company owning the property.

(Added on 23 July 1992; see HISTORY)

8. *Canada* reserves the right to include in paragraph 3 a reference to income from the alienation of immovable property.

(Added on 29 April 2000; see HISTORY)

9. *New Zealand* reserves the right to include fishing and rights relating to all natural resources under this Article.

(Added on 29 April 2000; see HISTORY)

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10. The *United States* reserves the right to add a paragraph to Article 6 allowing a resident of a Contracting State to elect to be taxed by the other Contracting State on a net basis on income from real property.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 3 read as follows:

> "3. Paragraph 3 indicates that the general rule applies irrespective of the form of exploitation of the immovable property. Paragraph 4 makes it clear that the provisions of paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises and to income from immovable property used for the performance of independent personal services."

Paragraph 4: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 4 read as follows:

> "4. It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise or of non-industrial and non-commercial activities, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner in which income from immovable property is to be taxed."

Paragraph 5: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by substituting the word "held" for the word "owned".

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 8: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 9: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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Paragraph 10: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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COMMENTARY ON ARTICLE 7
CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.

2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor

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in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. However, since such problems may result in unrelieved double taxation or non taxation of certain profits, it is more important for tax authorities to agree on mutually consistent methods of dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25, than to adopt unilateral interpretations of basic principles to be adhered to despite differences of opinion with other States. In this respect, the methods for solving some of the problems most often encountered are discussed below.

(Amended on 31 March 1994; see HISTORY)

2.1 Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character.

(Added on 29 April 2000; see HISTORY)

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II. Commentary on the provisions of the Article

Paragraph 1

3. This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.

4. There have been, since the 1950s, rapid developments of activities in space: the launching of rockets and spaceships, the permanent presence of many satellites in space with human crews spending longer and longer periods on board, industrial activities being carried out in space, etc. Since all this could give rise to new situations as regards the implementation of double taxation conventions, would it be desirable to insert in the Model Convention special provisions covering these new situations? Firstly, no country envisage extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory. Consequently, space could not be considered as the source of income or profits and hence activities carried out or to be carried out there would not run any new risks of double taxation. Secondly, if there are double taxation problems, the Model Convention, by giving a ruling on the taxing rights of the State of residence and the State of source of the income, should be sufficient to settle them. The same applies with respect to individuals working on board space stations: it is not necessary to derogate from double taxation conventions, since Articles 15 and 19, as appropriate, are sufficient to determine which Contracting State has the right to tax remuneration and Article 4 should make it possible to determine the residence of the persons concerned, it being understood that any difficulties or doubts can be settled in accordance with the mutual agreement procedure.

(Amended on 31 March 1994; see HISTORY)

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5. The second and more important point is that it is laid down — in the second sentence — that when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment, in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other Articles.

(Renumbered on 23 July 1992; see HISTORY)

6. On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view.

(Renumbered on 23 July 1992; see HISTORY)

7. Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to

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prove that that was the case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result.

(Renumbered on 23 July 1992; see HISTORY)

8. Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organisation of modern business is highly complex. In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course, reasons based, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an Article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention.

(Renumbered on 23 July 1992; see HISTORY)

9. It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

(Renumbered on 23 July 1992; see HISTORY)

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10. For the reasons given above, it is thought that the argument that the solution advocated might lead to increased avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organisation and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 2

11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length principle" discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. The arm's length principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may in their bilateral negotiations, agree upon more detailed provisions or amend paragraph 2 to read as follows:

> "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 independent enterprise engaged in the same or similar activities under the same or similar conditions."

(Replaced on 31 March 1994; see HISTORY)

12. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business

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organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 24 to 28 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.

(Replaced on 31 March 1994; see HISTORY)

12.1 This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or,

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conversely, were given the role of intermediary or agent when in reality it was a principal.

(Added on 31 March 1994; see HISTORY)

12.2 In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 17.1 ff below).

(Added on 31 March 1994; see HISTORY)

13. Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the arm's length principle (cf. paragraph 2 above). Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

(Replaced on 31 March 1994; see HISTORY)

14. In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent

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establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figure so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market.

(Renumbered on 23 July 1992; see HISTORY)

15. Many States consider that there is a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law.

(Replaced on 31 March 1994; see HISTORY)

15.1 Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or — in the event that it is

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wound up — its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of overtaxation.

(Added on 31 March 1994; see HISTORY)

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

(Added on 31 March 1994; see HISTORY)

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

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question is further discussed in the report of the Committee on Fiscal Affairs entitled "Attribution of Income to Permanent Establishments"[1]).

(Added on 31 March 1994; see HISTORY)

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

(Added on 31 March 1994; see HISTORY)

Paragraph 3

16. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment

1. *Attribution of Income to Permanent Establishments*, reproduced in Volume II at page R(13)-1.

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allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

(Renumbered on 23 July 1992; see HISTORY)

17. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

(Replaced on 31 March 1994; see HISTORY)

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17.1 In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, i.e. by normally including in the sale price an appropriate profit.

(Added on 31 March 1994; see HISTORY)

17.2 On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of

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which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.[1]

(Added on 31 March 1994; see HISTORY)

17.3 Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material e.g. in the case of machinery, the depreciation costs that relate to its use by each of these parts. It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (sub-paragraph 4 *d*) of Article 5) so that no question of attribution of profit arises in such circumstances.

(Added on 31 March 1994; see HISTORY)

17.4 In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g. payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the

1. Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have already been dealt with in a separate study entitled "The Taxation of Multinational Banking Enterprises" (published under the title *Transfer Pricing and Multinational Enterprises - Three Taxation Issues*, OECD, Paris, 1984) and which are the subject of paragraphs 19 and 20 below.

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enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (e.g. the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge.

(Added on 31 March 1994; see HISTORY)

17.5 The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer.

(Added on 31 March 1994; see HISTORY)

17.6 Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case.

(Added on 31 March 1994; see HISTORY)

17.7 However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the

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costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise.

(Added on 31 March 1994; see HISTORY)

18. Special considerations apply to payments which, under the name of interest, are made to a head office by its permanent establishment with respect to loans made by the former to the latter. In that case, the main issue is not so much whether a debtor/creditor relationship should be recognized within the same legal entity as whether an arm's length interest rate should be charged. This is because:

— from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment;
— from the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity-funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.

(Replaced on 31 March 1994; see HISTORY)

18.1 If debts incurred by the head office of an enterprise were used solely to finance its activity or clearly and exclusively the activity of a particular permanent establishment, the problem would be reduced to one of thin capitalisation of the actual user of such loans. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain extent, the rest of the money borrowed providing basic capital for its permanent establishments.

(Added on 31 March 1994; see HISTORY)

18.2 The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of

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total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality.

(Added on 31 March 1994; see HISTORY)

18.3 Consequently, the majority of Member countries considered that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organization and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below (this question is further discussed in the reports of the Committee entitled "Attribution of Income to Permanent Establishment" and "Thin Capitalisation").

(Added on 31 March 1994; see HISTORY)

19. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. This problem, as well as other problems relating to the transfer of financial assets, are considered in the report on multinational banking enterprises included in the OECD 1984 publication entitled *Transfer Pricing and Multinational Enterprises — Three Taxation Studies*. This Commentary does not depart from the positions expressed in the report on this topic. One issue not discussed in the report relates to the transfer of debts by bankers from one part of the bank to another; this is discussed in paragraphs 15.2 to 15.4 above.

(Replaced on 31 March 1994; see HISTORY)

20. The above-mentioned report also addresses the issue of the attribution of capital to the permanent establishment of a bank in situations where either actual assets were transferred to such a branch and in situations where they were not. Difficulties in practice continue to arise from the differing views of Member countries on these questions and the present Commentary can only emphasise the desirability of agreement on mutually consistent methods of dealing with these problems.

(Replaced on 31 March 1994; see HISTORY)

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21. Another case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skilful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company had been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

(Amended on 31 March 1994; see HISTORY)

22. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the Article is designed to prevent this. Nevertheless it follows from what is said in paragraph 21 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

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

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23. It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

(Renumbered on 23 July 1992; see HISTORY)

24. It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a "separate enterprise" footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, e.g. by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits.

(Renumbered on 23 July 1992; see HISTORY)

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Paragraph 4

25. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

(Renumbered on 23 July 1992; see HISTORY)

26. It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treatises on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use.

(Renumbered on 23 July 1992; see HISTORY)

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27. The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say *in vacuo* that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

(Renumbered on 23 July 1992; see HISTORY)

28. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be

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accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 5

29. In paragraph 4 of Article 5 there are listed a number of examples of activities which, even though carried on at a fixed place of business, are deemed not to be included in the term "permanent establishment". In considering rules for the allocation of profits to a permanent establishment the most important of these examples is the activity mentioned in paragraph 5 of this Article, i.e. the purchasing office.

(Renumbered on 23 July 1992; see HISTORY)

30. Paragraph 5 is not, of course, concerned with the organisation established solely for purchasing; such an organisation is not a permanent establishment and the profits allocation provisions of this Article would not therefore come into play. The paragraph is concerned with a permanent establishment which, although carrying on other business, also carries on purchasing for its head office. In such a case the paragraph provides that the profits of the permanent establishment shall not be increased by adding to them a notional figure for profits from purchasing. It follows, of course, that any expenses that arise from the purchasing activities will also be excluded in calculating the taxable profits of the permanent establishment.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 6

31. This paragraph is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home

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State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 7

32. Although it has not been found necessary in the Convention to define the term "profits", it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD Member countries.

(Renumbered on 23 July 1992; see HISTORY)

33. This interpretation of the term "profits", however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g. dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

(Renumbered on 23 July 1992; see HISTORY)

34. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, and paragraph 2 of Article 21).

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

35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3

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of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discusses the principles governing whether, in the particular case of computer software, payments should be classified as income within Articles 7 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States.

(Amended on 29 April 2000; see HISTORY)

36. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term "profits" with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term "profits" includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits.

(Renumbered on 23 July 1992; see HISTORY)

37. It should also be noted that, whilst the definition of "royalties" in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments "for the use of, or the right to use, industrial, commercial, or scientific equipment", the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 rather than those of Article 12, a result that the Committee on Fiscal Affairs considers to be appropriate given the nature of such income.

(Replaced on 23 July 1992; see HISTORY)

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Observations on the Commentary

38. *Greece* will take into consideration the comments in paragraph 18 above where payments under the name of royalties are made to a head office by its permanent establishment.

(Added on 21 September 1995; see HISTORY)

39. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 2.1 — as far as the method for computing taxes is concerned, national systems are not affected by the new wording of the model, i.e. by the elimination of Article 14.

(Added on 29 April 2000; see HISTORY)

40. *Australia* does not recognise intra-entity transfers for tax purposes. Accordingly, Australia does not allow a mark-up for profit on dealings between permanent establishments or between a permanent establishment and its head office.

(Replaced on 31 March 1994; see HISTORY)

Reservations on the Article

41. *Australia* and *New Zealand* reserve the right to include a provision that will permit their domestic law to apply in relation to the taxation of profits from any form of insurance.

(Amended on 29 April 2000; see HISTORY)

42. *Australia* and *New Zealand* reserve the right to include a provision clarifying their right to tax a share of business profits to which a resident of the other Contracting State is beneficially entitled where those profits are derived by a trustee of a trust estate (other than certain unit trusts that are treated as companies for Australian and New Zealand tax purposes) from the carrying on of a business in Australia or New Zealand, as the case may be, through a permanent establishment.

(Amended on 29 April 2000; see HISTORY)

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43. *Korea*, *Portugal* and *Spain* reserve the right to tax persons performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in any twelve month period, even if they do not have a permanent establishment (or a fixed base) available to them for the purpose of performing such services or activities.

(Added on 29 April 2000; see HISTORY)

44. *Italy* and *Portugal* reserve the right to tax persons performing independent personal services under a separate article which corresponds to Article 14 as it stood before its elimination in 2000.

(Added on 29 April 2000; see HISTORY)

45. The *United States* reserves the right to amend Article 7 to provide that, in applying paragraphs 1 and 2 of the Article, any income or gain attributable to a permanent establishment during its existence may be taxable by the Contracting State in which the permanent establishment exists even if the payments are deferred until after the permanent establishment has ceased to exist. The United States also wishes to note that it reserves the right to apply such a rule, as well, under Articles 11, 12, 13 and 21.

(Added on 29 April 2000; see HISTORY)

46. [Renumbered on 21 September 1995; see HISTORY]

47. [Deleted on 21 September 1995; see HISTORY]

48. [Deleted on 21 September 1995; see HISTORY]

49. [Renumbered on 21 September 1995; see HISTORY]

50. *Turkey* reserves the right to subject income from the leasing of containers to a withholding tax at source in all cases. In case of the application of Articles 5 and 7 to such income, Turkey would like to apply the permanent establishment rule to the simple depot, depot-agency and operational branches cases.

(Added on 23 July 1992; see HISTORY)

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51. *Norway* and the *United States* reserve the right to treat income from the use, maintenance or rental of containers used in international traffic under Article 8 in the same manner as income from shipping and air transport.

(Added on 23 July 1992; see HISTORY)

52. *Australia* and *Portugal* reserve the right to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

(Amended on 29 April 2000; see HISTORY)

53. [Deleted on 29 April 2000; see HISTORY]

54. *Mexico* reserves the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise carried out directly by its home office situated in the other Contracting State, provided that those goods and merchandise are of the same or similar kind as the ones sold through that permanent establishment. The Government of Mexico will apply this rule only as a safeguard against abuse and not as a general "force of attraction" principle; Thus, the rule will not apply when the enterprise proves that the sales have been carried out for reasons other than obtaining a benefit under the Convention.

(Added on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 2 previously read as follows:

> "2. It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organises itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an Article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles."

Paragraph 2.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 4 previously read as follows:

> "4. There have been, over the last decades, rapid developments of activities in space: the launching of rockets and spaceships, the permanent presence of many satellites in space with human crews spending longer and longer periods on board, the prospect in the fairly near future of industrial activities being carried out in satellites, etc. Since all this could give rise to new situations as regards the implementation of double taxation conventions, would it be desirable to insert in the Model Convention special provisions covering these new situations? Firstly, no country envisage extending its tax sovereignty to activities exercised in space or treating these as activities exercised on its territory. Consequently, space could not be considered as the source of income or profits and hence activities carried out or to be carried out there would not run any new risks of double taxation. Secondly, if there are double

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taxation problems, the Model Convention, by giving a ruling on the taxing rights of the State of residence and the State of source of the income, should be sufficient to settle them. The same applies with respect to individuals working on board space stations: it is not necessary to derogate from double taxation conventions, since Articles 15 and 19, as appropriate, are sufficient to determine which Contracting State has the right to tax remuneration and Article 4 should make it possible to determine the residence of the persons concerned, it being understood that any difficulties or doubts can be settled in accordance with the mutual agreement procedure."

Paragraph 4 replaced paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was renumbered as paragraph 5 (cf. history of paragraph 5) and new paragraph 4 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 5: Corresponds to paragraph 4 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was renumbered as paragraph 6 (cf. history of paragraph 6) and paragraph 4 was renumbered as paragraph 5 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 6: Corresponds to paragraph 5 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was renumbered as paragraph 7 (cf. history of paragraph 7) and paragraph 5 was renumbered as paragraph 6 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 7: Corresponds to paragraph 6 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was renumbered as paragraph 8 (cf. history of paragraph 8) and paragraph 6 was renumbered as paragraph 7 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 8: Corresponds to paragraph 7 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was renumbered as paragraph 9 (cf. history of paragraph 9) and paragraph 7 was renumbered as paragraph 8 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 9: Corresponds to paragraph 8 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was renumbered as paragraph 10 (cf. history of paragraph 10) and paragraph 8 was renumbered as paragraph 9 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 10: Corresponds to paragraph 9 of the 1977 Model Convention. Paragraph 10 of the 1977 Model Convention was renumbered as paragraph 11 (cf. history of paragraph 11) and paragraph 9 was renumbered as paragraph 10 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 11: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 11 previously read as follows:

"11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent

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establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may in their bilateral negotiations, agree upon more detailed provisions."

Paragraph 11, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 10 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was amended and renumbered as paragraph 12 (cf. history of paragraph 12) and paragraph 10 was renumbered as paragraph 11 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 12 previously read as follows:

"12. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 24 to 28 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs 17 below and following)."

Paragraph 12, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 11 of the 1977 Model Convention. Paragraph 12 of the 1977 Model Convention was renumbered as paragraph 13 (cf. history of paragraph 13) and paragraph 11 was renumbered as paragraph 12, and amended by replacing the reference therein to paragraphs 16 and 23 to 27 by a reference to paragraphs 17 and 24 to 28, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12.1: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution

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of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 12.2: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 13: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 13 previously read as follows:

> "13. Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts, in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa."

Paragraph 13, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 12 of the 1977 Model Convention. Paragraph 13 of the 1977 Model Convention was renumbered as paragraph 14 (cf. history of paragraph 14) and paragraph 12 was renumbered as paragraph 13 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14: Corresponds to paragraph 13 of the 1977 Model Convention. Paragraph 14 of the 1977 Model Convention was amended and renumbered as paragraph 15 (cf. history of paragraph 15) and paragraph 13 was renumbered as paragraph 14 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 15: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 15 previously read as follows:

> "15. Some States consider that there is a realisation of a taxable profit when an asset, other than trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated in paragraphs 11 to 14 above."

Paragraph 15, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 14 of the 1977 Model Convention. Paragraph 15 of the 1977 Model Convention was renumbered as paragraph 16 (cf. history of paragraph 16) and paragraph 14 was renumbered as paragraph 15, and amended by replacing the reference therein to paragraphs 10 to 13 by a reference to paragraphs 11 to 14, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 15.1: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 15.2: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 15.3: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 15.4: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 16: Corresponds to paragraph 15 of the 1977 Model Convention. Paragraph 16 of the 1977 Model Convention was renumbered as paragraph 17 (cf. history of paragraph 17) and paragraph 15 was renumbered as paragraph 16 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 17: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 17 previously read as follows:

> "17. Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply."

Paragraph 17, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 16 of the 1977 Model Convention. Paragraph 17 of the 1977 Model Convention was renumbered as paragraph 18 (cf. history of paragraph 18) and paragraph 16 was renumbered as paragraph 17 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 17.1: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 17.2: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution

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of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 17.3: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 17.4: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 17.5: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 17.6: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 17.7: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 18: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 18 previously read as follows:

> "18. The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment."

Paragraph 18, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 17 of the 1977 Model Convention. Paragraph 18 of the 1977 Model Convention was renumbered as

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paragraph 19 (cf. history of paragraph 19) and paragraph 17 was renumbered as paragraph 18 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 18.1: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 18.2: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 18.3: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of a previous report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 19: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 19 previously read as follows:

> "19. The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profits should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact, if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a notional commission increasing the profits of the permanent establishment."

Paragraph 19, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 18 of the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was renumbered as paragraph 20 (cf. history of paragraph 20) and paragraph 18 was renumbered as paragraph 19 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 20: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled

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"Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993). Paragraph 20 previously read as follows:

> "20. After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a "commission" figure. While, on one view, to include a "commission" figure in the profits of every permanent establishment that has performed services otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional "commission". In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any credit for "commission". If as a general rule the "separate enterprise" test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional "commission" profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the "commission" element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no "commission" element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no "commission" element should be deducted in determining the profits of the permanent establishment."

Paragraph 20, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 19 of the 1977 Model Convention. Paragraph 20 of the 1977 Model Convention was renumbered as paragraph 21 (cf. history of paragraph 21) and paragraph 19 was renumbered as paragraph 20 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Amended by replacing the words "The third" by "Another" at the beginning of the paragraph, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994, on the basis of Annex III of another report entitled "Attribution of Income to Permanent Establishments" (adopted by the Council of the OECD on 26 November 1993).

Paragraph 21, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 20 of the 1977 Model Convention. Paragraph 21 of the 1977 Model Convention was renumbered as paragraph 22 (cf. history of paragraph 22) and paragraph 20 was renumbered as paragraph 21 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 22: Corresponds to paragraph 21 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention was renumbered as paragraph 23 (cf. history of paragraph 23) and paragraph 21 was renumbered as paragraph 22, and amended by replacing the reference therein to paragraph 20 by a reference to paragraph 21, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 23: Corresponds to paragraph 22 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 22

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was renumbered as paragraph 23 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 24: Corresponds to paragraph 23 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 23 was renumbered as paragraph 24 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 25: Corresponds to paragraph 24 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and paragraph 24 was renumbered as paragraph 25 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 26: Corresponds to paragraph 25 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was renumbered as paragraph 27 (cf. history of paragraph 27) and paragraph 25 was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 27: Corresponds to paragraph 26 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was renumbered as paragraph 28 (cf. history of paragraph 28) and paragraph 26 was renumbered as paragraph 27 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Corresponds to paragraph 27 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was renumbered as paragraph 29 (cf. history of paragraph 29) and paragraph 27 was renumbered as paragraph 28 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Corresponds to paragraph 28 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was renumbered as paragraph 30 (cf. history of paragraph 30) and paragraph 28 was renumbered as paragraph 29 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 30: Corresponds to paragraph 29 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 29 was renumbered as paragraph 30 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 31: Corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was renumbered as paragraph 32 (cf. history of paragraph 32) and paragraph 30 was renumbered as paragraph 31 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 32: Corresponds to paragraph 31 of the 1977 Model Convention. Paragraph 32 of the 1977 Model Convention was renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 31 was renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 33: Corresponds to paragraph 32 of the 1977 Model Convention. Paragraph 33 of the 1977 Model Convention was amended and renumbered as paragraph 34 (cf. history of paragraph 34) and paragraph 32 was renumbered as paragraph 33 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 34: Corresponds to paragraph 33 of the 1977 Model Convention. Paragraph 34 of the 1977 Model Convention was amended and renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 33 was renumbered as paragraph 34, and amended by substituting the word "noted" for "noticed" in the second sentence, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 35: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Prior to 29 April 2000, paragraph 35 read as follows:

> "35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discusses the principles governing whether, in the particular case of computer software, payments should be classified as commercial income within Articles 7 or 14 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States."

Paragraph 35 corresponds to paragraph 34 of the 1977 Model Convention. Paragraph 35 of the 1977 Model Convention was renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 34 was renumbered as paragraph 35 and amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 of the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention and before 23 July 1992, paragraph 34 read as follows:

> "34. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States."

Paragraph 36: Corresponds to paragraph 35 of the 1977 Model Convention. Paragraph 36 of the 1977 Model Convention was renumbered as paragraph 38 (cf. history of paragraph 38) and paragraph 35

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was renumbered as paragraph 36 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 37: Replaced paragraph 37 of the 1977 Model Convention. Paragraph 37 of the 1977 Model Convention was renumbered as paragraph 39 and new paragraph 37 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of two previous reports entitled "The Taxation of Income from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and "The Taxation of Income from the Leasing of Containers" (adopted by the Council of the OECD on 13 September 1983).

Paragraph 38: Added by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995.

An earlier Observation under paragraph 38 was amended and renumbered as paragraph 52 (cf. history of paragraph 52) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 39: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

A previous paragraph 39 was deleted on 31 March 1994 when it was amended and renumbered as paragraph 53 (cf. history of paragraph 53) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 40: Replaced by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 40 previously read as follows:

> "40. While *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations."

Paragraph 40, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 38 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was deleted and paragraph 38 was renumbered as paragraph 40 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 40 read as follows:

> "40. The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase "separate enterprise" to "independent enterprise" and by deleting the last fourteen words."

Paragraph 41: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 41 read as follows:

> "41. *New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of insurance."

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Paragraph 41 corresponds to paragraph 39 of the 1977 Model Convention. Paragraph 39 was renumbered as paragraph 41 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Amended, by adding New Zealand to the countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 42 read as follows:

> "42. *Australia* reserves the right to include a provision clarifying its right to tax a share of business profits to which a resident of the other Contracting State is beneficially entitled where those profits are derived by a trustee of a trust estate (other than certain unit trusts that are treated as companies for Australian tax purposes) from the carrying on of a business in Australia through a permanent establishment."

Paragraph 42 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 43: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

A previous paragraph 43 was deleted by on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention when it was renumbered as paragraph 39 of the Commentary on Article 12 (cf. history of paragraph 39 of the Commentary on Article 12).

Paragraph 44: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

A previous paragraph 44 was deleted on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Paragraph 44 previously read as follows:

> "44. *Canada* and *Japan* reserve the right to subject income derived from the leasing of industrial, commercial or scientific equipment and of containers to a withholding tax at source at a rate equal to that on royalties. However, they would be prepared to agree to apply, on a reciprocal basis, the rules of Article 8 to income derived from the leasing of containers used in international traffic."

Paragraph 44 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 29 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and of paragraph 47 of another report entitled "The Taxation of Income Derived from the Leasing of Containers" (also adopted by the Council of the OECD on 13 September 1983.

Paragraph 45: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

A previous paragraph 45 was deleted on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention" when paragraph 45 was amended and renumbered as paragraph 41 of the Commentary on Article 12 (cf. history of paragraph 41 of the Commentary on Article 12)

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Paragraph 46: Amended and renumbered as paragraph 42 of the Commentary on Article 12 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention"; see the History of that paragraph.

Paragraph 47: Deleted on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Paragraph 47 previously read as follows:

> "47. *Portugal* reserves the right to tax at source as royalties income from the leasing of industrial, commercial or scientific equipment and of containers, as well as income arising from technical assistance in connection with the use of, or the right to use, such equipment and containers."

Paragraph 47 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, partly on the basis of paragraph 31 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and of paragraph 49 of another report entitled "The Taxation of Income Derived from the Leasing of Containers" (also adopted by the Council of the OECD on 13 September 1983).

Paragraph 48: Deleted on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Paragraph 48 previously read as follows:

> "48. *Spain* reserves the right to tax at source as royalties payments from the leasing of industrial, commercial or scientific equipment and of containers."

Paragraph 48 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 31 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and of paragraph 49 of another report entitled "The Taxation of Income Derived from the Leasing of Containers" (also adopted by the Council of the OECD on 13 September 1983).

Paragraph 49: Renumbered as paragraph 46 of the Commentary on Article 12 (cf. history of paragraph 46 of the Commentary on Article 12) by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995.

Paragraph 50: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 50 of a previous report entitled "The Taxation of Income Derived from the Leasing of Containers" (adopted by the Council of the OECD on 13 September 1983).

Paragraph 51: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 52: Amended, by deleting New Zealand and adding Portugal in the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000 but after 31 March 1994, paragraph 52 read as follows:

> "52. *Australia* and *New Zealand* reserve the right to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such

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law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article."

Paragraph 52, as it read immediately before 29 April 2000, corresponded to paragraph 38, as it read before 31 March 1994, which was amended and renumbered as paragraph 52 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 38 previously read as follows:

"38. *Australia* and *New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article."

Paragraph 38, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 36 of the 1977 Model Convention. Paragraph 38 of the 1977 Model Convention was renumbered as paragraph 40 (cf. history of paragraph 40) and paragraph 36 was renumbered as paragraph 38 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 53: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 53 previously read as follows:

"53. *Australia* reserves the right to include a provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise."

Paragraph 53, as it read before 29 April 2000, corresponded to paragraph 39 as it read before 31 March 1994, which was amended and renumbered as paragraph 53 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 39 previously read as follows:

"39. *Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise."

Paragraph 39, as it read after 23 July 1992 but before 31 March 1994, corresponded to paragraph 37 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was renumbered as paragraph 41 (cf. history of paragraph 41) and paragraph 37 was renumbered as paragraph 39 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 54: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

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COMMENTARY ON ARTICLE 8
CONCERNING THE TAXATION OF PROFITS FROM SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Paragraph 1

1. The object of paragraph 1 concerning profits from the operation of ships or aircraft in international traffic is to secure that such profits will be taxed in one State alone. The provision is based on the principle that the taxing right shall be left to the Contracting State in which the place of effective management of the enterprise is situated. The term "international traffic" is defined in subparagraph *d*) of paragraph 1 of Article 3.

2. In certain circumstances the Contracting State in which the place of effective management is situated may not be the State of which an enterprise operating ships or aircraft is a resident, and some States therefore prefer to confer the exclusive taxing right on the State of residence. Such States are free to substitute a rule on the following lines:

> "Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State."

3. Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:

> "Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from the operation of ships or aircraft, other than those

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from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that other State."

4. The profits covered consist in the first place of the profits obtained by the enterprise from the carriage of passengers or cargo. With this definition, however, the provision would be unduly restrictive, in view of the development of shipping and air transport, and for practical considerations also. The provision therefore covers other classes of profits as well, i.e. those which by reason of their nature or their close relationship with the profits directly obtained from transport may all be placed in a single category. Some of these classes of profits are mentioned in the following paragraphs.

5. Profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article 7, and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft.

(Amended on 31 March 1994; see HISTORY)

6. The principle that the taxing right should be left to one Contracting State alone makes it unnecessary to devise detailed rules, e.g. for defining the profits covered, this being rather a question of applying general principles of interpretation.

7. Shipping and air transport enterprises—particularly the latter—often engage in additional activities more or less closely connected with the direct operation of ships and aircraft. Although it would be out of the question to list here all the auxiliary activities which could properly be brought under the provision, nevertheless a few examples may usefully be given.

8. The provision applies, inter alia, to the following activities:

a) the sale of passage tickets on behalf of other enterprises;
b) the operation of a bus service connecting a town with its airport;
c) advertising and commercial propaganda;
d) transportation of goods by truck connecting a depot with a port or airport.

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9. If an enterprise engaged in international transport undertakes to see to it that, in connection with such transport, goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this Article.

10. Recently, "containerisation" has come to play an increasing role in the field of international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article.

10.1 Another case would be that of a transport enterprise that would be required to have assets or personnel in a foreign country for purposes of operating its ships or aircraft in international traffic and that would derive income from providing goods or services in that country to other transport enterprises. This would include (for example) the provision of goods and services by engineers, ground staff, cargo handlers, catering staff and customer services personnel. Since the income so derived would not be related to the operation of ships or aircraft by the enterprise itself, that income would normally not fall within the scope of Article 8. Where, however, the enterprise provides goods to, or performs services for, another person that are supplementary or incidental to its operation of ships or aircraft in international traffic, the profits from the provision of such goods or services will fall under Article 8. Although the same considerations apply to a pool, joint business or international operating agency for the purposes of paragraph 4, what is required in that case is to examine how closely the activity is connected with the international transport activities of the pool, joint business or international operating agency as opposed to the activities of the individual enterprises participating in such arrangements.

(Added on 29 April 2000; see HISTORY)

11. On the other hand, the provision does not cover a clearly separate activity such as the keeping of a hotel as a separate business; the profits from such an establishment are in any case easily determinable. In certain cases, however, circumstances are such that the provision must apply even to a hotel business e.g. the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation, the cost of such a service being included in the price

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of the passage ticket. In such a case, the hotel can be regarded as a kind of waiting room.

12. There is another activity which is excluded from the field of application of the provision, namely a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.

13. It may be agreed bilaterally that profits from the operation of vessels engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this Article.

14. Investment income of shipping, inland waterways or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income, except where the investment that generates the income is made as an integral part of the carrying on of the business of operating the ships or aircraft in international traffic in the Contracting State. Thus, the Article would apply to interest income generated, for example, by the cash required in a Contracting State for the carrying on of that business or by bonds posted as security where this is required by law in order to carry on the business; it would not apply, however, to interest income derived in the course of the handling of cash-flow or other treasury activities for permanent establishments of the enterprise to which the income is not attributable or for associated enterprises, regardless of whether these are located within or outside that Contracting State, or for the head office (centralisation of treasury and investment activities), nor would it apply to interest income generated by the short-term investment of the profits generated by the local operation of the business where the funds invested are not required for that operation.

(Amended on 29 April 2000; see HISTORY)

Paragraph 2

15. The rules with respect to the taxing right of the State of residence as set forth in paragraphs 2 and 3 above apply also to this paragraph of the Article.

16. The object of this paragraph is to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic. The

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provision applies not only to inland waterways transport between two or more countries, but also to inland waterways transport carried on by an enterprise of one country between two points in another country.

17. The provision does not prevent specific tax problems which may arise in connection with inland waterways transport, in particular between adjacent countries, from being settled specially by bilateral agreement.

Enterprises not exclusively engaged in shipping, inland waterways transport or air transport

18. It follows from the wording of paragraphs 1 and 2 that enterprises not exclusively engaged in shipping, inland waterways transport or air transport nevertheless come within the provisions of these paragraphs as regards profits arising to them from the operation of ships, boats or aircraft belonging to them.

19. If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping, inland waterways transport or air transport.

20. Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be attributed to the permanent establishment. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g. consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g. staff costs). In this case, the permanent establishment's expenditure in respect of the operation of the ships, boats or aircraft should be attributed not to the permanent establishment but to the enterprise itself, since none of the profit obtained through the carrying benefits the permanent establishment.

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21. Where ships or aircraft are operated in international traffic, the application of the Article to the profits arising from such operation will not be affected by the fact that the ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise (for example, ships or aircraft put into service by the permanent establishment or figuring on the balance sheet of the permanent establishment).

(Replaced on 29 April 2000; see HISTORY)

Paragraph 3

22. This paragraph deals with the particular case where the place of effective management of the enterprise is aboard a ship or a boat. In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident.

Paragraph 4

23. Various forms of international co-operation exist in shipping or air transport. In this field international co-operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business.

24. In order to clarify the taxation position of the participant in a pool, joint business or in an international operating agency and to cope with any difficulties which may arise the Contracting States may bilaterally add the following, if they find it necessary:

> "but only to so much of the profits so derived as is attributable to the participant in proportion to its share in the joint operation."

25. [Amended and renumbered as paragraph 34 on 31 March 1994; see HISTORY]

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Observations on the Commentary

26. While agreeing in principle to abide by the provisions of Article 8 in bilateral conventions, *Turkey* intends in exceptional cases to apply the permanent establishment rule in taxing international transport profits.

27. *Portugal* and *Turkey* reserve the right, in the course of negotiations for concluding conventions with other Member countries, to propose that the part of inland transport (cf. paragraph 9 above) carried out by means other than that employed for international transport be excluded from the scope of the Article, whether or not the means of transport belong to the transporting enterprise.

(Amended on 23 July 1992; see HISTORY)

28. *Portugal* and *Turkey* also reserve the right, in the course of such negotiations, to propose that the leasing of containers (cf. paragraph 10 above) even if supplementary or incidental be regarded as an activity separate from international shipping or aircraft operations, and consequently be excluded from the scope of the Article.

(Amended on 23 July 1992; see HISTORY)

29. *Germany* reserves its position as to the application of the Article to income from inland transportation and container services (cf. paragraphs 9 and 10 above).

30. *Greece* will apply Article 12 to payments from leasing a ship or aircraft on a bareboat charter basis.

(Added on 21 September 1995; see HISTORY)

30.1 *Australia* does not agree with the interpretations given in paragraphs 8 *d*) and 9. Australia takes the view that international operation of ships and aircraft does not include inland transportation.

(Added on 29 April 2000; see HISTORY)

Reservations on the Article

31. *Canada, Hungary, Mexico, New Zealand* and *Poland* reserve the right to tax as profits from internal traffic profits from the carriage of passengers or cargo taken on board at one place in a respective country for discharge at

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another place in the same country. *New Zealand* also reserves the right to tax as profits from internal traffic profits from other coastal and continental shelf activities.

(Amended on 29 April 2000; see HISTORY)

32. *Canada, Turkey* and the *United States* reserve the right not to extend the scope of the Article to cover inland transportation in bilateral conventions (paragraph 2 of the Article).

(Renumbered on 21 September 1995; see HISTORY)

33. *Denmark, Norway* and *Sweden* reserve the right to insert special provisions regarding profits derived by the air transport consortium Scandinavian Airlines System (SAS).

(Renumbered on 21 September 1995; see HISTORY)

34. The *United Kingdom* reserves the right to include in paragraph 1 of the Article profits from the leasing of ships or aircraft on a bare boat basis (cf. paragraph 5 above) and from the leasing of containers (cf. paragraph 10 above).

(Renumbered on 21 September 1995; see HISTORY)

35. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic.

(Renumbered on 21 September 1995; see HISTORY)

36. *Mexico* reserves the right to tax at source profits derived from the provision of accommodation.

(Added on 21 September 1995; see HISTORY)

37. *Poland* reserves the right to broaden the scope of the Article to cover transport by road vehicles and to make a corresponding change to the definition of "international traffic" in Article 3.

(Added on 23 October 1997; see HISTORY)

38. *Australia* reserves the right to tax profits from the carriage of passengers or cargo taken on board at one place in Australia for discharge in Australia.

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Australia also reserves the right to tax profits from other coastal and continental shelf activities.

(Added on 29 April 2000; see HISTORY)

39. The *United States* reserves the right to include within the scope of paragraph 1, income from the rental of ships and aircraft on a full basis, and on a bareboat basis if either the ships or aircraft are operated in international traffic by the lessee, or if the rental income is incidental to profits from the operation of ships or aircraft in international traffic. The United States also reserves the right to include within the scope of the paragraph, income from the use, maintenance or rental of containers used in international traffic.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 5 previously read as follows:

> "5. Profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. The Article does not apply to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft."

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Unchanged from the 1977 Model Convention.

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 10.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 11: Unchanged from the 1977 Model Convention.

Paragraph 12: Unchanged from the 1977 Model Convention.

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 14 read as follows:

> "14. Investment income of shipping, inland waterways or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income."

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Unchanged from the 1977 Model Convention.

Paragraph 19: Unchanged from the 1977 Model Convention.

Paragraph 20: Unchanged from the 1977 Model Convention.

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Paragraph 21: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention and until 29 April 2000, paragraph 21 read as follows:

> "21. Where the enterprise's ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise (e.g. ships or aircraft put into service by the permanent establishment and figuring on its balance sheet), then the effective management for the purposes of paragraphs 1 and 2 must be considered, as regards the operation of the ships or aircraft, as being in the Contracting State in which the permanent establishment is situated."

Paragraph 22: Unchanged from the 1977 Model Convention.

Paragraph 23: Unchanged from the 1977 Model Convention.

Paragraph 24: Unchanged from the 1977 Model Convention.

Paragraph 25: Amended and renumbered as paragraph 34 (cf. history of paragraph 34) by the report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 26: Unchanged from the 1977 Model Convention.

Paragraph 27: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting Spain from the list of countries making the observation. In the 1977 Model Convention, paragraph 27 read as follows:

> "27. *Portugal*, *Spain* and *Turkey* reserve the right, in the course of negotiations for concluding conventions with other Member countries, to propose that the part of inland transport (cf. paragraph 9 above) carried out by means other than that employed for international transport be excluded from the scope of the Article, whether or not the means of transport belong to the transporting enterprise."

Paragraph 28: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by substituting the words "*Portugal* and *Turkey*" for the words "These countries" at the beginning of the paragraph. In the 1977 Model Convention, paragraph 28 read as follows:

> "28. These countries also reserve the right, in the course of such negotiations, to propose that the leasing of containers (cf. paragraph 10 above) even if supplementary or incidental be regarded as an activity separate from international shipping or aircraft operations, and consequently be excluded from the scope of the Article."

Paragraph 29: Unchanged from the 1977 Model Convention.

Paragraph 30: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 30.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 31: Amended, by deleting Australia from the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 31 read as follows:

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> "31. *Australia*, *Canada*, *Hungary*, *Mexico*, *New Zealand* and *Poland* reserve the right to tax as profits from internal traffic profits from the carriage of passengers or cargo taken on board at one place in a respective country for discharge at another place in the same country. *Australia* and *New Zealand* also reserve the right to tax as profits from internal traffic profits from other coastal and continental shelf activities."

Paragraph 31 had been previously amended, by adding Hungary and Poland to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 21 September 1995, but before 23 October 1997 paragraph 31 read as follows:

> "31. *Australia*, *Canada*, *Mexico* and *New Zealand* reserve the right to tax as profits from internal traffic profits from the carriage of passengers or cargo taken on board at one place in a respective country for discharge at another place in the same country. *Australia* and *New Zealand* also reserve the right to tax as profits from internal traffic profits from other coastal and continental shelf activities."

Paragraph 31 corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was amended, by adding Mexico and New Zealand to the list of countries making the reservation, and renumbered as paragraph 31 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". In the 1977 Model Convention paragraph 30 read as follows:

> "30. *Australia* and *Canada*, reserve the right to tax as profits from internal traffic profits from the carriage of passengers or cargo taken on board at one place in a respective country for discharge at another place in the same country. *Australia* also reserves the right to tax as profits from internal traffic profits from other coastal and continental shelf activities."

Paragraph 32: Corresponds to paragraph 31 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was renumbered as paragraph 32 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 33: Corresponds to paragraph 32 of the 1992 Model Convention. Paragraph 32 of the 1992 Model Convention was renumbered as paragraph 33 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 32 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 34: Corresponds to paragraph 33 of the 1992 Model Convention. Paragraph 33 of the 1992 Model Convention was renumbered as paragraph 34 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 33 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 35: Corresponds to paragraph 34 of the 1994 Model Convention. Paragraph 34 of the 1994 Model Convention was renumbered as paragraph 35 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 34 corresponded to paragraph 25 of the 1977 Model Convention. Paragraph 25 was amended and renumbered as paragraph 34 by the Report entitled "1994 Update to the Model Tax

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Convention", adopted by the Council of the OECD on 31 March 1994. Prior 31 March 1994 paragraph 25 read as follows:

> "25. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Paragraph 36: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 37: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 38: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 39: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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COMMENTARY ON ARTICLE 9
CONCERNING THE TAXATION OF ASSOCIATED ENTERPRISES

1. This Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms. The Committee has spent considerable time and effort (and continues to do so) examining the conditions for the application of this Article, its consequences and the various methodologies which may be applied to adjust profits where transactions have been entered into on other than arm's length terms. Its conclusions are set out in the report entitled *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[1], which is periodically updated to reflect the progress of the work of the Committee in this area. That report represents internationally agreed principles and provides guidelines for the application of the arm's length principle of which the Article is the authoritative statement.

(Replaced on 23 October 1997; see HISTORY)

Paragraph 1

2. This paragraph provides that the taxation authorities of a Contracting State may, for the purpose of calculating tax liabilities of associated enterprises, re-write the accounts of the enterprises if, as a result of the special relations between the enterprises, the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances. The provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis).

(Amended and renumbered on 23 October 1997; see HISTORY)

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1. The original version of that report was approved by the Council of the OECD on 27 June 1995. Published in a loose-leaf format as *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995.

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3. As discussed in the Committee on Fiscal Affairs' Report on Thin Capitalisation,[1] there is an interplay between tax treaties and domestic rules on thin capitalisation relevant to the scope of the Article. The Committee considers that:

a) the Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;

b) the Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;

c) the application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

(Amended and renumbered on 23 October 1997; see HISTORY)

4. The question arises as to whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all Member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with

1. Adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II at page R(4)-1.

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such situations by means of corresponding adjustments (see below) and under mutual agreement procedures.

(Replaced on 23 July 1992; see HISTORY)

Paragraph 2

5. The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B. Paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation.

(Renumbered on 23 July 1992; see HISTORY)

6. It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount.

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

7. The paragraph does not specify the method by which an adjustment is to be made. OECD Member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the

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other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

(Renumbered on 23 July 1992; see HISTORY)

8. It is not the purpose of the paragraph to deal with what might be called "secondary adjustments". Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1 and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y) and that in those circumstances there could have been other tax consequences (e.g. the operation of a withholding tax) depending upon the type of income concerned and the provisions of the Article dealing with such income.

(Renumbered on 23 July 1992; see HISTORY)

9. These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

(Renumbered on 23 July 1992; see HISTORY)

10. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended, in other words, that however many

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years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment (see on this point paragraphs 28, 29 and 30 of the Commentary on Article 25).

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

11. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented; the Commentary on that Article contains a number of considerations applicable to adjustments of the profits of associated enterprises carried out on the basis of the present Article (following, in particular, adjustment of transfer prices) and to the corresponding adjustments which must then be made in pursuance of paragraph 2 thereof (see in particular paragraphs 9, 10, 22, 23, 29 and 30 of the Commentary on Article 25).

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

Observations on the Commentary

12. [Amended and renumbered as paragraph 18 on 31 March 1994; see HISTORY]

13. [Deleted on 31 March 1994; see HISTORY]

14. *Germany* does not agree with the use of the term "arm's length profits" in paragraph 2 above.

(Added on 23 July 1992; see HISTORY)

15. The *United States* observes that there may be reasonable ways to address cases of thin capitalisation other than changing the character of the financial instrument from debt to equity and the character of the payment from interest to a dividend. For instance, in appropriate cases, the character of the instrument (as debt) and the character of the payment (as interest) may be unchanged, but the

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taxing State may defer the deduction for interest paid that otherwise would be allowed in computing the borrower's net income.

(Added on 23 July 1992; see HISTORY)

Reservations on the Article

16. The *Czech Republic*, *Finland*, *Hungary*, *Mexico*, *Norway* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions. The *Czech Republic*, however, is prepared in the course of negotiations to accept this paragraph and at the same time to add a third paragraph limiting the potential corresponding adjustment to bona fide cases.

(Amended on 29 April 2000; see HISTORY)

17. With respect to paragraph 2, *Belgium*, *France*, *Hungary*, *Poland* and *Portugal* reserve the right to specify in their conventions that they will proceed to a correlative adjustment if they consider this adjustment to be justified.

(Amended on 29 April 2000; see HISTORY)

18. *Australia* reserves the right to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

(Amended on 29 April 2000; see HISTORY)

19. *Canada* reserves the right not to insert paragraph 2 in its conventions unless the commitment to make an adjustment is subject to certain time limitations and does not apply in the case of fraud, wilful default or neglect.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Corresponds to paragraph 3 as it read immediately before 23 October 1997. Paragraph 1 was amended and renumbered as paragraph 2 (cf. history of paragraph 2) and paragraph 3 was amended and renumbered as paragraph 1 by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 3 previously read as follows:

> "3. The Committee has also studied the transfer pricing of goods, technology, trade marks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms. Its conclusions, which are set out in the report entitled "Transfer Pricing and Multinational Enterprises",[1] represent internationally agreed principles and provide valid guidelines for the application of the arm's length principle which underlies the Article.
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> 1. Adopted by the Council of the OECD on 16 May 1979. Published as "*Transfer Pricing and Multinational Enterprises*", OECD, Paris, 1979."

Paragraph 2: Corresponds to paragraph 1 as it read immediately before 23 October 1997. Paragraph 2 was amended and renumbered as paragraph 3 (cf. history of paragraph 3) and paragraph 1 was amended and renumbered as paragraph 2 by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 1 previously read as follows:

> "1. This Article deals with associated enterprises (parent and subsidiary companies and companies under common control) and its paragraph 1 provides that in such cases the taxation authorities of a Contracting State may for the purpose of calculating tax liabilities re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that adjustment should be sanctioned in such circumstances, and this paragraph seems to call for very little comment. It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's length basis)."

Paragraph 1 as it read before 23 October 1997 had replaced paragraph 2 of the 1977 Model Convention. Paragraph 2 of the 1977 Model Convention was renumbered as paragraph 5 (cf. history of paragraph 5) and new paragraph 2 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 48, 50 and 84 of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 3: Corresponds to paragraph 2 as it read immediately before 23 October 1997. Paragraph 3 was amended and renumbered as paragraph 1 (cf. history of paragraph 1) and paragraph 2 was amended, by replacing the footnote thereto, and renumbered as paragraph 3 by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. The footnote to paragraph 2 previously read as follows:

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"1. Adopted by the Council of the OECD on 26 November 1986. Published in *Thin Capitalisation — Taxation of Entertainers, Artistes and Sportsmen*, in "Issues in International Taxation" No. 2, OECD, Paris, 1987."

Paragraph 3, as it read before 23 October 1997, had replaced paragraph 3 of the 1977 Model Convention. Paragraph 3 of the 1977 Model Convention was amended and renumbered as paragraph 6 (cf. history of paragraph 6) and new paragraph 3 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 30 to 32 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 4: Replaced paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was renumbered as paragraph 7 (cf. history of paragraph 7) and new paragraph 4 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 30 to 32 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 5: Corresponds to paragraph 2 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was renumbered as paragraph 8 (cf. history of paragraph 8) and paragraph 2 was renumbered as paragraph 5 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 6: Corresponds to paragraph 3 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was renumbered as paragraph 9 (cf. history of paragraph 9) and paragraph 3 was renumbered as paragraph 6 and its second sentence amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982). In the 1977 Model Convention, the second sentence of paragraph 3 read as follows:

> "In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis."

Paragraph 7: Corresponds to paragraph 4 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was amended and renumbered as paragraph 10 (cf. history of paragraph 10) and paragraph 4 was renumbered as paragraph 7 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 8: Corresponds to paragraph 5 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was amended and renumbered as paragraph 11 (cf. history of paragraph 11) and paragraph 5 was renumbered as paragraph 8 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 9: Corresponds to paragraph 6 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was renumbered as paragraph 12 (cf. history of paragraph 12) and paragraph 6 was renumbered as paragraph 9 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 10: Corresponds to paragraph 7 of the 1977 Model Convention. Paragraph 10 of the 1977 Model Convention was renumbered as paragraph 13 (cf. history of paragraph 13) and paragraph 7 was

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renumbered as paragraph 10 and amended by adding the reference to the Commentary on Article 25 at the end thereof, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 11: Corresponds to paragraph 8 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was amended and renumbered as paragraph 16 (cf. history of paragraph 16) and paragraph 8 was amended and renumbered as paragraph 11 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 8 read as follows:

> "8. If there is a dispute between the interested parties over the character and amount of the appropriate adjustment, the matter will be dealt with in the same way as any other question of fact; if necessary the competent authorities may consult each other."

Paragraph 12: Amended and renumbered as paragraph 18 (cf. history of paragraph 18) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 13: Deleted by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 13 previously read as follows:

> "13. *Australia* would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise."

Paragraph 13, as it read after 23 July 1992 and before 31 March 1994, corresponded to paragraph 10 of the 1977 Model Convention. Paragraph 10 was renumbered as paragraph 13 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 89 of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 15: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 16: Amended, by deleting Portugal from the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 16 read as follows:

> "16. The *Czech Republic, Finland, Hungary, Mexico, Norway, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions. The Czech Republic, however, is prepared in the course of negotiations to accept this paragraph and at the same time to add a third paragraph limiting the potential corresponding adjustment to bona fide cases."

Paragraph 16 had been previously amended, by deleting Belgium and adding the Czech Republic and Hungary to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 21 September 1995, but before 23 October 1997 paragraph 16 read as follows:

> "16. *Belgium, Finland, Mexico, Norway, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions."

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Paragraph 16 was previously amended, by adding Mexico to the list of countries making the reservation, on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 16 corresponds to paragraph 11 of the 1977 Model Convention. Paragraph 11 was amended and renumbered as paragraph 16 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 11 read as follows:

> "11. *Belgium*, *Finland*, *Germany*, *Italy*, *Japan*, *Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions."

Paragraph 17: Amended, by adding Portugal to the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 17 read as follows:

> "17. With respect to paragraph 2, *Belgium*, *France*, *Hungary* and *Poland* reserve the right to specify in their conventions that they will proceed to a correlative adjustment if they consider this adjustment to be justified."

Paragraph 17 had been previously amended, by adding Belgium, Hungary and Poland to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 23 July 1992, but before 23 October 1997 paragraph 17 read as follows:

> "17. With respect to paragraph 2, *France* reserves the right to specify in its conventions that it will proceed to a correlative adjustment if it considers this adjustment to be justified."

Paragraph 17 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 18: Amended, by deleting New Zealand from the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 18 read as follows:

> "18. *Australia* and *New Zealand* reserve the right to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article."

Paragraph 18 had been previously amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 31 March 1994, but before 23 October 1997 paragraph 18 read as follows:

> "18. In negotiating conventions with other Member countries, *Australia* and *New Zealand* reserve the right to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article."

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Paragraph 18 corresponds to paragraph 12, as it read after 23 July 1992 and before 31 March 1994, which was amended and renumbered as paragraph 18 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 12 previously read as follows:

> "12. In negotiating conventions with other Member countries, *Australia* and *New Zealand* would wish to be free to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article."

Paragraph 12, as it read after 23 July 1992 and before 31 March 1994, corresponded to paragraph 9 of the 1977 Model Convention. Paragraph 12 of the 1977 Model Convention was deleted and paragraph 9 was renumbered as paragraph 12 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 12 read as follows:

> "12. The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State and a related enterprise of the other Contracting State, and that it should apply to "income, deductions, credits or allowances", not just to "profits".

Paragraph 19: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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COMMENTARY ON ARTICLE 10
CONCERNING THE TAXATION OF DIVIDENDS

I. Preliminary remarks

1. By "dividends" is generally meant the distribution of profits to the shareholders by companies limited by shares[1], limited partnerships with share capital[2] limited liability companies[3] or other joint stock companies[4]. Under the laws of the OECD Member countries, such joint stock companies are legal entities with a separate juridical personality distinct from all their shareholders. On this point, they differ from partnerships insofar as the latter do not have juridical personality in most countries.

2. The profits of a business carried on by a partnership are the partners' profits derived from their own exertions; for them they are business profits. So the partner is ordinarily taxed personally on his share of the partnership capital and partnership profits.

(Amended on 29 April 2000; see HISTORY)

3. The position is different for the shareholder; he is not a trader and the company's profits are not his; so they cannot be attributed to him. He is personally taxable only on those profits which are distributed by the company (apart from the provisions in certain countries' laws relating to the taxation of undistributed profits in special cases). From the shareholders' standpoint, dividends are income from the capital which they have made available to the company as its shareholders.

1. "Sociétés anonymes".
2. "Sociétés en commandite par actions".
3. "Sociétés à responsabilité limitée".
4. "Sociétés de capitaux".

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II. Commentary on the provisions of the Article

Paragraph 1

4. Paragraph 1 does not prescribe the principle of taxation of dividends either exclusively in the State of the beneficiary's residence or exclusively in the State of which the company paying the dividends is a resident.

5. Taxation of dividends exclusively in the State of source is not acceptable as a general rule. Furthermore, there are some States which do not have taxation of dividends at the source, while as a general rule, all the States tax residents in respect of dividends they receive from non-resident companies.

6. On the other hand, taxation of dividends exclusively in the State of the beneficiary's residence is not feasible as a general rule. It would be more in keeping with the nature of dividends, which are investment income, but it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished.

7. For this reason, paragraph 1 states simply that dividends may be taxed in the State of the beneficiary's residence. The term "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom.

8. The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases, cf. paragraphs 4 to 6 of the Commentary on Article 21).

Paragraph 2

9. Paragraph 2 reserves a right to tax to the State of source of the dividends, i.e. to the State of which the company paying the dividends is a resident; this right to tax, however, is limited considerably. The rate of tax is limited to 15 per

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cent, which appears to be a reasonable maximum figure. A higher rate could hardly be justified since the State of source can already tax the company's profits.

10. On the other hand, a lower rate (5 per cent) is expressly provided in respect of dividends paid by a subsidiary company to its parent company. If a company of one of the States owns directly a holding of at least 25 per cent in a company of the other State, it is reasonable that payments of profits by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international investment. The realisation of this intention depends on the fiscal treatment of the dividends in the State of which the parent company is a resident (cf. paragraphs 49 to 54 of the Commentary on Articles 23 A and 23 B).

11. If a partnership is treated as a body corporate under the domestic laws applying to it, the two Contracting States may agree to modify sub-paragraph *a*) of paragraph 2 in a way to give the benefits of the reduced rate provided for parent companies also to such partnership.

12. Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries.) States which wish to make this more explicit are free to do so during bilateral negotiations.

(Amended on 21 September 1995; see HISTORY)

13. The tax rates fixed by the Article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. The reduction of rates provided for in paragraph 2 refers solely to the taxation of dividends and not to the taxation of the profits of the company paying the dividends.

14. The two Contracting States may also, during bilateral negotiations, agree to a holding percentage lower than that fixed in the Article. A lower percentage is, for instance, justified in cases where the State of residence of the parent company,

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in accordance with its domestic law, grants exemption to such a company for dividends derived from a holding of less than 25 per cent in a non-resident subsidiary.

15. In sub-paragraph *a*) of paragraph 2, the term "capital" is used in relation to the taxation treatment of dividends, i.e. distributions of profits to shareholders. The use of this term in this context implies that, for the purposes of sub-paragraph *a*), it should be used in the sense in which it is used for the purposes of distribution to the shareholder (in the particular case, the parent company).

a) As a general rule, therefore, the term "capital" in sub-paragraph *a)* should be understood as it is understood in company law. Other elements, in particular the reserves, are not to be taken into account.

b) Capital, as understood in company law, should be indicated in terms of par value of all shares which in the majority of cases will be shown as capital in the company's balance sheet.

c) No account need be taken of differences due to the different classes of shares issued (ordinary shares, preference shares, plural voting shares, non-voting shares, bearer shares, registered shares, etc.), as such differences relate more to the nature of the shareholder's right than to the extent of his ownership of the capital.

d) When a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when on the basis of internal law or practice ("thin capitalisation", or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as "capital" within the meaning of sub-paragraph *a*).

e) In the case of bodies which do not have a capital within the meaning of company law, capital for the purpose of sub-paragraph *a*) is to be taken as meaning the total of all contributions to the body which are taken into account for the purpose of distributing profits.

In bilateral negotiations, Contracting States may depart from the criterion of "capital" used in sub-paragraph *a*) of paragraph 2 and use instead the criterion of "voting power".

16. Sub-paragraph *a*) of paragraph 2 does not require that the company receiving the dividends must have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This means that all that

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counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, i.e. in most cases the situation existing at the time when the dividends become legally available to the shareholders. The primary reason for this resides in the desire to have a provision which is applicable as broadly as possible. To require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD Member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received. In view of this, Contracting States may include a similar condition in their conventions.

17. The reduction envisaged in sub-paragraph *a*) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to sub-paragraph *a*) a provision along the following lines:

> "provided that this holding was not acquired primarily for the purpose of taking advantage of this provision".

18. Paragraph 2 lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.

19. The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a refund. Specific questions arise with triangular cases (see paragraph 53 of the Commentary on Article 24).

(Amended on 23 July 1992; see HISTORY)

20. It does not specify whether or not the relief in the State of source should be conditional upon the dividends being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

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21. The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the dividends. This question is dealt with in Articles 23 A and 23 B.

22. Attention is drawn generally to the following case: the beneficial owner of the dividends arising in a Contracting State is a company resident of the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the dividends the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.

Paragraph 3

23. In view of the great differences between the laws of OECD Member countries, it is impossible to define "dividends" fully and exhaustively. Consequently, the definition merely mentions examples which are to be found in the majority of the Member countries' laws and which, in any case, are not treated differently in them. The enumeration is followed up by a general formula. In the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution that does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between Member countries in the field of company law and taxation law, it did not appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws. It is open to the Contracting States, through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of "dividends" other payments by companies falling under the Article.

(Amended on 23 July 1992; see HISTORY)

24. The notion of dividends basically concerns distributions by companies within the meaning of sub-paragraph *b*) of paragraph 1 of Article 3. Therefore the definition relates, in the first instance, to distributions of profits the title to

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which is constituted by shares, that is holdings in a company limited by shares (joint stock company). The definition assimilates to shares all securities issued by companies which carry a right to participate in the companies' profits without being debt-claims; such are, for example, "jouissance" shares or "jouissance" rights, founders' shares or other rights participating in profits. In bilateral conventions, of course, this enumeration may be adapted to the legal situation in the Contracting States concerned. This may be necessary in particular, as regards income from "jouissance" shares and founders' shares. On the other hand, debt-claims participating in profits do not come into this category; (cf. paragraph 19 of the Commentary on Article 11); likewise interest on convertible debentures is not a dividend.

(Amended on 23 July 1992; see HISTORY)

25. Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company, i.e. when repayment depends largely on the success or otherwise of the enterprise's business. Articles 10 and 11 do not therefore prevent the treatment of this type of interest as dividends under the national rules on thin capitalisation applied in the borrower's country. The question whether the contributor of the loan shares the risks run by the enterprise must be determined in each individual case in the light of all the circumstances, as for example the following:

— the loan very heavily outweighs any other contribution to the enterprise's capital (or was taken out to replace a substantial proportion of capital which has been lost) and is substantially unmatched by redeemable assets;
— the creditor will share in any profits of the company;
— repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;
— the level or payment of interest would depend on the profits of the company;
— the loan contract contains no fixed provisions for repayment by a definite date.

(Replaced on 23 July 1992; see HISTORY)

26. The laws of many of the States put participations in a *société à responsabilité limitée* (limited liability company) on the same footing as shares.

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Likewise, distributions of profits by co-operative societies are generally regarded as dividends.

(Renumbered on 23 July 1992; see HISTORY)

27. Distributions of profits by partnerships are not dividends within the meaning of the definition, unless the partnerships are subject, in the State where their place of effective management is situated, to a fiscal treatment substantially similar to that applied to companies limited by shares (for instance, in Belgium, Portugal and Spain, also in France as regards distributions to *commanditaires* in the *sociétés en commandite simple*). On the other hand, clarification in bilateral conventions may be necessary in cases where the taxation law of a Contracting State gives the owner of holdings in a company a right to opt, under certain conditions, for being taxed as a partner of a partnership, or, vice versa, gives the partner of a partnership the right to opt for taxation as the owner of holdings in a company.

(Renumbered on 23 July 1992; see HISTORY)

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 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.

(Renumbered on 23 July 1992; see HISTORY)

29. The benefits to which a holding in a company confer entitlement are, as a general rule, available solely to the shareholders themselves. Should, however, certain of such benefits be made available to persons who are not shareholders within the meaning of company law, they may constitute dividends if:

— the legal relations between such persons and the company are assimilated to a holding in a company ("concealed holdings"); and

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— the persons receiving such benefits are closely connected with a shareholder; this is the case, for example, where the recipient is a relative of the shareholder or is a company belonging to the same group as the company owning the shares.

(Renumbered on 23 July 1992; see HISTORY)

30. When the shareholder and the person receiving such benefits are residents of two different States with which the State of source has concluded conventions, differences of views may arise as to which of these conventions is applicable. A similar problem may arise when the State of source has concluded a convention with one of the States but not with the other. This, however, is a conflict which may affect other types of income, and the solution to it can be found only through an arrangement under the mutual agreement procedure.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 4

31. Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 4 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". It does not stipulate that dividends flowing to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the dividends are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State, if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the dividends from any limitations under the Article. The foregoing explanations accord with those in the Commentary on Article 7.

(Renumbered on 23 July 1992; see HISTORY)

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32. [Deleted on 29 April 2000; see HISTORY]

Paragraph 5

33. The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other State. Certain States, however, tax not only dividends paid by companies resident therein but even distributions by non-resident companies of profits arising within their territory. Each State, of course, is entitled to tax profits arising in its territory which are made by non-resident companies, to the extent provided in the Convention (in particular in Article 7). The shareholders of such companies should not be taxed as well at any rate, unless they are residents of the State and so naturally subject to its fiscal sovereignty.

(Renumbered on 23 July 1992; see HISTORY)

34. Paragraph 5 rules out the extra-territorial taxation of dividends, i.e. the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, realised through a permanent establishment situated therein). There is, of course, no question of extra-territorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment situated in that State.

(Amended on 29 April 2000; see HISTORY)

35. Moreover, it can be argued that such a provision does not aim at, or cannot result in, preventing a State from subjecting the dividends to a withholding tax when distributed by foreign companies if they are cashed in its territory. Indeed, in such a case, the criterion for tax liability is the fact of the payment of the dividends, and not the origin of the corporate profits allotted for distribution. But if the person cashing the dividends in a Contracting State is a resident of the other Contracting State (of which the distributing company is a resident), he may under Article 21 obtain exemption from, or refund of, the withholding tax of the first-mentioned State. Similarly, if the beneficiary of the dividends is a resident of a third State which had concluded a double taxation convention with the State where the dividends are cashed, he may, under

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Article 21 of that convention, obtain exemption from, or refund of, the withholding tax of the last-mentioned State.

(Renumbered on 23 July 1992; see HISTORY)

36. Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits.

(Renumbered on 23 July 1992; see HISTORY)

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

(Replaced on 23 July 1992; see HISTORY)

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

(Replaced on 23 July 1992; see HISTORY)

39. Where dividends are actually distributed by the base company, the provisions of a bilateral convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the

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convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (i.e. tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder's country of residence, even if the distributed profit (the dividend) has been taxed years before under counteracting legislation. However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the counteracting legislation) and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the counteracting measures and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (e.g. time lapsed since the taxation of the "deemed dividend"). However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot fully be safeguarded by tax authorities.

(Replaced on 23 July 1992; see HISTORY)

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

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

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

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

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

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A. Dividends distributed to individuals

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

(Renumbered on 23 July 1992; see HISTORY)

1. States with the classical system

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

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

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2. States applying a split rate company tax

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

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

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

(Renumbered on 23 July 1992; see HISTORY)

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

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

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

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

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

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

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

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

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

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

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

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

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constitutes an adjustment of the company's tax. No refund, therefore, is given if the tax credit exceeds that personal tax.

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

51. The Committee could not reach a general agreement on whether the systems of the States referred to in paragraph 50 above display a fundamental difference that could justify different solutions at the international level.

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

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

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

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

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

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

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

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

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

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

(Renumbered on 23 July 1992; see HISTORY)

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57. [Deleted on 31 March 1994; see HISTORY]

58. [Deleted on 31 March 1994; see HISTORY]

B. Dividends distributed to companies

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

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

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

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

61. Various opinions were expressed in the course of the discussion. Opinions diverge even when the discussion is limited to the taxation of subsidiaries and parent companies. They diverge still more if the discussion takes into account more general economic considerations and extends to the taxation of shareholders of the parent company.

(Renumbered on 23 July 1992; see HISTORY)

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

(Renumbered on 23 July 1992; see HISTORY)

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

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

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

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

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

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

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

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

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

66. The question has been considered whether States of this kind should extend the benefit of the tax credit to the shareholders of parent companies resident of another State, or even to grant the tax credit directly to such parent

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companies. It has not been possible in the Committee to get views to converge on this question, the solution of which is left to bilateral negotiations.

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

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

(Renumbered on 23 July 1992; see HISTORY)

Observation on the Commentary

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

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

Reservations on the Article

Paragraph 2

69. *New Zealand* reserves the right to tax, at a rate of 15 per cent, dividends paid by a company that is a resident of New Zealand for purposes of its tax.

(Replaced on 29 April 2000; see HISTORY)

70. [Deleted on 29 April 2000; see HISTORY]

71. [Deleted on 29 April 2000; see HISTORY]

72. The *United States* reserves the right to provide that shareholders of certain pass-through entities, such as Regulated Investment Companies and Real Estate Investment Trusts, will not be granted the direct dividend investment rate, even if they would qualify based on their percentage ownership.

(Amended on 29 April 2000; see HISTORY)

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73. *Italy* reserves its position concerning the percentage envisaged for the holding (25 per cent) and can only agree to a rate of tax of 5 per cent for a direct holding of more than 50 per cent.

(Renumbered on 23 July 1992; see HISTORY)

74. *The Netherlands* reserves its position on the rate of 5 per cent, since it considers that transfers of profits within a group of enterprises should be entirely exempted from tax at the source.

(Renumbered on 23 July 1992; see HISTORY)

75. *Portugal*, *Mexico* and *Turkey* reserve their positions on the rates of tax in paragraph 2.

(Amended on 29 April 2000; see HISTORY)

76. *Spain* reserves its position on the rate of tax of 5 per cent and the determination of the minimum percentage for the holding.

(Renumbered on 23 July 1992; see HISTORY)

77. *Poland* reserves its position on the minimum percentage for the holding (25 per cent) and the rates of tax (5 per cent and 15 per cent).

(Added on 23 October 1997; see HISTORY)

Paragraph 3

78. *Belgium* reserves the right to broaden the definition of dividends in paragraph 3 so as to cover expressly income—even when paid in the form of interest—which is subjected to the same taxation treatment as income from shares by its internal law.

(Amended on 31 March 1994; see HISTORY)

79. *Denmark* reserves the right, in certain cases, to consider as dividends the selling price derived from the sale of shares.

(Replaced on 23 July 1992; see HISTORY)

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80. *France* reserves the right to amplify the definition of dividends in paragraph 3 so as to cover all income subjected to the taxation treatment of distributions.

(Replaced on 23 July 1992; see HISTORY)

81. *Canada, Germany, Ireland* and *Spain* reserve the right to amplify the definition of dividends in paragraph 3 so as to cover certain interest payments which are treated as distributions under their domestic law.

(Amended on 31 March 1994; see HISTORY)

81.1 *Portugal* reserves the right to amplify the definition of dividends in paragraph 3 so as to cover certain payments, made under profit participation arrangements, which are treated as distributions under its domestic law.

(Added on 31 March 1994; see HISTORY)

Paragraph 4

82. *Italy* reserves the right to subject dividends to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the holding on which the dividends are paid is not effectively connected with such permanent establishment.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 5

83. *Canada* and the *United States* reserve the right to impose their branch tax on the earnings of a company attributable to a permanent establishment situated in these countries.

(Amended on 31 March 1994; see HISTORY)

84. [Deleted on 21 September 1995; see HISTORY]

85. *Turkey* reserves the right to tax, in a manner corresponding to that provided by paragraph 2 of the Article, the part of the profits of a company of

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the other Contracting State that carries on business through a permanent establishment situated in Turkey that remains after taxation pursuant to Article 7.

(Replaced on 23 July 1992; see HISTORY)

86. [Deleted on 29 April 2000; see HISTORY]

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 2 read as follows:

> "2. The profits of a business carried on by a partnership are the partners' profits derived from their own exertions; for them they are industrial or commercial profits. So the partner is ordinarily taxed personally on his share of the partnership capital and partnership profits."

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Unchanged from the 1977 Model Convention.

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Unchanged from the 1977 Model Convention.

Paragraph 12: Included in the 1977 Model Convention. Paragraph 12 of the 1977 Model Convention was amended by OECD Council Recommendation C(95)132/FINAL, adopted on 21 September 1995, which amended the Appendix to Recommendation C(94)11/FINAL in order to reflect a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Prior to this amendment, paragraph 12 read as follows:

> "12. Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations."

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Unchanged from the 1977 Model Convention.

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Unchanged from the 1977 Model Convention.

Paragraph 19: Included in the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council

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of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 19 read as follows:

> "19. The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a refund."

Paragraph 20: Unchanged from the 1977 Model Convention.

Paragraph 21: Unchanged from the 1977 Model Convention.

Paragraph 22: Unchanged from the 1977 Model Convention.

Paragraph 23: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by replacing, in the fifth sentence, the words "it does not yet appear to be possible" by "it did not appear possible".

Paragraph 24: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by replacing the reference therein to paragraph 18 of the Commentary on Article 11 by a reference to paragraph 19 of that Commentary.

Paragraph 25: Replaced paragraph 25 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and new paragraph 25 added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 29 of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 26: Corresponds to paragraph 25 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was renumbered as paragraph 27 (cf. history of paragraph 27) and paragraph 25 was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 27: Corresponds to paragraph 26 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was renumbered as paragraph 28 (cf. history of paragraph 28) and paragraph 26 was renumbered as paragraph 27 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Corresponds to paragraph 27 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was renumbered as paragraph 29 (cf. history of paragraph 29) and paragraph 27 was renumbered as paragraph 28 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Corresponds to paragraph 28 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was renumbered as paragraph 30 (cf. history of paragraph 30) and paragraph 28 was renumbered as paragraph 29 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 30: Corresponds to paragraph 29 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 29 was renumbered as paragraph 30 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 31: Corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was renumbered as paragraph 32 (cf. history of paragraph 32) and paragraph 30 was renumbered as paragraph 31 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 32: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 32 previously read as follows:

> "32. The rules set out above also apply where the beneficiary of the dividends has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the holding in respect of which the dividends are paid is effectively connected."

Paragraph 32, as it read before 29 April 2000, corresponded to paragraph 31 of the 1977 Model Convention. Paragraph 32 of the 1977 Model Convention was renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 31 was renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 33: Corresponds to paragraph 32 of the 1977 Model Convention. Paragraph 33 of the 1977 Model Convention was renumbered as paragraph 34 (cf. history of paragraph 34) and paragraph 32 was renumbered as paragraph 33 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 34: Amended, by deleting the words "or fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 34 previously read as follows:

> "34. Paragraph 5 rules out the extra-territorial taxation of dividends, i.e. the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, realised through a permanent establishment situated therein). There is, of course, no question of extra-territorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment or fixed base situated in that State."

Paragraph 34 corresponds to paragraph 33 of the 1977 Model Convention. Paragraph 34 of the 1977 Model Convention was renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 33 was renumbered as paragraph 34 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 35: Corresponds to paragraph 34 of the 1977 Model Convention. Paragraph 35 of the 1977 Model Convention was renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 34 was renumbered as paragraph 35 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 36: Corresponds to paragraph 35 of the 1977 Model Convention. Paragraph 36 of the 1977 Model Convention was amended and renumbered as paragraph 40 (cf. history of paragraph 40) and

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paragraph 35 was renumbered as paragraph 36 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 37: Replaced paragraph 37 of the 1977 Model Convention. Paragraph 37 of the 1977 Model Convention was renumbered as paragraph 41 (cf. history of paragraph 41) and new paragraph 37 added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 49 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 38: Replaced paragraph 38 of the 1977 Model Convention. Paragraph 38 of the 1977 Model Convention was amended and renumbered as paragraph 42 (cf. history of paragraph 42) and new paragraph 38 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 50 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 39: Replaced paragraph 39 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was amended and renumbered as paragraph 43 (cf. history of paragraph 43) and new paragraph 39 added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 51 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 40: Corresponds to paragraph 36 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was renumbered as paragraph 44 (cf. history of paragraph 44) and the heading preceding paragraph 36 in the 1977 Model Convention was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting a footnote to it. In the 1977 Model Convention, that footnote read as follows:

> "1. This Section reflects the position as of 1st January, 1977".

Paragraph 36 was amended by the same report. In the 1977 Model Convention, paragraph 36 read as follows:

> "36. Certain countries' laws seek to avoid or mitigate economic double taxation, i.e. the simultaneous taxation of the company's profits at the level of the company and of the dividends at the level of the shareholder. There are various ways of achieving this:
>
> — company tax in respect of distributed profits is charged at a lower rate than that on retained profits (Austria, Finland, Germany, Iceland, Japan, Norway);
>
> — the tax paid by the company on the distributed profits is partly set off against the shareholder's personal tax (Belgium; Canada; Denmark, from 1977; France; Germany, from 1977; Ireland, from 1976; Turkey; United Kingdom);
>
> — dividends bear only one tax, the distributed profits not being taxed at the level of the company (Greece).
>
> The Committee on Fiscal Affairs has examined the question whether the special features of the tax laws of such countries would justify solutions other than those contained in the Model Convention."

Paragraph 41: Corresponds to paragraph 37 of the 1977 Model Convention. Paragraph 41 of the 1977 Model Convention was renumbered as paragraph 45 (cf. history of paragraph 45) and paragraph 37

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was renumbered as paragraph 41 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Corresponds to paragraph 38 of the 1977 Model Convention. Paragraph 42 of the 1977 Model Convention was renumbered as paragraph 46 (cf. history of paragraph 46), paragraph 38 was renumbered as paragraph 42 and amended, by replacing, in the last line thereof, the words "in 1963" by "in the Model Convention", and the heading preceding paragraph 38 was amended, by deleting its last part and a footnote to it, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, this heading and its footnote read as follows:

> "1. *States with the classical system*
> (no relief of economic double taxation: All Member countries not referred to in paragraph 36 above[1]; hereinafter called type A States)
>
> 1. The Italian system in force as from 1st January, 1974, may be considered as close to the classical system although it will be noted that economic double taxation is mitigated to a certain extent by the fact that the shareholder is not subject to local tax on the income he receives."

Paragraph 43: Corresponds to paragraph 39 of the 1977 Model Convention. Paragraph 43 of the 1977 Model Convention was renumbered as paragraph 47 (cf. history of paragraph 47), the heading preceding paragraph 39 was amended and paragraph 39 was amended and renumbered as paragraph 43 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, this heading and paragraph 39 read as follows:

> "2. *States applying a split rate company tax*
> (Austria; Finland; Germany; Iceland[2]; Japan; Norway; hereinafter called type B States)
>
> 39. These States levy company tax at different rates according to what the company does with its profits: the high rate is charged on any profits retained and the lower rate on those distributed. These rates are, respectively, in Austria, 55 and 27.5 per cent (maximum rates); in Germany, 56 and 36 per cent; in Japan, 40 and 30 percent (maximum rates) and in Norway 50.8 and 23 per cent. Finland should be considered among the split rate countries as it grants in the state income taxation a deduction calculated at 40 per cent on profits distributed. While undistributed profits are taxed at the rate of 43 per cent distributed profits are taxed at a correspondingly lower effective rate Therefore, the effects of this deduction are similar to those of the normal split rate system.
>
> 2. The effects of the Icelandic corporation tax system are similar to those of a split-rate system, insofar as dividends paid out during the fiscal year are deductible from net income in that year, to a maximum of 10 per cent of the nominal value of capital stock."

Paragraph 44: Corresponds to paragraph 40 of the 1977 Model Convention. Paragraph 44 of the 1977 Model Convention was amended and renumbered as paragraph 48 (cf. history of paragraph 48) and paragraph 40 was renumbered as paragraph 44 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45: Corresponds to paragraph 41 of the 1977 Model Convention. Paragraph 45 of the 1977 Model Convention was amended and renumbered as paragraph 49 (cf. history of paragraph 49) and paragraph 41 was amended and renumbered as paragraph 45 by the Report entitled "The Revision of

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the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 41 read as follows:

> "41. The Committee considered whether States in that group should not be recognised as being entitled to levy withholding tax exceeding 15 per cent on dividends distributed by their companies to residents of the other State (type A), with the proviso that the excess over 15 per cent, which would be designed to offset, in relation to the shareholder concerned, the effects of the lower rate of company tax on distributed profits of companies of State B, would not be creditable against the tax payable by the shareholder in the type A State of which he is a resident."

Paragraph 46: Corresponds to paragraph 42 of the 1977 Model Convention. Paragraph 46 of the 1977 Model Convention was deleted and paragraph 42 was amended and renumbered as paragraph 46 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 42 read as follows:

> "42. Most members considered that in a type B State regard should be had to the average level of company tax, and that such average level should be considered as the counterpart to the charge levied in the form of a single-rate tax on companies resident of State A. The levy by State B of an additional withholding tax not credited in State A would, moreover, create twofold discrimination: on the one hand, dividends, distributed by a company resident of State B would be more heavily taxed when distributed to residents of State A than when distributed to residents of State B, and, on the other hand, the resident of State A would pay higher personal tax on his dividends from State B than on his dividends from State A. The idea of a "balancing tax" was not, therefore, adopted by the Committee."

In the 1977 Model Convention, paragraph 46 read as follows:

> "*Case of Turkey*
>
> 46. Certain features of the Turkish system suggest that it should be regarded as analogous to the French and British systems. The Turkish Delegation has pointed out that account ought to be taken of the requirements of Turkey's economic and fiscal policy; for this reason, Turkey would not consider extending in a bilateral convention the tax credit (set off for additional withholding tax levy) to non-resident shareholders. The Turkish Delegation furthermore considers that this problem can be dealt with only in bilateral negotiations where the sacrifices and advantages which the convention entails for each Contracting State may be best appreciated."

Paragraph 47: Corresponds to paragraph 43 of the 1977 Model Convention. Paragraph 47 of the 1977 Model Convention was amended and renumbered as paragraph 50 (cf. history of paragraph 50), paragraph 43 was renumbered as paragraph 47 and the heading preceding paragraph 43 was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, this heading read as follows:

> "3. *States which allow a part of company tax against the shareholder's tax*
> (Belgium; Canada; Denmark, from 1977; France; Germany, from 1977; Ireland, from 1976; Turkey; the United Kingdom; hereinafter called type C States)"

Paragraph 48: Corresponds to paragraph 44 of the 1977 Model Convention. Paragraph 48 of the 1977 Model Convention was amended and renumbered as paragraph 51 (cf. history of paragraph 51) and paragraph 44 was amended and renumbered as paragraph 48 by the Report entitled "The Revision of

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the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 44 read as follows:

> "44. The rate of this tax credit, in terms of the dividend declared, is 46 per cent in Belgium (where it is called the "crédit d'impôt"), 33 1/3 per cent in Canada, about 15 per cent in Denmark, 50 per cent in France (where it is called the "avoir fiscal"), 9/16 in Germany, 7/13 in Ireland, 15/60 in Turkey and 35/65 in the United Kingdom. Internal law of States in this group does not provide for the extension of the tax credit to the international field. This credit is allowed only to residents and only in respect of dividends of domestic sources[1]. However, in recent conventions, some States extended the right to the tax credit to residents of the other Contracting States.
>
> 1. In Ireland and in the United Kingdom, however, the right to the tax credit is given to shareholders who are not residents of those States but are nationals of the States."

Paragraph 49: Corresponds to paragraph 45 of the 1977 Model Convention. Paragraph 49 of the 1977 Model Convention was amended and renumbered as paragraph 52 (cf. history of paragraph 52), paragraph 45 was amended and renumbered as paragraph 49 and the heading preceding it was deleted by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 45 and the heading preceding it read as follows:

> "*Case of France and the United Kingdom*
>
> 45. Under the French "avoir fiscal" system and the United Kingdom tax credit system, the resident shareholder receives a credit in recognition of the fact that the profits out of which the dividends are paid have already been taxed in the hands of the company. The resident shareholder is taxed on his dividend grossed up by the "avoir fiscal" or tax credit; this "avoir fiscal" or tax credit is set against the tax payable and can possibly give rise to refund. These imputation systems differ in structure from the split rate systems of type B States, but both these types of systems may, if the conditions are comparable, have a similar result, provided that the shareholder of the company in the type B State reports his dividends. In double taxation conventions France and the United Kingdom have respectively given the "avoir fiscal" and the tax credit to shareholders who are residents of the other Contracting States."

Paragraph 50: Corresponds to paragraph 47 in the 1977 Model Convention. Paragraph 50 of the 1977 Model Convention was amended and renumbered as paragraph 53 (cf. history of paragraph 53), paragraph 47 was amended and renumbered as paragraph 50 and the heading preceding it was deleted by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 47 and the heading preceding it read as follows:

> "*Case of Belgium and Canada*
>
> 47. These States claim that under their systems the company tax remains in its entirety a true company tax, in that it is charged by reference solely to the company's own situation, without any regard to the person and the residence of the shareholder, and in that, having been so charged, it remains appropriated to the Treasury. The tax credit given to the shareholder is designed to relieve his personal tax liability and in no way constitutes an adjustment of the company's tax. No refund, therefore, is given if the tax credit exceeds that personal tax."

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Paragraph 51: Corresponds to paragraph 48 of the 1977 Model Convention. Paragraph 51 of the 1977 Model Convention was amended and renumbered as paragraph 54 (cf. history of paragraph 54) and paragraph 48 was amended and renumbered as paragraph 51 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 48 read as follows:

> "48. The Committee could not reach a general agreement on whether these two countries' systems and the French or British system display a fundamental difference that could justify different solutions at the international level."

Paragraph 52: Corresponds to paragraph 49 of the 1977 Model Convention. Paragraph 52 of the 1977 Model Convention was amended and renumbered as paragraph 55 (cf. history of paragraph 55) and paragraph 49 was amended and renumbered as paragraph 52 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 49 read as follows:

> "49. Some members were of the opinion that such a fundamental difference does not exist. This opinion leaves room for the conclusion that the two countries concerned should—like France and the United Kingdom (paragraph 45 above)—extend the tax credit to non-resident shareholders. Such a solution tends to ensure neutrality as regards dividends distributed by companies of these countries the same treatment being given to resident and non-resident shareholders. On the other hand, it would in relation to shareholders who are residents of a Contracting State (a type A State in particular) encourage investment in a type C State; residents of State A receive a tax credit (in fact a refund of company tax) for dividends from State C while they do not receive one for dividends from their own country. However, these effects, which also occur in the case of France and the United Kingdom, are similar to those which present themselves between a type B and a type A State or between two type A States one of which has a lower company tax rate than the other (paragraphs 38 and 39 to 42 above)."

Paragraph 53: Corresponds to paragraph 50 of the 1977 Model Convention. Paragraph 53 of the 1977 Model Convention was renumbered as paragraph 56 (cf. history of paragraph 56) and paragraph 50 was amended and renumbered as paragraph 53 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 50 read as follows:

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

Paragraph 54: Corresponds to paragraph 51 of the 1977 Model Convention. Paragraph 54 of the 1977 Model Convention and the heading preceding it were deleted and paragraph 51 was amended and renumbered as paragraph 54 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 51 read as follows:

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

In the 1977 Model Convention, paragraph 54 and the heading preceding it read as follows:

"*Case of Denmark, Germany and Ireland*

54. Denmark and Ireland have company tax systems similar to the French and British ones. The German company tax system as it is in effect from 1977, differs from the other systems insofar as it combines the economic effects of a split rate system and a credit system. The rate of tax on company profits is 56 per cent, but it is reduced by 20 percentage points in respect to profits distributed, which are therefore taxed at a rate of 36 per cent (cf. paragraph 39 above). Moreover, resident shareholders of a German company (individuals and companies) are entitled to a tax credit of 9/16 of the cash dividends received from the company with the effect that the whole company tax on profits distributed to such shareholders is credited against the latter's tax on income. If the tax on income is lower than the credit to be given the excess part is reimbursed. As their systems have been introduced very recently, these countries wish to leave to bilateral negotiations the question whether the special features of their tax laws would justify solutions other than those contained in the Model Convention.[1]

1. Since the introduction in Ireland of the imputation system of company taxation, that country has concluded only one double taxation convention, namely, that with the United Kingdom. The convention provides for giving the tax credit to United Kingdom portfolio investors but this is not regarded by Ireland as constituting a guideline for future conventions."

Paragraph 55: Corresponds to paragraph 52 of the 1977 Model Convention. Paragraph 55 of the 1977 Model Convention was renumbered as paragraph 57 (cf. history of paragraph 57) and paragraph 52 was amended and renumbered as paragraph 55 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 52 read as follows:

"52. To overcome these objections, it might be a conceivable proposition, amongst other possibilities, that State A—which will have collected company tax on dividends distributed by resident companies—should bear the cost of the tax credit that State C would allow, by transferring funds to that State. As, however, such transfers are hardly favoured by the States this might be more simply achieved by means of a "compositional" arrangement under which State A would relinquish all withholding tax on dividends paid to residents of State C, and

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the latter would then allow against its own tax, not the 15 per cent withholding tax (abolished in State A) but a tax credit similar to that which it gives on dividends of domestic source."

Paragraph 56: Corresponds to paragraph 53 of the 1977 Model Convention. Paragraph 56 of the 1977 Model Convention was renumbered as paragraph 58 (cf. history of paragraph 58) and paragraph 53 was renumbered as paragraph 56 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 57: Paragraph 57 and the title preceding it were deleted by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 57 and the title preceding it previously read as follows:

"*4. State with a special system (Greece)*

57. Under the Greek system, a company's profits are taxed at the level of the company, but any part of them which is distributed—whether immediately or subsequent-ly—to the shareholders is taxed once only, the tax paid by the company on this part of its profits being refunded to it."

Paragraph 57, as it read after 23 July 1992 and before 31 March 1994, corresponded to paragraph 55 of the 1977 Model Convention. Paragraph 57 of the 1977 Model Convention was amended and renumbered as paragraph 59 (cf. history of paragraph 59) and paragraph 55 was renumbered as paragraph 57 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 58: Deleted by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 58 previously read as follows:

"58. Since Greece does not tax distributed profits at the level of the company, the Committee recognises this State's right to tax at source profits distributed by its companies at a higher rate than those specified in paragraph 2. The maximum rate must in this case be fixed by bilateral negotiations, regard being had to the special features of each situation, e.g. the respective levels of the taxes in the two States, the budgetary sacrifices accepted by the two States, etc."

Paragraph 58, as it read after 23 July 1992 and before 31 March 1994, corresponded to paragraph 56 of the 1977 Model Convention. Paragraph 58 of the 1977 Model Convention was amended and renumbered as paragraph 60 (cf. history of paragraph 60) and paragraph 56 was renumbered as paragraph 58 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 59: Corresponds to paragraph 57 of the 1977 Model Convention. Paragraph 59 of the 1977 Model Convention was renumbered as paragraph 61 (cf. history of paragraph 61) and paragraph 57 was amended by deleting a footnote to it and renumbered as paragraph 59 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the footnote to paragraph 57 read as follows:

"1. This problem is the subject of other work by the Committee on Fiscal Affairs."

Paragraph 60: Corresponds to paragraph 58 of the 1977 Model Convention. Paragraph 60 of the 1977 Model Convention was renumbered as paragraph 62 (cf. history of paragraph 62) and paragraph 58 was renumbered as paragraph 60, and amended by replacing the reference therein to paragraph 39 by a reference to paragraph 42, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 61: Corresponds to paragraph 59 of the 1977 Model Convention. Paragraph 61 of the 1977 Model Convention was renumbered as paragraph 63 (cf. history of paragraph 63) and paragraph 59 was renumbered as paragraph 61 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 62: Corresponds to paragraph 60 of the 1977 Model Convention. Paragraph 62 of the 1977 Model Convention was renumbered as paragraph 64 (cf. history of paragraph 64) and paragraph 60 was renumbered as paragraph 62 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 63: Corresponds to paragraph 61 of the 1977 Model Convention. Paragraph 63 of the 1977 Model Convention was renumbered as paragraph 65 (cf. history of paragraph 65), the heading preceding paragraph 61 was amended and paragraph 61 was renumbered as paragraph 63 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the heading preceding paragraph 61 read as follows:

"1. *Classical system in the State of the subsidiary*
(Type A States—paragraph 38 above) ".

Paragraph 64: Corresponds to paragraph 62 of the 1977 Model Convention. Paragraph 64 of the 1977 Model Convention was renumbered as paragraph 66 (cf. history of paragraph 66), the heading preceding paragraph 62 was amended and paragraph 62 was renumbered as paragraph 64 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the heading preceding paragraph 62 read as follows:

"2. *Split-rate company tax system in the State of the subsidiary*
(Type B States—paragraphs 39 to 42 above) ".

Paragraph 65: Corresponds to paragraph 63 of the 1977 Model Convention. Paragraph 65 of the 1977 Model Convention was renumbered as paragraph 67 (cf. history of paragraph 67), the heading preceding paragraph 63 was amended and paragraph 63 was renumbered as paragraph 65 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the heading preceding paragraph 63 read as follows:

"3. *Imputation system in the State of the subsidiary*
(Type C States--paragraphs 43 and following)".

Paragraph 66: Corresponds to paragraph 64 of the 1977 Model Convention. Paragraph 66 of the 1977 Model Convention was deleted and paragraph 64 was amended by deleting a footnote to it and renumbered as paragraph 66 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the footnote to paragraph 64 read as follows:

> "1. This solution is provided for in a Draft Directive presented on 1st August, 1975 by the Commission of the European Communities. According to this draft, the State in which the parent company is resident should, when shareholders resident in its territory are taxed, wholly or partly offset the company tax levied in the State in which the subsidiary is a resident. The draft also provides for compensation for the tax burden resulting from offsetting between the State in which the parent company is a resident and that in which the subsidiary is a resident."

In the 1977 Model Convention, paragraph 66 read as follows:

"66. *Portugal* makes the following observations as regards paragraph 27 above. Indeed gains from the increase in capital of companies with a head office or place of effective management in Portugal, when the increase results from the capitalisation of reserves or

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the issue of shares, are taxed under the Portuguese domestic law as capital gains. In bilateral conventions, Portugal usually inserts in Article 13 a provision allowing it to tax such gains."

Paragraph 67: Corresponds to paragraph 65 of the 1977 Model Convention. Paragraph 67 of the 1977 Model Convention was amended and renumbered as paragraph 68 (cf. history of paragraph 69) and paragraph 65 was renumbered as paragraph 67 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 68: Corresponds to paragraph 67 of the 1977 Model Convention. Paragraph 68 of the 1977 Model Convention was amended and renumbered as paragraph 69 (cf. history of paragraph 69) and paragraph 67 was amended and renumbered as paragraph 68 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 67 read as follows:

> "67. The *United Kingdom* does not adhere to paragraph 24 above. Under United Kingdom law, certain interest payments are treated as distributions, and are therefore included by the United Kingdom in the definition of dividends."

Paragraph 69: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 69 previously read as follows:

> "69. *Australia* reserves the right to tax, at a rate of not less than 15 per cent, dividends paid by a company that is a resident of Australia for purposes of its tax."

Paragraph 69 had been previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994 which deleted the word "always" from the reservation. After 23 July 1992, but before 31 March 1994 paragraph 69 read as follows:

> "69. *Australia* reserves the right always to tax, at a rate of not less than 15 per cent, dividends paid by a company which is a resident of Australia for purposes of its tax."

Paragraph 69, as it read prior to 31 March 1994, corresponds to paragraph 68 of the 1977 Model Convention. Paragraph 69 of the 1977 Model Convention was amended and renumbered as paragraph 70 (cf. history of paragraph 70) and paragraph 68 was renumbered as paragraph 69 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 70: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 70 previously read as follows:

> "70. *New Zealand* reserves its positions on sub-paragraph *a*) because it wishes to retain its freedom of action with regard to the treatment of holding (parent companies and subsidiaries)."

Paragraph 70, as it read before 29 April 2000, corresponded to paragraph 69 of the 1977 Model Convention. Paragraph 70 of the 1977 Model Convention was amended and renumbered as paragraph 71 (cf. history of paragraph 71) and paragraph 69 was amended and renumbered as paragraph 70 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 69 read as follows:

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"69. *Belgium*, *Japan* and *New Zealand* reserve their positions on sub-paragraph *a*) because they wish to retain their freedom of action with regard to the treatment of holding (parent companies and subsidiaries)."

Paragraph 71: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 71 previously read as follows:

"71. *Canada* reserves the right to apply a 10 per cent rate of tax at source in the case of holdings (parent companies and subsidiaries)."

Paragraph 71, as it read before 29 April 2000, corresponded to paragraph 70 of the 1977 Model Convention. Paragraph 71 of the 1977 Model Convention was renumbered as paragraph 72 (cf. history of paragraph 72) and paragraph 70 was renumbered as paragraph 71 and amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention and before 23 July 1992 paragraph 70 read as follows:

"70. *Canada* reserves the right to apply a 15 per cent rate of tax at source on dividends paid to non-residents without regard to the relation between the company paying the dividends and the beneficial owner."

Paragraph 72: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 72 previously read as follows:

"72. The *United States* reserves the right to provide that shareholders of pass-through entities will not be granted the direct dividend investment rate, even if they would qualify (based on their percentage of ownership)."

Paragraph 72 corresponds to paragraph 71 of the 1977 Model Convention. On 23 July 1992, paragraph 72 of the 1977 Model Convention was renumbered as paragraph 73 (cf. history of paragraph 73) and paragraph 71 was renumbered as paragraph 72 and replaced by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention paragraph 71 read as follows:

"71. *Germany*, with a view to its system of company taxation, reserves its position on paragraph 2."

Paragraph 73: Corresponds to paragraph 72 of the 1977 Model Convention. Paragraph 73 of the 1977 Model Convention was renumbered as paragraph 74 (cf. history of paragraph 74) and paragraph 72 was renumbered as paragraph 73 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 74: Corresponds to paragraph 73 of the 1977 Model Convention. Paragraph 74 of the 1977 Model Convention was renumbered as paragraph 75 (cf. history of paragraph 75) and paragraph 73 was renumbered as paragraph 74 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 75: Amended, by deleting the second sentence, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 75 previously read as follows:

"75. *Portugal*, *Mexico* and *Turkey* reserve their positions on the rates of tax in paragraph 2. *Mexico* will seek a zero tax rate for all dividends, because it does not levy tax on profits in the hands of the shareholders but taxes profits only at the corporate level."

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Paragraph 75 was previously amended on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". After 23 July 1992, but before 21 September 1995, paragraph 75 read as follows:

"75. *Portugal* reserves its position on the rates of tax in paragraph 2."

Paragraph 75 corresponded to paragraph 74 of the 1977 Model Convention. Paragraph 75 of the 1977 Model Convention was renumbered as paragraph 76 (cf. history of paragraph 76) and paragraph 74 was renumbered as paragraph 75 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 76: Corresponds to paragraph 75 of the 1977 Model Convention. Paragraph 76 of the 1977 Model Convention was amended and renumbered as paragraph 77 (cf. history of paragraph 77) and paragraph 75 was renumbered as paragraph 76 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 77: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 77, as it read before 21 September 1995, was deleted by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 77 previously read as follows:

"77. *Turkey* reserves its position on the rate of tax in paragraph 2."

Paragraph 77, as it read before 21 September 1995, corresponded to paragraph 76 of the 1977 Model Convention. Paragraph 77 of the 1977 Model Convention was amended and renumbered as paragraph 78 (cf. history of paragraph 78) and paragraph 76 was amended and renumbered as paragraph 77 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 76 read as follows:

"76. *Turkey* cannot accept a rate of tax which is lower than 20 per cent."

Paragraph 78: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 78 previously read as follows:

"78. *Belgium* reserves the right to amplify the definition of dividends in paragraph 3 so as to cover expressly income from capital invested by partners in Belgian partnerships even when this income is paid in the form of interest."

Paragraph 78 corresponds to paragraph 77 of the 1977 Model Convention. Paragraph 78 of the 1977 Model Convention was deleted and paragraph 77 was amended and renumbered as paragraph 78 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 78 read as follows:

"78. In view, moreover, of the fact that Belgian law excludes distributions of liquidation surpluses from the movable capital income category ("revenus mobiliers") and subjects them to a compositional charge to company tax which relieves the individual shareholders or partners from any liability to personal tax, *Belgium* reserves the right to levy, in accordance with its internal law, such "special contributions", either in the case of the redemption of its own shares or partnership shares by a company or partnership resident in Belgium or on the division of its assets by such a company or partnership among its shareholders or members. Such special contributions fall neither under the restrictions provided in paragraph 2, as regards distribution tax charged on dividends, nor under any other

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restrictive provision whatever of the Convention (paragraph 4 of Article 13; paragraph 1 of Article 21, etc.)."

In the 1977 Model Convention, paragraph 77 read as follows:

"77. *Belgium* reserves the right to amplify the definition of dividends in paragraph 3 so as to cover expressly income—even when paid in the form of interest—which is taxable as income from capital invested by partners in Belgian partnerships which have not opted for their profits to be charged to personal income tax in the names of such partners individually."

Paragraph 79: Replaced paragraph 79 of the 1977 Model Convention. Paragraph 79 of the 1977 Model Convention was renumbered as paragraph 82 (cf. history of paragraph 82) and new paragraph 79 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992."

Paragraph 80: Replaced paragraph 80 of the 1977 Model Convention. Paragraph 80 of the 1977 Model Convention was deleted and new paragraph 80 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 80 read as follows:

"80. *Australia* reserves the right to impose tax on the undistributed Australian income of a private (close) company which is a resident of the other State."

Paragraph 81: Amended, by deleting Portugal from the list of countries making the reservation, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 81 previously read as follows:

"81. *Canada, Germany, Ireland, Portugal* and *Spain* reserve the right to amplify the definition of dividends in paragraph 3 so as to cover certain interest payments which are treated as distributions under their domestic law."

Paragraph 81 replaced paragraph 81 of the 1977 Model Convention. Paragraph 81 of the 1977 Model Convention was amended and renumbered as paragraph 84 (cf. history of paragraph 84) and new paragraph 81 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 81.1: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 82: Corresponds to paragraph 79 of the 1977 Model Convention. Paragraph 82 of the 1977 Model Convention was deleted and paragraph 79 was renumbered as paragraph 82 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 82 read as follows:

"82. *Spain* cannot adhere without a reservation to the provisions of this paragraph ow-ing to the structure of its fiscal law which provides that permanent establishments in Spain of foreign companies are to be taxed under the same conditions as Spanish companies."

Paragraph 83: Amended, by adding the United States as a country making the reservation, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 83 previously read as follows:

"83. *Canada* reserves its right to impose its branch tax on the earnings of a company attributable to a permanent establishment in Canada."

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Paragraph 83 replaced paragraph 83 of the 1977 Model Convention. Paragraph 83 of the 1977 Model Convention was deleted and new paragraph 83 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 83 read as follows:

> "83. The *United States* believes that the text should clarify that the prohibition of paragraph 5 will apply regardless of whether the company derives profits or income from the other Contracting State."

Paragraph 84: Deleted on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Paragraph 84 previously read as follows:

> "84. In order to align the tax treatment of permanent establishments and subsidiaries, *France* wishes to retain the possibility of applying the provisions in its laws according to which profits made in France by foreign companies are deemed to be distributed to non-resident shareholders and are taxed accordingly. France is prepared, however, to reduce in bilateral conventions the rate provided for in its domestic laws."
>
> Paragraph 84 corresponded to paragraph 81 of the 1977 Model Convention. Paragraph 84 of the 1977 Model Convention was renumbered as paragraph 86 (cf. history of paragraph 86) and paragraph 81 was amended and renumbered as paragraph 84 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 81 read as follows:
>
> "81. *France* cannot adhere to the provisions of this paragraph. France wishes to retain the possibility of applying the provisions in its laws according to which profits made in France by foreign companies are deemed to be distributed to non-resident shareholders and are taxed accordingly. France is prepared, however, to reduce in bilateral conventions the rate provided for in its domestic laws."

Paragraph 85: Replaced paragraph 85 of the 1977 Model Convention. Paragraph 85 of the 1977 Model Convention was deleted and new paragraph 85 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 85 read as follows:

> "85. The *United States* reserves the right to apply its dividend withholding tax to dividends paid by a company which is incorporated outside the United States, if at least one half of the company's income consists of profits attributable to a permanent establishment in the United States."

Paragraph 86: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 86 previously read as follows:

> "86. *The United States* reserves the right to impose its accumulated earnings tax and personal holding company tax, to prevent tax avoidance."

Paragraph 86, as it read before 29 April 2000, corresponded to paragraph 84 of the 1977 Model Convention. Paragraph 84 of the 1977 Model Convention was renumbered as paragraph 86 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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COMMENTARY ON ARTICLE 11
CONCERNING THE TAXATION OF INTEREST

I. Preliminary remarks

1. "Interest" is generally taken to mean remuneration on money lent, being remuneration coming within the category of "income from movable capital" (*revenus de capitaux mobiliers*). Unlike dividends, interest does not suffer economic double taxation, that is, it is not taxed both in the hands of the debtor and in the hands of the creditor. Unless it is provided to the contrary by the contract, payment of the tax charged on interest falls on the recipient. If it happens that the debtor undertakes to bear any tax chargeable at the source, this is as though he had agreed to pay his creditor additional interest corresponding to such tax.

2. But, like dividends, interest on bonds or debentures or loans usually attracts tax charged by deduction at the source when the interest is paid. This method is, in fact, commonly used for practical reasons, as the tax charged at the source can constitute an advance of the tax payable by the recipient in respect of his total income or profits. If in such a case the recipient is a resident of the country which practises deduction at the source, any double taxation he suffers is remedied by internal measures. But the position is different if he is a resident of another country: he is then liable to be taxed twice on the interest, first by the State of source and then by the State of which he is a resident. It is clear that his double charge of tax can reduce considerably the interest on the money lent and so hamper the movement of capital and the development of international investment.

3. A formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary's residence or the State of source, could not be sure of receiving general approval. Therefore a compromise solution was adopted. It provides that interest may be taxed in the State of residence, but leaves to the State of source the right to impose a tax if its laws so provide, it being implicit in this right that the State of source is free to give up all taxation on interest paid to non-residents. Its exercise of this right will however be limited by a ceiling which its tax cannot exceed but, it goes without saying, the Contracting States can agree to adopt an even lower rate of taxation in the State of source. The sacrifice that the latter would accept in such conditions will be

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matched by a relief to be given by the State of residence, in order to take into account the tax levied in the State of source (cf. Article 23 A or 23 B).

4. Certain countries do not allow interest paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the interest is paid by a resident of a Contracting State to a resident of the other State, is dealt with in paragraph 4 of Article 24.

(Amended on 23 July 1992; see HISTORY)

II. Commentary on the provisions of the Article

Paragraph 1

5. Paragraph 1 lays down the principle that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in the latter. In doing so, it does not stipulate an exclusive right to tax in favour of the State of residence. The term "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.

6. The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases, cf. paragraphs 4 to 6 of the Commentary on Article 21).

Paragraph 2

7. Paragraph 2 reserves a right to tax interest to the State in which the interest arises; but it limits the exercise of that right by determining a ceiling for the tax, which may not exceed 10 per cent. This rate may be considered a reasonable maximum bearing in mind that the State of source is already entitled to tax profits or income produced on its territory by investments financed out of borrowed capital. The Contracting States may agree in bilateral negotiations

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upon a lower tax or even on exclusive taxation in the State of the beneficiary's residence.

8. Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. (The text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries.) States which wish to make this more explicit are free to do so during bilateral negotiations.

(Amended on 21 September 1995; see HISTORY)

9. The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law. Specific questions arise with triangular cases (see paragraph 53 of the Commentary on Article 24).

(Amended on 23 July 1992; see HISTORY)

10. It does not specify whether or not the relief in the State of source should be conditional upon the interest being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

11. The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the interest. This question is dealt with in Articles 23 A and 23 B.

12. Attention is drawn generally to the following case: the beneficial owner of interest arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether, in the case of such a company, it is justifiable to allow in the State of source of the interest the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are

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being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.

13. It should, however, be pointed out that the solution adopted, given the combined effect of the right to tax accorded to the State of source and the allowance to be made for the tax levied there against that due in the State of residence, could, in certain cases, result in maintaining partial double taxation and lead to adverse economic consequences. In fact, when the beneficiary of the interest has himself had to borrow in order to finance the operation which earns him interest, the profit he will realise by way of interest will be much smaller than the nominal amount of interest he receives; if the interest he pays and that which he receives balance, there will be no profit at all. In such a case, the allowance to be made under paragraph 2 of Article 23 A, or paragraph 1 of Article 23 B, raises a difficult and sometimes insoluble problem in view of the fact that the tax levied in the State where the interest arises is calculated on the gross amount thereof, whereas the same interest is reflected in the beneficiary's business results at its net amount only. The result of this is that part, or sometimes even the whole amount, of the tax levied in the State where the interest arises cannot be allowed as a credit in the beneficiary's State of residence and so constitutes an excess charge for the beneficiary, who, to that extent, suffers double taxation. Moreover, the latter, in order to avoid the disadvantage just mentioned, will tend to increase the rate of interest he charges his debtor, whose financial burden would then be increased to a corresponding extent. Thus in certain cases the practice of taxation at the source can constitute an obstacle to international trade. Furthermore, if the payer of the interest happens to be the State itself, a public sector institution, or an enterprise guaranteed by the State, the end result may well be that the tax levied at source is actually borne by the Treasury of the debtor's State, which latter thus derives no real benefit from its own taxation.

14. The disadvantages just mentioned arise in business, particularly with the sale on credit of equipment, other commercial credit sales, and loans granted by banks. The supplier in such cases very often merely passes on to the customer, without any additional charge, the price he will himself have had to pay to a bank or an export finance agency to finance the credit; similarly, the banker generally finances the loan which he grants with funds lent to his bank and, in particular, funds accepted by him on deposit. In the case especially of the person

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selling equipment on credit, the interest is more an element of the selling price than income from invested capital.

15. If two Contracting States, in order to eliminate all risks of double taxation, should desire to avoid the imposition of a tax in the State of source on interest arising from the above-mentioned categories of debts, their common intention can be expressed by an additional paragraph which would follow paragraph 2 of the Article, and which might be drafted in the following terms:

> "3. Notwithstanding the provisions of paragraph 2, any such interest as is mentioned in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident, if such recipient is the beneficial owner of the interest and if such interest is paid:
> *a*) in connection with the sale on credit of any industrial, commercial or scientific equipment,
> *b*) in connection with the sale on credit of any merchandise by one enterprise to another enterprise, or
> *c*) on any loan of whatever kind granted by a bank."

16. As regards, more particularly, the types of credit sale referred to in sub-paragraph *a*) of the text suggested above, they comprise not only sales of complete units, but also sales of separate components thereof. Furthermore, as regards credit sales of the types referred to in sub-paragraphs *a*) and *b*) of the suggested text, it is immaterial whether the interest is stipulated separately and as additional to the sale price, or is included from the outset in the price payable by instalments.

17. Contracting States may add to the categories of interest enumerated in the text suggested in paragraph 15 above, other categories in regard to which the imposition of a tax in the State of source might appear to them to be undesirable. They may also agree that the exclusion of a right to tax in the State of source shall be limited to certain of the categories of interest mentioned.

Paragraph 3

18. Paragraph 3 specifies the meaning to be attached to the term "interest" for the application of the taxation treatment defined by the Article. The term designates, in general, income from debt-claims of every kind, whether or not

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secured by mortgage and whether or not carrying a right to participate in profits. The term "debt-claims of every kind" obviously embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital (*revenus de capitaux mobiliers*), even though certain countries assimilate it to income from immovable property. On the other hand, debt-claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest.

(Amended on 23 July 1992; see HISTORY)

19. Interest on participating bonds should not normally be considered as a dividend, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company (see *inter alia* paragraph 25 of the Commentary on Article 10). In situations of presumed thin capitalisation, it is sometimes difficult to distinguish between dividends and interest and in order to avoid any possibility of overlap between the categories of income dealt with in Article 10 and Article 11 respectively, it should be noted that the term "interest" as used in Article 11 does not include items of income which are dealt with under Article 10.

(Replaced on 23 July 1992; see HISTORY)

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 interest that is taxable. On the other hand, any profit or loss which a holder of such a security realises by the sale thereof to another person does not enter into the

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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.

(Replaced on 23 July 1992; see HISTORY)

21. Moreover, the definition of interest in the first sentence of paragraph 3 is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations:

a) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;
b) the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws;
c) in the Model Convention references to domestic laws should as far as possible be avoided.

It nevertheless remains understood that in a bilateral convention two Contracting States may widen the formula employed so as to include in it any income which is taxed as interest under either of their domestic laws but which is not covered by the definition and in these circumstances may find it preferable to make reference to their domestic laws.

(Renumbered on 23 July 1992; see HISTORY)

21.1 The definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of nontraditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a "substance over form" rule, an "abuse of rights" principle, or any similar doctrine.

(Added on 21 September 1995; see HISTORY)

22. The second sentence of paragraph 3 excludes from the definition of interest penalty charges for late payment but Contracting States are free to omit this sentence and treat penalty charges as interest in their bilateral conventions. Penalty charges, which may be payable under the contract, or by customs or by virtue of a judgement, consist either of payments calculated *pro rata temporis* or

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else of fixed sums; in certain cases they may combine both forms of payment. Even if they are determined *pro rata temporis* they constitute not so much income from capital as a special form of compensation for the loss suffered by the creditor through the debtor's delay in meeting his obligations. Moreover, considerations of legal security and practical convenience make it advisable to place all penalty charges of this kind, in whatever form they be paid, on the same footing for the purposes of their taxation treatment. On the other hand, two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends.

(Renumbered on 23 July 1992; see HISTORY)

23. Finally, the question arises whether annuities ought to be assimilated to interest; it is considered that they ought not to be. On the one hand, annuities granted in consideration of past employment are referred to in Article 18 and are subject to the rules governing pensions. On the other hand, although it is true that instalments of purchased annuities include an interest element on the purchase capital as well as return of capital, such instalments thus constituting "*fruits civils*" which accrue from day to day, it would be difficult for many countries to make a distinction between the element representing income from capital and the element representing a return of capital in order merely to tax the income element under the same category as income from movable capital. Taxation laws often contain special provisions classifying annuities in the category of salaries, wages and pensions, and taxing them accordingly.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 4

24. Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 4 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". It does not stipulate that interest arising to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in

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the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the interest is taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident in the other State, if it is paid in respect of debt-claims forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the interest from any limitation under the Article. The foregoing explanations accord with those in the Commentary on Article 7.

(Renumbered on 23 July 1992; see HISTORY)

25. [Deleted on 29 April 2000; see HISTORY]

Paragraph 5

26. This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State.

(Amended on 21 September 1995; see HISTORY)

27. In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a "taxable quota" proportional to the importance of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut. In this connection, a number of possible cases may be distinguished:

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a) The management of the permanent establishment has contracted a loan which it uses for the specific requirements of the permanent establishment; it shows it among its liabilities and pays the interest thereon directly to the creditor.

b) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a permanent establishment situated in another country. The interest is serviced by the head office but is ultimately borne by the permanent establishment.

c) The loan is contracted by the head office of the enterprise and its proceeds are used for several permanent establishments situated in different countries.

In cases *a*) and *b*) the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the permanent establishment is situated is to be regarded as the State where the interest arises. Case *c*), however, falls outside the provisions of paragraph 5, the text of which precludes the attribution of more than one source to the same loan. Such a solution, moreover, would give rise to considerable administrative complications and make it impossible for lenders to calculate in advance the taxation that interest would attract. It is, however, open to two Contracting States to restrict the application of the final provision in paragraph 5 to case *a*) or to extend it to case *c*).

(Renumbered on 23 July 1992; see HISTORY)

28. Paragraph 5 provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third State and the interest is borne by that establishment. As paragraph 5 now stands, therefore, only its first sentence will apply in such a case. The interest will be deemed to arise in the Contracting State of which the payer is a resident and not in the third State in whose territory is situated the permanent establishment for the account of which the loan was effected and by which the interest is payable. Thus the interest will be taxed both in the Contracting State of which the payer is a resident and in the Contracting State of which the beneficiary is a resident. But, although double taxation will be avoided between these two States by the arrangements provided in the Article, it will not be avoided between them and the third State if the latter

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taxes the interest on the loan at the source when it is borne by the permanent establishment in its territory.

(Renumbered on 23 July 1992; see HISTORY)

29. It has not, however, been considered possible to refer to such a case in a bilateral convention and provide for it a solution consisting for example, in obliging the Contracting State of the payer's residence to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. The risk of double taxation just referred to can only be fully avoided through a bilateral convention containing a similar provision to that in paragraph 5, between the Contracting State of which the payer of the interest is a resident and the third State in which the permanent establishment paying the interest is situated, or through a multilateral convention containing such a provision.

(Renumbered on 23 July 1992; see HISTORY)

30. Moreover, in the case — not settled in paragraph 5 — where whichever of the two Contracting States is that of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence from concerting measures to avoid the double taxation that would result from such claims. The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph 5. Another solution would be for two Contracting States to word the second sentence of paragraph 5 in the following way:

> "Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated."

(Amended on 29 April 2000; see HISTORY)

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31. If two Contracting States agree in bilateral negotiations to reserve to the State where the beneficiary of the income resides the exclusive right to tax such income, then *ipso facto* there is no value in inserting in the convention which fixes their relations that provision in paragraph 5 which defines the State of source of such income. But it is equally obvious that double taxation would not be fully avoided in such a case if the payer of the interest owned, in a third State which charged its tax at the source on the interest, a permanent establishment for the account of which the loan had been borrowed and which bore the interest payable on it. The case would then be just the same as is contemplated in paragraphs 28 to 30 above.

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

Paragraph 6

32. The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of interest in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last-mentioned amount and that the excess part of the interest shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.

(Renumbered on 23 July 1992; see HISTORY)

33. It is clear from the text that for this clause to apply the interest held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

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

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34. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest.

(Renumbered on 23 July 1992; see HISTORY)

35. With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary to substitute other words for the phrase "having regard to the debt-claim for which it is paid". Nevertheless, this paragraph can affect not only the recipient but also the payer of excessive interest and if the law of the State of source permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the interest, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not alter its general purport.

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

36. Should the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

(Renumbered on 23 July 1992; see HISTORY)

Observation on the Commentary

37. *Canada* and the *United Kingdom* do not adhere to paragraph 18 above. Under their domestic legislation, certain interest payments are treated as distributions, and are therefore dealt with under Article 10.

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

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Reservations on the Article

Paragraph 2

38. *Hungary*, *Mexico*, *Portugal* and *Turkey* reserve their positions on the rate provided in paragraph 2.

(Amended on 23 October 1997; see HISTORY)

39. *Norway* reserves the right to treat interest as taxable only in the State where the beneficial owner of the interest is a resident.

(Replaced on 23 July 1992; see HISTORY)

40. The *United States* reserves the right to tax certain forms of contingent interest at the rate applicable to portfolio dividends under subparagraph *b*) of paragraph 2 of Article 10. It also reserves the right to tax under its law a form of interest that is "an excess inclusion with respect to residual interest in a real estate mortgage investment conduit".

(Added on 29 April 2000; see HISTORY)

Paragraph 3

41. *Greece* and *Mexico* reserve the right to exclude from the scope of this Article interest from debt-claim created or assigned mainly for the purpose of taking advantage of this Article and not for *bona fide* commercial reasons. *Mexico* reserves the right to consider as interest other types of income, such as income derived from financial leasing and factoring contracts.

(Amended on 21 September 1995; see HISTORY)

42. *Belgium*, *Canada* and *Ireland* reserve the right to amend the definition of interest so as to secure that interest payments treated as distributions under their domestic law fall within Article 10.

(Added on 23 July 1992; see HISTORY)

43. *Canada* and *Norway* reserve the right to delete the reference to debt-claims carrying the right to participate in the debtor's profits.

(Added on 23 July 1992; see HISTORY)

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44. *Greece, Portugal* and *Spain* reserve the right to widen the definition of interest by including a reference to their domestic law in line with the definition contained in the 1963 Draft Convention.

(Amended on 21 September 1995; see HISTORY)

Paragraph 4

45. *Italy* reserves the right to subject interest to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the indebtedness in respect of which the interest is paid is not effectively connected with such permanent establishment.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 6

46. As regards paragraph 6 of the Article, *Mexico* and the *United Kingdom* reserve the right (in accordance with paragraph 35 above) to include after "exceeds" the words "for whatever reason" in place of "having regard to the debt-claim for which it is paid". This permits interest and other payments in respect of certain loans to be dealt with as distributions in a range of circumstances provided for in its domestic law, including those where the amount of the loan or the rate of interest or other terms relating to it are not what would have been agreed in the absence of a special relationship.

(Amended on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Included in the 1977 Model Convention. Amended by replacing, in the last line, the reference to paragraph 5 of Article 24 by a reference to paragraph 4 of that Article, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Included in the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was amended by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995. Paragraph 8 previously read as follows:

> "8. Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations."

Paragraph 9: Included in the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 9 read as follows:

> "9. The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Unchanged from the 1977 Model Convention.

Paragraph 12: Unchanged from the 1977 Model Convention.

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Unchanged from the 1977 Model Convention.

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by

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deleting the 6th sentence and by moving the rest of the paragraph to a new paragraph 20 (cf. history of paragraph 20). In the 1977 Model Convention, paragraph 18 read as follows:

> "18. Paragraph 3 specifies the meaning to be attached to the term "interest" for the application of the taxation treatment defined by the Article. The term designates, in general, income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term "debt-claims of every kind" obviously embraces cash deposits and security in the form of money, as well as Government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital ("revenus de capitaux mobiliers"), even though certain countries assimilate it to income from immovable property. On the other hand, debt-claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest. In the contrary case, where the participation in profits rests upon a provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan and Article 11 does not apply. 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 interest that is taxable. On the other hand, any profit or loss which a holder of such a security realises by the sale thereof to another person 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."

Paragraph 19: Replaced paragraph 19 of the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was renumbered as paragraph 21 (cf. history of paragraph 21) and new paragraph 19 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 59 and 60 and sub-paragraph 85 *b*) of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 20: Replaced paragraph 20 of the 1977 Model Convention. Paragraph 20 of the 1977 Model Convention was renumbered as paragraph 22 (cf. history of paragraph 22) and new paragraph 20, which contains the text of the part of paragraph 18 of the 1977 Model Convention that followed the 6th sentence thereof (cf. history of paragraph 18), was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Corresponds to paragraph 19 of the 1977 Model Convention. Paragraph 21 of the 1977 Model Convention was renumbered as paragraph 23 (cf. history of paragraph 23) and paragraph 19 was renumbered as paragraph 21 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 21.1: Added by OECD Council Recommendation C(95)132/FINAL, adopted on 21 September 1995, which amended the Appendix to Recommendation C(94)11/FINAL in order to reflect a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 22: Corresponds to paragraph 20 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention was renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 20 was renumbered as paragraph 22 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 23: Corresponds to paragraph 21 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 21 was renumbered as paragraph 23 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 24: Corresponds to paragraph 22 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and paragraph 22 was renumbered as paragraph 24 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 25: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 25 previously read as follows:

> "25. The rules set out above also apply where the beneficiary of the interest has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the debt-claim in respect of which the interest is paid is effectively connected."

Paragraph 25, as it read before 29 April 2000, corresponded to paragraph 23 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was renumbered as paragraph 27 (cf. history of paragraph 27) and paragraph 23 was renumbered as paragraph 25 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 26: Amended by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995. Paragraph 26 previously read as follows:

> "26. This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident, who may, moreover, be that State itself or one of its political subdivisions or local authorities. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State."

Paragraph 26 corresponded to paragraph 24 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was renumbered as paragraph 28 (cf. history of paragraph 28) and paragraph 24 was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 27: Corresponds to paragraph 25 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was renumbered as paragraph 29 (cf. history of paragraph 29) and paragraph 25 was renumbered as paragraph 27 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Corresponds to paragraph 26 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was renumbered as paragraph 30 (cf. history of paragraph 30) and paragraph 26 was renumbered as paragraph 28 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Corresponds to paragraph 27 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was amended and renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 27 was renumbered as paragraph 29 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 30: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). The amendment deletes the words "or fixed base" and "or a fixed base" from paragraph 30. Paragraph 30 previously read as follows:

> "30. Moreover, in the case — not settled in paragraph 5 — where whichever of the two Contracting States is that of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence from concerting measures to avoid the double taxation that would result from such claims. The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph 5. Another solution would be for two Contracting States to word the second sentence of paragraph 5 in the following way:
>
> > "Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent estab-lishment or fixed base is situated.""

Paragraph 30 corresponds to paragraph 28 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was renumbered as paragraph 32 (cf. history of paragraph 32) and paragraph 28 was renumbered as paragraph 30 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 31: Corresponds to paragraph 29 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was amended and renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 29 was renumbered as paragraph 31, and amended by replacing the reference therein to paragraphs 26 to 28 by a reference to paragraphs 28 to 30, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 32: Corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 32 of the 1977 Model Convention was renumbered as paragraph 34 (cf. history of paragraph 34) and paragraph 30 was renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 33: Corresponds to paragraph 31 of the 1977 Model Convention. Paragraph 33 of the 1977 Model Convention was amended and renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 31 was renumbered as paragraph 33 and amended, by substituting the words "both of them and some other person" for "either of them and some other person" at the end of the first sentence, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 34: Corresponds to paragraph 32 of the 1977 Model Convention. Paragraph 34 of the 1977 Model Convention was renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 32 was renumbered as paragraph 34 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 35: Corresponds to paragraph 33 of the 1977 Model Convention. Paragraph 35 of the 1977 Model Convention was amended and renumbered as paragraph 37 (cf. history of paragraph 37) and paragraph 33 was renumbered as paragraph 35 and amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 61 and 62 of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986). In the 1977 Model Convention, paragraph 33 read as follows:

> "33. With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the interest, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not alter its general purport."

Paragraph 36: Corresponds to paragraph 34 of the 1977 Model Convention. Paragraph 36 of the 1977 Model Convention was deleted and paragraph 34 was renumbered as paragraph 36 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 36 read as follows:

> "36. The *United States* observes that the Article does not limit the taxation by internal law of interest not attributable to a United States permanent establishment in cases where 50 per cent or more of a non-resident payer's gross income is effectively connected with a trade or business in the United States. The United States is willing, in appropriate situations, to limit such taxation by making appropriate modifications in the text of the Article."

Paragraph 37: Corresponds to paragraph 35 of the 1977 Model Convention. Paragraph 37 of the 1977 Model Convention was amended and renumbered as paragraph 38 (cf. history of paragraph 38) and paragraph 35 was amended and renumbered as paragraph 37 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 35 read as follows:

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"35. The *United Kingdom* does not adhere to paragraph 18 above. Under United Kingdom law, certain interest payments are treated as distributions, and are therefore dealt with under Article 10."

Paragraph 38: Amended, by adding Hungary to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 38 previously read as follows:

"38. *Mexico*, *Portugal* and *Turkey* reserve their positions on the rate provided in paragraph 2."

Paragraph 38 was previously amended, by adding Mexico and Turkey to the list of countries making the Reservation, by a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 995.

Paragraph 38 corresponded to paragraph 37 of the 1977 Model Convention. Paragraph 38 of the 1977 Model Convention was deleted and paragraph 37 was amended and renumbered as paragraph 38 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 37 read as follows:

"37. *Belgium*, *Portugal* and *Spain* reserve their position on the rate provided in paragraph 2."

In the 1977 Model Convention, paragraph 38 read as follows:

"38. *Canada* reserves its position on paragraph 2 and wishes to retain a 15 per cent rate of tax at source in its bilateral conventions."

Paragraph 39: Replaced paragraph 39 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was amended and renumbered as paragraph 40 (cf. history of paragraph 40) and new paragraph 39 was added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 40: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

A previous paragraph 40 was deleted by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995. Paragraph 40 previously read as follows:

"40. *Turkey* reserves its position on the rate of tax in paragraph 2."

Paragraph 40, as it read before 21 September 1995, corresponded to paragraph 39 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was renumbered as paragraph 45 (cf. history of paragraph 45) and paragraph 39 was amended and renumbered as paragraph 40 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 39 read as follows:

"39. *Turkey* cannot accept a rate of tax which is lower than 20 per cent."

Paragraph 41: Amended by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995. Paragraph 41 previously read as follows:

"41. *Greece* reserves it right to exclude from the scope of this Article interest from debt-claim created or assigned mainly for the purpose of taking advantage of this Article and not for *bona fide* commercial reasons."

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Paragraph 41 was added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 43: Added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44: Amended, by adding Greece to the list of countries making the reservation, on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 44 was added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45: Corresponds to paragraph 40 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was renumbered as paragraph 45 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 46: Amended, by adding Mexico to the list of countries making the Reservation, on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 46 had been previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 46 previously read as follows:

> "46. As regards paragraph 6 of the Article (cf. paragraph 32 above), the *United Kingdom* reserves the right to include after "exceeds" the words "for whatever reason" in place of "having regard to the debt-claim for which it is paid" so as to make it clear that abuse may occur not only where an uncommercial rate of interest is charged on the loan but also where the amount of the loan to which the interest relates exceeds that which would have been loaned between two parties acting at arm's length."

Paragraph 46 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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COMMENTARY ON ARTICLE 12
CONCERNING THE TAXATION OF ROYALTIES

I. Preliminary remarks

1. In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an enterprise (e.g. the use of literary copyright granted by a publisher or the use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. use of a patent granted by the inventor's heirs).

(Amended on 29 April 2000; see HISTORY)

2. Certain countries do not allow royalties paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the royalties are paid by a resident of a Contracting State to a resident of the other State, is dealt with in paragraph 4 of Article 24.

(Amended on 23 July 1992; see HISTORY)

II. Commentary on the provisions of the Article

Paragraph 1

3. Paragraph 1 lays down the principle of exclusive taxation of royalties in the State of the beneficial owner's residence. The only exception to this principle is that made in the cases dealt with in paragraph 3.

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

(Amended on 23 October 1997; see HISTORY)

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

(Amended on 23 October 1997; see HISTORY)

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

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

Paragraph 2

8. Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right. It should also be noted that the word "payment", used in the definition, has a very wide meaning since the concept of payment means the fulfilment of the

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obligation to put funds at the disposal of the creditor in the manner required by contract or by custom. As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, the provision of information.

(Amended on 23 October 1997; see HISTORY)

9. Whilst the definition of the term "royalties" in the 1963 Draft Convention and the 1977 Model Convention included payments "for the use of, or the right to use, industrial, commercial or scientific equipment", the reference to these payments was subsequently deleted from the definition. Given the nature of income from the leasing of industrial, commercial or scientific equipment, including the leasing of containers, the Committee on Fiscal Affairs decided to exclude income from such leasing from the definition of royalties and, consequently, to remove it from the application of Article 12 in order to make sure that it would fall under the rules for the taxation of business profits, as defined in Articles 5 and 7.

(Replaced on 23 July 1992; see HISTORY)

10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as business profits and, in consequence, subjected to the provisions of Articles 7 and 9.

(Amended on 29 April 2000; see HISTORY)

11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the *"Association des Bureaux pour la Protection de la Propriété Industrielle"* (ANBPPI), states that "know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique." In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account,

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his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Thus, payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments generally fall under Article 7. In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.

(Amended on 29 April 2000; see HISTORY)

12. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. In 1992, the Commentary was amended to describe the principles by which such classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome.

(Amended on 29 April 2000; see HISTORY)

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

(Added on 29 April 2000; see HISTORY)

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

(Added on 29 April 2000; see HISTORY)

13. The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.2 below). In

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unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.3).

(Replaced on 29 April 2000; see HISTORY)

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

(Added on 29 April 2000; see HISTORY)

14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of

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software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.

(Replaced on 29 April 2000; see HISTORY)

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

(Added on 29 April 2000; see HISTORY)

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

(Added on 29 April 2000; see HISTORY)

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

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separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.

(Added on 29 April 2000; see HISTORY)

15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there are extensive but partial alienation of rights involving:

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

(Amended on 29 April 2000; see HISTORY)

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

(Amended on 29 April 2000; see HISTORY)

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

(Amended on 29 April 2000; see HISTORY)

18. The suggestions made above regarding mixed contracts could also be applied in regard to certain performances by artists and, in particular, in regard

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to an orchestral concert given by a conductor or a recital given by a musician. The fee for the musical performance, together with that paid for any simultaneous radio broadcasting thereof, seems to fall to be treated under Article 17. Where, whether under the same contract or under a separate one, the musical performance is recorded and the artist has stipulated that he be paid royalties on the sale or public playing of the records, then so much of the payment received by him as consists of such royalties falls to be treated under Article 12.

(Renumbered on 23 July 1992; see HISTORY)

19. It is further pointed out that variable or fixed payments for the working of mineral deposits, sources or other natural resources are governed by Article 6 and do not, therefore, fall within the present Article.

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

Paragraph 3

20. Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 3 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". It does not stipulate that royalties arising to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the royalties are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State, if they are paid in respect of rights or property forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 3 relieves the State of source of the royalties from any limitations under the Article. The foregoing explanations accord with those in the Commentary on Article 7.

(Renumbered on 23 July 1992; see HISTORY)

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21. [Deleted on 29 April 2000; see HISTORY]

Paragraph 4

22. The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of royalties in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last-mentioned amount and that the excess part of the royalty shall remain taxable according to the laws of the two Contracting States due regard being had to the other provisions of the Convention.

(Renumbered on 23 July 1992; see HISTORY)

23. It is clear from the text that for this clause to apply the payment held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where royalties are paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

(Renumbered on 23 July 1992; see HISTORY)

24. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty.

(Renumbered on 23 July 1992; see HISTORY)

25. With regard to the taxation treatment to be applied to the excess part of the royalty, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purpose of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases required, to the excess part of the royalties,

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there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 4, as long as they do not alter its general purport.

(Renumbered on 23 July 1992; see HISTORY)

26. Should the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

(Renumbered on 23 July 1992; see HISTORY)

Observations on the Commentary

27. *Canada* does not adhere to paragraphs 14 through 14.3. In Canada, payments by a user of computer software pursuant to a contract that requires that the source code or program be kept confidential, are payments for the use of a secret formula or process and thus are royalties within the meaning of paragraph 2 of the Article.

(Amended on 29 April 2000; see HISTORY)

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

(Replaced on 23 July 1992; see HISTORY)

29. The *United States* believes that in interpreting the definition of "royalties" in paragraph 2 of the Article, with respect to payments for software, it should be understood that where a payment for the acquisition of software for the personal or business use of the purchaser is measured by reference to the productivity or use of such software, the payment may represent a royalty under the Article.

(Replaced on 23 July 1992; see HISTORY)

30. [Deleted on 29 April 2000; see HISTORY]

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31. *Greece* does not adhere to the interpretation in paragraphs 14 and 15 above. *Greece* takes the view that payments related to software fall within the scope of this Article, whether the payments are in consideration for the use of (or the right to use) software for commercial exploitation or for the personal or business use of the purchaser.

(Added on 21 September 1995; see HISTORY)

31.1 With respect to paragraph 14, *Korea* is of the opinion that the paragraph may neglect the fact that know-how can be transferred in the form of computer software. Therefore, Korea considers know-how imparted by non-residents through software or computer program to be treated in accordance with Article 12.

(Added on 23 October 1997; see HISTORY)

Reservations on the Article

Paragraph 1

32. [Deleted on 29 April 2000; see HISTORY]

33. *Greece* is unable to accept a provision which would preclude it, in bilateral conventions for the avoidance of double taxation, from stipulating a clause conferring on it the right to tax royalties at a rate of up to 10 per cent.

(Amended on 23 October 1997; see HISTORY)

34. The *Czech Republic* reserves the right to tax at a rate of 10 per cent royalties that, under Czech law, have a source in the Czech Republic. The Czech Republic also reserves the right to subject payments for the use of, or the right to use, software rights to a tax regime different from that provided for copyrights.

(Added on 23 October 1997; see HISTORY)

35. *Canada* reserves its position on paragraph 1 and wishes to retain a 10 per cent rate of tax at source in its bilateral conventions. However, Canada would be prepared to provide an exemption from tax for copyright royalties in respect of cultural, dramatic, musical or artistic work, but not including royalties in respect of motion picture films and works on films or video tape or other means of

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reproduction for use in connection with television. Canada would also be prepared in most circumstances to provide an exemption for royalties in respect of computer software, patents and know-how.

(Amended on 29 April 2000; see HISTORY)

36. *Australia, Japan, Korea, Mexico, New Zealand, Poland, Portugal, Spain* and *Turkey* reserve the right to tax royalties at source.

(Amended on 29 April 2000; see HISTORY)

37. *Italy* reserves the right to tax royalties at source, but is prepared to grant favourable treatment to certain royalties (e.g. copyright royalties). Italy also reserves the right to subject the use of, or the right to use, software rights to a tax regime different from that provided for copyright.

(Renumbered on 21 September 1995; see HISTORY)

Paragraph 2

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

(Renumbered and amended on 21 September 1995; see HISTORY)

39. *Australia* reserves the right to tax income derived from the leasing of industrial, commercial or scientific equipment and of containers as royalties under its double taxation agreements, where such income, under Australian law, has a source in Australia.

(Renumbered on 21 September 1995; see HISTORY)

40. *Canada, the Czech Republic, Hungary, Korea and Poland* reserve the right to add the words "for the use of, or the right to use, industrial, commercial or scientific equipment" to paragraph 2.

(Amended on 23 October 1997; see HISTORY)

41. *Greece, Italy* and *Mexico* reserve the right to continue to include income derived from the leasing of industrial, commercial or scientific equipment and of

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containers in the definition of "royalties" as provided for in paragraph 2 of Article 12 of the 1977 Model Convention.

(Renumbered and amended on 21 September 1995; see HISTORY)

42. *New Zealand* reserves the right to tax at source payments from the leasing of industrial, commercial or scientific equipment and of containers.

(Renumbered on 21 September 1995; see HISTORY)

43. *Portugal* reserves the right to treat and tax as royalties all software income that is not derived from a total transfer of the rights attached to the software. Portugal also reserves the right to tax at source as royalties income from the leasing of industrial, commercial or scientific equipment and of containers, as well as income arising from technical assistance in connection with the use of, or the right to use, such equipment and containers.

(Renumbered on 21 September 1995; see HISTORY)

44. *Portugal* and *Spain* reserve the right to tax at source as royalties income arising from technical assistance in connection with the use of, or right to use, rights or information of the type referred to in paragraph 2 of the Article.

(Renumbered on 21 September 1995; see HISTORY)

45. *Spain* reserves its right to continue to adhere in its conventions to a definition of royalties which includes income from the leasing of industrial, commercial or scientific equipment and of containers.

(Renumbered on 21 September 1995; see HISTORY)

46. *Turkey* reserves the right to tax at source income from the leasing of industrial, commercial or scientific equipment.

(Renumbered on 21 September 1995; see HISTORY)

46.1. The *United States* reserves the right to treat as a royalty a gain derived from the alienation of a property described in paragraph 2 of the Article, provided that the gain is contingent on the productivity, use or disposition of the property.

(Added on 29 April 2000; see HISTORY)

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Paragraph 3

47. *Italy* reserves the right to subject royalties and profits from the alienation of rights or property giving rise to royalties to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the rights or property in respect of which the royalties are paid is not effectively connected with such permanent establishment.

(Renumbered on 21 September 1995; see HISTORY)

48. *Belgium, Canada, the Czech Republic, Mexico* and *France* reserve the right, in order to fill what they consider as a gap in the Article, to propose a provision defining the source of royalties by analogy with the provisions of paragraph 5 of Article 11, which deals with the same problem in the case of interest.

(Amended on 23 October 1997; see HISTORY)

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HISTORY

Paragraph 1: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 1 read as follows:

> "1. In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an industrial or commercial enterprise (e.g. the use of literary copyright granted by a publisher) or an independent pro- fession (e.g. use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. use of a patent granted by the inventor's heirs)."

Paragraph 2: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by replacing, at the end of the paragraph, the reference to paragraph 5 of Article 24 paragraph by a reference to paragraph 4 of Article 24.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Included in the 1977 Model Convention. Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 4 previously read as follows:

> "4. Under paragraph 1, the exemption from tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations. The term "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom."

Paragraph 5: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997, paragraph 5 read as follows:

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

Paragraph 5 was included in the 1977 Model Convention but had been subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 5 read as follows:

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"5. The Article deals only with royalties arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to royalties arising in a third State as well as to royalties arising in a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases cf. paragraphs 4 to 6 of the Commentary on Article 21)."

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997, paragraph 5 read as follows:

"8. Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right. As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, the provision of information."

Paragraph 8 was included in the 1977 Model Convention but had been subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting the words "equipment renting and" in the last line. In the 1977 Model Convention, paragraph 8 read as follows:

"8. Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of industrial and commercial property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying of infringing the right. As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, equipment renting and the provision of information."

Paragraph 9: Replaced paragraph 9 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was deleted and new paragraph 9 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of two previous reports entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and "The Taxation of Income Derived from the Leasing of Containers" (adopted by the Council of the OECD on 13 September 1983). In the 1977 Model Convention, paragraph 9 read as follows:

"9. A clear distinction must be made between royalties paid for the use of equipment, which fall under Article 12, and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7, 13, 14 or 21. Some contracts combine the hire element and the sale element, so that it sometimes proves

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difficult to determine their true legal import. In the case of credit sale agreements and hire purchase agreements, it seems clear that the sale element is the paramount use, because the parties have from the outset agreed that the ownership of the property in question shall be transferred from one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/hirer do not, in principle, constitute royalties. In the case, however, of lend-lease, and of leasing in particular, the sole, or at least the principal, purpose of the contract is normally that of hire, even if the hirer has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the normal case to the rentals paid by the hirer, including all rentals paid by him up to the date he exercises any right to purchase."

Paragraph 10: Included in the 1977 Model Convention. Amended, by replacing the words "industrial and commercial" with the word "business", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 10 read as follows:

"10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as industrial and commercial profits and, in consequence, subjected to the provisions of Articles 7 and 9."

Paragraph 11: Amended, by deleting "or Article 14", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 11 previously read as follows:

"11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the "*Association des Bureaux pour la Protection de la Propriété Industrielle*" (ANBPPI), states that "know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique." In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Thus, payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments generally fall under Article 7 or Article 14. In business practice, contracts are encountered which cover

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both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part."

Paragraph 11 corresponds to paragraph 12 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was deleted and paragraph 12 was renumbered as paragraph 11 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. Paragraph 11 of the 1977 Model Convention read as follows:

"11. The rules set out above in regard to rents in respect of cinematograph films could also be applied in regard to rentals derived by a shipping enterprise from the hire of its containers for the conveyance of goods on land after leaving the ship. It is considered, however, that where the hire of the containers is a supplementary or incidental activity of a transport company, the income should be treated as profits falling under Article 8."

Paragraph 12: Amended, by moving all but the first sentence of paragraph 12 into new paragraphs 12.1 and 12.2 and adding three new sentences after the first sentence, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 12 previously read as follows:

"12. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. Software may be described as a programme, or series of programmes, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing, on a magnetic tape or disc, or on a laser disc. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware. The rights in computer software are a form of intellectual property. Research into the practices of OECD Member countries has established that all but one protect software rights either explicitly or implicitly under copyright law. Transfers of rights occur in many different ways ranging from the alienation of the entire rights to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment."

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Paragraph 12 of the 1977 Model Convention was renumbered as paragraph 11 (cf. history of paragraph 11) and new paragraph 12 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 to the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 12.1 corresponds, with minor amendment, to the second to fifth sentences of paragraph 12 (cf. history of paragraph 12) as they read after 23 July 1992 and before 29 April 2000.

Paragraph 12.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 12.2 includes the sixth to tenth sentences of paragraph 12 (cf. history of paragraph 12) as they read after 23 July 1992 and before 29 April 2000.

Paragraph 13: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. The first five sentences of paragraph 13 were deleted and the remaining sentences of paragraph 13 were incorporated into a new paragraph 13.1 by that report. Paragraph 13 previously read as follows:

> "13. Three situations are considered. The first is of payments made where less than the full rights in software are transferred. In a partial transfer of rights the consideration is likely to represent a royalty only in very limited circumstances. One such case is where the transferor is the author of the software (or has acquired from the author his rights of distribution and reproduction) and he has placed part of his rights at the disposal of a third party to enable the latter to develop or exploit the software itself commercially, for example by development and distribution of it. It should be noted that even where a software payment is properly to be regarded as a royalty there are difficulties in applying the copyright provisions of the Article to software royalties since paragraph 2 requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of copyrights or refers specifically to software."

Paragraph 13 of the 1977 Model Convention was renumbered as paragraph 18 (cf. history of paragraph 18) and new paragraph 13 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 to the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 13.1 includes, with minor amendment, the fifth, sixth and seventh sentence of paragraph 13 (cf. history of paragraph 13) as they read after 23 July 1992 and before 29 April 2000.

Paragraph 14: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 14 previously read as follows:

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"14. In other cases, the acquisition of the software will generally be for the personal or business use of the purchaser. The payment will then fall to be dealt with as commercial income in accordance with Articles 7 or 14. It is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it."

Paragraph 14 of the 1977 Model Convention was amended and renumbered as paragraph 19 (cf. history of paragraph 19) and new paragraph 14 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 to the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 14.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 14.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 15: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 15 previously read as follows:

"15. The second situation is where the payments are made as consideration for the alienation of rights attached to the software. It is clear that where consider-ation is paid for the transfer of the full ownership, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there are extensive but partial alienation of rights involving:

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

Paragraph 15 of the 1977 Model Convention was renumbered as paragraph 20 (cf. history of paragraph 20) and new paragraph 15 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 to the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992.

Paragraph 16: Amended, by deleting "or 14" in the second line, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 16 previously read as follows:

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

Paragraph 16 of the 1977 Model Convention was renumbered as paragraph 21 (cf. history of paragraph 21) and new paragraph 16 was added by the Report entitled "The Revision of the Model

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Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 to the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992.

Paragraph 17: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 17 previously read as follows:

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

Paragraph 17 of the 1977 Model Convention was renumbered as paragraph 22 (cf. history of paragraph 22) and new paragraph 17 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 to the Report entitled "The Tax Treatment of Software", adopted by the Council of the OECD on 23 July 1992.

Paragraph 18: Corresponds to paragraph 13 of the 1977 Model Convention. Paragraph 18 of the 1977 Model Convention was renumbered as paragraph 23 (cf. history of paragraph 23) and paragraph 13 was renumbered as paragraph 18 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 19: Corresponds to paragraph 14 of the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 14 was renumbered as paragraph 19 and amended, by deleting the second sentence thereof as a consequence of the change to the definition of the term "royalties" in paragraph 2 of Article 12, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 14 read as follows:

> "14. It is further pointed out that variable or fixed payments for the working of mineral deposits, sources or other natural resources are governed by Article 6 and do not, therefore, fall within the present Article. If two Contracting States should have difficulty from the legal standpoint in applying this distinction in regard to consideration for the use of, or the right to use, equipment, they could add to the text of paragraph 2, after the words "industrial, commercial or scientific equipment", the words "not constituting immovable property referred to in Article 6".

Paragraph 20: Corresponds to paragraph 15 of the 1977 Model Convention. Paragraph 20 of the 1977 Model Convention was renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 15 was renumbered as paragraph 20 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of

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another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 21 previously read as follows:

> "21. The rules set out above also apply where the beneficiary of the royalties has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the right or property in respect of which the royalties are paid is effectively connected."

Paragraph 21 corresponds to paragraph 16 of the 1977 Model Convention. Paragraph 21 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and paragraph 16 was renumbered as paragraph 21 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 22: Corresponds to paragraph 17 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention was deleted and paragraph 17 was renumbered as paragraph 22 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 22 read as follows:

> "22. The observation made by *Portugal*, *Spain* and *Turkey* on the Commentary on Article 8 (cf. paragraph 28 of the Commentary thereon) applies also to paragraph 11 of the present Commentary for the leasing of containers."

Paragraph 23: Corresponds to paragraph 18 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 18 was renumbered as paragraph 23 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 24: Corresponds to paragraph 19 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was amended and renumbered as paragraph 32 (cf. history of paragraph 32) and paragraph 19 was renumbered as paragraph 24 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 25: Corresponds to paragraph 20 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was amended and renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 20 was renumbered as paragraph 25 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 26: Corresponds to paragraph 21 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was deleted and paragraph 21 was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 26 read as follows:

> "26. *Finland* reserves the right to tax royalties at source. However, Finland would be prepared to provide an exemption from tax for copyright royalties in respect of any literary, artistic or scientific work."

Paragraph 27: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 27 previously read as follows:

> "27. *Canada* does not adhere to paragraph 14. In Canada, payments by a user of computer software pursuant to a contract that requires that the source code or program be kept confidential, are payments for the use of a secret formula or process and thus are royalties within the meaning of paragraph 2 of the Article."

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Paragraph 27 was included in the 1977 Model Convention but was subsequently renumbered as paragraph 34 (cf. history of paragraph 34) and new paragraph 27 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Replaced paragraph 28 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was amended and renumbered as paragraph 35 (cf. history of paragraph 35) and new paragraph 28 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Replaced paragraph 29 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was deleted and new paragraph 29 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 29 read as follows:

> "29. *Turkey* cannot accept a rate of tax which is lower than 20 per cent."

Paragraph 30: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 30 previously read as follows:

> "30. In relation to paragraphs 13 and 14, *Australia* takes the view that payments made for the right to copy or adapt the software in a manner which would, without the permission of the copyright owner, constitute an infringement of copyright, are royalties."

Paragraph 30 of the 1977 Model Convention was amended and renumbered as paragraph 42 (cf. history of paragraph 42) and new paragraph 30 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 31: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 31.1: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 32: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 32 read as follows:

> "32. *Australia* reserves the right to tax royalties that, under Australian law, have a source in Australia."

Paragraph 32, as it read before 29 April 2000, corresponded to paragraph 31 of the 1992 Model Convention. Paragraph 32 of the 1992 Model Convention was renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 31 was renumbered as paragraph 32 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 31 of the 1992 Model corresponded to paragraph 23 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was renumbered as paragraph 43 (cf. history of paragraph 43) and paragraph 23 was renumbered as paragraph 31 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 33: Amended, by deleting the reference to Austria, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 33 previously read as follows:

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> "33. *Austria* and *Greece* are unable to accept a provision which would preclude them, in bilateral conventions for the avoidance of double taxation, from stipulating a clause conferring on them the right to tax royalties at a rate of up to 10 per cent."

Paragraph 33 corresponds to paragraph 32 of the 1992 Model Convention. Paragraph 33 of the 1992 Model Convention was renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 32 was renumbered as paragraph 33 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 32 corresponded to paragraph 24 of the 1977 Model Convention. Paragraph 24 was amended by deleting the word "Luxembourg" and renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 24 read as follows:

> "24. *Austria*, *Greece* and *Luxembourg* are unable to accept a provision which would preclude them, in bilateral conventions for the avoidance of double taxation, from stipulating a clause conferring on them the right to tax royalties at a rate of up to 10 per cent."

Paragraph 34: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

A previous paragraph 34 was deleted on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Paragraph 34 previously read as follows:

> "34. *France* reserves the right to retain some tax on royalties of French origin when flows of royalties between France and the other Contracting State are unbalanced to France's disadvantage."

Paragraph 34, as it read immediately before 21 September 1995, corresponded to paragraph 27 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was renumbered as paragraph 34 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 35: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 35 read as follows:

> "35. *Canada* reserves its position on paragraph 1 and wishes to retain a 10 per cent rate of tax at source in its bilateral conventions. However, Canada would be prepared to provide an exemption from tax for copyright royalties in respect of a cultural, dramatic, musical or artistic work, but not including royalties in respect of motion picture films and works on film or videotape or other means of reproduction for use in connection with television."

Paragraph 35 corresponds to paragraph 33 of the 1992 Model Convention. Paragraph 35 of the 1992 Model Convention was amended and renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 33 was renumbered as paragraph 35 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 33 of the 1992 Model Convention corresponded to paragraph 25 of the 1977 Model Convention. Paragraph 25 was amended and renumbered as paragraph 33 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 25 read as follows:

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"25. *Canada* reserves its position on paragraph 1 and wishes to retain a 10 per cent rate of tax at source in its bilateral conventions. However, Canada would be prepared to provide an exemption from tax for copyright royalties in respect of any literary, dramatic, musical or artistic work, but not including royalties in respect of motion picture films, and films or video tapes for use in connection with television."

Paragraph 36: Amended, by adding Australia to the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Prior to 29 April 2000, paragraph 36 read as follows:

"36. *Korea, Japan, Mexico, New Zealand, Poland, Portugal, Spain* and *Turkey* reserve the right to tax royalties at source. "

Paragraph 36 had been previously amended, by adding Korea and Poland to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 21 September 1995 and before 23 October 1997, paragraph 36 read as follows:

"36. *Japan, Mexico, New Zealand, Portugal, Spain* and *Turkey* reserve the right to tax royalties at source."

Paragraph 36 corresponds to paragraph 35 of the 1992 Model Convention. On 21 September 1995 paragraph 36 of the 1992 Model Convention was renumbered as paragraph 37 (cf. history of paragraph 37), paragraph 35 was renumbered as paragraph 36, and paragraph 35 was amended by adding Mexico to the list of countries making the reservation. The 1995 changes reflected a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". After 23 July 1992, but before 21 September 1995, paragraph 36 read as follows:

"35. *Japan, New Zealand, Portugal, Spain* and *Turkey* reserve the right to tax royalties at source."

Paragraph 35 corresponded to paragraph 28 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was amended by adding Turkey to the list of countries making the reservation and renumbered as paragraph 35 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, but before 23 July 1992 paragraph 28 read as follows:

"28. *Japan, New Zealand, Portugal* and *Spain* reserve the right to tax royalties at source."

Paragraph 37: Corresponds to paragraph 36 of the 1992 Model Convention. Paragraph 37 of the 1992 Model Convention was renumbered as paragraph 38 (cf. history of paragraph 38) and paragraph 36 was renumbered as paragraph 37 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 36 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 38: Corresponds to paragraph 40 of the 1992 Model Convention. Paragraph 38 of the 1992 Model Convention was renumbered as paragraph 44 (cf. history of paragraph 44) and paragraph 40 was amended, by adding Mexico to the list of countries making the reservation, and renumbered as paragraph 38 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 40 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 39: Corresponds to paragraph 43 of the Commentary on Article 7 of the 1992 Model Convention. Paragraph 39 of the 1992 Model Convention was renumbered as paragraph 40 (cf. history of paragraph 40) and paragraph 43 of the Commentary on Article 7 was renumbered as paragraph 39 of the Commentary on Article 12 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 43 of the Commentary on Article 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 28 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983).

Paragraph 40: Amended, by adding the Czech Republic, Hungary, Korea and Poland to the country making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 40 previously read as follows:

> "2. *Canada* reserves the right to add the words "for the use of, or the right to use, industrial, commercial or scientific equipment" to paragraph 2."

Paragraph 40 corresponds to paragraph 39 of the 1992 Model Convention. Paragraph 40 of the 1992 Model Convention was amended and renumbered as paragraph 38 (cf. history of paragraph 38), and paragraph 39 was renumbered as paragraph 40 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 39 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 41: Corresponds to paragraph 45 of the Commentary on Article 7 of the 1992 Model Convention. Paragraph 41 of the 1992 Model Convention was renumbered as paragraph 45 (cf. history of paragraph 45) and paragraph 45 of the Commentary on Article 7 was renumbered as paragraph 41, and amended by adding Mexico to the list of countries making the reservation, by the Report entitled "The 1995 Update to the Model Tax Convention" adopted by the OECD Council on 21 September 1995.

Paragraph 45 of the Commentary on Article 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis, in the case of Italy, of paragraph 30 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and of paragraph 48 of another report entitled "The Taxation of Income Derived from the Leasing of Containers" (also adopted by the Council of the OECD on 13 September 1983).

Paragraph 42: Corresponds to paragraph 46 of the Commentary on Article 7 of the 1992 Model Convention. Paragraph 42 of the 1992 Model Convention was renumbered as paragraph 47 (cf. history of paragraph 47) and paragraph 46 of the Commentary on Article 7 was renumbered as paragraph 42 of the Commentary on Article 12 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 46 of the Commentary on Article 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 31 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983) and of paragraph 49 of another report entitled "The Taxation of Income Derived from the Leasing of Containers" (also adopted by the Council of the OECD on 13 September 1983).

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Paragraph 43: Corresponds to paragraph 37 of the 1992 Model Convention. Paragraph 43 of the 1992 Model Convention was renumbered as paragraph 48 (cf. history of paragraph 48), and paragraph 37 was renumbered as paragraph 43 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 37 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44: Corresponds to paragraph 38 of the 1992 Model Convention. Paragraph 38 was renumbered as paragraph 44 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 38 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45: Corresponds to paragraph 41 of the 1992 Model Convention. Paragraph 41 was renumbered as paragraph 45 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 41 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 46: Corresponds to paragraph 49 of the Commentary on Article 7 of the 1992 Model Convention. Paragraph 49 of the Commentary on Article 7 was renumbered as paragraph 46 of the Commentary on Article 12 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 49 of the Commentary on Article 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 31 of a previous report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial and Scientific Equipment" (adopted by the Council of the OECD on 13 September 1983).

Paragraph 46.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 47: Corresponds to paragraph 42 of the 1992 Model Convention. Paragraph 42 was renumbered as paragraph 47 on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 42 corresponded to paragraph 30 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was renumbered as paragraph 42 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 48: Amended, by adding the Czech Republic to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 48 previously read as follows:

> "48. *Belgium, Canada, Mexico* and *France* reserve the right, in order to fill what they consider as a gap in the Article, to propose a provision defining the source of royalties by analogy with the provisions of paragraph 5 of Article 11, which deals with the same problem in the case of interest.

Paragraph 48 corresponds to paragraph 43 of the 1992 Model Convention. Paragraph 43 was amended, by adding Mexico to the list of countries making the reservation, and renumbered as paragraph 48 on

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21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 43 corresponded to paragraph 31 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was amended and renumbered as paragraph 43 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 31 read as follows:

> "31. *Belgium* reserves the right, in order to fill what it considers as a gap in the Article, to propose a provision defining the source of royalties by analogy with the provision in paragraph 5 of Article 11, which deals with the same problem in the case of interest."

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COMMENTARY ON ARTICLE 13
CONCERNING THE TAXATION OF CAPITAL GAINS

I. Preliminary remarks

1. A comparison of the tax laws of the OECD Member countries shows that the taxation of capital gains varies considerably from country to country:

- in some countries capital gains are not deemed to be taxable income;
- in other countries capital gains accrued to an enterprise are taxed, but capital gains made by an individual outside the course of his trade or business are not taxed;
- even where capital gains made by an individual outside the course of his trade or business are taxed, such taxation often applies only in specified cases, e.g. profits from the sale of immovable property or speculative gains (where an asset was bought to be resold).

2. Moreover, the taxes on capital gains vary from country to country. In some OECD Member countries, capital gains are taxed as ordinary income and therefore added to the income from other sources. This applies especially to the capital gains made by the alienation of assets of an enterprise. In a number of OECD Member countries, however, capital gains are subjected to special taxes, such as taxes on profits from the alienation of immovable property, or general capital gains taxes, or taxes on capital appreciation (increment taxes). Such taxes are levied on each capital gain or on the sum of the capital gains accrued during a year, mostly at special rates, which do not take into account the other income (or losses) of the taxpayer. It does not seem necessary to describe all those taxes.

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. 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.

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II. Commentary on the provisions of the Article

General remarks

4. It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.

5. The Article does not give a detailed definition of capital gains. This is not necessary for the reasons mentioned above. The words "alienation of property" are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.

6. Most States taxing capital gains do so when an alienation of capital assets takes place. Some of them, however, tax only so-called realised capital gains. Under certain circumstances, though there is an alienation no realised capital gain is recognised for tax purposes (e.g. when the alienation proceeds are used for acquiring new assets). Whether or not there is a realisation has to be determined according to the applicable domestic tax law. No particular problems arise when the State which has the right to tax does not exercise it at the time the alienation takes place.

7. As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation.

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8. Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.

9. Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below.

(Amended on 29 April 2000; see HISTORY)

10. In some States the transfer of an asset from a permanent establishment situated in the territory of such State to a permanent establishment or the head office of the same enterprise situated in another State is assimilated to an alienation of property. The Article does not prevent these States from taxing profits or gains deemed to arise in connection with such a transfer, provided, however, that such taxation is in accordance with Article 7.

11. The Article does not distinguish as to the origin of the capital gain. Therefore all capital gains, those accruing over a long term, parallel to a steady improvement in economic conditions, as well as those accruing in a very short period (speculative gains) are covered. Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.

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12. The Article does not specify how to compute a capital gain, this being left to the domestic law applicable. As a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price. In some cases the cost after deduction of the depreciation allowances already given is taken into account. Some tax laws prescribe another base instead of cost, e.g. the value previously reported by the alienator of the asset for capital tax purposes.

13. Special problems may arise when the basis for the taxation of capital gains is not uniform in the two Contracting States. The capital gain from the alienation of an asset computed in one State according to the rules mentioned in paragraph 12 above, may not necessarily coincide with the capital gain computed in the other State under the accounting rules used there. This may occur when one State has the right to tax capital gains because it is the State of situs while the other State has the right to tax because the enterprise is a resident of that other State.

14. The following example may illustrate this problem: an enterprise of State A bought immovable property situated in State B. The enterprise may have entered depreciation allowances in the books kept in State A. If such immovable property is sold at a price which is above cost, a capital gain may be realised and, in addition, the depreciation allowances granted earlier may be recovered. State B, in which the immovable property is situated and where no books are kept, does not have to take into account, when taxing the income from the immovable property, the depreciation allowances booked in State A. Neither can State B substitute the value of the immovable property shown in the books kept in State A for the cost at the time of the alienation. State B cannot, therefore, tax the depreciation allowances realised in addition to the capital gain as mentioned in paragraph 12 above.

15. On the other hand, State A of which the alienator is a resident, cannot be obliged in all cases to exempt such book profits fully from its taxes under paragraph 1 of the Article and Article 23 A (there will be hardly any problems for States applying the tax credit method). To the extent that such book profits are due to the realisation of the depreciation allowances previously claimed in State A and which had reduced the income or profits taxable in such State A, that State cannot be prevented from taxing such book profits. The situation corresponds to that dealt with in paragraph 44 of the Commentary on Article 23 A.

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16. Further problems may arise in connection with profits due to changes of the rate of exchange between the currencies of State A and State B. After the devaluation of the currency of State A, enterprises of such State A may, or may have to, increase the book value of the assets situated outside the territory of State A. Apart from any devaluation of the currency of a State, the usual fluctuations of the rate of exchange may give rise to so-called currency gains or losses. Take for example an enterprise of State A having bought and sold immovable property situated in State B. If the cost and the selling price, both expressed in the currency of State B, are equal, there will be no capital gain in State B. When the value of the currency of State B has risen between the purchase and the sale of the asset in relation to the currency of State A, in the currency of that State a profit will accrue to such enterprise. If the value of the currency of State B has fallen in the meantime, the alienator will sustain a loss which will not be recognised in State B. Such currency gains or losses may also arise in connection with claims and debts contracted in a foreign currency. If the balance sheet of a permanent establishment situated in State B of an enterprise of State A shows claims and debts expressed in the currency of State B, the books of the permanent establishment do not show any gain or loss when repayments are made. Changes of the rate of exchange may be reflected, however, in the accounts of the head office. If the value of the currency of State B has risen (fallen) between the time the claim has originated and its repayment, the enterprise, as a whole, will realise a gain (sustain a loss). This is true also with respect to debts if between the time they have originated and their repayment, the currency of State B has fallen (risen) in value.

17. The provisions of the Article do not settle all questions regarding the taxation of such currency gains. Such gains are in most cases not connected with an alienation of the asset; they may often not even be determined in the State on which the right to tax capital gains is conferred by the Article. Accordingly, the question, as a rule, is not whether the State in which a permanent establish-ment is situated has a right to tax, but whether the State of which the taxpayer is a resident must, if applying the exemption method, refrain from taxing such currency gains which, in many cases, cannot be shown but in the books kept in the head office. The answer to that latter question depends not only on the Article but also on Article 7 and on Article 23 A. If in a given case differing opinions of two States should result in an actual double taxation, the case should be settled under the mutual agreement procedure provided for by Article 25.

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18. Moreover the question arises which Article should apply when there is paid for property sold an annuity during the lifetime of the alienator and not a fixed price. Are such annuity payments, as far as they exceed costs, to be dealt with as a gain from the alienation of the property or as "income not dealt with" according to Article 21? Both opinions may be supported by arguments of equivalent weight, and it seems difficult to give one rule on the matter. In addition such problems are rare in practice, so it therefore seems unnecessary to establish a rule for insertion in the Convention. It may be left to Contracting States who may be involved in such a question to adopt a solution in the mutual agreement procedure provided for by Article 25.

19. The Article is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.

20. The Article deals first with the gains which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph 4 gives the right to tax to the State of which the alienator is a resident.

21. As capital gains are not taxed by all States, it may be considered reasonable to avoid only actual double taxation of capital gains. Therefore, Contracting States are free to supplement their bilateral convention in such a way that a State has to forego its right to tax conferred on it by the domestic laws only if the other State on which the right to tax is conferred by the Convention makes use thereof. In such a case, paragraph 4 of the Article should be supplemented accordingly. Besides, a modification of Article 23 A as suggested in paragraph 35 of the Commentary on Article 23 A is needed.

Paragraph 1

22. Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise. For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of Article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State. It does not, therefore, apply to gains derived from the alienation of immovable property

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situated in the Contracting State of which the alienator is a resident in the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such gains.

(Amended on 29 April 2000; see HISTORY)

23. Certain tax laws assimilate the alienation of all or part of the shares in a company, the exclusive or main aim of which is to hold immovable property, to the alienation of such immovable property. In itself paragraph 1 does not allow that practice: a special provision in the bilateral convention can alone provide for such an assimilation. Contracting States are of course free either to include in their bilateral conventions such special provision, or to confirm expressly that the alienation of shares cannot be assimilated to the alienation of the immovable property.

Paragraph 2

24. Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise. The term "movable property" means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment is situated, which corresponds to the rules for business profits (Article 7).

(Amended on 29 April 2000; see HISTORY)

25. The paragraph makes clear that its rules apply when movable property of a permanent establishment is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply *mutatis mutandis* without express reference thereto. For the transfer of an asset from a permanent establishment in one State to a permanent establishment (or the head office) in another State, cf. paragraph 10 above.

(Amended on 29 April 2000; see HISTORY)

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26. On the other hand, paragraph 2 may not always be applicable to capital gains from the alienation of a participation in an enterprise. The provision applies only to property which was owned by the alienator, either wholly or jointly with another person. Under the laws of some countries, capital assets of a partnership are considered to be owned by the partners. Under some other laws, however, partnerships and other associations are treated as body corporate for tax purposes, distinct from their partners (members), which means that participations in such entities are dealt with in the same way as shares in a company. Capital gains from the alienation of such participations, like capital gains from the alienation of shares, are therefore taxable only in the State of residence of the alienator. Contracting States may agree bilaterally on special rules governing the taxation of capital gains from the alienation of a participation in a partnership.

27. Certain States consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. Paragraph 2 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". The paragraph merely provides that gains from the alienation of movable property forming part of the business property of a permanent establishment may be taxed in the State where the permanent establishment is situated. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in paragraph 4. The foregoing explanations accord with those in the Commentary on Article 7.

(Amended on 29 April 2000; see HISTORY)

Paragraph 3

28. An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic and for boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, aircraft and boats. Gains from the alienation of such assets are taxable only in the State in which the place of effective management of the enterprise operating such ships, aircraft and boats is situated. This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 22. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of such enterprise is aboard a ship or a boat. Contracting States which would prefer to confer the exclusive taxing

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right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free, in bilateral conventions, to substitute to paragraph 3 a provision corresponding to those proposed in paragraphs 2 and 3 of the Commentary on Article 8.

Paragraph 4

29. As regards gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, paragraph 4 provides that they are taxable only in the State of which the alienator is a resident. This corresponds to the rules laid down in Article 22.

30. The Article does not contain special rules for gains from the alienation of shares in a company or of securities, bonds, debentures and the like. Such gains are, therefore, taxable only in the State of which the alienator is a resident.

31. If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price 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. 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 (cf. also paragraphs 20 and 21 of the Commentary on Article 11).

(Amended on 23 July 1992; see HISTORY)

32. [Amended and renumbered as paragraph 47 on 31 March 1994; see HISTORY]

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Reservations on the Article

33. *Australia* reserves the right to tax gains from the alienation of property other than property mentioned in the first three paragraphs of this Article. It also reserves the right to propose changes to reflect the fact that the terms "movable property" and "immovable property" are terms not used in Australian law.

(Amended on 23 July 1992; see HISTORY)

34. *Canada* reserves its position on paragraph 4 in order to keep the right to tax gains from the alienation of shares of a company, or of interests in a partnership or trust, the value of which is derived principally from immovable property situated in Canada and in order to keep the right to tax gains of an individual who was a resident of Canada at any time during the 6 years preceding the alienation of a particular property.

(Amended on 23 July 1992; see HISTORY)

35. *Finland* reserves the right to tax gains from the alienation of shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and held by the company.

(Amended on 23 July 1992; see HISTORY)

36. *France* can accept the provisions of paragraph 4, but wishes to retain the possibility of applying the provisions in its laws relative to the taxation of gains from the alienation of shares or rights which are part of a substantial participation in a company which is a resident of France, or of shares or rights of companies the assets of which consist mainly of immovable property situated in France.

37. *Italy* reserves the right to subject capital gains from Italian sources to the taxes imposed by its law whenever the alienator has a permanent establishment in Italy, even if the property or assets alienated did not form part of the business property employed in such permanent establishment.

38. *New Zealand* reserves its position on paragraphs 3 and 4.

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39. *Sweden* wants to reserve the right to tax gains from the alienation of shares or other corporate rights in Swedish companies.

(Replaced on 23 July 1992; see HISTORY)

40. *Turkey* reserves the right, in accordance with its legislation, to tax capital gains from the alienation, within its territory, of movable capital and any property other than those mentioned in paragraph 2 if the delay between their acquisition and their alienation is less than two years.

41. Notwithstanding paragraph 4 of this Article, where the selling price of shares is considered to be dividends under Danish legislation, *Denmark* reserves the right to tax this selling price as dividends in accordance with paragraph 2 of Article 10.

(Added on 23 July 1992; see HISTORY)

42. *Japan* wishes to retain the right to tax gains from the alienation of shares or other corporate rights which are part of a substantial participation in a Japanese company.

(Added on 23 July 1992; see HISTORY)

43. *Denmark, Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding capital gains relating to offshore hydrocarbon exploration and exploitation and related activities.

(Amended on 31 March 1994; see HISTORY)

44. *Denmark, Norway* and *Sweden* reserve the right to insert special provisions regarding capital gains derived by the air transport consortium Scandinavian Airlines System (SAS).

(Added on 23 July 1992; see HISTORY)

45. *Korea* and *Spain* reserve the right to tax gains from the alienation of shares or other rights in a company whose assets consist mainly of immovable property situated on their territory. They also reserve the right to tax gains from the alienation of shares or other rights forming part of a substantial participation in a company which is a resident.

(Amended on 23 October 1997; see HISTORY)

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46. The *United States* wants to reserve its right to apply its tax on certain real estate gains under the Foreign Investment in Real Property Tax Act.

(Added on 23 July 1992; see HISTORY)

47. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to capital gains from the alienation of ships in international traffic and movable property pertaining to the operation of such ships.

(Added on 31 March 1994; see HISTORY)

48. *Ireland* reserves the right to subject to tax gains from the alienation of shares, rights, or an interest in a company the assets of which consist primarily of immovable property.

(Added on 21 September 1995; see HISTORY)

49. *Mexico* reserves its position to retain the possibility of applying the provisions in its laws relative to the taxation of gains from the alienation of shares or rights that are part of a substantial participation in a company that is a resident of Mexico, or of shares or rights of companies the assets of which consist mainly of immovable property situated in Mexico.

(Added on 21 September 1995; see HISTORY)

50. The *United States* reserves the right to include gains from the alienation of containers within the scope of paragraph 3 of the Article.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Included in the 1977 Model Convention. Amended, by deleting the words "or pertaining to a fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention paragraph 9 read as follows:

> "9. Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment or pertaining to a fixed base, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below."

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Unchanged from the 1977 Model Convention.

Paragraph 12: Unchanged from the 1977 Model Convention.

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Unchanged from the 1977 Model Convention.

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Unchanged from the 1977 Model Convention.

Paragraph 19: Unchanged from the 1977 Model Convention.

Paragraph 20: Unchanged from the 1977 Model Convention.

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Paragraph 21: Unchanged from the 1977 Model Convention.

Paragraph 22: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention paragraph 22 read as follows:

> "22. Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise or used for performing independent personal services. For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of Article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State. It does not, therefore, apply to gains derived from the alienation of immovable property situated in the Contracting State of which the alienator is a resident in the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such gains."

Paragraph 23: Unchanged from the 1977 Model Convention.

Paragraph 24: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention paragraph 24 read as follows:

> "24. Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise or pertaining to a fixed base used for performing independent personal services. The term "movable property" means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment or fixed base is situated, which corresponds to the rules for business profits and for income from independent personal services (Articles 7 and 14)."

Paragraph 25: Included in the 1977 Model Convention. Amended, by deleting the references to "fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention paragraph 25 read as follows:

> "25. The paragraph makes clear that its rules apply when movable property of a permanent establishment or fixed base is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) or the fixed base as such is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply *mutatis mutandis* without express reference thereto. For the transfer of an asset from a permanent

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establishment in one State to a permanent establishment (or the head office) in another State, cf. paragraph 10 above."

Paragraph 26: Unchanged from the 1977 Model Convention.

Paragraph 27: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention paragraph 27 read as follows:

"27. Certain States consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. Paragraph 2 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". The paragraph merely provides that gains from the alienation of movable property forming part of the business property of a permanent establishment or of movable property pertaining to a fixed base used for performing independent personal services may be taxed in the State where the permanent establishment or the fixed base is situated. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in paragraph 4. The foregoing explanations accord with those in the Commentary on Article 7."

Paragraph 28: Unchanged from the 1977 Model Convention.

Paragraph 29: Unchanged from the 1977 Model Convention.

Paragraph 30: Unchanged from the 1977 Model Convention.

Paragraph 31: Included in the 1977 Model Convention. Amended by replacing the reference therein to paragraph 27 of the Commentary on Article 10 and to paragraphs 18 and 19 of the Commentary on Article 11 by a reference to paragraph 28 and to paragraphs 20 and 21 respectively, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 32: Amended and renumbered as paragraph 47 (cf. history of paragraph 47) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 33: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 33 read as follows:

"33. *Australia* reserves the right to propose changes to reflect the facts that Australia does not levy a capital gains tax and that the terms "movable property" and "immovable property" are terms not used in Australian law."

Paragraph 34: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 34 read as follows:

"34. *Canada* reserves its position on paragraph 4 of the Article, in order to reserve the right to tax gains from the alienation of property, other than those mentioned in the first three paragraphs."

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Paragraph 35: Included in the 1977 Model Convention. Amended by substituting the word "held" for the word "owned" by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 35 read as follows:

> "35. *Finland* reserves the right to tax gains from the alienation of shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and owned by the company."

Paragraph 36: Unchanged from the 1977 Model Convention.

Paragraph 37: Unchanged from the 1977 Model Convention.

Paragraph 38: Unchanged from the 1977 Model Convention.

Paragraph 39: Replaced paragraph 39 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was deleted and new paragraph 39 was added by the Report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 39 read as follows:

> "39. *Portugal* reserves the right to tax gains from the increase in capital of companies with a head office or place of effective management in Portugal, when the increase results from the capitalisation of reserves or the issue of shares."

Paragraph 40: Unchanged from the 1977 Model Convention.

Paragraph 41: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 43: Amended, by adding the United Kingdom to the list of countries making the reservation, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 43 previously read as follows:

> "43. *Denmark* and *Norway* reserve the right to insert in a special article provisions regarding capital gains relating to offshore hydrocarbon exploration and exploitation and related activities."

Paragraph 43 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45: Amended, by adding Korea to the country making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 45 previously read as follows:

> "45. Spain reserves its right to tax gains from the alienation of shares or other rights in a company whose assets consist mainly of immovable property situated in Spain. It also reserves its right to tax gains from the alienation of shares or other rights forming part of a substantial participation in a company which is a resident of Spain.

Paragraph 45 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 46: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 47: Corresponds to paragraph 32, as it read before 31 March 1994. Paragraph 32 was amended and renumbered as paragraph 47 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 32 previously read as follows:

> "32. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Paragraph 48: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 49: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 50: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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[COMMENTARY ON ARTICLE 14 CONCERNING THE TAXATION OF INDEPENDENT PERSONAL SERVICES]

[Article 14 was deleted from the Model Tax Convention on 29 April 2000 on the basis of the report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the Committee on Fiscal Affairs on 27 January 2000 and reproduced in Volume II at page R(16)-1). That decision reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. In addition, it was not always clear which activities fell within Article 14 as opposed to Article 7. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits.]

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HISTORY

[The whole of Article 14 and the Commentary thereon were deleted from the Model Tax Convention on 29 April 2000.]

Paragraph 1: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 1 previously read as follows:

> "1. The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment, e.g. a physician serving as a medical officer in a factory. It should, however, be observed that the Article does not concern independent activities of artistes and sportsmen, these being covered by Article 17."

Paragraph 1 was included in the 1977 Model Convention but was subsequently amended by replacing the words "entertainers and athletes" at the end thereof by "artistes and sportsmen", by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 1 read as follows:

> "1. The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment, e.g. a physician serving as a medical officer in a factory. It should, however, be observed that the Article does not concern independent activities of entertainers and athletes, these being covered by Article 17."

Paragraph 2: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 2 read as follows:

> "2. The meaning of the term "professional services" is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive. Difficulties of interpretation which might arise in special cases may be solved by mutual agreement between the competent authorities of the Contracting States concerned."

Paragraph 3: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 3 previously read as follows:

> "3. The provisions of the Article are similar to those for business profits and rest in fact on the same principles as those of Article 7. The provisions of Article 7 and the Commentary thereon could therefore be used as guidance for inter-preting and applying Article 14. Thus the principles laid down in Article 7 for instance as regards allocation of profits between head office and permanent estab-lishment could be applied also in apportioning income between the State of resi-dence of a person performing independent personal services and the State

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where such services are performed from a fixed base. Equally, expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment (cf. paragraph 3 of Article 7). Also in other respects Article 7 and the Commentary thereon could be of assistance for the interpretation of Article 14, e.g. in determining whether computer software payments should be classified as commercial income within Articles 7 or 14 or as royalties within Article 12."

Paragraph 3 was included in the 1977 Model Convention but was subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Appendix 3 of the Report entitled "The Tax Treatment of Software" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 3 read as follows:

"3. The provisions of the Article are similar to those for business profits and rest in fact on the same principles as those of Article 7. The provisions of Article 7 and the Commentary thereon could therefore be used as guidance for interpreting and applying Article 14. Thus the principles laid down in Article 7 for instance as regards allocation of profits between head office and permanent establishment could be applied also in apportioning income between the State of residence of a person performing independent personal services and the State where such services are performed from a fixed base. Equally, expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment (cf. paragraph 3 of Article 7). Also in other respects Article 7 and the Commentary thereon could be of assistance for the interpretation of Article 14."

Paragraph 4: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 4 read as follows:

"4. Even if Articles 7 and 14 are based on the same principles, it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities. The term "fixed base" has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities."

Paragraph 4.1: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 4.1 was previously added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. From 21 September 1995 until 29 April 2000 paragraph 4.1 read as follows:

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"4.1 *Mexico* considers that this Article is applicable to companies that perform professional services."

Paragraph 5: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Prior to 29 April 2000 paragraph 5 read as follows:

"5. *Turkey* reserves the right to tax persons performing professional services or other activities of an independent character if they are present in this country for a period or periods exceeding in the aggregate 183 days in the calendar year, even if they do not have a fixed base available to them for the purpose of performing such services or activities."

Paragraph 5 was included in the 1977 Model Convention but was subsequently amended, by deleting the reference to New Zealand and making the reservation by New Zealand a separate paragraph 9 (cf. history of paragraph 9), by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. In the 1977 Model Convention, paragraph 5 read as follows:

"5. *New Zealand* and *Turkey* reserve the right to tax persons performing professional services or other activities of an independent character if they are present in these countries for a period or periods exceeding in the aggregate 183 days in the fiscal (for New Zealand) or calendar (for Turkey) year, even if they do not have a fixed base available to them for the purpose of performing such services or activities."

Paragraph 6: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 6 read as follows:

"6. *Portugal* and *Spain* reserve their position on paragraph 1."

Paragraph 7: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 7 previously read as follows:

"7. *Denmark*, *Mexico* and *Norway* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their respective territory for a period or periods exceeding in the aggregate 183 days in any twelve month period."

Paragraph 7 was amended on 21 September 1995 by adding Mexico to the list of countries making the reservation, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". After 31 March 1994 and before 21 September 1995, paragraph 7 read as follows:

"7. *Denmark* and *Norway* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their respective territory for a period or periods exceeding in the aggregate 183 days in any twelve month period."

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Paragraph 7 was previously amended, by transforming the second sentence into a separate paragraph 8 (cf. history of paragraph 8), by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. After 23 July 1992 but before 31 March 1994, paragraph 7 read as follows:

> "7. *Denmark* and *Norway* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their respective territory for a period or periods exceeding in the aggregate 183 days in any twelve month period. They also reserve the right to insert in a special article provisions regarding income derived from independent personal services relating to offshore hydrocarbon exploration and exploitation and related activities."

Paragraph 7 replaced paragraph 7 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was deleted and a new paragraph 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 7 read as follows:

> "7. The *United States* reserves the right to tax services performed by individuals who are present in the United States for more than 183 days during the taxable year. The United States also believes that this Article should be limited to individuals and to income from the performance of personal services."

Paragraph 8: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 8 previously read as follows:

> "8. *Denmark, Ireland, Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from independent personal services relating to offshore hydrocarbon exploration and exploitation and related activities."

Paragraph 8 was previously amended, by adding Ireland to the list of countries making the reservation, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. After 31 March 1994 but before 21 September 1995, paragraph 8 read as follows:

> "8. *Denmark, Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from independent personal services relating to offshore hydrocarbon exploration and exploitation and related activities."

Paragraph 8 was added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 8 corresponds to the second sentence of paragraph 7, as it read after 23 July 1992 but before 31 March 1994, which became paragraph 8 on 31 March 1994 (cf. history of paragraph 7); at the same time, the United Kingdom was added to the list of countries making the reservation in that new paragraph.

Paragraph 9: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 9 previously read as follows:

> "9. *Greece*, the *Czech Republic* and *New Zealand* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their respective territory for a period or periods exceeding in the aggregate 183

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days in any twelve month period, even if they do not have a fixed base available to them for the purpose of performing such services or activities."

Paragraph 9 was amended, by adding the Czech Republic to the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 21 September 1995 but before 23 October 1997, paragraph 9 read as follows:

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

Paragraph 9 was previously amended, by adding Greece to the list of countries making the reservation, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. After 31 March 1994 but before 21 September 1995, paragraph 9 read as follows:

"9. *New Zealand* reserves the right to tax individuals performing professional services or other activities of an independent character if they are present in New Zealand for a period or periods exceeding in the aggregate 183 days in any twelve month period, even if they do not have a fixed base available to them for the purpose of performing such services or activities.

Paragraph 9 was added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 9 corresponds in part to the reservation by New Zealand that was previously found in paragraph 5, as it read after 23 July 1992 and before 31 March 1994 (cf. history of paragraph 5).

Paragraph 10: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 10 previously read as follows:

"10. *Greece* reserves the right to insert special provisions regarding income derived from independent personal services relating to offshore activities."

Paragraph 10 was added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

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COMMENTARY ON ARTICLE 15
CONCERNING THE TAXATION
OF INCOME FROM EMPLOYMENT[1]

1. Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. Employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid. One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State.

(Amended on 23 October 1997; see HISTORY)

2. The general rule is subject to exception only in the case of pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Non-employment remuneration of members of boards of directors of companies is the subject of Article 16.

(Amended on 23 October 1997; see HISTORY)

2.1 Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. the use of a residence or automobile, health or life insurance coverage and club memberships).

(Added on 23 October 1997; see HISTORY)

3. Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception covers all individuals rendering services in the course of an employment (sales representatives, construction workers, engineers, etc.), to

1. Before 2000, the title of Article 15 referred to "Dependent Personal Services" by contrast to the title of Article 14 which referred to "Independent Personal Services". As a result of the elimination of the latter Article (see the HISTORY of Article 14), the title of Article 15 was changed to refer to "Employment", a term that is more commonly used to describe the activities to which the Article applies. This change was not intended to affect the scope of the Article in any way.

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the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen.

(Amended on 29 April 2000; see HISTORY)

4. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The first condition is that the exemption is limited to the 183 day period. It is further stipulated that this time period may not be exceeded "in any twelve month period commencing or ending in the fiscal year concerned". This contrasts with the 1963 Draft Convention and the 1977 Model Convention which provided that the 183 day period should not be exceeded "in the fiscal year concerned", a formulation that created difficulties where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organised in such a way that, for example, workers stayed in the State concerned for the last 5 1/2 months of one year and the first 5 1/2 months of the following year. The present wording of sub-paragraph 2 *a*) does away with such opportunities for tax avoidance.

(Amended on 23 July 1992; see HISTORY)

5. Although various formulas have been used by Member countries to calculate the 183 day period, there is only one way which is consistent with the wording of this paragraph: the "days of physical presence" method. The application of this method is straightforward as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family. However, days spent in the State of activity in transit in the course of a trip between two points outside the State of activity should be excluded from the computation. It follows from these principles that any entire day spent outside the State of activity, whether for holidays, business trips, or any other reason, should not be taken into account. A day during any part of which, however brief, the taxpayer is present in

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a State counts as a day of presence in that State for purposes of computing the 183 day period.

(Amended on 21 September 1995; see HISTORY)

6. The second condition is that the employer paying the remuneration must not be a resident of the State in which the employment is exercised. Some Member countries may, however, consider that it is inappropriate to extend the exception of paragraph 2 to cases where the employer is not a resident of the State of residence of the employee, as there might then be administrative difficulties in determining the employment income of the employee or in enforcing withholding obligations on the employer. Contracting States that share this view are free to adopt bilaterally the following alternative wording of sub-paragraph 2 *b*):

> "*b*) the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State, and"

(Renumbered on 29 April 2000; see HISTORY)

6.1 The application of the second condition in the case of fiscally transparent partnerships present difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (cf. paragraph 8.2 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an "employer" (especially under the domestic law definitions of the term in some countries, e.g. where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.

(Added on 29 April 2000; see HISTORY)

6.2 The object and purpose of subparagraphs *b*) and *c*) of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to be constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of

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subparagraph *b*) that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of "employer" and "resident", as found in subparagraph *b*), are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax Conventions must be applied at the partners' rather than at the partnership's level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (i.e. the State in which the greatest part of the deduction will be claimed).

(Added on 29 April 2000; see HISTORY)

7. Under the third condition, if the employer has in the State in which the employment is exercised a permanent establishment, the exemption is given only on condition that the remuneration is not borne by a permanent establishment which he has in that State. The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph *c*) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that is deductible, having regard to the principles of Article 7, in computing the profits of a permanent establishment situated in the State in which the employment is exercised. In this regard, it must be noted that the fact that the employer has, or has not, actually deducted the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether the remuneration would be allowed as a deduction for tax purposes; that test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled.

(Renumbered and amended on 29 April 2000; see HISTORY)

7.1 [Renumbered on 29 April 2000; see HISTORY]

8. Paragraph 2 has given rise to numerous cases of abuse through adoption of the practice known as "international hiring-out of labour". In this system, a local employer wishing to employ foreign labour for one or more periods of less

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than 183 days recruits through an intermediary established abroad who purports to be the employer and hires the labour out to the employer. The worker thus fulfils *prima facie* the three conditions laid down by paragraph 2 and may claim exemption from taxation in the country where he is temporarily working. To prevent such abuse, in situations of this type, the term "employer" should be interpreted in the context of paragraph 2. In this respect, it should be noted that the term "employer" is not defined in the Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. In cases of international hiring-out of labour, these functions are to a large extent exercised by the user. In this context, substance should prevail over form, i.e. each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user. It is therefore up to the Contracting States to agree on the situations in which the intermediary does not fulfil the conditions required for him to be considered as the employer within the meaning of paragraph 2. In settling this question, the competent authorities may refer not only to the above-mentioned indications but to a number of circumstances enabling them to establish that the real employer is the user of the labour (and not the foreign intermediary):

— the hirer does not bear the responsibility or risk for the results produced by the employee's work;
— the authority to instruct the worker lies with the user;
— the work is performed at a place which is under the control and responsibility of the user;
— the remuneration to the hirer is calculated on the basis of the time utilised, or there is in other ways a connection between this remuneration and wages received by the employee;
— tools and materials are essentially put at the employee's disposal by the user;
— the number and qualifications of the employees are not solely determined by the hirer.

(Added on 23 July 1992; see HISTORY)

9. Paragraph 3 applies to the remuneration of crews of ships or aircraft operated in international traffic, or of boats engaged in inland waterways transport, a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport, that is, to tax them in the Contracting State in which the place of effective management of the enterprise

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concerned is situated. In the Commentary on Article 8, it is indicated that Contracting States may agree to confer the right to tax such income on the State of the enterprise operating the ships, boats or aircraft. The reasons for introducing that possibility in the case of income from shipping, inland waterways and air transport operations are valid also in respect of remuneration of the crew. Accordingly Contracting States are left free to agree on a provision which gives the right to tax such remuneration to the State of the enterprise. Such a provision, as well as that of paragraph 3 of Article 15, assumes that the domestic laws of the State on which the right to tax is conferred allows it to tax the remuneration of a person in the service of the enterprise concerned, irrespective of his residence. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat. According to the domestic laws of some Member countries, tax is levied on remuneration received by non-resident members of the crew in respect of employment aboard ships only if the ship has the nationality of such a State. For that reason conventions concluded between these States provide that the right to tax such remuneration is given to the State of the nationality of the ship. On the other hand many States cannot make use of such a taxation right and the provision could in such cases lead to non-taxation. However, States having that taxation principle in their domestic laws may agree bilaterally to confer the right to tax remuneration in respect of employment aboard ships on the State of the nationality of the ship.

(Renumbered on 23 July 1992; see HISTORY)

10. It should be noted that no special rule regarding the taxation of income of frontier workers is included as it would be more suitable for the problems created by local conditions to be solved directly between the States concerned.

(Renumbered on 23 July 1992; see HISTORY)

11. No special provision has been made regarding remuneration derived by visiting professors or students employed with a view to their acquiring practical experience. Many conventions contain rules of some kind or other concerning such cases, the main purpose of which is to facilitate cultural relations by providing for a limited tax exemption. Sometimes, tax exemption is already provided under domestic taxation laws. The absence of specific rules should not be interpreted as constituting an obstacle to the inclusion of such rules in bilateral conventions whenever this is felt desirable.

(Renumbered on 23 July 1992; see HISTORY)

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12. [Amended and renumbered as paragraph 20 on 31 March 1994; see HISTORY]

Observation on the Commentary

13. *Switzerland* is of the opinion that the comments in paragraph 8 above should only apply to situations of international hiring-out of labour in case of abusive arrangements.

(Added on 23 July 1992; see HISTORY)

13.1 With respect to paragraph 6.2, *Germany* holds the view that a partnership as such should be considered as the employer (as under the national law of most OECD member States even if these States do not tax the partnership as such). The residence of the partnership would then have to be determined hypothetically as if the partnership were liable to tax by reason of one of the criteria mentioned in paragraph 1.

(Added on 29 April 2000; see HISTORY)

Reservations on the Article

14. [Deleted on 21 September 1995; see HISTORY]

15. *Denmark*, *Norway* and *Sweden* reserve the right to insert special provisions regarding remuneration derived in respect of an employment exercised aboard an aircraft operated in international traffic by the air transport consortium Scandinavian Airlines System (SAS).

(Added on 23 July 1992; see HISTORY)

16. *Germany* and *Norway* reserve the right to include an express reference in paragraph 2 to income earned by hired-out personnel of one Contracting State working in the other Contracting State, in order to clarify the understanding that the exception in paragraph 2 does not apply in situations of "international hiring-out of labour" (cf. paragraph 8 above).

(Added on 23 July 1992; see HISTORY)

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17. *Ireland*, *Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from employment relating to offshore hydrocarbon exploration and exploitation and related activities.

(Amended on 29 April 2000; see HISTORY)

18. [Deleted on 21 September 1995; see HISTORY]

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

(Added on 23 July 1992; see HISTORY)

20. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to remuneration of crews of ships in international traffic.

(Added on 31 March 1994; see HISTORY)

21. *Greece* reserves the right to insert special provisions regarding income from employment relating to offshore activities.

(Amended on 29 April 2000; see HISTORY)

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HISTORY

Title: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, the heading read as follows:

> "COMMENTARY ON ARTICLE 15 CONCERNING THE TAXATION OF DEPENDENT PERSONAL SERVICES".

Paragraph 1: Included in the 1977 Model Convention. Amended, by adding the second sentence, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 1 previously read as follows:

> "1. Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State."

Paragraph 2: Included the 1977 Model Convention. Amended, by adding the word "Non-employment" at the beginning of the second sentence, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 2 previously read as follows:

> "2. The general rule is subject to exception only in the case of pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Remuneration of members of boards of directors of companies is the subject of Article 16."

Paragraph 2.1: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 3: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 3 previously read as follows:

> "3. Paragraph 2 contains, however, a general exception to the rule in para-graph 1. This exception covers all individuals rendering dependent personal services (sales representatives, construction workers, engineers, etc.), to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen."

Paragraph 3 was included in the 1977 Model Convention but was subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of a previous report entitled "Taxation Issues Relating to International Hiring-out of Labour" (adopted by the Council of the OECD on 24 August 1984) and paragraph 27 of a previous report entitled "The 183 Day Rule: Some Problems of Application and

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Interpretation" (adopted by the Council of the OECD on 24 October 1991). In the 1977 Model Convention, paragraph 3 read as follows:

> "3. Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception, which concerns employment of short duration abroad, is mainly intended to facilitate the international movement of qualified personnel, as in the case of firms which sell capital goods and are responsible for installing and assembling them abroad. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The exemption is limited to the 183-day period. It is further stipulated that this time period may not be exceeded "in the fiscal year concerned". The formulation used may create difficulties in cases where the fiscal years of the Contracting States do not coincide. In order to avoid these difficulties such Contracting States may prefer to use another phrasing, for instance "fiscal year of that other State" or "calendar year". The employer paying the remuneration must not be a resident of the State in which the employment is exercised. Furthermore, should the employer have in that State a permanent establishment (or a fixed base if he performs professional services or other activities of an independent character), the exemption is given only on condition that the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State. It should be noted that, under the provisions of Article 17, the exemption does not apply to remuneration of artistes and athletes."

Paragraph 4: Replaced paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was renumbered as paragraph 9 (cf. history of paragraph 9) and new paragraph 4 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 27 of a previous report entitled "The 183 Day Rule: Some Problems of Application and Interpretation" (adopted by the Council of the OECD on 24 October 1991).

Paragraph 5: Amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 5 previously read as follows:

> "5. Although various formulas have been used by Member countries to calculate the 183 day period, there is only one way which is consistent with the wording of this paragraph: the "days of physical presence" method. The application of this method is straightforward as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays (see paragraph 6 below) before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family. The following days are not taken into account: transit between two different points outside the State of activity, holidays spent outside the State of activity and short breaks (for whatever reason) spent outside the State of activity."

Paragraph 5 replaced paragraph 5 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was renumbered as paragraph 10 (cf. history of paragraph 10) and new paragraph 5 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 27 of a previous report entitled "The 183 Day Rule:

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Some Problems of Application and Interpretation" (adopted by the Council of the OECD on 24 October 1991).

Paragraph 6: Corresponds to paragraph 7 as it read before 29 April 2000. Paragraph 7, as it then read, was renumbered as paragraph 6 by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 7, as it read before 29 April 2000, had been previously amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 7 previously read as follows:

> "7. The second condition is that the employer paying the remuneration must not be a resident of the State in which the employment is exercised. Thirdly, should the employer have in the State in which the employment is exercised a permanent establishment (or a fixed base if he performs professional services or other activities of an independent character), the exemption is given only on condition that the remuneration is not borne by a permanent establishment or a fixed base which he has in that State. It should be noted that, where remuneration is dealt with under a different Article of the Convention, such as Article 17, the provisions of that Article, and not of this Article, apply."

Paragraph 7, as it read before 21 September 1995, replaced paragraph 7 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was renumbered as paragraph 12 (cf. history of paragraph 12) and new paragraph 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 27 of a previous report entitled "The 183 Day Rule: Some Problems of Application and Interpretation" (adopted by the Council of the OECD on 24 October 1991).

A previous paragraph 6 was deleted on 21 September 1995 by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. After 23 July 1992, but before 21 September 1995, paragraph 6 read as follows:

> "6. While holidays spent inside the State of activity are normally included in the calculation, some flexibility is acceptable if the taxpayer can demonstrate to the satisfaction of the tax authorities of both Contracting States that the holidays are clearly related or not related to the activity."

Paragraph 6 replaced paragraph 6 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was renumbered as paragraph 11 (cf. history of paragraph 11) and new paragraph 6 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 27 of a previous report entitled "The 183 Day Rule: Some Problems of Application and Interpretation" (adopted by the Council of the OECD on 24 October 1991).

Paragraph 6.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 6.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of

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another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 7: Corresponds to paragraph 7.1 of the Model Tax Convention as it read before 29 April 2000. Paragraph 7, as it read prior to 29 April 2000, was renumbered as paragraph 6 (cf. history of paragraph 6) and paragraph 7.1 was amended and renumbered paragraph 7 by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). After 21 September 1995, but before 29 April 2000, paragraph 7.1 read as follows:

> "7.1 Under the third condition, if the employer has in the State in which the employment is exercised a permanent establishment (or a fixed base if he performs professional services or other activities of an independent character), the exemption is given only on condition that the remuneration is not borne by a permanent establishment or a fixed base which he has in that State."

Paragraph 7.1 was added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 7.1: Renumbered paragraph 7 (cf. history of paragraph 7) and amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 8: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 73 to 79 of a previous report entitled "Taxation Issues Relating to International Hiring-out of Labour" (adopted by the Council of the OECD on 24 August 1984).

Paragraph 9: Corresponds to paragraph 4 of the 1977 Model Convention. Renumbered as paragraph 9 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 10: Corresponds to paragraph 5 of the 1977 Model Convention. Renumbered as paragraph 10 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 11: Corresponds to paragraph 6 of the 1977 Model Convention. Renumbered as paragraph 11 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12: Amended and renumbered as paragraph 20 (cf. history of paragraph 20) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 13: Added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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Paragraph 14: Deleted on 21 September 1995 by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 14 was added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992. Paragraph 14 previously read as follows:

> "14. *Denmark* and *Norway* reserve the right, with reference to sub-paragraph 2 *b*) of the Article, to require that the remuneration be paid by, or on behalf of, an employer who is a resident of the State of which the recipient is a resident."

Paragraph 15: Added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 16: Added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 17: Amended, by replacing the words "dependent personal services" with the word "employment", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 17 previously read as follows:

> "17. *Ireland*, *Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from dependent personal services relating to offshore hydrocarbon exploration and exploitation and related activities. "

Paragraph 17 had been previously amended by adding Ireland to the list of countries making the reservation, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. After 31 March 1994, but before 21 September 1995, paragraph 17 read as follows:

> "17. *Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from dependent personal services relating to offshore hydrocarbon exploration and exploitation and related activities."

Paragraph 17 had been previously amended, by adding United Kingdom as a country making the reservation, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. After 23 July 1992, but before 31 March 1994 paragraph 17 read as follows:

> "17. *Norway* reserves the right to insert in a special article provisions regarding income derived from dependent personal services relating to offshore hydrocarbon exploration and exploitation and related activities."

Paragraph 17 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 18: Deleted on 21 September 1995, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 18 previously read as follows:

> "18. *Portugal* reserves the right, with reference to sub-paragraph 2 *b*) of the Article, to require that the remuneration be paid by, or on behalf of, an employer who is a resident of the State of which the recipient is a resident."

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Paragraph 18 was added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 19: Added by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 20: Corresponds to paragraph 12, as it read after 23 July 1992 and before 31 March 1994. Paragraph 12 was amended and renumbered as paragraph 20 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 12 previously read as follows:

> "12. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Paragraph 12, as it read after 23 July 1992 and before 31 March 1994, corresponded to paragraph 7 of the 1977 Model Convention, which was renumbered as paragraph 12 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Amended, by replacing the words "dependent personal services" with the word "employment", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 21 previously read as follows:

> "21. *Greece* reserves the right to insert special provisions regarding income from dependent personal services relating to offshore activities."

Paragraph 21 was add by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

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COMMENTARY ON ARTICLE 16
CONCERNING THE TAXATION OF DIRECTORS' FEES

1. This Article relates 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. Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.

1.1 Member countries have generally understood the term "fees and other similar payments" to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. the use of a residence or automobile, health or life insurance coverage and club memberships).

(Added on 23 October 1997; see HISTORY)

2. A member of the board of directors of a company often also has other functions with the company, e.g. as ordinary employee, adviser, consultant, etc. It is clear that the Article does not apply to remuneration paid to such a person on account of such other functions.

3. In some countries organs of companies exist which are similar in function to the board of directors. Contracting States are free to include in bilateral conventions such organs of companies under a provision corresponding to Article 16.

Reservations on the Article

4. *Portugal* reserves the right to tax under Article 15 any remuneration of a member of the board of directors or of any other body of a company, for the carrying out of a permanent activity.

5. The *United States* will require that any tax imposed on such fees be limited to the income earned from services performed in the country of source.

(Replaced on 23 July 1992; see HISTORY)

6. *Belgium* reserves the right to also apply Article 16 to remuneration derived from functions which are other than that of an administrator or commission

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member but which are treated as such under Belgian domestic law. Also, Belgium wishes to apply Article 15, and not Article 16, not only in respect of remuneration for daily activities received by persons performing the functions of an administrator or commission member or similar functions, but also to remuneration derived by partners in a Belgian partnership from their personal activities.

(Added on 23 July 1992; see HISTORY)

7. *Greece* reserves the right to apply Article 16 to remuneration of a partner who acts in the capacity of a manager of a Greek limited liability company or of a Greek partnership.

(Added on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 1.1: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Included in the 1977 Model Convention. Replaced by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 5 read as follows:

> "5. The *United States* reserves its position with regard to this Article. The United States believe that directors' fees should be subject to tax under Article 14."

Paragraph 6: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 7: Added on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

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COMMENTARY ON ARTICLE 17
CONCERNING THE TAXATION OF ARTISTES AND SPORTSMEN

Paragraph 1

1. Paragraph 1 provides that artistes and sportsmen who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of a business or employment nature. This provision is an exception to the rules in Article 7 and to that in paragraph 2 of Article 15, respectively.

(Amended on 29 April 2000; see HISTORY)

2. This provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to business activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article 7. In such a case, artistes and sportsmen performing in the course of an employment would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

(Amended on 29 April 2000; see HISTORY)

3. Paragraph 1 refers to artistes and sportsmen. It is not possible to give a precise definition of "artiste", but paragraph 1 includes examples of persons who would be regarded as such. These examples should not be considered as exhaustive. On the one hand, the term "artiste" clearly includes the stage performer, film actor, actor (including for instance a former sportsman) in a television commercial. The Article may also apply to income received from activities which involve a political, social, religious or charitable nature, if an entertainment character is present. On the other hand, it does not extend to a visiting conference speaker or to administrative or support staff (e.g. cameramen for a film, producers, film directors, choreographers, technical staff, road crew for a pop group etc.). In between there is a grey area where it is necessary to review the overall balance of the activities of the person concerned.

(Replaced on 23 July 1992; see HISTORY)

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4. An individual may both direct a show and act in it, or may direct and produce a television programme or film and take a role in it. In such cases it is necessary to look at what the individual actually does in the State where the performance takes place. If his activities in that State are predominantly of a performing nature, the Article will apply to all the resulting income he derives in that State. If, however, the performing element is a negligible part of what he does in that State, the whole of the income will fall outside the Article. In other cases an apportionment should be necessary.

(Replaced on 23 July 1992; see HISTORY)

5. Whilst no precise definition is given of the term "sportsmen" it is not restricted to participants in traditional athletic events (e.g. runners, jumpers, swimmers). It also covers, for example, golfers, jockeys, footballers, cricketers and tennis players, as well as racing drivers.

(Replaced on 23 July 1992; see HISTORY)

6. The Article also applies to income from other activities which are usually regarded as of an entertainment character, such as those deriving from billiards and snooker, chess and bridge tournaments.

(Replaced on 23 July 1992; see HISTORY)

7. Income received by impresarios, etc. for arranging the appearance of an artiste or sportsman is outside the scope of the Article, but any income they receive on behalf of the artiste or sportsman is of course covered by it.

(Replaced on 23 July 1992; see HISTORY)

8. Paragraph 1 applies to income derived directly and indirectly by an individual artiste or sportsman. In some cases the income will not be paid directly to the individual or his impresario or agent. For instance, a member of an orchestra may be paid a salary rather than receive payment for each separate performance: a Contracting State where a performance takes place is entitled, under paragraph 1, to tax the proportion of the musician's salary which corresponds to such a performance. Similarly, where an artiste or sportsman is employed by e.g. a one person company, the State where the performance takes place may tax an appropriate proportion of any remuneration paid to the individual. In addition, where its domestic laws "look through" such entities and treat the income as accruing directly to the individual, paragraph 1 enables that

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State to tax income derived from appearances in its territory and accruing in the entity for the individual's benefit, even if the income is not actually paid as remuneration to the individual.

(Replaced on 23 July 1992; see HISTORY)

9. Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (cf. paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article 7 or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7 or 15, as the case may be.

(Amended on 29 April 2000; see HISTORY)

10. The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc.

(Added on 23 July 1992; see HISTORY)

Paragraph 2

11. Paragraph 1 of the Article deals with income derived by individual artistes and sportsmen from their personal activities. Paragraph 2 deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to

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tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in the hands of the person receiving the remuneration. If the person receiving the income carries on business activities, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. But it will not always be so. There are three main situations of this kind:

a) The first is the management company which receives income for the appearance of e.g. a group of sportsmen (which is not itself constituted as a legal entity).

b) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed periodic remuneration and it would be difficult to allocate a portion of that income to particular performances, Member countries may decide, unilaterally or bilaterally, not to tax it. The profit element accruing from a performance to the legal entity would be liable to tax under paragraph 2.

c) The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits it to impose a tax on the profits diverted from the income of the artiste or sportsman to the enterprise. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to other solutions or to leave paragraph 2 out of their bilateral conventions.

(Amended on 29 April 2000; see HISTORY)

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11.1 The application of paragraph 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, e.g. a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, e.g. a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

(Added on 29 April 2000; see HISTORY)

11.2 As a general rule it should be noted, however, that, regardless of Article 17, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1.

(Added on 29 April 2000; see HISTORY)

Additional considerations relating to paragraphs 1 and 2

12. Where, in the cases dealt with in paragraphs 1 and 2, the exemption method for relieving double taxation is used by the State of residence of the person receiving the income, that State would be precluded from taxing such income even if the State where the activities were performed could not make use of its right to tax. It is therefore understood that the credit method should be used in such cases. The same result could be achieved by stipulating a subsidiary right to tax for the State of residence of the person receiving the income, if the State where the activities are performed cannot make use of the right conferred on it by paragraphs 1 and 2. Contracting States are free to choose any of these methods in order to ensure that the income does not escape taxation.

(Renumbered and amended, heading added on 23 July 1992; see HISTORY)

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13. Article 17 will ordinarily apply when the artiste or sportsman is employed by a Government and derives income from that Government; see paragraph 6 of the Commentary on Article 19. Certain conventions contain provisions excluding artistes and sportsmen employed in organisations which are subsidised out of public funds from the application of Article 17.

(Amended on 21 September 1995; see HISTORY)

14. Some countries may consider it appropriate to exclude from the scope of the Article events supported from public funds. Such countries are free to include a provision to achieve this but the exemptions should be based on clearly definable and objective criteria to ensure that they are given only where intended. Such a provision might read as follows:

> "The provisions of paragraphs 1 and 2 shall not apply to income derived from activities performed in a Contracting State by artistes or sportsmen if the visit to that State is wholly or mainly supported by public funds of one or both of the Contracting States or political subdivisions or local authorities thereof. In such a case, the income is taxable only in the Contracting State in which the artiste or the sportsman is a resident".

(Added on 23 July 1992; see HISTORY)

Observations on the Commentary

15. [Deleted on 29 April 2000; see HISTORY]

15.1 *France* considers that the statement in the first sentence of paragraph 13, which is at variance with the wording prior to the 1995 revision, is incorrect, because it does not conform with reality to characterize a priori as business the public activities at issue — and in particular cultural activities — that do not ordinarily have a profit motive. In addition, this statement is not consistent with the second sentence of the same paragraph or with paragraph 14, which explicitly provides the right to apply a special exemption regime to the public activities in question: if applied generally to business activities, such a regime would be unjustified, because it would then be contrary to fiscal neutrality and tax equality.

(Amended on 29 April 2000; see HISTORY)

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Reservations on the Article

16. *Canada, Switzerland* and the *United States* are of the opinion that paragraph 2 of the Article should apply only to cases mentioned in sub-paragraph 11 *c*) above and these countries reserve the right to propose an amendment to that effect.

(Amended on 23 October 1997; see HISTORY)

17. [Deleted on 21 September 1995; see HISTORY]

18. [Deleted on 21 September 1995; see HISTORY]

19. [Deleted on 21 September 1995; see HISTORY]

20. The *United States* reserves the right to limit paragraph 1 to situations where the entertainer or sportsman earns a specified amount.

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

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HISTORY

Title: Replaced by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987). In the 1977 Model Convention, the title read as follows:

> "COMMENTARY ON ARTICLE 17 CONCERNING THE TAXATION OF ARTISTES AND ATHLETES"

Paragraph 1: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 1 previously read as follows:

> "1. Paragraph 1 provides that artistes and sportsmen who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of an independent or of a dependent nature. This provision is an exception to the rules in Article 14 and to that in paragraph 2 of Article 15, respectively."

Paragraph 1 was included in the 1977 Model Convention. The heading "*Paragraph 1*" was added and paragraph 1 was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987). In the 1977 Model Convention, paragraph 1 read as follows:

> "1. Paragraph 1 provides that entertainers and athletes who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of an independent or of a dependent nature. This provision is an exception to the rules in Article 14 and to that in paragraph 2 of Article 15, respectively."

Paragraph 2: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 2 previously read as follows:

> "2. This provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to independent activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article 14. In such a case, artistes and sportsmen performing for a salary or wages would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article."

Paragraph 2 was included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and

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Sporting Activities" (adopted by the Council of the OECD on 27 March 1987). In the 1977 Model Convention, paragraph 2 read as follows:

> "2. This provision makes it possible to avoid the practical difficulties which often arise in taxing entertainers and athletes performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement limit the application of paragraph 1 to independent activities by adding its provisions to those of Article 14. In such a case, entertainers and athletes performing for a salary or wages would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article."

Paragraph 3: Replaced paragraph 3 of the 1977 Model Convention. Paragraph 3 of the 1977 Model Convention was amended and renumbered as paragraph 13 (cf. history of paragraph 13) and new paragraph 3 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 68 and 72 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 4: Replaced paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was amended and included as part of new paragraph 11 (cf. history of paragraph 11) and new paragraph 4 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 69 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 5: Replaced paragraph 5 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was amended and renumbered as paragraph 12 (cf. history of paragraph 12) and new paragraph 5 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 70 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 6: Replaced paragraph 6 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was amended and renumbered as paragraph 16 (cf. history of paragraph 16) and new paragraph 6 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 71 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 7: Replaced paragraph 7 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was amended and divided in new paragraphs 17 and 19 (cf. history of paragraphs 17 and 19) and new paragraph 7 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 73 and 74 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 8: Replaced paragraph 8 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was amended and renumbered as paragraph 18 (cf. history of paragraph 18) and new paragraph 8 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 76 of a previous report entitled

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"The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 9: Amended, by deleting the references to "Article 14", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 9 previously read as follows:

> "9. Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (cf. paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article 14 or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7, 14 or 15, as the case may be."

On 23 July 1992, a new paragraph 9 was added and paragraph 9 of the 1977 Model Convention was amended and renumbered as paragraph 20 (cf. history of paragraph 20) by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 78 to 84 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 10: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 94 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 11: Amended, by replacing, in its preamble, the words "is an enterprise" with "carries on business activities" in the forth sentence and deleting the fifth sentence which read "If the person receiving the income is an individual, the income may be taxed even in the absence of a fixed base.", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). The preamble of paragraph 11 previously read as follows:

> "11. Paragraph 1 of the Article deals with income derived by individual artistes and sportsmen from their personal activities. Paragraph 2 deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in the hands of the person receiving the remuneration. If the person receiving

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the income is an enterprise, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. If the person receiving the income is an individual, the income may be taxed even in the absence of a fixed base. But it will not always be so. There are three main situations of this kind:"

Sub-paragraph *b*) of paragraph 11 was previously amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Sub-paragraph *b*) previously read as follows:

"*b*) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance. The profit element accruing from a performance to the legal entity would be liable to tax under paragraph 2."

Sub-paragraph *c*) of paragraph 11 corresponds to paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was included in new paragraph 11 which was added, together with the heading preceding it, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 85, 86, 89 and 91 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987). In the 1977 Model Convention, paragraph 4 read as follows:

"4. The purpose of paragraph 2 is to counteract certain tax avoidance devices in cases where remuneration for the performance of an entertainer or athlete is not paid to the entertainer or athlete himself but to another person, e.g. a so-called artiste-company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the entertainer or athlete nor as profits of the enterprise in the absence of a permanent establishment. Paragraph 2 permits the State in which the performance is given to impose a tax on the profits diverted from the income of the entertainer or athlete to the enterprise where for instance the entertainer or athlete has control over or rights to the income thus diverted or has obtained or will obtain some benefit directly or indirectly from that income. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to alternative solutions or to leave paragraph 2 out of their bilateral convention."

Paragraph 11.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 11.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 12: Corresponds to paragraph 5 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was amended and renumbered as paragraph 12, and the heading preceding it was added, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 5 read as follows:

"5. Where in the cases dealt with in paragraph 2 the exemption method for relieving double taxation is used by the State of residence of the person receiving the income, that State would be precluded from taxing such income even if the State where the activities were performed could not make use of its right to tax. It is therefore understood that the credit

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method should be used in such cases. The same result could be achieved by stipulating a subsidiary right to tax for the State of residence of the person receiving the income, if the State where the activities are performed cannot make use of the right conferred on it by paragraph 2. Contracting States are free to choose any of these methods in order to ensure that the income does not escape taxation."

Paragraph 13: Amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 13 previously read as follows:

"13. The provisions of the Article do not apply when the artiste or sportsman is employed by a Government and derives the income from that Government. Such income is to be treated under the provisions of Article 19. Certain conventions contain provisions excluding artistes and sportsmen employed in organisations which are subsidised out of public funds from the application of Article 17."

Paragraph 13 corresponded to paragraph 3 of the 1977 Model Convention. Paragraph 3 of the 1977 Model Convention was amended and renumbered as paragraph 13 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 3 read as follows:

"3. The provisions of the Article shall not prevent Contracting States from agreeing bilaterally on particular provisions concerning such artistes and sportsmen. The provisions of the Article do not apply when the entertainer or athlete is employed by a Government and derives the income from that Government. Such income is to be treated under the provisions of Article 19. Certain conventions contain provisions excluding entertainers and athletes employed in organisations which are subsidised out of public funds from the application of Article 17. The provisions of the Article shall not prevent Contracting States from agreeing bilaterally on particular provisions concerning such entertainers and athletes."

Paragraph 14: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 98 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

Paragraph 15: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 15 previously read as follows:

"15. In *Germany*, the taxation of income derived by a company resident in a third country from activity exercised in Germany by artistes employed by it should take account of the legal relationship between the German organiser and that company. If there is no double taxation agreement with the third country, Germany can fully tax such income under its domestic legislation. Withholding tax is levied on gross receipts at the rate of 15 per cent. The same applies to third countries with which there is an agreement containing a provision corresponding to paragraph 2 of the Article."

Paragraph 15 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 93 of a previous report entitled "The Taxation of Income Derived from Entertainment, Artistic and Sporting Activities" (adopted by the Council of the OECD on 27 March 1987).

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Paragraph 15.1: Amended by replacing the words "industrial or commercial" with the word "business" by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 15.1 previously read as follows:

> "15.1 *France* considers that the statement in the first sentence of paragraph 13, which is at variance with the wording prior to the 1995 revision, is incorrect, because it does not conform with reality to characterize *a priori* as industrial or commercial the public activities at issue — and in particular cultural activities — that do not ordinarily have a profit motive. In addition, this statement is not consistent with the second sentence of the same paragraph or with paragraph 14, which explicitly provides the right to apply a special exemption regime to the public activities in question: if applied generally to industrial or commercial activities, such a regime would be unjustified, because it would then be contrary to fiscal neutrality and tax equality."

Paragraph 15.1 was added on 21 September 1995, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 16: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 16 previously read as follows:

> "16. *Canada*, *Switzerland* and the *United States* are of the opinion that paragraph 2 of the Article should apply only to cases mentioned in sub-para-graph 11 *c*) above and these countries reserve the right to propose an amendment to that effect when negotiating conventions with other Member countries."

Paragraph 16 corresponds to paragraph 6 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was amended, changed from an observation to a reservation and renumbered as paragraph 16 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 6 read as follows:

> "6. *Canada* and the *United States* are of the opinion that paragraph 2 of the Article applies only to cases mentioned in paragraph 4 above and these countries will propose an amendment to that effect when negotiating conventions with other Member countries."

Paragraph 17: Deleted by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 17 previously read as follows:

> "17. *Greece* reserves its right to apply the provisions of Article 17 to income paid to entertainers and sportsmen employed by a State, a political subdivision or a local authority thereof."

Paragraph 17 corresponded to the reservation by Greece in paragraph 7 of the 1977 Model Convention (cf. also history of paragraph 19). Paragraph 7 of the 1977 Model Convention was amended, divided and renumbered as paragraphs 17 and 19 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 7 read as follows:

> "7. *Greece* and *Portugal* reserve the right to apply the provisions of Article 17, not 19, to income of Government artistes and athletes."

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Paragraph 18: Deleted on 21 September 1995 by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 18 previously read as follows:

> "18. *Japan* reserves the right to apply the provisions of this Article to income derived in connection with trade or business by entertainers or sportsmen who are employed by the Government."

Paragraph 18 corresponded to paragraph 8 of the 1977 Model Convention. Paragraph 8 was amended and renumbered as paragraph 18 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 8 read as follows:

> "8. *Japan* reserves the right to apply the provisions of this Article to income derived in connection with trade or business by entertainers or athletes who are employed by the Government."

Paragraph 19: Deleted on 21 September 1995 by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 19 previously read as follows:

> "19. *Portugal* reserves the right to apply the provisions of Article 17, not 19, to income of Government entertainers and sportsmen."

Paragraph 19 corresponded to the reservation by Portugal in paragraph 7 of the 1977 Model Convention (cf. also history of paragraph 17). Paragraph 7 of the 1977 Model Convention was amended, divided and renumbered as paragraphs 17 and 19 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 7 read as follows:

> "7. *Greece* and *Portugal* reserve the right to apply the provisions of Article 17, not 19, to income of Government artistes and athletes."

Paragraph 20: Corresponds to paragraph 9 of the 1977 Model Convention. Renumbered as paragraph 20 and amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 9 read as follows:

> "9. The *United States* reserves the right to limit paragraph 1 to situations where the entertainer or athlete is present in the other State for a specified period or earns a specified amount."

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COMMENTARY ON ARTICLE 18
CONCERNING THE TAXATION OF PENSIONS

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

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

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

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

3. The treatment under the taxation laws of the OECD Member countries of amounts paid to an employee on the cessation of his employment is highly diversified. Some States regard such a payment as a pension, private or Government as the case may be, paid as a lump sum. In such a case it would

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be natural to consider the income as falling under Article 18 or 19. In the tax laws of other States such a payment is looked upon as the final remuneration for the work performed. Then it should of course be treated under Article 15 or 19, as the case may be. Others again consider such a payment as a bonus which is not taxable under their income tax laws but perhaps subjected to a gift tax or a similar tax. It has not been possible to reach a common solution on the tax treatment of payments of this kind under the Model Convention. If the question of taxing such payments should arise between Contracting States, the matter therefore has to be solved by recourse to the provisions of Article 25.

The tax treatment of contributions to foreign pension schemes

A. General comments

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

(Replaced on 23 July 1992; see HISTORY)

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

(Replaced on 23 July 1992; see HISTORY)

6. The tax treatment accorded to pension contributions of employees who are assigned to work outside their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment, employees commonly qualify for tax relief on pension contributions paid in the home country. When assigned abroad, employees in some cases continue to qualify for relief. Where an individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue

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to qualify for relief there. But frequently, contributions paid in the home country by an individual assigned to work abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the home country during a foreign assignment. Paragraph 11 below suggests a provision which Member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions of employees assigned to work outside their home country.

(Replaced on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

9. The provision is confined to the tax treatment of contributions to pension schemes by or on behalf of individuals who exercise employments within the meaning of Article 15 away from their home State. It does not deal with contributions by individuals who perform business activities covered by Article 7.

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However, States may wish, in bilateral negotiations, to agree on a provision covering individuals rendering services within both Article 7 and Article 15.

(Amended on 29 April 2000; see HISTORY)

B. Aim of the provision

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

(Added on 23 July 1992; see HISTORY)

C. Suggested provision

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

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

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

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

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

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

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

(Amended on 29 April 2000; see HISTORY)

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

(Amended on 29 April 2000; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Amended on 29 April 2000; see HISTORY)

19. The suggested provision places no limits on the length of time for which an employee can work in a host State. It could be argued that, if an employee works in the host State for long enough, it in effect becomes his home country and the provision should no longer apply. Indeed, some host countries already

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restrict relief for contributions to foreign employee/employer pension schemes to cases where the seconded employees are present on a temporary basis.

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

23. However, it would not be in accordance with the stated aim of securing, as far as possible, equivalent tax treatment of employee contributions to give relief for contributions which do not—at least broadly—correspond to domestically recognised schemes. To do so would mean that the amount of relief in the host

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State would become dependent on legislation in the home State. In addition, it could be hard to defend treating employees working side by side differently depending on whether their pension scheme was at home or abroad (and if abroad, whether it was one country rather than another). By limiting the suggested provision to schemes which generally correspond to those in the host country such difficulties are avoided.

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

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the manner in which relief would be given if the contributions were to a scheme established in the host State.

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

30. Being assigned to work abroad may not only mean that an employee's contributions to a pension scheme in his home country cease to qualify for tax relief. It may also mean that contributions to the pension scheme by the employer are regarded as the employee's income for tax purposes. In some Member countries employees are taxed on employer's contributions to domestic schemes whilst working in the home country whereas in others these contributions remain exempt. The provision, therefore, is silent on the treatment of such contributions, although Member countries may wish to extend the suggested provision in bilateral treaties, to ensure that employers contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Amended on 29 April 2000; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

Observation on the Commentary

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

(Added on 23 July 1992; see HISTORY)

Reservations on the Article

39. *Australia, New Zealand* and *Portugal* reserve the right to propose that all pensions be taxable only in the country of residence of the recipient.

(Amended on 29 April 2000; see HISTORY)

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

(Amended on 31 March 1994; see HISTORY)

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

(Amended on 23 October 1997; see HISTORY)

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

(Added on 23 July 1992; see HISTORY)

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

(Amended on 29 April 2000; see HISTORY)

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

(Amended on 21 September 1995; see HISTORY)

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

(Added on 31 March 1994; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Replaced paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was renumbered as paragraph 39 (cf. history of paragraph 39) and new paragraph 4 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 5: Replaced paragraph 5 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was renumbered as paragraph 40 (cf. history of paragraph 40) and new paragraph 5 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 6: Replaced paragraph 6 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was amended and renumbered as paragraph 41 (cf. history of paragraph 41) and new paragraph 6 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 7: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 8: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 9: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 9 previously read as follows:

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

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Paragraph 9 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 10: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 11: Amended, by replacing the words "dependent personal services" with "services in the course of an employment" and replacing the words "dependent personal services" with the word "employment", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 11 previously read as follows:

> "11. The following is the suggested text of the provision that could be included in bilateral conventions to deal with the problem identified above:
>
> "*a*) Contributions borne by an individual who renders dependent personal services in a Contracting State to a pension scheme established in and recognised for tax purposes in the other Contracting State shall be deducted, in the first-mentioned State, in determining the individual's taxable income, and treated in that State, in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State, provided that:
>
> (*i*) the individual was not a resident of that State, and was contributing to the pension scheme, immediately before he began to exercise employment in that State; and
>
> *(ii)* the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.
>
> *b*) For the purposes of sub-paragraph a):
>
> *(i)* the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the dependent personal services referred to in sub-paragraph a); and
>
> *(ii)* a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State."

Paragraph 11 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 12: Amended, by replacing the words "dependent personal services" with "services in the course of an employment", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 12 previously read as follows:

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

Paragraph 12 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 13: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 14: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 15: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 16: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 17: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 18: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 19: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 20: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax

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Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 21: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 22: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 23: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 24: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 25: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 26: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 27: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 28: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 29: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 30: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

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Paragraph 31: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 32: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 33: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 34: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 35: Amended, by deleting the words "dependent personal services rendered", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 35 previously read as follows:

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

Paragraph 35 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 36: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 37: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of Annex C of the Report entitled "The Tax Treatment of Employees' Contributions to Foreign Pension Schemes" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 38: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 39: Amended, by adding New Zealand and Portugal as countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 39 previously read as follows:

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

Paragraph 39 was previously amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. After 31 March 1994, but before 23 October 1997 paragraph 39 previously read as follows:

> "39. When negotiating with other Member countries, *Australia* will propose that all pensions be taxable only in the country of residence of the recipient."

Paragraph 39 had been previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Before 31 March 1994 paragraph 39 read as follows:

> "39. *Australia* reserves its position on this Article. When negotiating with other Member countries, the Australian authorities will propose that all pensions be taxable only in the country of residence of the recipient."

Paragraph 39 corresponds to paragraph 4 of the 1977 Model Convention. Paragraph 4 of the 1977 Model Convention was renumbered as paragraph 39 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 40: Amended, by deleting the second sentence of the paragraph and making it a separate new paragraph 45 (cf. history of paragraph 45) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 40 previously read as follows:

> "40. *Canada* reserves its position on this Article. When negotiating conventions, the Canadian authorities will propose that the country in which the pensions arise be given a limited right to tax. Canada would also wish to apply this rule to pensions referred to in Article 19 in order to achieve uniformity of treatment."

Paragraph 40 corresponds to paragraph 5 of the 1977 Model Convention. Paragraph 5 of the 1977 Model Convention was renumbered as paragraph 40 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 41: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 41 previously read as follows:

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

Paragraph 41 corresponds to paragraph 6 of the 1977 Model Convention. Paragraph 6 of the 1977 Model Convention was amended and renumbered as paragraph 41 by the Report entitled "The Revision of the 1977 Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 6 read as follows:

> "6. *Sweden*, when negotiating conventions with other Member countries, would wish to retain the right to tax pensions paid to non-residents of Sweden, where such pensions are paid in respect of past services rendered mainly within Sweden."

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Paragraph 42: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 43: Amended, by adding the United States as a country making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 43 previously read as follows:

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

Paragraph 43 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44: Amended, by adding Ireland to the list of countries making the reservation, on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 44 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45: Added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Corresponds to the second sentence of paragraph 40 and to paragraph 12 of the Commentary on Article 19, as they read after 23 July 1992 and before 31 March 1994, which were merged in new paragraph 45 (cf. history of paragraph 40 and of paragraph 12 of the Commentary on Article 19).

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COMMENTARY ON ARTICLE 19
CONCERNING THE TAXATION OF REMUNERATION IN RESPECT OF GOVERNMENT SERVICE

1. This Article applies to salaries, wages, and other similar remuneration, and pensions, in respect of government service. Similar provisions in old bilateral conventions were framed in order to conform with the rules of international courtesy and mutual respect between sovereign States. They were therefore rather limited in scope. However, the importance and scope of Article 19 has increased on account of the fact that, consequent on the growth of the public sector in many countries, governmental activities abroad have been considerably extended. According to the original version of paragraph 1 of Article 19 in the 1963 Draft Convention the paying State had a right to tax payments made for services rendered to that State or political subdivision or local authority thereof. The expression "may be taxed" was used and this did not connote an exclusive right of taxation.

(Amended on 31 March 1994; see HISTORY)

2. In the 1977 Model Convention, paragraph 1 was split into two paragraphs, paragraph 1 concerning salaries, wages, and other similar remuneration other than a pension and paragraph 2 concerning pensions, respectively. Unlike the original provision, sub-paragraph *a*) of paragraphs 1 and 2 are both based on the principle that the paying State shall have an exclusive right to tax the payments. Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraphs 1 and 2. If both Contracting States apply the exemption method for relieving double taxation, they can continue to use the expression "may be taxed" instead of "shall be taxable only". In relation to such countries the effect will of course be the same irrespective of which of these expressions they use. It is understood that the expression "shall be taxable only" shall not prevent a Contracting State from taking into account the income exempted under sub-paragraph *a*) of paragraphs 1 and 2 in determining the rate of tax to be imposed on income derived by its residents from other sources. 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. It is also in conformity with the conception of international courtesy which is at the basis of the Article and with the provisions of the Vienna Conventions on

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Diplomatic and Consular Relations. It should, however, be observed that the Article is not intended to restrict the operation of any rules originating from international law in the case of diplomatic missions and consular posts (cf. Article 27) but deals with cases not covered by such rules.

(Amended on 31 March 1994; see HISTORY)

2.1 In 1994, a further amendment was made to paragraph 1 by replacing the term "remuneration" by the words "salaries, wages, and other similar remuneration". This amendment was intended to clarify the scope of the Article, which only applies to State employees and to persons deriving pensions from past employment by a State, and not to persons rendering independent services to a State or deriving pensions related to such services.

(Added on 31 March 1994; see HISTORY)

2.2 Member countries have generally understood the term "salaries, wages and other similar remuneration [...] paid" to include benefits in kind received in respect of services rendered to a State or political subdivision or local authority thereof (e.g. the use of a residence or automobile, health or life insurance coverage and club memberships).

(Replaced on 23 October 1997; see HISTORY)

3. The provisions of the Article apply to payments made not only by a State but also by its political subdivisions and local authorities (constituent states, regions, provinces, *départements*, cantons, districts, *arrondissements*, *Kreise*, municipalities, or groups of municipalities, etc.).

4. An exception from the principle of giving exclusive taxing power to the paying State is contained in sub-paragraph *b*) of paragraph 1. It is to be seen against the background that, according to the Vienna Conventions mentioned above, the 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. Given that pensions paid to retired government officials ought to be treated for tax purposes in the same way as salaries or wages paid to such employees during their active time, an exception like the one in sub-paragraph *b*) of paragraph 1 is incorporated also in sub-paragraph *b*) of paragraph 2 regarding pensions. Since the condition laid down in subdivision *b*)(*ii*) of paragraph 1 cannot be valid in relation to a pensioner, the

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only pre-requisite for the receiving State's power to tax the pension is that the pensioner must be one of its own residents and nationals. It should be noted that the expression "out of funds created by" in sub-paragraph *a*) of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by them.

(Amended on 23 July 1992; see HISTORY)

5. According to Article 19 of the 1963 Draft Convention, the services rendered to the State, political subdivision or local authority had to be rendered "in the discharge of functions of a governmental nature". That expression was deleted in the 1977 Model Convention. Some OECD Member countries, however, thought that the exclusion would lead to a widening of the scope of the Article. Contracting States who are of that view and who feel that such a widening is not desirable may continue to use, and preferably specify, the expression "in the discharge of functions of a governmental nature" in their bilateral conventions.

(Amended on 23 July 1992; see HISTORY)

6. Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the salaries, wages, or other similar remuneration or the pensions. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors' fees and other similar payments, Article 17 for artistes and sportsmen, and Article 18 for pensions. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so thus bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, e.g. State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 salaries, wages, and other similar remuneration, and pensions, paid by such bodies, even if they could be said to be performing business activities.

(Amended on 21 September 1995; see HISTORY)

Observation on the Commentary

7. [Deleted on 21 September 1995; see HISTORY]

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Reservations on the Article

8. The *United States* reserves the right to exclude from paragraph 2 of the Article, and tax as a social security benefit under Article 18, social security benefits paid in respect of Government service.

(Added on 29 April 2000; see HISTORY)

9. The *United States* reserves the right to modify the text to indicate that its application is not limited by Article 1.

(Renumbered on 23 July 1992; see HISTORY)

10. [Deleted on 29 April 2000; see HISTORY)

11. *France* reserves the right to specify in its conventions that salaries, wages, and other similar remuneration paid by a Contracting State or a political subdivision or 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 if the individual is a national of both Contracting States. Also, France reserves its position concerning subdivision *b*)(*ii*) of paragraph 1 in view of the difficulties raised by this provision.

(Amended on 31 March 1994; see HISTORY)

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

(Amended on 31 March 1994; see HISTORY)

13. *France* considers that the scope of the application of Article 19 should cover:

— remuneration paid by public legal entities of the State or a political subdivision or local authority thereof, because the identity of the payer is less significant than the public nature of the income;
— public remuneration of artistes and sportsmen in conformity with the wording of the Model prior to 1995 (without applying the criterion of business activity, seldom relevant in these cases), as long as Article 17 does not contain a provision along the lines suggested in paragraph 14 of the Commentary on Article 17.

(Amended on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Amended, as a consequence of the amendment to paragraphs 1 and 3 of Article 19, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 1 previously read as follows:

> "1. This Article applies to remuneration in respect of government service. Similar provisions in old bilateral conventions were framed in order to conform with the rules of international courtesy and mutual respect between sovereign States. They were therefore rather limited in scope. However, the importance and scope of Article 19 has increased on account of the fact that, consequent on the growth of the public sector in many countries, governmental activities abroad have been considerably extended. According to the original version of paragraph 1 of Article 19 in the 1963 Draft Convention the paying State had a right to tax payments made for services rendered to that State or political subdivision or local authority thereof. The expression "may be taxed" was used and this did not connote an exclusive right of taxation."

Paragraph 2: Amended, as a consequence of the amendment to paragraphs 1 and 3 of Article 19, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. After 23 July 1992 but before 31 March 1994, paragraph 2 read as follows:

> "2. In the 1977 Model Convention, paragraph 1 was split into two paragraphs, paragraph 1 concerning remuneration other than a pension and paragraph 2 concerning pensions, respectively. Unlike the original provision, sub-paragraph *a*) of paragraphs 1 and 2 are both based on the principle that the paying State shall have an exclusive right to tax the payments. Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraphs 1 and 2. If both Contracting States apply the exemption method for relieving double taxation, they can continue to use the expression "may be taxed" instead of "shall be taxable only". In relation to such countries the effect will of course be the same irrespective of which of these expressions they use. It is understood that the expression "shall be taxable only" shall not prevent a Contracting State from taking into account the income exempted under sub-paragraph *a*) of paragraphs 1 and 2 in determining the rate of tax to be imposed on income derived by its residents from other sources. 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. It is also in conformity with the conception of international courtesy which is at the basis of the Article and with the provisions of the Vienna Conventions on Diplomatic and Consular Relations. It should, however, be observed that the Article is not intended to restrict the operation of any rules originating from international law in the case of diplomatic missions and consular posts (cf. Article 27) but deals with cases not covered by such rules."

Paragraph 2 was previously amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by substituting the words "In the 1977 Model Convention" for "On revision of the Article" at the beginning of the paragraph.

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Paragraph 2.1: Added, as a consequence of the amendment to paragraphs 1 and 3 of Article 19, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 2.2: Replaced by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 2.2 previously read as follows:

> "2.2 It should be noted that the term "paid" has a very wide meaning in the context of paragraph 1. It would apply, for instance, to the provision of remuneration in the form of a taxable employment benefit (e.g. the payment by the employer of the rent for an apartment occupied by the employee) granted to an employee by a Contracting State or political subdivision or local authority thereof."

Paragraph 2.2 was added by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Included in the 1977 Model Convention. Amended by substituting the words "subdivision *b*)(*ii*)" for "sub-paragraph *b*)(*ii*)" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 5: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by replacing the second sentence. In the 1977 Model Convention, the second sentence of paragraph 5 read as follows:

> "In the course of the revision of the Article, it was decided to delete that expression."

Paragraph 6: Amended by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 6 previously read as follows:

> "6. Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the salaries, wages, or other similar remuneration or the pensions. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors' fees and other similar payments and Article 18 for pensions. Article 17 is not mentioned because paragraphs 1 and 2 of Article 19 are to apply to salaries, wages, and other similar remuneration, and to pensions, paid to artistes employed by the State, a political subdivision or a local authority thereof, irrespective of whether such artistes could be said to be rendering services in connection with business carried on by the State, the political subdivision or the local authority. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so thus bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, e.g. State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 salaries, wages, and other similar remuneration, and pensions, paid by such bodies, even if they could be said to be performing business activities."

Paragraph 6 was previously amended, as a consequence of the amendment to paragraphs 1 and 3 of Article 19, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 6 previously read as follows:

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"6. Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the remuneration. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors' fees and other similar payments and Article 18 for pensions. Article 17 is not mentioned because paragraphs 1 and 2 of Article 19 are to apply to remuneration paid to artistes employed by the State, a political subdivision or a local authority thereof, irrespective of whether such artistes could be said to be rendering services in connection with business carried on by the State, the political subdivision or the local authority. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so thus bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, e.g. State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 remuneration paid by such bodies, even if they could be said to be performing business activities."

Paragraph 7: Deleted on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 7 previously read as follows:

"7. *Greece* does not adhere to the interpretation given in paragraph 6 of the Commentary regarding the tax treatment of income derived from activities dealt with in Article 17."

Paragraph 7 replaced paragraph 7 of the 1977 Model Convention. Paragraph 7 of the 1977 Model Convention was amended and renumbered as paragraph 8 (cf. history of paragraph 8) and new paragraph 7 and the heading "Observations on the Commentary" preceding it were added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 8: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

A previous paragraph 8 was deleted on 21 September 1995 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 8 previously read as follows:

"8. *Japan* believes that a reference to Article 17 should be added to paragraph 3, so that government-employed artistes may be governed by Article 17 if their services are rendered in connection with a business."

Paragraph 8 corresponded to paragraph 7 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was renumbered as paragraph 9 (cf. history of paragraph 9) and paragraph 7 was amended by deleting the reference to the United States and renumbered as paragraph 8 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 7 read as follows:

"7. *Japan* and the *United States* believe that a reference to Article 17 should be added to paragraph 3, so that government-employed artistes may be governed by Article 17 if their services are rendered in connection with a business.

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Paragraph 9: Corresponds to paragraph 8 of the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was renumbered as paragraph 9 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 10: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph previously read as follows:

> "10. *Canada* is of the opinion that paragraph 1 should only apply in respect of services rendered in a State that is not the paying State and will propose an amendment to that effect while negotiating conventions."

Paragraph 10 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 11: Amended, as a consequence of the amendment to paragraphs 1 and 3 of Article 19, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 11 previously read as follows:

> "11. *France* reserves the right to specify in its conventions that remuneration paid by a Contracting State or a political subdivision or 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 if the individual is a national of both Contracting States. Also, France reserves its position concerning subdivision *b*)(*ii*) of paragraph 1 in view of the difficulties raised by this provision."

Paragraph 11 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12: Amended, by adding Canada as a country making the reservation, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 12 previously read as follows:

> "12. *Norway* reserves the right to extend the application of Article 18 to pensions referred to in Article 19 in order to achieve uniformity of treatment."

Paragraph 12 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13: Amended, by replacing the words "industrial or commercial" with the word "business", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 13 previously read as follows:

> "13. *France* considers that the scope of the application of Article 19 should cover:
>
> — remuneration paid by public legal entities of the State or a political subdivision or local authority thereof, because the identity of the payer is less significant than the public nature of the income;
>
> — public remuneration of artistes and sportsmen in conformity with the wording of the Model prior to 1995 (without applying the criterion of industrial or commercial activity, seldom relevant in these cases), as long as Article 17 does not contain a provision along the lines suggested in paragraph 14 of the Commentary on Article 17."

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Paragraph 13 was added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

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COMMENTARY ON ARTICLE 20
CONCERNING THE TAXATION OF STUDENTS

1. The rule established in this Article concerns certain payments received by students or business apprentices for the purpose of their maintenance, education or training. All such payments received from sources outside the State in which the student or business apprentice concerned is staying shall be exempted from tax in that State.

2. The word "immediately" was inserted in the 1977 Model Convention in order to make clear that the Article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State.

(Amended on 23 July 1992; see HISTORY)

Reservation on the Article

3. *Australia* and *New Zealand* reserve the right to have the operation of this Article limited to students.

(Amended on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 2 read as follows:

> "2. In the course of revision of the 1963 Draft Convention it was decided to insert the word "immediately" in order to make clear that the Article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State."

Paragraph 3: Included in the 1977 Model Convention. Amended, by adding New Zealand as a country making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 3 read as follows:

> "3. *Australia* reserves the right to have the operation of this Article limited to students."

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COMMENTARY ON ARTICLE 21
CONCERNING THE TAXATION OF OTHER INCOME

1. This Article provides a general rule relating to income not dealt with in the foregoing Articles of the Convention. The income concerned is not only income of a class not expressly dealt with but also income from sources not expressly mentioned. The scope of the Article is not confined to income arising in a Contracting State; it extends also to income from third States.

Paragraph 1

2. Under this paragraph the exclusive right to tax is given to the State of residence. In cases of conflict between two residences, Article 4 will also allocate the taxation right in respect of third State income.

3. The rule set out in the paragraph applies irrespective of whether the right to tax is in fact exercised by the State of residence, and thus, when the income arises in the other Contracting State, that State cannot impose tax even if the income is not taxed in the first-mentioned State. Likewise, when income arises in a third State and the recipient of this income is considered as a resident by both Contracting States under their domestic law, the application of Article 4 will result in the recipient being treated as a resident of one Contracting State only and being liable to comprehensive taxation ("full tax liability") in that State only. In this case, the other Contracting State may not impose tax on the income arising from the third State, even if the recipient is not taxed by the State of which he is considered a resident under Article 4. In order to avoid non-taxation, Contracting States may agree to limit the scope of the Article to income which is taxed in the Contracting State of which the recipient is a resident and may modify the provisions of the paragraph accordingly. In fact, this problem is merely a special aspect of the general problem dealt with in paragraphs 34 and 35 of the Commentary on Article 23 A.

Paragraph 2

4. This paragraph provides for an exception from the provisions of paragraph 1 where the income is associated with the activity of a permanent establishment which a resident of a Contracting State has in the other Contracting State.

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The paragraph includes income from third States. In such a case, a right to tax is given to the Contracting State in which the permanent is situated. Paragraph 2 does not apply to immovable property for which, according to paragraph 4 of Article 6, the State of situs has a primary right to tax (cf. paragraphs 3 and 4 of the Commentary on Article 6). Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is in consistency with the rules laid down in Articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable property of a permanent establishment.

(Amended on 29 April 2000; see HISTORY)

5. The paragraph also covers the case where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment is situated. Where double taxation occurs, the State of residence should give relief under the provisions of Article 23 A or 23 B. However, a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.

(Amended on 29 April 2000; see HISTORY)

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6. Some States which apply the exemption method (Article 23 A) may have reason to suspect that the treatment accorded in paragraph 2 may provide an inducement to an enterprise of a Contracting State to attach assets such as shares, bonds or patents, to a permanent establishment situated in the other Contracting State in order to obtain more favourable tax treatment there. To counteract such arrangements which they consider would represent abuse, some States might take the view that the transaction is artificial and, for this reason, would regard the assets as not effectively connected with the permanent establishment. Some other States may strengthen their position by adding in paragraph 2 a condition providing that the paragraph shall not apply to cases where the arrangements were primarily made for the purpose of taking advantage of this provision.

7. Some countries have encountered difficulties in dealing with income arising from certain nontraditional financial instruments when the parties to the instrument have a special relationship. These countries may wish to add the following paragraph to Article 21:

> "3. Where, by reason of a special relationship between the person referred to in paragraph 1 and some other person, or between both of them and some third person, the amount of the income referred to in paragraph 1 exceeds the amount (if any) which would have been agreed upon between them in the absence of such a relationship, the provisions of this Article shall apply only to the last mentioned amount. In such a case, the excess part of the income shall remain taxable according to the laws of each Contracting State, due regard being had to the other applicable provisions of this Convention."

(Replaced on 21 September 1995; see HISTORY)

8. This paragraph restricts the operation of the provisions concerning the taxation of income not dealt with in other Articles in the same way that paragraph 6 of Article 11 restricts the operation of the provisions concerning the taxation of interest. In general, the principles enunciated in paragraphs 32-34 of the Commentary on Article 11 apply to this paragraph as well.

(Replaced on 21 September 1995; see HISTORY)

9. Although the restriction could apply to any income otherwise subject to Article 21, it is not envisaged that in practice it is likely to be applied to payments such as alimony payments or social security payments but rather that

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it is likely to be most relevant where certain nontraditional financial instruments are entered into in circumstances and on terms such that they would not have been entered into in the absence of the special relationship (see paragraph 21.1 of the Commentary to Article 11.)

(Replaced on 21 September 1995; see HISTORY)

10. The restriction of Article 21 differs from the restriction of Article 11 in two important respects. First, the paragraph permits, where the necessary circumstances exist, all of the payments under a nontraditional financial instrument to be regarded as excessive. Second, income that is removed from the operation of the interest Article might still be subject to some other Article of the Convention, as explained in paragraphs 35-36 of the Commentary on Article 11. Income to which Article 21 would otherwise apply is by definition not subject to any other Article. Therefore, if the Article 21 restriction removes a portion of income from the operation of that Article, then Articles 6 through 20 of the Convention are not applicable to that income at all, and each Contracting State may tax it under its domestic law.

(Added on 21 September 1995; see HISTORY)

11. Other provisions of the Convention, however, will continue to be applicable to such income, such as Article 23 (Relief from Double Taxation), Article 25 (Mutual Agreement Procedure), and Article 26 (Exchange of Information).

(Added on 21 September 1995; see HISTORY)

12. The Committee on Fiscal Affairs is actively studying the taxation of nontraditional financial instruments. Further changes to the Model or Commentaries may be necessary. The inclusion of proposed paragraph 3 carries no implication about the treatment of innovative financial transactions between independent persons or under other provisions of the Convention.

(Added on 21 September 1995; see HISTORY)

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Reservations on the Article

13. *Australia, Canada, Mexico, New Zealand* and *Portugal* reserve their positions on this Article and would wish to maintain the right to tax income arising from sources in their own country.

(Renumbered and amended on 21 September 1995; see HISTORY)

14. *Finland* and *Sweden* would wish to retain the right to tax certain annuities and similar payments to non-residents, where such payments are made on account of a pension insurance issued in their respective country.

(Amended on 23 October 1997; see HISTORY)

15. *Ireland* and the *United Kingdom* wish to maintain the right to tax income paid by their residents to non-residents in the form of income from a trust or from estates of deceased persons in the course of administration.

(Amended on 23 October 1997; see HISTORY)

16. In order to avoid non-taxation, *Belgium* reserves the right to allow the State in which income arises to tax that income where the State of residence, which would otherwise have the exclusive right to tax that income, does not effectively exercise that right.

(Added on 23 October 1997; see HISTORY)

17. The *United States* reserves the right to provide for exemption in both States of child support payments.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Included in the 1977 Model Convention. Amended, by deleting the words "or fixed base" and "or the fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 4 read as follows:

> "4. This paragraph provides for an exception from the provisions of paragraph 1 where the income is associated with the activity of a permanent establishment or fixed base which a resident of a Contracting State has in the other Contracting State. The paragraph includes income from third States. In such a case, a right to tax is given to the Contracting State in which the permanent establishment or the fixed base is situated. Paragraph 2 does not apply to immovable property for which, according to paragraph 4 of Article 6, the State of situs has a primary right to tax (cf. paragraphs 3 and 4 of the Commentary on Article 6). Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is in consistency with the rules laid down in Articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable property of a permanent establishment."

Paragraph 5: Included in the 1977 Model Convention. Amended, by deleting the words "or a fixed base" and "or the fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 5 read as follows:

> "5. The paragraph also covers the case where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment or a fixed base, which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment or the fixed base is situated. Where double taxation occurs, the State of residence should give relief under the provisions of Article 23 A or 23 B. However, a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according

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to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws."

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Replaced paragraph 7 as it read before 21 September 1995. Paragraph 7 was amended and renumbered paragraph 13 (cf. history of paragraph 13) and new paragraph 7 was added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 8: Replaced paragraph 8 as it read before 21 September 1995. Paragraph 8 was renumbered paragraph 14 (cf. history of paragraph 14) and new paragraph 8 was added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 9: Replaced paragraph 9 as it read before 21 September 1995. Paragraph 9 was renumbered paragraph 15 (cf. history of paragraph 15) and new paragraph 9 was added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 10: Added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 11: Added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 12: Added by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 13: Corresponds to paragraph 7 as it read before 21 September 1995. Paragraph 7 was amended, by adding Mexico to the list of countries making the reservation, and renumbered as paragraph 13 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 7, as it read before 21 September 1995, was included in the 1977 Model Convention but had been subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting Spain from the list of countries making the reservation. In the 1977 Model Convention, paragraph 7 read as follows:

"7. *Australia, Canada, New Zealand, Portugal* and *Spain* reserve their positions on this Article and would wish to maintain the right to tax income arising from sources in their own country."

Paragraph 14: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 14 previously read as follows:

"14. *Finland* and *Sweden*, when negotiating conventions with other Member countries, would wish to retain the right to tax certain annuities and similar payments to non-residents,

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where such payments are made on account of a pension insurance issued in their respective country."

Paragraph 14 corresponds to paragraph 8 as it read before 21 September 1995. Paragraph 8 was renumbered as paragraph 14 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 8, as it read before 21 September 1995, was included in the 1977 Model Convention but had been subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 8 read as follows:

"8. *Sweden*, when negotiating conventions with other Member countries, would wish to retain the right to tax certain annuities and similar payments to non-residents of Sweden, where such payments are made on account of a pension insurance issued in Sweden."

Paragraph 15: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 15 previously read as follows:

"15. In negotiating conventions with other Member countries, *Ireland* and the *United Kingdom* wish to maintain the right to tax income paid by their residents to non-residents in the form of income from a trust or from estates of deceased persons in the course of administration."

Paragraph 15 corresponded to paragraph 9 as it read before 21 September 1995. Paragraph 9 was renumbered as paragraph 15 by the report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 9, as it read before 21 September 1995, was included in the 1977 Model Convention but had been subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 9 read as follows:

"9. In negotiating conventions with other Member States, the *United Kingdom* also wishes to maintain the right to tax income paid by residents of the United Kingdom to non-residents of the United Kingdom in the form of income from a trust."

Paragraph 16: Added by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997.

Paragraph 17: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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COMMENTARY ON ARTICLE 22
CONCERNING THE TAXATION OF CAPITAL

1. This Article deals only with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. Taxes on capital to which the Article applies are those referred to in Article 2.

2. Taxes on capital generally constitute complementary taxation of income from capital. Consequently, taxes on a given element of capital can be levied, in principle, only by the State which is entitled to tax the income from this element of capital. However, it is not possible to refer purely and simply to the rules relating to the taxation of such class of income, for not all items of income are subject to taxation exclusively in one State.

3. The Article, therefore, enumerates first property which may be taxed in the State in which they are situated. To this category belong immovable property referred to in Article 6 which a resident of a Contracting State owns and which is situated in the other Contracting State (paragraph 1), and 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 (paragraph 2).

(Amended on 29 April 2000; see HISTORY)

4. Ships and aircraft operated in international traffic and boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, boats or aircraft shall be taxable only in the State in which the place of effective management of the enterprise is situated (paragraph 3). This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 13. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free in bilateral conventions to substitute for paragraph 3 a provision corresponding to those proposed in paragraphs 2 and 3 of the Commentary on Article 8. Immovable property pertaining to the operation of ships, boats or aircraft may be taxed in the State in which they are situated in accordance with the rule laid down in paragraph 1.

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5. As regards elements of capital other than those listed in paragraphs 1 to 3, the Article provides that they are taxable only in the Contracting State of which the person to whom they belong is a resident (paragraph 4).

6. If, when the provisions of paragraph 4 are applied to elements of movable property under usufruct, double taxation subsists because of the disparity between domestic laws, the States concerned may resort to the mutual agreement procedure or settle the question by means of bilateral negotiations.

7. The Article does not provide any rule about the deductions of debts. The laws of OECD Member countries are too different to allow a common solution for such a deduction. The problem of the deduction of debts which could arise when the taxpayer and the creditor are not residents of the same State is dealt with in paragraph 4 of Article 24.

(Amended on 23 July 1992; see HISTORY)

8. [Amended and renumbered as paragraph 14 on 31 March 1994; see HISTORY]

Reservations on the Article

9. *Finland* reserves the right to tax shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and held by the company.

(Amended on 23 July 1992; see HISTORY)

10. *New Zealand*, *Portugal* and *Turkey* reserve their positions on this Article if and when they impose taxes on capital.

(Amended on 23 July 1992; see HISTORY)

11. *France* can accept the provisions of paragraph 4 but wishes to retain the possibility of applying the provisions of its law relative to the taxation of shares or rights which are part of a substantial participation in a company which is a

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resident of France, or of shares or rights of companies the assets of which consist mainly of immovable property situated in France.

(Replaced on 23 July 1992; see HISTORY)

12. *Denmark*, *Norway* and *Sweden* reserve the right to insert special provisions regarding capital represented by aircraft operated in international traffic, when owned by the air transport consortium Scandinavian Airlines System (SAS).

(Added on 23 July 1992; see HISTORY)

13. *Spain* reserves its right to tax capital represented by shares or other rights in a company whose assets consist mainly of immovable property situated in Spain, by shares or other corporate rights which entitle its owner to a right of enjoyment of immovable property situated in Spain or by shares or other rights constituting a substantial participation in a company which is a resident of Spain.

(Added on 23 July 1992; see HISTORY)

14. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships.

(Added on 31 March 1994; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 3 read as follows:

> "3. The Article, therefore, enumerates first property which may be taxed in the State in which they are situated. To this category belong immovable property referred to in Article 6 which a resident of a Contracting State owns and which is situated in the other Contracting State (paragraph 1), and 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 pertaining to a fixed base which a resident of a Contracting State has in the other Contracting State for the performance of independent personal services (paragraph 2)."

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Included in the 1977 Model Convention. Amended, by replacing the reference therein to paragraph 5 of Article 24 by a reference to paragraph 4 of that Article, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 8: Amended and renumbered as paragraph 14 (cf. history of paragraph 14) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994.

Paragraph 9: Included in the 1977 Model Convention. Amended by substituting the word "held" for "owned" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 9 read as follows:

> "9. *Finland* reserves the right to tax shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and owned by the company."

Paragraph 10: Included in the 1977 Model Convention. Amended, by adding Turkey to the countries making the reservation, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 10 read as follows:

> "10. *New Zealand* and *Portugal* reserve their positions on this Article if and when they impose taxes on capital."

Paragraph 11: Replaced paragraph 11 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was deleted and new paragraph 11 was added by the Report entitled "The Revision

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of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 11 read as follows:

> "11. The *United Kingdom* reserves its position on this Article pending the introduction of a wealth tax."

Paragraph 12: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14: Corresponds to paragraph 8, as it read before 31 March 1994. Paragraph 8 was amended and renumbered as paragraph 14 by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 8 previously read as follows:

> "8. In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

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COMMENTARY ON ARTICLES 23 A AND 23 B CONCERNING THE METHODS FOR ELIMINATION OF DOUBLE TAXATION

1. Preliminary remarks

A. The scope of the Articles

1. These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State.

2. This case has to be distinguished especially from the so-called economic double taxation, i.e. where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

3. International juridical double taxation may arise in three cases:

a) where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax, cf. paragraph 4 below);

b) where a person is a resident of a Contracting State (R)[1] and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital (cf. paragraph 5 below);

c) where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability, cf. paragraph 11 below).

(Amended on 29 April 2000; see HISTORY)

1. Throughout the Commentary on Articles 23 A and 23 B, the letter "R" stands for the State of residence within the meaning of the Convention, "S" for the State of source or situs, and "E" for the State where a permanent establishment is situated.

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4. The conflict in case *a*) is reduced to that of case *b*) by virtue of Article 4. This is because that Article defines the term "resident of a Contracting State" by reference to the liability to tax of a person under domestic law by reason of his domicile, residence, place of management or any other criterion of a similar nature (paragraph 1 of Article 4) and by listing special criteria for the case of double residence to determine which of the two States is the State of residence (R) within the meaning of the Convention (paragraphs 2 and 3 of Article 4).

5. The conflict in case *b*) may be solved by allocation of the right to tax between the Contracting States. Such allocation may be made by renunciation of the right to tax either by the State of source or situs (S) or of the situation of the permanent establishment (E), or by the State of residence (R), or by a sharing of the right to tax between the two States. The provisions of the Chapters III and IV of the Convention, combined with the provisions of Article 23 A or 23 B, govern such allocation.

(Amended on 29 April 2000; see HISTORY)

6. For some items of income or capital, an exclusive right to tax is given to one of the Contracting States, and the relevant Article states that the income or capital in question "shall be taxable only" in a Contracting State.[1] The words "shall be taxable only" in a Contracting State preclude the other Contracting State from taxing, thus double taxation is avoided. The State to which the exclusive right to tax is given is normally the State of which the taxpayer is a resident within the meaning of Article 4, that is State R, but in four Articles[2] the exclusive right may be given to the other Contracting State (S) of which the taxpayer is not a resident within the meaning of Article 4.

(Footnote amended on 23 July 1992; see HISTORY)

7. For other items of income or capital, the attribution of the right to tax is not exclusive, and the relevant Article then states that the income or capital in

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1. Cf. first sentence of paragraph 1 of Article 7, paragraphs 1 and 2 of Article 8, paragraph 1 of Article 12, paragraphs 3 and 4 of Article 13, first sentence of paragraph 1 of Article 14, first sentence of paragraph 1 and paragraph 2 of Article 15, Article 18, paragraphs 1 and 2 of Article 19, paragraph 1 of Article 21 and paragraphs 3 and 4 of Article 22.

2. Cf. paragraphs 1 and 2 of Article 8, paragraph 3 of Article 13, sub-paragraph *a*) of paragraphs 1 and 2 of Article 19 and paragraph 3 of Article 22.

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question "may be taxed" in the Contracting State (S or E) of which the taxpayer is not a resident within the meaning of Article 4. In such case the State of residence (R) must give relief so as to avoid the double taxation. Paragraphs 1 and 2 of Article 23 A and paragraph 1 of Article 23 B are designed to give the necessary relief.

8. Articles 23 A and 23 B apply to the situation in which a resident of State R derives income from, or owns capital in, the other Contracting State E or S (not being the State of residence within the meaning of the Convention) and that such income or capital, in accordance with the Convention, may be taxed in such other State E or S. The Articles, therefore, apply only to the State of residence and do not prescribe how the other Contracting State E or S has to proceed.

9. Where a resident of the Contracting State R derives income from the same State R through a permanent establishment which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment (paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment situated in State E, notwithstanding the fact that the income in question originally arises in State R (cf. paragraph 5 of the Commentary on Article 21). However, where the Contracting States agree to give to State R which applies the exemption method a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Articles 10 or 11 (cf. paragraph 5 of the Commentary on Article 21), then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.

(Amended on 29 April 2000; see HISTORY)

10. Where a resident of State R derives income from a third State through a permanent establishment which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 4 of Article 24 any

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relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R (cf. paragraphs 49 to 54 of the Commentary on Article 24).

(Amended on 29 April 2000; see HISTORY)

11. The conflict in case *c*) of paragraph 3 above is outside the scope of the Convention as, under Article 1, it applies only to persons who are residents of one or both of the States. It can, however, be settled by applying the mutual agreement procedure (cf. also paragraph 10 above).

B. Description of methods for elimination of double taxation

12. In the existing conventions, two leading principles are followed for the elimination of double taxation by the State of which the taxpayer is a resident. For purposes of simplicity, only income tax is referred to in what follows; but the principles apply equally to capital tax.

1. The principle of exemption

13. Under the principle of exemption, the State of residence R does not tax the income which according to the Convention may be taxed in State E or S (nor, of course, also income which shall be taxable only in State E or S; cf. paragraph 6 above).

14. The principle of exemption may be applied by two main methods:

a) the income which may be taxed in State E or S is not taken into account at all by State R for the purposes of its tax; State R is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the rest of the income; this method is called "full exemption";

b) the income which may be taxed in State E or S is not taxed by State R, but State R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income; this method is called "exemption with progression".

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2. The principle of credit

15. Under the principle of credit, the State of residence R calculates its tax on the basis of the taxpayer's total income including the income from the other State E or S which, according to the Convention, may be taxed in that other State (but not including income which shall be taxable only in State S; cf. paragraph 6 above). It then allows a deduction from its own tax for the tax paid in the other State.

16. The principle of credit may be applied by two main methods:

a) State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State, this method is called "full credit";

b) the deduction given by State R for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State; this method is called "ordinary credit".

17. Fundamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax.

C. Operation and effects of the methods

18. An example in figures will facilitate the explanation of the effects of the various methods. Suppose the total income to be 100,000, of which 80,000 is derived from one State (State of residence R) and 20,000 from the other State (State of source S). Assume that in State R the rate of tax on an income of 100,000 is 35 per cent and on an income of 80,000 is 30 per cent. Assume further that in State S the rate of tax is either 20 per cent — case (*i*) — or 40 per cent —case (*ii*) — so that the tax payable therein on 20,000 is 4,000 in case (*i*) or 8,000 in case *(ii)*, respectively.

19. If the taxpayer's total income of 100,000 arises in State R, his tax would be 35,000. If he had an income of the same amount, but derived in the manner set out above, and if no relief is provided for in the domestic laws of State R and no conventions exists between State R and State S, then the total amount of tax

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would be, in case (*i*): 35,000 plus 4,000 = 39,000, and in case (*ii*): 35,000 plus 8,000 = 43,000.

1. Exemption methods

20. Under the exemption methods, State R limits its taxation to that part of the total income which, in accordance with the various Articles of the Convention, it has a right to tax, i.e. 80,000.

a) Full exemption

State R imposes tax on 80,000 at the rate of tax applicable to 80,000, i.e. at 30 per cent.

	Case *(i)*	Case *(ii)*
Tax in State R, 30% of 80,000	24,000	24,000
plus tax in State S	4,000	8,000
Total taxes	28,000	32,000
Relief has been given by State R in the amount of	11,000	11,000

b) Exemption with progression

State R imposes tax on 80,000 at the rate of tax applicable to total income wherever it arises (100,000), i.e. at 35 per cent.

	Case *(i)*	Case *(ii)*
Tax in State R, 35% of 80,000	28,000	28,000
Plus tax in State S	4,000	8,000
Total taxes	32,000	36,000
Relief has been given by State R in the amount of	7,000	7,000

21. In both cases, the level of tax in State S does not affect the amount of tax given up by State R. If the tax on the income from State S is lower in State S than the relief to be given by State R — cases *a* (*i*), a (*ii*), and *b (i)* — then the taxpayer

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will fare better than if his total income were derived solely from State R. In the converse case — case *b (ii)* — the taxpayer will be worse off.

22. The example shows also that the relief given where State R applies the full exemption method may be higher than the tax levied in State S, even if the rates of tax in State S are higher than those in State R. This is due to the fact that under the full exemption method, not only the tax of State R on the income from State S is surrendered (35 per cent of 20,000 = 7,000; as under the exemption with progression), but that also the tax on remaining income (80,000) is reduced by an amount corresponding to the differences in rates at the two income levels in State R (35 less 30 = 5 per cent applied to 80,000 = 4,000).

2. Credit methods

23. Under the credit methods, State R retains its right to tax the total income of the taxpayer, but against the tax so imposed, it allows a deduction.

a) Full credit

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S.

	Case (*i*)	Case (*ii*)
Tax in State R, 35% of 100,000	35,000	35,000
Less tax in State S	- 4,000	- 8,000
Tax due	31,000	27,000
Total taxes	35,000	35,000
Relief has been given by State R in the amount of	4,000	8,000

b) Ordinary credit

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S, but in no case it allows more than the portion of tax in State R attributable to the income

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from S (maximum deduction). The maximum deduction would be 35 per cent of 20,000 = 7,000.

	Case (i)	Case (*ii*)
Tax in State R, 35% of 100,000	35,000	35,000
less tax in State S	- 4,000	
less maximum tax		- 7,000
Tax due	31,000	28,000
Total taxes	35,000	36,000
Relief has been given by State R in the amount of	4,000	7,000

24. A characteristic of the credit methods compared with the exemption methods is that State R is never obliged to allow a deduction of more than the tax due in State S.

25. Where the tax due in State S is lower than the tax of State R appropriate to the income from State S (maximum deduction), the taxpayer will always have to pay the same amount of taxes as he would have had to pay if he were taxed only in State R, i.e. as if his total income were derived solely from State R.

26. The same result is achieved, where the tax due in State S is the higher while State R applies the full credit, at least as long as the total tax due to State R is as high or higher than the amount of the tax due in State S.

27. Where the tax due in State S is higher and where the credit is limited (ordinary credit), the taxpayer will not get a deduction for the whole of the tax paid in State S. In such event the result would be less favourable to the taxpayer than if his whole income arose in State R, and in these circumstances the ordinary credit method would have the same effect as the method of exemption with progression.

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Table 23-1

TOTAL AMOUNT OF TAX IN THE DIFFERENT CASES ILLUSTRATED ABOVE

A. All income arising in State R	Total tax = 35,000	
B. Income arising in two States, viz. 80,000 in State R and 20,000 in State S	Total tax if tax in State S is	
	4,000 (case (*i*))	8,000 (case (*ii*))
No convention (19)[1]	39,000	43,000
Full exemption (20*a*)	28,000	32,000
Exemption with progression (20*b*)	32,000	36,000
Full credit (23*a*)	35,000	35,000
Ordinary credit (23*b*)	35,000	36,000

1. Numbers in brackets refer to paragraphs in this Commentary.

Table 23-2

AMOUNT OF TAX GIVEN UP BY THE STATE OF RESIDENCE

	If tax in State S is	
	4,000 (case (*i*))	8,000 (case (*ii*))
No convention	0	0
Full exemption (20*a*)[1]	11,000	11,000
Exemption with progression (20*b*)	7,000	7,000
Full credit (23*a*)	4,000	8,000
Ordinary credit (23*b*)	4,000	7,000

1. Numbers in brackets refer to paragraphs in this Commentary.

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D. The methods proposed in the Articles

28. In the conventions concluded between OECD Member countries both leading principles have been followed. Some States have a preference for the first one, some for the other. Theoretically a single principle could be held to be more desirable, but, on account of the preferences referred to, each State has been left free to make its own choice.

29. On the other hand, it has been found important to limit the number of methods based on each leading principle to be employed. In view of this limitation, the Articles have been drafted so that Member countries are left free to choose between two methods:

— the exemption method with progression (Article 23 A), and
— the ordinary credit method (Article 23 B).

30. If two Contracting States both adopt the same method, it will be sufficient to insert the relevant Article in the convention. On the other hand, if the two Contracting States adopt different methods, both Articles may be amalgamated in one, and the name of the State must be inserted in each appropriate part of the Article, according to the method adopted by that State.

31. Contracting States may use a combination of the two methods. Such combination is indeed necessary for a Contracting State R which generally adopts the exemption method in the case of income which under Articles 10 and 11 may be subjected to a limited tax in the other Contracting State S. For such case, Article 23 A provides in paragraph 2 a credit for the limited tax levied in the other Contracting State S. Moreover, States which in general adopt the exemption method may wish to exclude specific items of income from exemption and to apply to such items the credit method. In such case, paragraph 2 of Article 23 A could be amended to include these items of income.

32. The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable. Contracting States which find it necessary to settle any problem in the Convention itself are left free to do so in bilateral negotiations.

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E. Conflicts of qualification

32.1 Both Articles 23 A and 23 B require that relief be granted, through the exemption or credit method, as the case may be, where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention. Thus, the State of residence has the obligation to apply the exemption or credit method in relation to an item of income or capital where the Convention authorises taxation of that item by the State of source.

(Added on 29 April 2000; see HISTORY)

32.2 The interpretation of the phrase "in accordance with the provisions of this Convention, may be taxed", which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.

(Added on 29 April 2000; see HISTORY)

32.3 Different situations need to be considered in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

(Added on 29 April 2000; see HISTORY)

32.4 This point may be illustrated by the following example. A business is carried on through a permanent establishment in State E by a partnership established in that State. A partner, resident in State R, alienates his interest in that partnership. State E treats the partnership as fiscally transparent whereas State R treats it as taxable entity. State E therefore considers that the alienation of the interest in the partnership is, for the purposes of its Convention with State R, an alienation by the partner of the underlying assets of the business carried on by the

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partnership, which may be taxed by that State in accordance with paragraph 1 or 2 of Article 13. State R, as it treats the partnership as a taxable entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which could not be taxed by State E by reason of paragraph 4 of Article 13. In such a case, the conflict of qualification results exclusively from the different treatment of partnerships in the domestic laws of the two States and State E must be considered by State R to have taxed the gain from the alienation "in accordance with the provisions of the Convention" for purposes of the application of Article 23 A or Article 23 B. State R must therefore grant an exemption pursuant to Article 23 A or give a credit pursuant to Article 23 B irrespective of the fact that, under its own domestic law, it treats the alienation gain as income from the disposition of shares in a corporate entity and that, if State E's qualification of the income were consistent with that of State R, State R would not have to give relief under Article 23 A or Article 23 B. No double taxation will therefore arise in such a case.

(Added on 29 April 2000; see HISTORY)

32.5 Article 23 A and Article 23 B, however, do not require that the State of residence eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable. For instance, in the example above, if, for purposes of applying paragraph 2 of Article 13, State E considers that the partnership carried on business through a fixed place of business but State R considers that paragraph 4 applies because the partnership did not have a fixed place of business in State E, there is actually a dispute as to whether State E has taxed the income in accordance with the provisions of the Convention. The same may be said if State E, when applying paragraph 2 of Article 13, interprets the phrase "forming part of the business property" so as to include certain assets which would not fall within the meaning of that phrase according to the interpretation given to it by State R. Such conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification described in the above paragraph where the divergence is based not on different interpretations of the provisions of the Convention but on different provisions of domestic law. In the former case, State R can argue that State E has not imposed its tax in accordance with the provisions of the Convention if it has applied its tax based on what State R considers to be a wrong interpretation of the

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facts or a wrong interpretation of the Convention. States should use the provisions of Article 25 (Mutual Agreement Procedure), and in particular paragraph 3 thereof, in order to resolve this type of conflict in cases that would otherwise result in unrelieved double taxation.

(Added on 29 April 2000; see HISTORY)

32.6 The phrase "in accordance with the provisions of this Convention, may be taxed" must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have taxed, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

(Added on 29 April 2000; see HISTORY)

32.7 This situation may be illustrated by reference to a variation of the example described above. A business is carried on through a fixed place of business in State E by a partnership established in that State and a partner, resident in State R, alienates his interest in that partnership. Changing the facts of the example, however, it is now assumed that State E treats the partnership as a taxable entity whereas State R treats it as fiscally transparent; it is further assumed that State R is a State that applies the exemption method. State E, as it treats the partnership as a corporate entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which it cannot tax by reason of paragraph 4 of Article 13. State R, on the other hand, considers that the alienation of the interest in the partnership should have been taxable by State E as an alienation by the partner of the underlying assets of the business carried on by the partnership to which paragraphs 1 or 2 of Article 13 would have been applicable. In determining whether it has the obligation to exempt the income under paragraph 1 of Article 23 A, State R should nonetheless consider that, given the way that the provisions of the Convention apply in conjunction with the domestic law of State E, that State may not tax the income in accordance with the

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provisions of the Convention. State R is thus under no obligation to exempt the income.

(Added on 29 April 2000; see HISTORY)

II. Commentary on the provisions of Article 23 A (exemption method)

Paragraph 1

A. The obligation of the State of residence to give exemption

33. In the Article it is laid down that the State of residence R shall exempt from tax income and capital which in accordance with the Convention "may be taxed" in the other State E or S.

34. The State of residence must accordingly exempt income and capital which may be taxed by the other State in accordance with the Convention whether or not the right to tax is in effect exercised by that other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State.

(Amended on 29 April 2000; see HISTORY)

34.1 The obligation imposed on the State of residence to exempt a particular item of income or capital depends on whether this item may be taxed by the State of source in accordance with the Convention. Paragraphs 32.1 to 32.7 above discuss how this condition should be interpreted. Where the condition is met, however, the obligation may be considered as absolute, subject to the exceptions of paragraphs 2 and 4 of Article 23 A. Paragraph 2 addresses the case, already mentioned in paragraph 31 above, of items of income which may only be subjected to a limited tax in the State of source. For such items of income, the paragraph provides for the credit method (cf. paragraph 47 below). Paragraph 4 addresses the case of certain conflicts of qualification which would result in double non-taxation as a consequence of the application of the Convention if the State of residence were obliged to give exemption (cf. paragraphs 56.1 to 56.3 below).

(Added on 29 April 2000; see HISTORY)

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35. Occasionally, negotiating States may find it reasonable in certain circumstances, in order to avoid double non-taxation, to make an exception to the absolute obligation on the State of residence to give exemption in cases where neither paragraph 3 or 4 would apply. Such may be the case where no tax on specific items of income or capital is provided under the domestic laws of the State of source, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid such double non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself (cf. paragraph 9 of the Commentary on Article 15 and paragraph 12 of the Commentary on Article 17; for the converse case where relief in the State of source is subject to actual taxation in the State of residence, cf. paragraph 20 of the Commentary on Article 10, paragraph 10 of the Commentary on Article 11, paragraph 6 of the Commentary on Article 12, paragraph 21 of the Commentary on Article 13 and paragraph 3 of the Commentary on Article 21). One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption (cf. paragraph 31 above).

(Amended on 29 April 2000; see HISTORY)

36. [Deleted on 29 April 2000; see HISTORY]

B. Alternative formulation of the Article

37. An effect of the exemption method as it is drafted in the Article is that the taxable income or capital in the State of residence is reduced by the amount exempted in that State. If in a particular State the amount of income as determined for income tax purposes is used as a measure for other purposes, e.g. social benefits, the application of the exemption method in the form proposed may have the effect that such benefits may be given to persons who ought not to receive them. To avoid such consequences, the Article may be altered so that the income in question is included in the taxable income in the State of residence. The State of residence must, in such cases, give up that part of the total tax appropriate to the income concerned. This procedure would give the same result as the Article in the form proposed. States can be left free to make such modifications in the drafting

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of the Article. If a State wants to draft the Article as indicated above, paragraph 1 may be drafted as follows:

> "Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only or may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraph 2, allow as a deduction from the income tax or capital tax that part of the income tax or capital tax, respectively, which is applicable, as the case may be, to the income derived from or the capital owned in that other State."

If the Article is so drafted, paragraph 3 would not be necessary and could be omitted.

C. Miscellaneous problems

38. Article 23 A contains the principle that the State of residence has to give exemption, but does not give detailed rules on how the exemption has to be implemented. This is consistent with the general pattern of the Convention. Articles 6 to 22 too lay down rules attributing the right to tax in respect of the various types of income or capital without dealing, as a rule, with the determination of taxable income or capital, deductions, rate of tax, etc. (cf., however, paragraph 3 of Article 7 and Article 24). Experience has shown that many problems may arise. This is especially true with respect to Article 23 A. Some of them are dealt with in the following paragraphs. In the absence of a specific provision in the Convention, the domestic laws of each Contracting State are applicable. Some conventions contain an express reference to the domestic laws but of course this would not help where the exemption method is not used in the domestic laws. In such cases, Contracting States which face this problem should establish rules for the application of Article 23 A, if necessary, after having consulted with the competent authority of the other Contracting State (paragraph 3 of Article 25).

1. Amount to be exempted

39. The amount of income to be exempted from tax by the State of residence is the amount which, but for the Convention, would be subjected to domestic income tax according to the domestic laws governing such tax. It may, therefore, differ

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from the amount of income subjected to tax by the State of source according to its domestic laws.

40. Normally, the basis for the calculation of income tax is the total net income, i.e. gross income less allowable deductions. Therefore, it is the gross income derived from the State of source less any allowable deductions (specified or proportional) connected with such income which is to be exempted.

41. Problems arise from the fact that most countries provide in their respective taxation laws for additional deductions from total income or specific items of income to arrive at the income subject to tax. A numerical example may illustrate the problem:

a)	Domestic income (gross less allowable expenses)	100
b)	Income from the other State (gross less allowable expenses)	100
c)	Total income	200
d)	Deductions for other expenses provided for under the laws of the State of residence which are not connected with any of the income under *a* or *b*, such as insurance premiums, contributions to welfare institutions	- 20
e)	"Net" income	180
f)	Personal and family allowances	- 30
g)	Income subject to tax	150

The question is, what amount should be exempted from tax, e.g.

— 100 (line *b*), leaving a taxable amount of 50;
— 90 (half of line *e*, according to the ratio between line *b* and line *c*), leaving 60 (line *f* being fully deducted from domestic income);
— 75 (half of line *g*, according to the ratio between line *b* and line *c*). leaving 75;
— or any other amount.

42. A comparison of the laws and practices of the OECD Member countries shows that the amount to be exempted varies considerably from country to country. The solution adopted by a State will depend on the policy followed by that State and its tax structure. It may be the intention of a State that its residents always enjoy the full benefit of their personal and family allowances and other deductions. In other States these tax free amounts are apportioned.

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In many States personal or family allowances form part of the progressive scale, are granted as a deduction from tax, or are even unknown, the family status being taken into account by separate tax scales.

43. In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. Contracting States which prefer to have special problems solved in their convention are, of course, free to do so in bilateral negotiations. Finally, attention is drawn to the fact that the problem is also of importance for States applying the credit method (cf. paragraph 62 below).

2. Treatment of losses

44. Several States in applying Article 23 A treat losses incurred in the other State in the same manner as they treat income arising in that State: as State of residence (State R), they do not allow deduction of a loss incurred from immovable property or a permanent establishment situated in the other State (E or S). Provided that this other State allows carry-over of such loss, the taxpayer will not be at any disadvantage as he is merely prevented from claiming a double deduction of the same loss namely in State E (or S) and in State R. Other States may, as State of residence R, allow a loss incurred in State E (or S) as a deduction from the income they assess. In such a case State R should be free to restrict the exemption under paragraph 1 of Article 23 A for profits or income which are made subsequently in the other State E (or S) by deducting from such subsequent profits or income the amount of earlier losses which the taxpayer can carry over in State E (or S). As the solution depends primarily on the domestic laws of the Contracting States and as the laws of the OECD Member countries differ from each other substantially, no solution can be proposed in the Article itself, it being left to the Contracting States, if they find it necessary, to clarify the above-mentioned question and other problems connected with losses (cf. paragraph 62 below for the credit method) bilaterally, either in the Article itself or by way of a mutual agreement procedure (paragraph 3 of Article 25).

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3. Taxation of the rest of the income

45. Apart from the application of progressive tax rates which is now dealt with in paragraph 3 of the Article (cf. paragraphs 55 and 56 below), some problems may arise from specific provisions of the tax laws. Thus, e.g. some tax laws provide that taxation starts only if a minimum amount of taxable income is reached or exceeded (tax exempt threshold). Total income before application of the Convention may clearly exceed such tax free threshold, but by virtue of the exemption resulting from the application of the Convention which leads to a deduction of the tax exempt income from total taxable income, the remaining taxable income may be reduced to an amount below this threshold. For the reasons mentioned in paragraph 43 above, no uniform solution can be proposed. It may be noted, however, that the problem will not arise, if the alternative formulation of paragraph 1 of Article 23 A (as set out in paragraph 37 above) is adopted.

46. Certain States have introduced special systems for taxing corporate income (cf. paragraphs 40 to 67 of the Commentary on Article 10). In States applying a split rate corporation tax (paragraph 43 of the said Commentary), the problem may arise whether the income to be exempted has to be deducted from un-distributed income (to which the normal rate of tax applies) or from distributed income (to which the reduced rate applies) or whether the income to be exempted has to be attributed partly to distributed and partly to undistributed income. Where, under the laws of a State applying the split rate corporation tax, a supplementary tax is levied in the hands of a parent company on dividends which it received from a domestic subsidiary company but which it does not redistribute (on the grounds that such supplementary tax is a compensation for the benefit of a lower tax rate granted to the subsidiary on the distributions), the problem arises, whether such supplementary tax may be charged where the subsidiary pays its dividends out of income exempt from tax by virtue of the Convention. Finally a similar problem may arise in connection with taxes (*précompte*, Advance Corporation Tax) which are levied on distributed profits of a corporation in order to cover the tax credit attributable to the shareholders (cf. paragraph 47 of the Commentary on Article 10). The question is whether such special taxes connected with the distribution of profits, could be levied insofar as distributions are made out of profits exempt from tax. It is left to Contracting States to settle these questions by bilateral negotiations.

(Amended on 23 July 1992; see HISTORY)

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Paragraph 2

47. In Articles 10 and 11 the right to tax dividends and interest is divided between the State of residence and the State of source. In these cases, the State of residence is left free not to tax if it wants to do so (cf. e.g. paragraphs 72 to 78 below) and to apply the exemption method also to the above-mentioned items of income. However, where the State of residence prefers to make use of its right to tax such items of income, it cannot apply the exemption method to eliminate the double taxation since it would thus give up fully its right to tax the income concerned. For the State of residence, the application of the credit method would normally seem to give a satisfactory solution. Moreover, as already indicated in paragraph 31 above, States which in general apply the exemption method may wish to apply to specific items of income the credit method rather than exemption. Consequently, the paragraph is drafted in accordance with the ordinary credit method. The Commentary on Article 23 B hereafter applies *mutatis mutandis* to paragraph 2 of Article 23 A.

(Amended on 23 July 1992; see HISTORY)

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 (cf. also paragraph 63 below).

Dividends from substantial holdings by a company

49. The combined effect of paragraphs 1 and 2 of Article 10 and Article 23 (Article 23 A and 23 B as appropriate) is that the State of residence of the shareholder is allowed to tax dividends arising in the other State, but that it must credit against its own tax on such dividends the tax which has been collected by the State where the dividends arise at a rate fixed under paragraph 2 of Article 10. This regime equally applies when the recipient of the dividends is a parent company receiving dividends from a subsidiary; in this case, the tax withheld in

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the State of the subsidiary — and credited in the State of the parent company — is limited to 5 per cent of the gross amount of the dividends by the application of sub-paragraph *a*) of paragraph 2 of Article 10.

50. These provisions effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. Many States have recognised this and have inserted in their domestic laws provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions.

51. The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. Some States, fearing tax evasion, preferred to maintain their freedom of action and to settle the question only in their domestic laws.

52. In the end, it appeared preferable to leave States free to choose their own solution to the problem. For States preferring to solve the problem in their conventions, the solutions would most frequently follow one of the principles below:

a) Exemption with progression

The State of which the parent company is a resident exempts the dividends it receives from its subsidiary in the other State, but it may nevertheless take these dividends into account in computing the tax due by the parent company on the remaining income (such a provision will frequently be favoured by States applying the exemption method specified in Article 23A).

b) Credit for underlying taxes

As regards dividends received from the subsidiary, the State of which the parent company is a resident gives credit as provided for in paragraph 2 of Article 23 A or in paragraph 1 of Article 23 B, as appropriate, not only for the tax on dividends as such, but also for the tax paid by the subsidiary on the

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profits distributed (such a provision will frequently be favoured by States applying as a general rule the credit method specified in Article 23 B).

c) Assimilation to a holding in a domestic subsidiary

The dividends that the parent company derives from a foreign subsidiary are treated, in the State of the parent company, in the same way for tax purposes as dividends received from a subsidiary which is a resident of that State.

53. When the State of the parent company levies taxes on capital, a similar solution should also be applied to such taxes.

54. Moreover, States are free to fix the limits and methods of application of these provisions (definition and minimum duration of holding of the shares, proportion of the dividends deemed to be taken up by administrative or financial expenses) or to make the relief granted under the special regime subject to the condition that the subsidiary is carrying out a genuine economic activity in the State of which it is a resident, or that it derives the major part of its income from that State or that it is subject to a substantial taxation on profits therein.

Paragraph 3

55. The 1963 Draft Convention reserved expressly the application of the progressive scale of tax rates by the State of residence (last sentence of paragraph 1 of Article 23 A) and most conventions concluded between OECD Member countries which adopt the exemption method follow this principle. According to paragraph 3 of Article 23 A, the State of residence retains the right to take the amount of exempted income or capital into consideration when determining the tax to be imposed on the rest of the income or capital. The rule applies even where the exempted income (or items of capital) and the taxable income (or items of capital) accrue to those persons (e.g. husband and wife) whose incomes (or items of capital) are taxed jointly according to the domestic laws. This principle of progression applies to income or capital exempted by virtue of paragraph 1 of Article 23 A as well as to income or capital which under any other provision of the Convention "shall be taxable only" in the other Contracting State (cf. paragraph 6 above). This is the reason why, in the 1977 Model Convention, the principle of progression was transferred from paragraph 1 of Article 23 A to a new

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paragraph 3 of the said Article, and reference was made to exemption "in accordance with any provision of the Convention".

(Amended on 23 July 1992; see HISTORY)

56. Paragraph 3 of Article 23 A relates only to the State of residence. The form of the Article does not prejudice the application by the State of source of the provisions of its domestic laws concerning the progression.

Paragraph 4

56.1 The purpose of this paragraph is to avoid double non taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or on the interpretation of the provisions of the Convention. The paragraph applies where, on the one hand, the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that eliminates its right to tax that item or limits the tax that it can impose while, on the other hand, the State of residence adopts a different interpretation of the facts or of the provisions of the Convention and thus considers that the item may be taxed in the State of source in accordance with the Convention, which, absent this paragraph, would lead to an obligation for the State of residence to give exemption under the provisions of paragraph 1.

(Added on 29 April 2000; see HISTORY)

56.2 The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10 or 11 to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source (cf. paragraph 34 above). Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of

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the income that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10 or 11.

(Added on 29 April 2000; see HISTORY)

56.3 Cases where the paragraph apply must be distinguished from cases where the qualification of an item of income under the domestic law of the State of source interacts with the provisions of the Convention to preclude that State from taxing an item of income or capital in circumstances where the qualification of that item under the domestic law of the State of residence would not have had the same result. In such a case, which is discussed in paragraphs 32.6 and 32.7 above, paragraph 1 does not impose an obligation on the State of residence to give exemption because the item of income may not be taxed in the State of source in accordance with the Convention. Since paragraph 1 does not apply, the provisions of paragraph 4 are not required in such a case to ensure the taxation right of the State of residence.

(Added on 29 April 2000; see HISTORY)

III. Commentary on the provisions of Article 23 B (credit method)

Paragraph 1

A. Methods

57. Article 23 B, based on the credit principle, follows the ordinary credit method: the State of residence (R) allows, as a deduction from its own tax on the income or capital of its resident, an amount equal to the tax paid in the other State E (or S) on the income derived from, or capital owned in, that other State E (or S), but the deduction is restricted to the appropriate proportion of its own tax.

58. The ordinary credit method is intended to apply also for a State which follows the exemption method but has to give credit, under paragraph 2 of Article 23 A, for the tax levied at limited rates in the other State on dividends and interest (cf. paragraph 47 above). The possibility of some modification as mentioned in paragraphs 47 and 48 above (full credit) could, of course, also be of relevance in the case of dividends and interest paid to a resident of a State which adopted the ordinary credit method (cf. also paragraph 63 below).

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59. The obligation imposed by Article 23 B on a State R to give credit for the tax levied in the other State E (or S) on an item of income or capital depends on whether this item may be taxed by the State E (or S) in accordance with the Convention. Paragraphs 32.1 to 32.7 above discuss how this condition should be interpreted. Items of income or capital which according to Article 8, to paragraph 3 of Article 13, to sub-paragraph *a*) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22, "shall be taxable only" in the other State, are from the outset exempt from tax in State R (cf. paragraph 6 above), and the Commentary on Article 23 A applies to such exempted income and capital. As regards progression, reference is made to paragraph 2 of the Article (and paragraph 79 below).

(Amended on 29 April 2000; see HISTORY)

60. Article 23 B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. This is consistent with the general pattern of the Convention. Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B. Where the credit method is not used in the domestic laws of a Contracting State, this State should establish rules for the application of Article 23 B, if necessary after consultation with the competent authority of the other Contracting State (paragraph 3 of Article 25).

61. The amount of foreign tax for which a credit has to be allowed is the tax effectively paid in accordance with the Convention in the other Contracting State. Problems may arise, e.g. where such tax is not calculated on the income of the year for which it is levied but on the income of a preceding year or on the average income of two of more preceding years. Other problems may arise in connection with different methods of determining the income or in connection with changes in the currency rates (devaluation or revaluation). However, such problems could hardly be solved by an express provision in the Convention.

62. According to the provisions of the second sentence of paragraph 1 of Article 23 B, the deduction which the State of residence (R) is to allow is

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restricted to that part of the income tax which is appropriate to the income derived from the State S, or E (so-called "maximum deduction"). Such maximum deduction may be computed either by apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or by applying the tax rate for total income to the income for which credit is to be given. In fact, in cases where the tax in State E (or S) equals or exceeds the appropriate tax of State R, the credit method will have the same effect as the exemption method with progression. Also under the credit method, similar problems as regards the amount of income, tax rate, etc. may arise as are mentioned in the Commentary on Article 23 A (cf. especially paragraphs 39 to 41 and 44 above). For the same reasons mentioned in paragraphs 42 and 43 above, it is preferable also for the credit method not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. This is also true for some further problems which are dealt with below.

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 (cf. 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. 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).

64. If a resident of State R derives income of different kinds from State S, and the latter State, according to its tax laws imposes tax only on one of these items, the maximum deduction which State R is to allow will normally be that part of its tax which is appropriate only to that item of income which is taxed in State S. However, other solutions are possible, especially in view of the following broader problem: the fact that credit has to be given, e.g. for several items of income on which tax at different rates is levied in State S, or for income from

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several States, with or without conventions, raises the question whether the maximum deduction or the credit has to be calculated separately for each item of income, or for each country, or for all foreign income qualifying for credit under domestic laws and under conventions. Under an "overall credit" system, all foreign income is aggregated, and the total of foreign taxes is credited against the domestic tax appropriate to the total foreign income.

65. Further problems may arise in case of losses. A resident of State R, deriving income from State E (or S), may have a loss in State R, or in State E (or S) or in a third State. For purposes of the tax credit, in general, a loss in a given State will be set off against other income from the same State. Whether a loss suffered outside State R (e.g. in a permanent establishment) may be deducted from other income, whether derived from State R or not depends on the domestic laws of State R. Here similar problems may arise, as mentioned in the Commentary on Article 23 A (paragraph 44 above). When the total income is derived from abroad, and no income but a loss not exceeding the income from abroad arises in State R, then the total tax charged in State R will be appropriate to the income from State S, and the maximum deduction which State R is to allow will consequently be the tax charged in State R. Other solutions are possible.

66. The aforementioned problems depend very much on domestic laws and practice, and the solution must, therefore, be left to each State. In this context, it may be noted that some States are very liberal in applying the credit method. Some States are also considering or have already adopted the possibility of carrying over unused tax credits. Contracting States are, of course, free in bilateral negotiations to amend the Article to deal with any of the aforementioned problems.

67. In so-called "thin capitalisation" situations, the Model Convention allows the State of the borrower company, under certain conditions, to treat an interest payment as a distribution of dividends in accordance with its domestic legislation; the essential condition is that the contributor of the loan should effectively share the risks run by the borrower company. This gives rise to two consequences:

— the taxing at source of such "interest" at the rate for dividends (paragraph 2 of Article 10);

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— the inclusion of such "interest" in the taxable profits of the lender company.

(Replaced on 23 July 1992; see HISTORY)

68. If the relevant conditions are met, the State of residence of the lender would be obliged to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend. It should then give credit for tax effectively withheld on this interest in the State of residence of the borrower at the rate applicable to dividends and, in addition, if the lender is the parent company of the borrower company, apply to such "interest" any additional relief under its parent/subsidiary regime. This obligation may result:

a) from the actual wording of Article 23 of the Convention, when it grants relief in respect of income defined as dividends in Article 10 or of items of income dealt with in Article 10;

b) from the context of the Convention i.e. from a combination of Articles 9, 10, 11, and 23 and if need be, by way of the mutual agreement procedure:

— where the interest has been treated in the country of residence of the borrower company as a dividend under rules which are in accordance with paragraph 1 of Article 9 or paragraph 6 of Article 11 and where the State of residence of the lender agrees that it has been properly so treated and is prepared to apply a corresponding adjustment;

— when the State of residence of the lender applies similar thin capitalisation rules and would treat the payment as a dividend in a reciprocal situation, i.e. if the payment were made by a company established in its territory to a resident in the other Contracting State;

— in all other cases where the State of residence of the lender recognises that it was proper for the State of residence of the borrower to treat the interest as a dividend.

(Replaced on 23 July 1992; see HISTORY)

69. As regards dividends from a substantial holding by a company, reference is made to paragraphs 49 to 54 above.

(Renumbered on 23 July 1992; see HISTORY)

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69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State of source treats a partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of source may, subject to the applicable provisions of the Convention, tax the partnership on its income when that income is realised and, subject to the limitations of paragraph 2 of Article 10, may also tax the distribution of profits by the partnership to its non-resident partners. The State of residence, however, will only tax the partner on his share of the partnership's income when that income is realised by the partnership.

(Added on 29 April 2000; see HISTORY)

69.2 The first issue that arises in this case is whether the State of residence, which taxes the partner on his share in the partnership's income, is obliged, under the Convention, to give credit for the tax that is levied in the State of source on the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that the State of residence flows-through the income of the partnership to the partner for the purpose of taxing him, it must adopt a coherent approach and flow-through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.

(Added on 29 April 2000; see HISTORY)

69.3 A second issue that arises in this case is the extent to which the State of residence must provide credit for the tax levied by the State of source on the distribution, which is not taxed in the State of residence. The answer to that question lies in that last fact. Since the distribution is not taxed in the State of residence, there is simply no tax in the State of residence against which to credit the tax levied by the State of source upon the distribution. A clear distinction must be made between the generation of profits and the distribution of those profits and the State of residence should not be expected to credit the tax levied by the State of source upon the distribution against its own tax levied upon generation (cf. the first sentence of paragraph 64 above).

(Added on 29 April 2000; see HISTORY)

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B. Remarks concerning capital tax

70. As paragraph 1 is drafted, credit is to be allowed for income tax only against income tax and for capital tax only against capital tax. Consequently, credit for or against capital tax will be given only if there is a capital tax in both Contracting States.

(Renumbered on 23 July 1992; see HISTORY)

71. In bilateral negotiations, two Contracting States may agree that a tax called a capital tax is of a nature closely related to income tax and may, therefore, wish to allow credit for it against income tax and vice versa. There are cases where, because one State does not impose a capital tax or because both States impose capital taxes only on domestic assets, no double taxation of capital will arise. In such cases it is, of course, understood that the reference to capital taxation may be deleted. Furthermore, States may find it desirable, regardless of the nature of the taxes under the convention, to allow credit for the total amount of tax in the State of source or situs against the total amount of tax in the State of residence. Where, however, a convention includes both real capital taxes and capital taxes which are in their nature income taxes, the States may wish to allow credit against income tax only for the latter capital taxes. In such cases, States are free to alter the proposed Article so as to achieve the desired effect.

(Renumbered on 23 July 1992; see HISTORY)

C. Tax sparing

72. Some States grant different kinds of tax incentives to foreign investors for the purpose of attracting foreign investment. When the State of residence of a foreign investor applies the credit method, the benefit of the incentive granted by a State of source may will be reduced to the extent that the State of residence, when taxing income that has benefited from the incentive, will allow a deduction only for the tax actually paid in the State of source. Similarly, if the State of residence applies the exemption method but subject the application of that method to a certain level of taxation by the State of source, the granting of a tax reduction by the State of source may have the effect of denying the investor the application of the exemption method in his State of residence.

(Replaced on 29 April 2000; see HISTORY)

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73. To avoid any such effect in the State of residence, some States that have adopted tax incentive programmes wish to include provisions, usually referred to as "tax sparing" provisions, in their conventions. The purpose of these provisions is to allow non-residents to obtain a foreign tax credit for the taxes that have been "spared" under the incentive programme of the source State or to ensure that these taxes will be taken into account for the purposes of applying certain conditions that may be attached to exemption systems.

(Replaced on 29 April 2000; see HISTORY)

74. Tax sparing provisions constitute a departure from the provisions of Articles 23 A and 23 B. Tax sparing provisions may take different forms, as for example:

a) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (e.g. limitations of rates provided for dividends and interest in Articles 10 and 11) even if the State of source has waived all or part of that tax under special provisions for the promotion of its economic development;

b) as a counterpart for the tax reduction by the State of the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;

c) the State of residence exempts the income which has benefited from tax incentives in the State of source.

(Replaced on 29 April 2000; see HISTORY)

75. A 1998 report by the Committee of Fiscal Affairs, entitled "Tax Sparing a Reconsideration",[1] analyses the tax policy considerations that underlie tax sparing provisions as well as their drafting. The report identifies a number of concerns that put into question the overall usefulness of the granting of tax sparing relief. These concerns relate in particular to:

— the potential for abuse offered by tax sparing;

— the effectiveness of tax sparing as an instrument of foreign aid to promote economic development of the source country; and

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— general concerns with the way in which tax sparing may encourage States to use tax incentives.

(Replaced on 29 April 2000; see HISTORY)

76. Experience has shown that tax sparing is very vulnerable to taxpayer abuse, which can be very costly in terms of lost revenue to both the State of residence and the State of source. This kind of abuse is difficult to detect. In addition, even where it is detected, it is difficult for the State of residence to react quickly against such abuse. The process of removing or modifying existing tax sparing provisions to prevent such abuses is often slow and cumbersome.

(Replaced on 29 April 2000; see HISTORY)

77. Furthermore, tax sparing is not necessarily an effective tool to promote economic development. A reduction or elimination of the benefit of the tax incentive by the State of residence will, in most cases, only occur to the extent that profits are repatriated. By promoting the repatriation of profits, tax sparing may therefore provide an inherent incentive to foreign investors to engage in short-term investment projects and a disincentive to operate in the source State on a long-term basis. Also, foreign tax credit systems are usually designed in a way that allows a foreign investor, in computing its foreign tax credit, to offset to some extent the reduction of taxes resulting from a particular tax incentive with the higher taxes paid in that or other country so that, ultimately, no additional taxes are levied by the State of residence as a result of the tax incentive.

(Replaced on 29 April 2000; see HISTORY)

78. Finally, the accelerating integration of national economies has made many segments of the national tax bases increasingly geographically mobile. These developments have induced some States to adopt tax regimes that have as their primary purpose the erosion of the tax bases of other countries. These types of tax incentives are specifically tailored to target highly mobile financial and other services that are particularly sensitive to tax differentials. The potentially harmful effects of such regimes may be aggravated by the existence of ill-designed tax sparing provisions in treaties. This is particularly so where a State adopts a tax regime subsequent to the conclusion of treaties and tailors this regime so as to ensure that it is covered by the scope of the existing tax sparing provision.

(Replaced on 29 April 2000; see HISTORY)

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78.1 The Committee concluded that Member States should not necessarily refrain from adopting tax sparing provisions. The Committee expressed the view, however, that tax sparing should be considered only in regard to States the economic level of which is considerably below that of OECD Member States. Member States should employ objective economic criteria to define States eligible for tax sparing. Where States agree to insert a tax sparing provision, they are therefore encouraged to follow the guidance set out in section VI of the tax sparing report. The use of these "best practices" will minimise the potential for abuse of such provisions by ensuring that they apply exclusively to genuine investments aimed at developing the domestic infrastructure of the source State. A narrow provision applying to real investment would also discourage harmful tax competition for geographically mobile activities.

(Added on 29 April 2000; see HISTORY)

Paragraph 2

79. This paragraph has been added to enable the State of residence to retain the right to take the amount of income or capital exempted in that State into consideration when determining the tax to be imposed on the rest of the income or capital. The right so retained extends to income or capital which "shall be taxable only" in the other State. The principle of progression is thus safeguarded for the State of residence, not only in relation to income or capital which "may be taxed" in the other State, but also for income or capital which "shall be taxable only" in that other State. The Commentary on paragraph 3 of Article 23 A in relation to the State of source also applies to paragraph 2 of Article 23 B.

(Renumbered on 23 July 1992; see HISTORY)

Observations on the Article

80. The *Netherlands* in principle is in favour of solving situations of both double taxation and double non-taxation due to conflicts of qualification between Contracting States, since in the Netherlands view such situations are not intended by the Contracting States and moreover go against the object and purpose of a tax treaty. However, the Netherlands does not agree with the interpretation given in paragraphs 32.4 and 32.6 to the phrase "in accordance with the provisions of this Convention" in Articles 23 A and 23 B of the Convention that in cases of conflicts

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of qualification that are due to differences in domestic law between the State of source and the State of residence as a rule the qualification given by the State of source would prevail for purposes of the application by the State of residence of Article 23 A or 23 B. The Netherlands wishes to preserve its right to subject a solution and its modalities for a certain conflict of qualification to the circumstances of the cases at hand and to the relationship with the Contracting State concerned. The Netherlands therefore will adhere to said interpretation in paragraphs 32.4 and 32.6 only, and to the extent which, it is explicitly so confirmed in a specific tax treaty, as a result of mutual agreement between competent authorities as meant in Article 25 of the Convention or as unilateral policy.

(Added on 29 April 2000; see HISTORY)

81. *Switzerland* reserves its right not to apply the rules laid down in paragraph 32 in cases where a conflict of qualification results from a modification to the internal law of the State of source subsequent to the conclusion of a Convention.

(Added on 29 April 2000; see HISTORY)

Reservation on the Article

82. *Portugal* reserves its position on paragraph 4 of Article 23 A.

(Added on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Included in the 1977 Model Convention. Paragraph 3 and the footnote thereto were amended, to delete the references therein to "fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 3 and its footnote read as follows:

> "3. International juridical double taxation may arise in three cases:
>
> *a*) where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax, cf. paragraph 4 below);
>
> *b*) where a person is a resident of a Contracting State (R)[1] and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital (cf. paragraph 5 below);
>
> *c*) where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment or fixed base in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability, cf. paragraph 11 below).

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1. Throughout the Commentary on Articles 23 A and 23 B, the letter "R" stands for the State of residence within the meaning of the Convention, "S" for the State of source or situs, and "E" for the State where a permanent establishment or fixed base is situated."

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Included in the 1977 Model Convention. Amended, by deleting the words "or the fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 5 read as follows:

> "5. The conflict in case *b*) may be solved by allocation of the right to tax between the Contracting States. Such allocation may be made by renunciation of the right to tax either by the State of source or situs (S) or of the situation of the permanent establishment or the fixed base (E), or by the State of residence (R), or by a sharing of the right to tax between the two States. The provisions of the Chapters III and IV of the Convention, combined with the provisions of Article 23 A or 23 B, govern such allocation."

Paragraph 6: Unchanged from the 1977 Model Convention, except that footnote 1 to paragraph 6 of the 1977 Model Convention was amended by the Report entitled "The Revision of the Model

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Convention", adopted by the Council of the OECD on 23 July 1992, by deleting the reference therein to paragraph 2 of Article 13.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Included in the 1977 Model Convention. Amended, by deleting the words "or a fixed base" and "or fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 9 read as follows:

> "9. Where a resident of the Contracting State R derives income from the same State R through a permanent establishment or a fixed base which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment or fixed base (paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment or fixed base situated in State E, notwithstanding the fact that the income in question originally arises in State R (cf. paragraph 5 of the Commentary on Article 21). However, where the Contracting States agree to give to State R which applies the exemption method a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Articles 10 or 11 (cf. paragraph 5 of the Commentary on Article 21), then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B."

Paragraph 10: Amended, by deleting the words "or a fixed base" and "or fixed base", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 10 previously read as follows:

> "10. Where a resident of State R derives income from a third State through a permanent establishment or a fixed base which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment or fixed base (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment or fixed base in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 4 of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R (cf. paragraphs 49 to 54 of the Commentary on Article 24)."

Paragraph 10 was included in the 1977 Model Convention but was subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 10 read as follows:

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"10. Where a resident of State R derives income from a third State through a permanent establishment or a fixed base which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment or fixed base (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment or fixed base in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 4 of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R (cf. paragraphs 51 to 55 of the Commentary on Article 24). Cases in which more than two States are involved (triangular cases) raise many problems in regard to which not only the convention between the States R and E but also conventions between States R and/or E with State S may come into play. It could be argued that a provision in a convention between State R and State E obliging State E to give credit or exemption for income derived from a third State leads to a more favourable treatment of the permanent establishment than is granted by State E to its own residents, and that the effect of the combined application of domestic laws and of one or more conventions may even result in double or multiple relief. It is, therefore, left to Contracting States to settle the question bilaterally either generally in a convention to be concluded between them or by way of a mutual agreement procedure (Article 25)."

Paragraph 11: Unchanged from the 1977 Model Convention.

Paragraph 12: Unchanged from the 1977 Model Convention.

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Unchanged from the 1977 Model Convention.

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Unchanged from the 1977 Model Convention.

Paragraph 19: Unchanged from the 1977 Model Convention.

Paragraph 20: Unchanged from the 1977 Model Convention.

Paragraph 21: Unchanged from the 1977 Model Convention.

Paragraph 22: Unchanged from the 1977 Model Convention.

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Paragraph 24: Unchanged from the 1977 Model Convention.

Paragraph 25: Unchanged from the 1977 Model Convention.

Paragraph 26: Unchanged from the 1977 Model Convention.

Paragraph 27: Unchanged from the 1977 Model Convention.

Paragraph 28: Unchanged from the 1977 Model Convention.

Paragraph 29: Unchanged from the 1977 Model Convention.

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Paragraph 30: Unchanged from the 1977 Model Convention.

Paragraph 31: Unchanged from the 1977 Model Convention.

Paragraph 32: Unchanged from the 1977 Model Convention.

Paragraph 32.1: Paragraph 32.1 and the heading preceding it were added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 32.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 32.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 32.4: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 32.5: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 32.6: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 32.7: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 33: Unchanged from the 1977 Model Convention.

Paragraph 34: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). In the 1977 Model Convention, paragraph 34 read as follows:

> "34. The State of residence must accordingly give exemption whether or not the right to tax is in effect exercised by the other State. This method is regarded as the most practical one

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since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State."

Paragraph 34.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 35: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). Paragraph 35 previously read as follows:

> "35. Occasionally, negotiating States may find it reasonable in certain circumstances to make an exception to the absolute obligation on the State of residence to give exemption. Such may be the case, in order to avoid non-taxation, where under the domestic laws of the State of source no tax on specific items of income or capital is provided, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself (cf. paragraph 9 of the Commentary on Article 15 and paragraph 12 of the Commentary on Article 17; for the converse case where relief in the State of source is subject to actual taxation in the State of residence, cf. paragraph 20 of the Commentary on Article 10, paragraph 10 of the Commentary on Article 11, paragraph 6 of the Commentary on Article 12, paragraph 21 of the Commentary on Article 13 and paragraph 3 of the Commentary on Article 21). One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption (cf. paragraph 31 above)."

Paragraph 35 was included in the 1977 Model Convention but was subsequently amended, by replacing the references therein to paragraph 4 of the Commentary on Article 15 and to paragraph 5 of the Commentary on Article 17 by references to paragraphs 9 and 12 respectively, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 36: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). Paragraph 36 previously read as follows:

> "36. As already mentioned in paragraph 31 above, the exemption method does not apply to such items of income which according to the Convention may be taxed in the State of residence but may also be subjected to a limited tax in the other Contracting State. For such items of income, paragraph 2 of Article 23 A provides for the credit method (cf. paragraph 47 below)."

Paragraph 37: Unchanged from the 1977 Model Convention.

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Paragraph 38: Unchanged from the 1977 Model Convention.

Paragraph 39: Unchanged from the 1977 Model Convention.

Paragraph 40: Unchanged from the 1977 Model Convention.

Paragraph 41: Unchanged from the 1977 Model Convention.

Paragraph 42: Unchanged from the 1977 Model Convention.

Paragraph 43: Unchanged from the 1977 Model Convention.

Paragraph 44: Unchanged from the 1977 Model Convention.

Paragraph 45: Unchanged from the 1977 Model Convention.

Paragraph 46: Included in the 1977 Model Convention. Amended by replacing the references therein to paragraphs 36 to 65, 39 and 43 of the Commentary on Article 10 by references to paragraphs 40 to 67, 43 and 47 respectively, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 47: Included in the 1977 Model Convention. Amended by replacing the references therein to paragraphs 70 to 76 by a reference to paragraphs 72 to 78, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 48: Unchanged from the 1977 Model Convention.

Paragraph 49: Unchanged from the 1977 Model Convention.

Paragraph 50: Unchanged from the 1977 Model Convention.

Paragraph 51: Unchanged from the 1977 Model Convention.

Paragraph 52: Unchanged from the 1977 Model Convention.

Paragraph 53: Unchanged from the 1977 Model Convention.

Paragraph 54: Unchanged from the 1977 Model Convention.

Paragraph 55: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 55 read as follows:

> "55. The 1963 Draft Convention reserved expressly the application of the progressive scale of tax rates by the State of residence (last sentence of paragraph 1 of Article 23 A) and most conventions concluded between OECD Member countries, which adopt the exemption method follow this principle. According to paragraph 3 of Article 23 A, as amended, the State of residence retains the right to take the amount of exempted income or capital into consideration when determining the tax to be imposed on the rest of the income or capital. The rule applies even where the exempted income (or items of capital) and the taxable income (or items of capital) accrue to those persons (e.g. husband and wife) whose incomes (or items of capital) are taxed jointly according to the domestic laws. This principle of progression applies to income or capital exempted by virtue of paragraph 1 of Article 23 A as well as to income or capital which under any other provision of the Convention "shall be taxable only" in the other Contracting State (cf. paragraph 6 above). This is the reason why the principle of progression is transferred from paragraph 1 of Article 23 A to a new

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paragraph 3 of the said Article, and reference is made to exemption "in accordance with any provision of the Convention".

Paragraph 56: Unchanged from the 1977 Model Convention.

Paragraph 56.1: Paragraph 56.1 and the preceding heading, "Paragraph 4", were added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 56.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 56.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 57: Unchanged from the 1977 Model Convention.

Paragraph 58: Unchanged from the 1977 Model Convention.

Paragraph 59: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999). Paragraph 59 previously read as follows:

> "59. It is to be noted that Article 23 B applies in a State R only to items of income or capital which, in accordance with the Convention, "may be taxed" in the other State E (or S). Items of income or capital which according to Article 8, to paragraph 3 of Article 13, to sub-paragraph *a*) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22, "shall be taxable only" in the other State, are from the outset exempt from tax in State R (cf. paragraph 6 above), and the Commentary on Article 23 A applies to such exempted income and capital. As regards progression, reference is made to paragraph 2 of the Article (and paragraph 79 below)."

Paragraph 59 was included in the 1977 Model Convention but was subsequently amended by replacing the reference therein to paragraph 77 by a reference to paragraph 79, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 60: Unchanged from the 1977 Model Convention.

Paragraph 61: Unchanged from the 1977 Model Convention.

Paragraph 62: Unchanged from the 1977 Model Convention.

Paragraph 63: Unchanged from the 1977 Model Convention.

Paragraph 64: Unchanged from the 1977 Model Convention.

Paragraph 65: Unchanged from the 1977 Model Convention.

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Paragraph 66: Unchanged from the 1977 Model Convention.

Paragraph 67: Replaced paragraph 67 of the 1977 Model Convention. Paragraph 67 of the 1977 Model Convention was renumbered as paragraph 69 (cf. history of paragraph 69) and new paragraph 67 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 86 of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 68: Replaced paragraph 68 of the 1977 Model Convention. Paragraph 68 of the 1977 Model Convention was renumbered as paragraph 70 (cf. history of paragraph 70) and new paragraph 68 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 86 of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 69: Corresponds to paragraph 67 of the 1977 Model Convention. Paragraph 69 of the 1977 Model Convention was renumbered as paragraph 71 (cf. history of paragraph 71) and paragraph 67 was renumbered as paragraph 69 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 69.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 69.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of Annex I of another report entitled "The Application of the OECD Model Tax Convention to Partnerships" (adopted by the OECD Committee on Fiscal Affairs on 20 January 1999).

Paragraph 69.3: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000).

Paragraph 70: Corresponds to paragraph 68 of the 1977 Model Convention. Paragraph 70 of the 1977 Model Convention was renumbered as paragraph 72 (cf. history of paragraph 72) and paragraph 68 was renumbered as paragraph 70 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 71: Corresponds to paragraph 69 of the 1977 Model Convention. Paragraph 71 of the 1977 Model Convention was renumbered as paragraph 73 (cf. history of paragraph 73) and paragraph 69 was renumbered as paragraph 71 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 72: Paragraph 72 and the preceding heading were replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 72 and the heading preceding it previously read as follows:

"***C. The relation in special cases between the taxation in the State of source and the ordinary credit method***

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72. In certain cases a State, especially a developing country, may for particular reasons give concessions to taxpayers, e.g. tax incentive reliefs to encourage industrial output. In a similar way, a State may exempt from tax certain kinds of income, e.g. pensions to war wounded soldiers."

The heading preceding paragraph 72 was included in the 1977 Model Tax Convention.

Paragraph 72 corresponds to paragraph 70 of the 1977 Model Convention. Paragraph 72 of the 1977 Model Convention was renumbered as paragraph 74 (cf. history of paragraph 74) and paragraph 70 was renumbered as paragraph 72 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 73: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 73 previously read as follows:

"73. When such a State concludes a convention with a State which applies the exemption method, no restriction of the relief given to the taxpayers arises, because that other State must give exemption regardless of the amount of tax, if any, imposed in the State of source (see paragraph 34 above). But when the other State applies the credit method, the concession may be nullified to the extent that such other State will allow a deduction only of the tax paid in the State of source. By reason of the concessions, that other State secures what may be called an uncovenanted gain for its own Exchequer."

Paragraph 73 corresponds to paragraph 71 of the 1977 Model Convention. Paragraph 73 of the 1977 Model Convention was renumbered as paragraph 75 (cf. history of paragraph 75) and paragraph 71 was renumbered as paragraph 73 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 74: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 74 previously read as follows:

"74. Should the two States agree that the benefit of the concessions given to the taxpayers in the State of source are not to be nullified, a derogation from paragraph 2 of Article 23 A, or from Article 23 B will be necessary."

Paragraph 74 corresponds to paragraph 72 of the 1977 Model Convention. Paragraph 74 of the 1977 Model Convention was renumbered as paragraph 76 (cf. history of paragraph 76) and paragraph 72 was renumbered as paragraph 74 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 75: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 75 previously read as follows:

"75. Various formulae can be used to this effect, as for example:

a) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (e.g. limitations of rates provided for

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dividends and interest in Articles 10 and 11) even if the State of source, as a developing country, has waived all or part of that tax under special provisions for the promotion of its economic development;

b) as a counterpart for the tax sacrifice which the developing country makes by reducing in a general way its tax at the source, the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;

c) the State of residence exempts the income which has benefited from tax incentives in the developing country.

Contracting States are free to devise other formulae in the course of bilateral negotiations."

Paragraph 75 corresponds to paragraph 73 of the 1977 Model Convention. Paragraph 75 of the 1977 Model Convention was renumbered as paragraph 77 (cf. history of paragraph 77) and paragraph 73 was renumbered as paragraph 75 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 76: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 76 previously read as follows:

"76. If a Contracting State agrees to stimulate especially investments in the other State being a developing country, the above provisions will generally be accompanied by guarantees for the investors, that is to say, the Convention will limit the rate of tax which can be imposed in the State of source on dividends, interest and royalties."

Paragraph 76 corresponds to paragraph 74 of the 1977 Model Convention. Paragraph 76 of the 1977 Model Convention was renumbered as paragraph 78 (cf. history of paragraph 78) and paragraph 74 was renumbered as paragraph 76 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 77: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 77 previously read as follows:

"77. Moreover, time restrictions or time limits can be provided for the application of the advantages referred to in formula *a*), and possibly *c*), above: the extended credit (or the exemption) may be granted only in respect of incentives applied temporarily in developing countries, or only for investments made or contracts concluded in the future (for instance, from the date of entry into force of the Convention) or for a determined period of time."

Paragraph 77 corresponds to paragraph 75 of the 1977 Model Convention. Paragraph 77 of the 1977 Model Convention was renumbered as paragraph 79 (cf. history of paragraph 79) and paragraph 75 was renumbered as paragraph 77 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 78: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997). Paragraph 78 previously read as follows:

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> "78. Thus, there exists a considerable number of solutions to this problem. In fact, the concrete effects of the provisions concerned can also vary as a result of other factors such as the amount to be included in the taxable income in the State of residence (formulae *a*) and *b*) above); it may be the net income derived (after deduction of the tax effectively paid in the State of source), or the net income grossed-up by an amount equal to the tax effectively paid in the State of source, or to the tax which could have been levied in accordance with the Convention (rates provided for in Articles 10 and 11) or to the tax which the State of residence agrees to allow as a deduction."

Paragraph 78 corresponds to paragraph 76 of the 1977 Model Convention. Paragraph 76 of the 1977 Model Convention was renumbered as paragraph 78 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 78.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of another report entitled "Tax Sparing — A Reconsideration" (adopted by the OECD Council on 23 October 1997).

Paragraph 79: Corresponds to paragraph 77 of the 1977 Model Convention. Paragraph 77 of the 1977 Model Convention was renumbered as paragraph 79 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 80: Added, together with the heading preceding it, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 81: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 82: Added, together with the heading preceding it, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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COMMENTARY ON ARTICLE 24
CONCERNING NON-DISCRIMINATION

Paragraph 1

1. This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

2. It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with its own nationals. The fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

3. The expression "in the same circumstances" refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact. The expression "in particular with respect to residence" makes clear that the residence of the taxpayer is one of the factors that are relevant in determining whether taxpayers are placed in similar circumstances. The expression "in the same circumstances" would be sufficient by itself to establish that a taxpayer who is a resident of a Contracting State and one

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who is not a resident of that State are not in the same circumstances. In fact, whilst the expression "in particular with respect to residence" did not appear in the 1963 Draft Convention or in the 1977 Model Convention, the Member countries have consistently held, in applying and interpreting the expression "in the same circumstances", that the residence of the taxpayer must be taken into account. However, in revising the Model Convention, the Committee on Fiscal Affairs felt that a specific reference to the residence of the taxpayers would be a useful clarification as it would avoid any possible doubt as to the interpretation to be given to the expression "in the same circumstances" in this respect.

(Amended on 23 July 1992; see HISTORY)

4. In applying paragraph 1, therefore, the underlying question is whether two persons who are residents of the same State are being treated differently solely by reason of having a different nationality. Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its nationals who reside in the other State. Similarly, paragraph 1 does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State (for instance, as a result of the application of provisions aimed at discouraging the use of tax havens) as the two persons are not in the same circumstances with respect to their residence.

(Amended on 31 March 1994; see HISTORY)

5. Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

6. Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.

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7. To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private business undertakings, the provisions of paragraph 1 will apply to them.

(Amended on 29 April 2000; see HISTORY)

8. As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

9. Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may 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 the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

10. Subject to the foregoing observation, the words "...shall not be subjected... to any taxation or any requirement connected therewith which is other or more burdensome..." mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the

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formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.

11. In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term "national" in sub-paragraph *f*) of paragraph 1 of Article 3.

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

Paragraph 2

12. On 28 September 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under Article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries.

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

13. It should, however, be recognised that the provisions of paragraph 2 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of Article 1 of the above-mentioned Convention of 28 September 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

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

14. The purpose of paragraph 2 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that or of the other Contracting State.

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

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15. By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other State.

(Renumbered on 23 July 1992; see HISTORY)

16. However, if States were to consider it desirable in their bilateral relations to extend the application of paragraph 2 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the following text which contains no condition as to residence in a Contracting State:

> "Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a 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 State in the same circumstances, in particular with respect to residence, are or may be subjected."

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

17. It is possible that in the future certain States will take exception to the provisions of paragraph 2 as being 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 wished to avoid this latter consequence, they would have 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."

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

18. Finally, it should be understood that the definition of the term "stateless person" to be used for the purposes of such a clause can only be that laid down

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in paragraph 1 of Article 1 of the Convention of 28 September 1954, which defines a stateless person as "a person who is not considered as a national by any State under the operation of its law".

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 3

19. Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

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

20. It appears necessary first to make it clear that the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

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

21. By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on business activities, and especially taxes on business profits.

(Amended on 29 April 2000; see HISTORY)

22. However, the second sentence of paragraph 3 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a

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permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

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

23. As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

(Renumbered on 23 July 1992; see HISTORY)

A. Assessment of tax

24. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

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b) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ("wholesale" writing down, accelerated depreciation, etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting — in accordance with commercial accounting principles — of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or "reserves" for investment. When such a right is enjoyed by all enterpris es, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises with respect to their permanent establishments situated in the State concerned, insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.

c) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

d) Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

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

25. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, the same does not always hold good for the tax incentive measures which most countries, faced with such problems as decentralisation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these

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problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

(Renumbered on 23 July 1992; see HISTORY)

26. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in business activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

(Amended on 29 April 2000; see HISTORY)

27. It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

(Renumbered on 23 July 1992; see HISTORY)

28. Finally, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

(Renumbered on 23 July 1992; see HISTORY)

B. Special treatment of dividends received in respect of holdings owned by permanent establishments

29. In many countries special rules exist for the taxation of dividends distributed between companies (parent company-subsidiary treatment, the *Schachtelprivileg*, the rule *non bis in idem*). The question arises whether such treatment should, by effect of the provisions of paragraph 3, also be enjoyed by

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permanent establishments in respect of dividends on holdings forming part of their assets.

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

30. On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle, profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

(Renumbered on 23 July 1992; see HISTORY)

31. Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward relates to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying

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such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends, its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 3 does not entail any obligation to extend such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

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

32. The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, *viz.*,

- — reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;
- — or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;
- — or simple reasons of practical convenience, in line with the present tendency towards decentralisation of management functions in large enterprises.

(Renumbered on 23 July 1992; see HISTORY)

33. In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 3. They can, if they so desire, explain their position, or

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change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

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

34. A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 of Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the same way as if they are received directly i.e. by the head offices of the latter companies, *viz.*, at the rate of:

— 5 per cent in the case of a holding of at least 25 per cent;
— 15 per cent in all other cases.

(Renumbered on 23 July 1992; see HISTORY)

35. Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

(Renumbered on 23 July 1992; see HISTORY)

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C. Structure and rate of tax

36. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 3 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems, which here too arise from the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

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

37. When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way (cf. paragraphs 55, 56 and 79 of the Commentary on Articles 23A and 23B). States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

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

38. When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed *a priori* that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 3 are not observed only if the minimum rate is higher.

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

39. However, even if the profits of the whole enterprise to which the permanent establishment belongs is taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the distinct and separate enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of Article 7. The minimum amount of the tax levied in the State where the permanent

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establishment is situated is, therefore, the amount which would be due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

(Renumbered on 23 July 1992; see HISTORY)

40. As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 3 to extend it to permanent establishments of non-resident companies. This attitude is based, in particular, on the view that the split-rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate as, generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

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

41. This view is, however, disputed. The States in favour of extending the split-rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is

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generally recognised that, by the effects of their provisions, such conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system. As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where distributions of profits made can be deducted from the taxable income of a company.

(Renumbered on 23 July 1992; see HISTORY)

42. As regards the imputation system ("*avoir fiscal*" or "tax credit"), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 3, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishments. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the *avoir fiscal* or tax credit. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the *avoir fiscal* or tax credit to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.

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

43. Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

(Renumbered on 23 July 1992; see HISTORY)

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D. Withholding tax on dividends, interest and royalties received by a permanent establishment

44. When permanent establishments receive dividends, interest, or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently — subject to the observations made in paragraph 34 above as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments (cf. paragraph 35 of the Commentary on Article 7).

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

45. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 (cf. respectively paragraphs 31, 24 and 20), these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means — and this is the generally accepted interpretation — that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

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

46. While this approach does not create any problems with regard to the provisions of paragraph 3 of Article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

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

47. In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 3 that for the purpose of taxing the income which is derived from their activity, or which is normally connected with it — as is recognised to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of

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Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

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

48. In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

(Renumbered on 23 July 1992; see HISTORY)

E. Credit for foreign tax

49. In a related context, when a permanent establishment receives foreign income which is included in its taxable profits, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

(Renumbered on 23 July 1992; see HISTORY)

50. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B), credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises as to the extension to permanent establishments of the benefit of conventions concluded with third States. This question is examined below, the particular case of dividends, interest and royalties being dealt with in paragraph 51.

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

F. Extension to permanent establishments of the benefit of double taxation conventions concluded with third States

51. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends, interest or royalties from a third State, then the question arises as to whether and to what extent the Contracting State in which the permanent establishment is situated should credit the tax that cannot be recovered from the third State.

(Replaced on 23 July 1992; see HISTORY)

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52. There is agreement that double taxation arises in these situations and that some method of relief should be found. The majority of Member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3. States that cannot give credit in such a way or that wish to clarify the situation may wish to supplement the provision in their convention with the Contracting State in which the enterprise is resident by wording that allows the State in which the permanent establishment is situated to credit the tax liability in the State in which the income originates to an amount that does not exceed the amount that resident enterprises in the Contracting State in which the permanent establishment is situated can claim on the basis of the Contracting State's convention with the third State. If the tax that cannot be recovered under the convention between the third State and the State of residence of the enterprise which has a permanent establishment in the other Contracting State is lower than that under the convention between the third State and the Contracting State in which the permanent establishment is situated, then only the lower tax collected in the third State shall be credited. This result would be achieved by adding the following words after the first sentence of paragraph 3:

> "When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends, interest or royalties from a third State and the right or the asset in respect of which the dividends, interest or royalties are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends, interest or royalties, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State can claim under that State's convention on income and capital with the third State."

(Amended on 23 October 1997; see HISTORY)

53. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention

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between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure as this procedure would provide useful information for audit purposes. Another question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.

(Replaced on 23 July 1992; see HISTORY)

54. 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 to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21). States can settle these matters in bilateral negotiations.

(Replaced on 23 July 1992; see HISTORY)

Paragraph 4

55. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a

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non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.

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

56. Paragraph 4 does not prohibit the country of the borrower from treating interest as a dividend under its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

(Replaced on 23 July 1992; see HISTORY)

Paragraph 5

57. This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.

(Heading amended on 23 July 1992; see HISTORY)

58. Paragraph 5, though relevant in principle to thin capitalisation, is worded in such general terms that it must take second place to more specific provisions in the Convention. Thus paragraph 4 (referring to paragraph 1 of Article 9 and paragraph 6 of Article 11) takes precedence over this paragraph in relation to the deduction of interest.

(Replaced on 23 July 1992; see HISTORY)

59. In the case of transfer pricing enquiries, almost all Member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of the Article.

(Replaced on 23 July 1992; see HISTORY)

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Paragraph 6

60. This paragraph states that the scope of the Article is not restricted by the provisions of Article 2. The Article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.

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

Observations on the Commentary

61. The interpretation given in paragraphs 38 and 39 above is not endorsed by *Germany*, the tax laws of which require the application of a minimum rate on exclusively inbound sources with respect to non-residents; the minimum rate is close to the lower end of the progressive tax scale.

(Amended on 31 March 1994; see HISTORY)

62. The *United States* observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income.

(Renumbered on 23 July 1992; see HISTORY)

63. With respect to paragraph 53, the *Netherlands* acknowledges that States may wish to include in their bilateral conventions a provision to assure that the benefits of the Convention are denied in "triangular cases" which may be regarded as abusive. In drafting provisions like this, however, the starting point should always be that the benefits of the Convention can be claimed unless the situation is regarded to be abusive. Further the Netherlands would like to express the opinion that the notion "normally taxed" is too ambiguous to serve as a decisive landmark in determining whether a situation is abusive or not.

(Replaced on 23 July 1992; see HISTORY)

Reservations on the Article

64. *Australia, Canada* and *New Zealand* reserve their positions on this Article.

(Renumbered on 23 July 1992; see HISTORY)

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65. The *United States* reserves its right to apply its branch tax.

(Replaced on 23 July 1992; see HISTORY)

Paragraph 1

66. *France* wishes to reserve the possibility of applying the provisions of paragraph 1 only to individuals, in view of the French case law and of the fact that paragraphs 3, 4 and 5 already provide companies with wide protection against discrimination.

(Amended on 21 September 1995; see HISTORY)

67. The *United Kingdom* reserves its position on the second sentence of paragraph 1.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 2

68. *Switzerland* reserves the right not to insert paragraph 2 in its conventions.

(Added on 23 July 1992; see HISTORY)

Paragraph 3

69. [Deleted on 23 October 1997; see HISTORY]

Paragraph 4

70. *France* accepts the provisions of paragraph 4 but wishes to reserve the possibility of applying the provisions in its domestic laws relative to the limitation to the deduction of interest paid by a French company to a foreign parent company.

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

71. [Deleted on 31 March 1994; see HISTORY]

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Paragraph 6

72. *Greece, Ireland,* and the *United Kingdom* reserve the right to restrict the scope of the Article to the taxes covered by the Convention.

(Amended on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. Paragraph 3 previously read as follows:

> "3. The expression "in the same circumstances" refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact."

Paragraph 4: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 4 previously read as follows:

> "4. Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its non-resident nationals."

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Included in the 1977 Model Convention. Amended, by replacing the words "industrial and commercial" with the word "business", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). In the 1977 Model Convention, paragraph 7 read as follows:

> "7. To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private industrial and commercial undertakings, the provisions of paragraph 1 will apply to them."

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Unchanged from the 1977 Model Convention.

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Corresponds to paragraph 13 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was amended and renumbered as paragraph 8 of the Commentary on Article 3 (cf. history of paragraph 8 of the Commentary on Article 3), the heading preceding it was deleted and paragraph 13 was amended and renumbered as paragraph 11 by the Report entitled "The Revision of

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the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 11 read as follows:

> "*Paragraph 2*
>
> 11. Paragraph 2 merely stipulates that the term "nationals" applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the Article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by "the nationals of a Contracting State", reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality."

In the 1977 Model Convention, paragraph 13 read as follows:

> "13. Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term "nationals".

Paragraph 12: Corresponds to paragraph 14 of the 1977 Model Convention. Paragraph 12 of the 1977 Model Convention was amended and renumbered as paragraph 9 of the Commentary on Article 3 (cf. history of paragraph 9 of the Commentary on Article 3), the heading preceding paragraph 14 was amended by replacing "3" by "2" and paragraph 14 was renumbered as paragraph 12 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 12 read as follows:

> "12. But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it."

Paragraph 13: Corresponds to paragraph 15 of the 1977 Model Convention. Paragraph 13 of the 1977 Model Convention was amended and renumbered as paragraph 11 (cf. history of paragraph 11) and paragraph 15 was amended by replacing the reference therein to paragraph 3 by a reference to paragraph 2 and renumbered as paragraph 13 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14: Corresponds to paragraph 16 of the 1977 Model Convention. Paragraph 14 of the 1977 Model Convention was renumbered as paragraph 12 (cf. history of paragraph 12) and paragraph 16 was amended by replacing the reference therein to paragraph 3 by a reference to paragraph 2 and renumbered as paragraph 14 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 15: Corresponds to paragraph 17 of the 1977 Model Convention. Paragraph 15 of the 1977 Model Convention was amended and renumbered as paragraph 13 (cf. history of paragraph 13) and paragraph 17 was renumbered as paragraph 15 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 16: Corresponds to paragraph 18 of the 1977 Model Convention. Paragraph 16 of the 1977 Model Convention was amended and renumbered as paragraph 14 (cf. history of paragraph 14) and paragraph 18 was renumbered as paragraph 16 and amended, by replacing the reference therein to paragraph 3 by a reference to paragraph 2 and by adding the words "in particular with respect to residence" at the end of the suggested provision included therein, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the suggested provision included in paragraph 18 read as follows:

> "Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a 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 State in the same circumstances are or may be subjected."

Paragraph 17: Corresponds to paragraph 19 of the 1977 Model Convention. Paragraph 17 of the 1977 Model Convention was renumbered as paragraph 15 (cf. history of paragraph 15) and paragraph 19 was renumbered as paragraph 17 and amended, by replacing the reference therein to paragraph 3 by a reference to paragraph 2 and by adding the words «in particular with respect to residence» at the end of the suggested provision included therein, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the suggested provision included in paragraph 19 read 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, are or may be subjected."

Paragraph 18: Corresponds to paragraph 20 of the 1977 Model Convention. Paragraph 18 of the 1977 Model Convention was amended and renumbered as paragraph 16 (cf. history of paragraph 16) and paragraph 20 was renumbered as paragraph 18 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 19: Corresponds to paragraph 21 of the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was amended and renumbered as paragraph 17 (cf. history of paragraph 17), the heading preceding paragraph 21 was amended by replacing "4" by "3" and paragraph 21 was renumbered as paragraph 19 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 20: Corresponds to paragraph 22 of the 1977 Model Convention. Paragraph 20 of the 1977 Model Convention was renumbered as paragraph 18 (cf. history of paragraph 18) and paragraph 22 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 20 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Amended, by replacing the words "industrial and commercial" with the word "business", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 21 previously read as follows:

> "21. By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this

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> provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on industrial and commercial activities, and especially taxes on business profits."

Paragraph 21 corresponds to paragraph 23 of the 1977 Model Convention. Paragraph 21 of the 1977 Model Convention was renumbered as paragraph 19 (cf. history of paragraph 19) and paragraph 23 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 21 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 22: Corresponds to paragraph 24 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention was amended and renumbered as paragraph 20 (cf. history of paragraph 20) and paragraph 24 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 22 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 23: Corresponds to paragraph 25 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was amended and renumbered as paragraph 21 (cf. history of paragraph 21) and paragraph 25 was renumbered as paragraph 23 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 24: Corresponds to paragraph 26 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was amended and renumbered as paragraph 22 (cf. history of paragraph 22) and paragraph 26 was renumbered as paragraph 24, and the last sentence of its paragraph *b*) was amended, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, the last sentence of paragraph *b*) of paragraph 26 read as follows:

> "When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises, or by all enterprises in a given sector of activity, it should in the State concerned, insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State."

Paragraph 25: Corresponds to paragraph 27 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was renumbered as paragraph 23 (cf. history of paragraph 23) and paragraph 27 was renumbered as paragraph 25 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 26: Amended, by replacing the words "industrial and commercial" with the word "business", by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000 on the basis of the Annex of another report entitled "Issues Related to Article 14 of the OECD Model Tax Convention" (adopted by the OECD Committee on Fiscal Affairs on 27 January 2000). Paragraph 26 previously read as follows:

> "26. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in industrial or commercial activity in that State, either under its

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legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States."

Paragraph 26 corresponds to paragraph 28 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was amended and renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 28 was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 27: Corresponds to paragraph 29 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 29 was renumbered as paragraph 27 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and paragraph 30 was renumbered as paragraph 28 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 29: Corresponds to paragraph 31 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was renumbered as paragraph 27 (cf. history of paragraph 27) and paragraph 31 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 29 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 30: Corresponds to paragraph 32 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was renumbered as paragraph 28 (cf. history of paragraph 28) and paragraph 32 was renumbered as paragraph 30 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 31: Corresponds to paragraph 33 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was amended and renumbered as paragraph 29 (cf. history of paragraph 29) and paragraph 33 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 31 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 32: Corresponds to paragraph 34 of the 1977 Model Convention. Paragraph 32 of the 1977 Model Convention was renumbered as paragraph 30 (cf. history of paragraph 30) and paragraph 34 was renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 33: Corresponds to paragraph 35 of the 1977 Model Convention. Paragraph 33 of the 1977 Model Convention was amended and renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 35 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 33 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 34: Corresponds to paragraph 36 of the 1977 Model Convention. Paragraph 34 of the 1977 Model Convention was renumbered as paragraph 32 (cf. history of paragraph 32) and paragraph 36 was renumbered as paragraph 34 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 35: Corresponds to paragraph 37 of the 1977 Model Convention. Paragraph 35 of the 1977 Model Convention was amended and renumbered as paragraph 33 (cf. history of paragraph 33) and paragraph 37 was renumbered as paragraph 35 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 36: Corresponds to paragraph 38 of the 1977 Model Convention. Paragraph 36 of the 1977 Model Convention was renumbered as paragraph 34 (cf. history of paragraph 34) and paragraph 38 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 36 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 37: Corresponds to paragraph 39 of the 1977 Model Convention. Paragraph 37 of the 1977 Model Convention was renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 39 was renumbered as paragraph 37 and amended, by replacing the reference therein to paragraph 77 by a reference to paragraph 79 of the Commentary on Articles 23A and 23B, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 38: Corresponds to paragraph 40 of the 1977 Model Convention. Paragraph 38 of the 1977 Model Convention was amended and renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 40 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 38 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 39: Corresponds to paragraph 41 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was amended and renumbered as paragraph 37 (cf. history of paragraph 37) and paragraph 41 was renumbered as paragraph 39 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 40: Corresponds to paragraph 42 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was amended and renumbered as paragraph 38 (cf. history of paragraph 38) and paragraph 42 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 40 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 41: Corresponds to paragraph 43 of the 1977 Model Convention. Paragraph 41 of the 1977 Model Convention was renumbered as paragraph 39 (cf. history of paragraph 39) and paragraph 43 was renumbered as paragraph 41 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Corresponds to paragraph 44 of the 1977 Model Convention. Paragraph 42 of the 1977 Model Convention was amended and renumbered as paragraph 40 (cf. history of paragraph 40) and paragraph 44 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 42 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 43: Corresponds to paragraph 45 of the 1977 Model Convention. Paragraph 43 of the 1977 Model Convention was renumbered as paragraph 41 (cf. history of paragraph 41) and paragraph 45 was renumbered as paragraph 43 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 44: Corresponds to paragraph 46 of the 1977 Model Convention. Paragraph 44 of the 1977 Model Convention was amended and renumbered as paragraph 42 (cf. history of paragraph 42) and paragraph 46 was renumbered as paragraph 44 and amended, by replacing the references therein to paragraph 36 of the present Commentary and to paragraph 34 of the Commentary on Article 7 by references to paragraph 34 of the present Commentary and to paragraph 35 of the Commentary on Article 7 respectively, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 45: Corresponds to paragraph 47 of the 1977 Model Convention. Paragraph 45 of the 1977 Model Convention was renumbered as paragraph 43 (cf. history of paragraph 43) and paragraph 47 was renumbered as paragraph 45 and amended, by replacing the references therein to paragraphs 30, 22 and 15 of the Commentary on Articles 10, 11 and 12 respectively by references to paragraph 31, 24 and 20 thereof, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 46: Corresponds to paragraph 48 of the 1977 Model Convention. Paragraph 46 of the 1977 Model Convention was amended and renumbered as paragraph 44 (cf. history of paragraph 44) and paragraph 48 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 46 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 47: Corresponds to paragraph 49 of the 1977 Model Convention. Paragraph 47 of the 1977 Model Convention was amended and renumbered as paragraph 45 (cf. history of paragraph 45) and paragraph 49 was amended by replacing the reference therein to paragraph 4 by a reference to paragraph 3 and renumbered as paragraph 47 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 48: Corresponds to paragraph 50 of the 1977 Model Convention. Paragraph 48 of the 1977 Model Convention was amended and renumbered as paragraph 46 (cf. history of paragraph 46) and paragraph 50 was renumbered as paragraph 48 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 49: Corresponds to paragraph 51 of the 1977 Model Convention. Paragraph 49 of the 1977 Model Convention was amended and renumbered as paragraph 47 (cf. history of paragraph 47) and paragraph 51 was renumbered as paragraph 49 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 50: Corresponds to paragraph 52 of the 1977 Model Convention. Paragraph 50 of the 1977 Model Convention was renumbered as paragraph 48 (cf. history of paragraph 48) and paragraph 52 was renumbered as paragraph 50 and amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 52 read as follows:

> "52. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States, which is examined in paragraph 54 below."

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Paragraph 51: Replaced paragraph 51 of the 1977 Model Convention. The heading preceding paragraph 54 in the 1977 Model Convention was moved immediately before paragraph 51, paragraph 51 of the 1977 Model Convention was renumbered as paragraph 49 (cf. history of paragraph 49) and new paragraph 51 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 52: Amended, by replacing the suggested provision included at the end of the paragraph, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. The suggested provision previously read as follows:

> "When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends, interest or royalties from a third State and the right or the asset in respect of which the dividends, interest or royalties are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends, interest or royalties, as the case may be, but the amount of such credit shall not exceed the amount calculated by applying the appropriate rate provided for under the convention with respect to taxes on income and on capital between the Contracting State of which the enterprise is a resident and the third."

Paragraph 52 replaced paragraph 52 of the 1977 Model Convention. Paragraph 52 of the 1977 Model Convention was amended and renumbered as paragraph 50 (cf. history of paragraph 50) and new paragraph 52 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992).

Paragraph 53: Replaced paragraph 53 of the 1977 Model Convention. Paragraph 53 of the 1977 Model Convention was deleted and new paragraph 53 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 53 read as follows:

> "53. It should, however, be pointed out that difficulties may arise as to the amount of the credit to be allowed, if permanent establishments in State A benefit from the convention which State B has concluded with State C. Such amount may be either the amount of tax effectively collected by State C or the amount of tax which State C may collect by virtue either of its convention with State A or its convention with State B. Moreover, the question arises whether such credit is not given twice, i.e. once in State A, where the permanent establishment is situated and again in State B, the State of residence. It is for Contracting States to settle such problems, if necessary, in their bilateral negotiations."

Paragraph 54: Replaced paragraph 54 of the 1977 Model Convention. Paragraph 54 of the 1977 Model Convention was deleted and new paragraph 54 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 60 of another report entitled "Triangular Cases" (adopted by the Council of the OECD on 23 July 1992). In the 1977 Model Convention, paragraph 54 read as follows:

> "54. While an enterprise of a State (A) can normally claim, in respect of the permanent establishment which it possesses in another State (B), the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State (C), invoke the provisions of the convention

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between States B and C for the benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States (cf. Article 1). This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States."

Paragraph 55: Corresponds to paragraph 56 of the 1977 Model Convention. Paragraph 55 of the 1977 Model Convention was deleted, the heading preceding paragraph 56 was amended by replacing the "5" therein by a "4" and paragraph 56 was renumbered as paragraph 55 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 55 read as follows:

"55. Nor could such an enterprise invoke for this purpose a most-favoured-nation clause, however general its terms, included in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied, "in special cases", to permanent establishments of enterprises of a third State."

Paragraph 56: Replaced paragraph 56 of the 1977 Model Convention. Paragraph 56 of the 1977 Model Convention was renumbered as paragraph 55 (cf. history of paragraph 55) and new paragraph 56 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 66 *a*) of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 57: Unchanged from the 1977 Model Convention except that the heading preceding paragraph 57 was amended by replacing the "6" therein by a "5" by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 58: Replaced paragraph 58 of the 1977 Model Convention. Paragraph 58 of the 1977 Model Convention was renumbered as paragraph 60 (cf. history of paragraph 60) and new paragraph 58 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 87 *b*) of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986).

Paragraph 59: Replaced paragraph 59 of the 1977 Model Convention. Paragraph 59 of the 1977 Model Convention was amended and renumbered as paragraph 61 (cf. history of paragraph 61) and new paragraph 59 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraphs 30 and 31 of a previous report entitled "Double Taxation Conventions and the Use of Base Companies" (adopted by the Council of the OECD on 27 November 1986).

Paragraph 60: Corresponds to paragraph 58 of the 1977 Model Convention. Paragraph 60 of the 1977 Model Convention was renumbered as paragraph 62 (cf. history of paragraph 62), paragraph 58 was renumbered as paragraph 60 and the heading preceding paragraph 60 was amended by replacing the "7" therein by "6", by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 61: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 61 previously read as follows:

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"61. The interpretation given in paragraphs 38 and 39 above is not endorsed by *Germany*, the tax laws of which require the application of a minimum rate with respect to non-residents. Under German tax laws, the profits of a permanent establishment of an enterprise operated in Germany by a non-resident individual are charged income tax at a minimum rate of 25 per cent. On the other hand, the German tax laws restrict the application of higher rates by strictly limiting the basis for determining the rate applicable to profits derived from German sources — thus excluding any profits derived by those parts of the enterprise which are situated abroad. Moreover, since the minimum rate of 25 per cent is close to the lower end of the progressive tax scale which ranges from 22 per cent to 56 per cent, Germany is of the opinion that the application of the minimum rate of 25 per cent does not violate the provisions of paragraph 3."

Paragraph 61 corresponds to paragraph 59 of the 1977 Model Convention. Paragraph 61 of the 1977 Model Convention was renumbered as paragraph 64 (cf. history of paragraph 64) and paragraph 59 was renumbered as paragraph 61 and amended, by replacing the references therein to paragraphs 40 and 41 and to paragraph 4 of the Article by references to paragraphs 38 and 39 and to paragraph 3 of the Article respectively, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 62: Corresponds to paragraph 60 of the 1977 Model Convention. Paragraph 62 of the 1977 Model Convention was amended and renumbered as paragraph 66 (cf. history of paragraph 66) and paragraph 60 was renumbered as paragraph 62 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 63: Replaced paragraph 63 of the 1977 Model Convention. Paragraph 63 of the 1977 Model Convention was renumbered as paragraph 67 (cf. history of paragraph 67) and new paragraph 63 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 64: Corresponds to paragraph 61 of the 1977 Model Convention. Paragraph 64 of the 1977 Model Convention was amended and renumbered as paragraph 69 (cf. history of paragraph 69) and paragraph 61 was renumbered as paragraph 64 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 65: Replaced paragraph 65 of the 1977 Model Convention. Paragraph 65 of the 1977 Model Convention was deleted and new paragraph 65 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 65 read as follows:

"65. *Japan* reserves the right not to extend to the permanent establishments of non-residents the benefit of tax incentive measures introduced for national policy objectives."

Paragraph 66: Amended on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention". Paragraph 66 previously read as follows:

"66. *France* wishes to reserve the possibility of applying the provisions of paragraph 1 only to individuals, in view of the French case law and of the fact that paragraphs 3, 4 and 5 already provide companies with wide protection against discrimination. It also wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its

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domestic laws, of gains from the alienation of immovable property which constitutes the residence in France of French nationals who are domiciled abroad."

Paragraph 66 corresponded to paragraph 62 of the 1977 Model Convention. Paragraph 66 of the 1977 Model Convention was amended and renumbered as paragraph 70 (cf. history of paragraph 70) and paragraph 62 was amended and renumbered as paragraph 66 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 62 read as follows:

"62. *France* accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the residence in France of French nationals who are domiciled abroad."

Paragraph 67: Corresponds to paragraph 63 of the 1977 Model Convention. Paragraph 63 of the 1977 Model Convention was renumbered as paragraph 67 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 68: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 69: Deleted on 23 October 1997 by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 69 previously read as follows:

"69. *Belgium* reserves in principle the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies resident in countries with which it undertakes negotiations. However, whenever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies resident in Belgium, Belgium will agree to tax these profits at the normal rate applicable to Belgian companies. Belgium also reserves the right to levy, as a minimum tax, its movable property prepayment (*précompte mobilier*) on dividends received by Belgian permanent establishments of non-resident companies.

Paragraph 69, as it read before 23 October 1997, corresponded to paragraph 64 of the 1977 Model Convention. Paragraph 64 of the 1977 Model Convention was amended and renumbered as paragraph 69 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 64 read as follows:

"64. *Belgium* reserves the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies and associations resident in countries with which it undertakes negotiations whenever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies and associations resident in Belgium (paragraph 4)."

Paragraph 70: Corresponds to paragraph 66 of the 1977 Model Convention. Paragraph 66 of the 1977 Model Convention was amended by replacing the reference therein to paragraph 5 by a reference to paragraph 4 and renumbered paragraph 70 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 71: Deleted by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 71 previously read as follows:

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> "71. *Greece* accepts the provisions of paragraph 4 but wishes to reserve the possibility of not applying the provisions of Articles 11 and 12 where the debt-claim in respect of which the interest is paid, and the property or the right giving rise to royalties, were created or assigned mainly for the purpose of taking advantage of Articles 11 and 12 respectively and not for *bona fide* commercial reasons."

Paragraph 71, as it read after 23 July 1992 and before 31 March 1994, was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 72: Amended, by adding Greece and Ireland to the list of countries making the reservation, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 72 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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COMMENTARY ON ARTICLE 25
CONCERNING THE MUTUAL AGREEMENT PROCEDURE

I. Preliminary remarks

1. This Article institutes a mutual agreement procedure for resolving difficulties arising out of the application of the Convention in the broadest sense of the term.

2. It provides first, in paragraphs 1 and 2, that the competent authorities shall endeavour by mutual agreement to resolve the situation of taxpayers subjected to taxation not in accordance with the provisions of the Convention.

3. It also, in paragraph 3, invites and authorises the competent authorities of the two States to resolve by mutual agreement problems relating to the interpretation or application of the Convention and, furthermore, to consult together for the elimination of double taxation in cases not provided for in the Convention.

4. Finally, as regards the practical operation of the mutual agreement procedure, the Article, in paragraph 4, merely authorises the competent authorities to communicate with each other directly, without going through diplomatic channels, and, if it seems advisable to them, to have an oral exchange of opinions through a joint commission appointed especially for the purpose.

5. Since the Article merely lays down general rules concerning the mutual agreement procedure, the comments now following are intended to clarify the purpose of such rules, and also to amplify them, if necessary, by referring, in particular, to the rules followed at international level in the conduct of mutual agreement procedures or at the internal level in the conduct of the procedures which exist in most OECD Member countries for dealing with disputed claims regarding taxes.

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II. Commentary on the provisions of the Article

Paragraphs 1 and 2

6. The rules laid down in paragraphs 1 and 2 provide for the elimination in a particular case of taxation which does not accord with the Convention. As is known, in such cases it is normally open to taxpayers to litigate in the tax court, either immediately or upon the dismissal of their objections by the taxation authorities. When taxation not in accordance with the Convention arises from an incorrect application of the Convention in both States, taxpayers are then obliged to litigate in each State, with all the disadvantages and uncertainties that such a situation entails. So paragraph 1 makes available to taxpayers affected, without depriving them of the ordinary legal remedies available, a procedure which is called the mutual agreement procedure because it is aimed, in its second stage, at resolving the dispute on an amicable basis, i.e. by agreement between competent authorities, the first stage being conducted exclusively in the State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter.

7. In any case, the mutual agreement procedure is clearly a special procedure outside the domestic law. It follows that it can be set in motion solely in cases coming within paragraph 1, i.e. cases where tax has been charged, or is going to be charged, in disregard of the provisions of the Convention. So where a charge of tax has been made contrary both to the Convention and the domestic law, this case is amenable to the mutual agreement procedure to the extent only that the Convention is affected, unless a connecting link exists between the rules of the Convention and the rules of the domestic law which have been misapplied.

8. In practice, the procedure applies to cases — by far the most numerous — where the measure in question leads to double taxation which it is the specific purpose of the Convention to avoid. Among the most common cases, mention must be made of the following:

— the questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of Article 7;

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— the taxation in the State of the payer — in case of a special relationship between the payer and the beneficial owner — of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph 4 of Article 12;
— cases of application of legislation to deal with thin capitalisation when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11;
— cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by an employee (paragraph 2 of Article 15).

(Amended on 23 July 1992; see HISTORY)

9. Article 25 also provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation, and especially those resulting from the inclusion of profits of associated enterprises under paragraph 1 of Article 9; the corresponding adjustments to be made in pursuance of paragraph 2 of the same Article thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount.

(Replaced on 23 July 1992; see HISTORY)

10. This in fact is implicit in the wording of paragraph 2 of Article 9 when the bilateral convention in question contains a clause of this type. When the bilateral convention does not contain rules similar to those of paragraph 2 of Article 9 (as is usually the case for conventions signed before 1977) the mere fact that Contracting States inserted in the convention the text of Article 9, as limited to the text of paragraph 1 — which usually only confirms broadly similar rules existing in domestic laws — indicates that the intention was to have economic double taxation covered by the Convention. As a result, most Member countries consider that economic double taxation resulting from adjustments made to profits by reason of transfer pricing is not in accordance with — at least — the spirit of the convention and falls within the scope of the mutual agreement procedure set up under Article 25. States which do not share this view do, however, in practice, find

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the means of remedying economic double taxation in most cases involving *bona fide* companies by making use of provisions in their domestic laws.

(Replaced on 23 July 1992; see HISTORY)

11. The mutual agreement procedure is also applicable in the absence of any double taxation contrary to the Convention, once the taxation in dispute is in direct contravention of a rule in the Convention. Such is the case when one State taxes a particular class of income in respect of which the Convention gives an exclusive right to tax to the other State even though the latter is unable to exercise it owing to a gap in its domestic laws. Another category of cases concerns persons who, being nationals of one Contracting State but residents of the other State, are subjected in that other State to taxation treatment which is discriminatory under the provisions of paragraph 1 of Article 24.

(Renumbered on 23 July 1992; see HISTORY)

12. It should be noted that the mutual agreement procedure, unlike the disputed claims procedure under domestic law, can be set in motion by a taxpayer without waiting until the taxation considered by him to be "not in accordance with the Convention" has been charged against or notified to him. To be able to set the procedure in motion, he must, and it is sufficient if he does, establish that the "actions of one or both of the Contracting States" will result in such taxation, and that this taxation appears as a risk which is not merely possible but probable. Such actions mean all acts or decisions, whether of a legislative or a regulatory nature, and whether of general or individual application, having as their direct and necessary consequence the charging of tax against the complainant contrary to the provisions of the Convention.

(Renumbered on 23 July 1992; see HISTORY)

13. To be admissible objections presented under paragraph 1 must first meet a twofold requirement expressly formulated in that paragraph: in principle, they must be presented to the competent authority of the taxpayer's State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national), and they must be so presented within three years of the first notification of the action which gives rise to taxation which is not in accordance with the Convention. The Convention does not lay down any special rule as to the form of the objections. The competent authorities may prescribe special procedures which they feel to be appropriate. If

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no special procedure has been specified, the objections may be presented in the same way as objections regarding taxes are presented to the tax authorities of the State concerned.

(Renumbered on 23 July 1992; see HISTORY)

14. The requirement laid on the taxpayer to present his case to the competent authority of the State of which he is a resident (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) is of general application, regardless of whether the taxation objected to has been charged in that or the other State and regardless of whether it has given rise to double taxation or not. If the taxpayer should have transferred his residence to the other Contracting State subsequently to the measure or taxation objected to, he must nevertheless still present his objection to the competent authority of the State of which he was a resident during the year in respect of which such taxation has been or is going to be charged.

(Renumbered on 23 July 1992; see HISTORY)

15. However, in the case already alluded to where a person who is a national of one State but a resident of the other complains of having been subjected in that other State to an action or taxation which is discriminatory under paragraph 1 of Article 24, it appears more appropriate for obvious reasons to allow him, by way of exception to the general rule set forth above, to present his objection to the competent authority of the Contracting State of which he is a national. Finally, it is to the same competent authority that an objection has to be presented by a person who, while not being a resident of a Contracting State, is a national of a Contracting State, and whose case comes under paragraph 1 of Article 24.

(Renumbered on 23 July 1992; see HISTORY)

16. On the other hand, Contracting States may, if they consider it preferable, give taxpayers the option of presenting their cases to the competent authority of either State. In such a case, paragraph 1 would have to be modified as follows:

> "1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of either Contracting State. The case must be presented

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within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention."

(Renumbered on 23 July 1992; see HISTORY)

17. The time limit of three years set by the second sentence of paragraph 1 for presenting objections is intended to protect administrations against late objections. This time limit must be regarded as a minimum, so that Contracting States are left free to agree in their bilateral conventions upon a longer period in the interests of taxpayers, e.g. on the analogy in particular of the time limits laid down by their respective domestic regulations in regard to tax conventions. Contracting States may omit the second sentence of paragraph 1 if they concur that their respective domestic regulations apply automatically to such objections and are more favourable in their effects to the taxpayers affected, either because they allow a longer time for presenting objections or because they do not set any time limits for such purpose.

(Renumbered on 23 July 1992; see HISTORY)

18. The provision fixing the starting point of the three-year time limit as the date of the "first notification of the action resulting in taxation not in accordance with the provisions of the Convention" should be interpreted in the way most favourable to the taxpayer. Thus, even if such taxation should be directly charged in pursuance of an administrative decision or action of general application, the time limit begins to run only from the date of the notification of the individual action giving rise to such taxation, that is to say, under the most favourable interpretation, from the act of taxation itself, as evidenced by a notice of assessment or an official demand or other instrument for the collection or levy of tax. If the tax is levied by deduction at the source, the time limit begins to run from the moment when the income is paid; however, if the taxpayer proves that only at a later date did he know that the deduction had been made, the time limit will begin from that date. Furthermore, where it is the combination of decisions or actions taken in both Contracting States resulting in taxation not in accordance with the Convention, it begins to run only from the first notification of the most recent decision or action.

(Renumbered on 23 July 1992; see HISTORY)

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19. As regards the procedure itself, it is necessary to consider briefly the two distinct stages into which it is divided (cf. paragraph 6 above).

(Renumbered on 23 July 1992; see HISTORY)

20. In the first stage, which opens with the presentation of the taxpayer's objections, the procedure takes place exclusively at the level of dealings between him and the competent authorities of his State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national). The provisions of paragraph 1 give the taxpayer concerned the right to apply to the competent authority of the State of which he is a resident, whether or not he has exhausted all the remedies available to him under the domestic law of each of the two States. On the other hand, that competent authority is under an obligation to consider whether the objection is justified and, if it appears to be justified, take action on it in one of the two forms provided for in paragraph 2.

(Renumbered on 23 July 1992; see HISTORY)

21. If the competent authority duly approached recognises that the complaint is justified and considers that the taxation complained of is due wholly or in part to a measure taken in the taxpayer's State of residence, it must give the complainant satisfaction as speedily as possible by making such adjustments or allowing such reliefs as appear to be justified. In this situation, the issue can be resolved without resort to the mutual agreement procedure. On the other hand, it may be found useful to exchange views and information with the competent authority of the other Contracting State, in order, for example, to confirm a given interpretation of the Convention.

(Renumbered on 23 July 1992; see HISTORY)

22. If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed it will be its duty — as clearly appears by the terms of paragraph 2 — to set in motion the mutual agreement procedure proper. It is important that the authority in question carry out this duty as quickly as possible, especially in cases where the profits of associated enterprises have been adjusted as a result of transfer pricing adjustments.

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

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23. A taxpayer is entitled to present his case under paragraph 1 to the competent authority of the State of which he is a resident whether or not he may also have made a claim or commenced litigation under the domestic law of that State. If litigation is pending, the competent authority of the State of residence should not wait for the final adjudication, but should say whether it considers the case to be eligible for the mutual agreement procedure. If it so decides, it has to determine whether it is itself able to arrive at a satisfactory solution or whether the case has to be submitted to the competent authority of the other Contracting State. An application by a taxpayer to set the mutual agreement procedure in motion should not be rejected without good reason.

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

24. If a claim has been finally adjudicated by a court in the State of residence, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, the competent authority may be able to arrive at a satisfactory solution which departs from the court decision. In other States, the competent authority is bound by the court decision. It may nevertheless present the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation.

(Renumbered on 23 July 1992; see HISTORY)

25. In its second stage — which opens with the approach to the competent authority of the other State by the competent authority to which the taxpayer has applied — the procedure is henceforward at the level of dealings between States, as if, so to speak, the State to which the complaint was presented had given it its backing. But while this procedure is indisputably a procedure between States, it may, on the other hand, be asked:

— whether, as the title of the Article and the terms employed in the first sentence of paragraph 2 suggest, it is no more than a simple procedure of mutual agreement, or constitutes the implementation of a *pactum de contrahendo* laying on the parties a mere duty to negotiate but in no way laying on them a duty to reach agreement;
— or whether on the contrary, it is to be regarded (on the assumption of course that it takes place within the framework of a joint commission) as a procedure of a jurisdictional nature laying on the parties a duty to resolve the dispute.

(Renumbered on 23 July 1992; see HISTORY)

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26. Paragraph 2 no doubt entails a duty to negotiate; but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result. However, Contracting States could agree on a more far-reaching commitment whereby the mutual agreement procedure, and above all the discussions in the joint commission, would produce a solution to the dispute. Such a rule could be established either by an amendment to paragraph 2 or by an interpretation specified in a protocol or an exchange of letters annexed to the Convention.

(Renumbered on 23 July 1992; see HISTORY)

27. In seeking a mutual agreement, the competent authorities must first, of course, determine their position in the light of the rules of their respective taxation laws and of the provisions of the Convention, which are as binding on them as much as they are on the taxpayer. Should the strict application of such rules or provisions preclude any agreement, it may reasonably be held that the competent authorities, as in the case of international arbitration, can, subsidiarily, have regard to considerations of equity in order to give the taxpayer satisfaction.

(Renumbered on 23 July 1992; see HISTORY)

28. The purpose of the last sentence of paragraph 2 is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits. This provision does not prevent, however, such States as are not, on constitutional or other legal grounds, able to overrule the time limits in the domestic law from inserting in the mutual agreement itself such time limits as are adapted to their internal statute of limitation. In certain extreme cases, a Contracting State may prefer not to enter into a mutual agreement, the implementation of which would require that the internal statute of limitation had to be disregarded. Apart from time limits there may exist other obstacles such as "final court decisions" to giving effect to an agreement. Contracting States are free to agree on firm provisions for the removal of such obstacles. As regards the practical implementation of the procedure, it is generally recommended that every effort should be made by tax administrations to ensure that as far as possible the mutual agreement procedure is not in any case frustrated by operational delays or, where time limits would be in point, by the combined effects of time limits and operational delays.

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

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29. The Committee on Fiscal Affairs made a number of recommendations on the problems raised by corresponding adjustments of profits following transfer pricing adjustments (implementation of paragraphs 1 and 2 of Article 9) and of the difficulties of applying the mutual agreement procedure to such situations:

a) Tax authorities should notify taxpayers as soon as possible of their intention to make a transfer pricing adjustment (and, where the date of any such notification may be important, to ensure that a clear formal notification is given as soon as possible), since it is particularly useful to ensure as early and as full contacts as possible on all relevant matters between tax authorities and taxpayers within the same jurisdiction and, across national frontiers, between the associated enterprises and tax authorities concerned.

b) Competent authorities should communicate with each other in these matters in as flexible a manner as possible, whether in writing, by telephone, or by face-to-face or round-the-table discussion, whichever is most suitable, and should seek to develop the most effective ways of solving relevant problems. Use of the provisions of Article 26 on the exchange of information should be encouraged in order to assist the competent authority in having well-developed factual information on which a decision can be made.

c) In the course of mutual agreement proceedings on transfer pricing matters, the taxpayers concerned should be given every reasonable opportunity to present the relevant facts and arguments to the competent authorities both in writing and orally.

(Replaced on 23 July 1992; see HISTORY)

30. As regards the mutual agreement procedure in general, the Committee recommended that:

a) The formalities involved in instituting and operating the mutual agreement procedure should be kept to a minimum and any unnecessary formalities eliminated.

b) Mutual agreement cases should each be settled on their individual merits and not by reference to any balance of the results in other cases.

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c) Competent authorities should, where appropriate, formulate and publicise domestic rules, guidelines and procedures concerning use of the mutual agreement procedure.

(Replaced on 23 July 1992; see HISTORY)

31. Finally, the case may arise where a mutual agreement is concluded in relation to a taxpayer who has brought a suit for the same purpose in the competent court of either Contracting State and such suit is still pending. In such a case, there would be no grounds for rejecting a request by a taxpayer that he be allowed to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court had delivered its judgment in the suit still pending. On the other hand, it is necessary to take into account the concern of the competent authority to avoid any divergence or contradiction between the decision of the court and the mutual agreement, with the difficulties or risks of abuse that they could entail. In short, therefore, it seems normal that the implementation of a mutual agreement should be made subject:

— to the acceptance of such mutual agreement by the taxpayer, and
— to the taxpayer's withdrawal of his suit at law concerning the points settled in the mutual agreement.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 3

32. The first sentence of this paragraph invites and authorises the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. These are essentially difficulties of a general nature which concern, or which may concern, a category of taxpayers, even if they have arisen in connection with an individual case normally coming under the procedure defined in paragraphs 1 and 2.

(Renumbered on 23 July 1992; see HISTORY)

33. This provision makes it possible to resolve difficulties arising from the application of the Convention. Such difficulties are not only those of a practical nature, which might arise in connection with the setting up and operation of procedures for the relief from tax deducted from dividends, interest and royalties in the Contracting State in which they arise, but also those which could impair or

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impede the normal operation of the clauses of the Convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the Convention.

(Renumbered on 23 July 1992; see HISTORY)

34. Under this provision the competent authorities can, in particular:

— where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty;
— where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes;
— determine whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when provision for such relief is made in the relevant bilateral convention).

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

35. Paragraph 3 confers on the "competent authorities of the Contracting States", i.e. generally the Ministers of Finance or their authorised representatives normally responsible for the administration of the Convention, authority to resolve by mutual agreement any difficulties arising as to the interpretation of the Convention. However, it is important not to lose sight of the fact that, depending on the domestic law of Contracting States, other authorities (Ministry of Foreign Affairs, courts) have the right to interpret international treaties and agreements as well as the "competent authority" designated in the Convention, and that this is sometimes the exclusive right of such other authorities.

(Renumbered on 23 July 1992; see HISTORY)

36. Mutual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.

(Renumbered on 23 July 1992; see HISTORY)

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37. The second sentence of paragraph 3 enables the competent authorities to deal also with such cases of double taxation as do not come within the scope of the provisions of the Convention. Of special interest in this connection is the case of a resident of a third State having permanent establishments in both Contracting States. It is of course desirable that the mutual agreement procedure should result in the effective elimination of the double taxation which can occur in such a situation. An exception must, however, be made for the case of Contracting States whose domestic law prevents the Convention from being complemented on points which are not explicitly or at least implicitly dealt with; in such a case, the Convention could be complemented only by a protocol subject, like the Convention itself, to ratification or approval.

(Renumbered on 23 July 1992; see HISTORY)

Paragraph 4

38. This paragraph determines how the competent authorities may consult together for the resolution by mutual agreement, either of an individual case coming under the procedure defined in paragraphs 1 and 2 or of general problems relating in particular to the interpretation or application of the Convention, and which are referred to in paragraph 3.

(Renumbered on 23 July 1992; see HISTORY)

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

(Renumbered on 23 July 1992; see HISTORY)

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

(Amended on 21 September 1995; see HISTORY)

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

(Renumbered on 23 July 1992; see HISTORY)

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

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

(Renumbered on 23 July 1992; see HISTORY)

43. However, disclosure to the taxpayer or his representatives of the papers in the case does not seem to be warranted, in view of the special nature of the procedure.

(Renumbered on 23 July 1992; see HISTORY)

44. Without infringing upon the freedom of choice enjoyed in principle by the competent authorities in designating their representatives on the joint commission, it would be desirable for them to agree to entrust the chairmanship of each Delegation — which might include one or more representatives of the service responsible for the procedure — to a high official or judge chosen primarily on account of his special experience; it is reasonable to believe, in fact, that the participation of such persons would be likely to facilitate reaching an agreement.

(Renumbered on 23 July 1992; see HISTORY)

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

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

(Added on 21 September 1995; see HISTORY)

44.2 Paragraph 3 of Article XXII of the GATS provides that a dispute as to the application of Article XVII of the Agreement, a national treatment rule, may not be dealt with under the dispute resolution mechanisms provided by Articles XXII and XXIII of the Agreement if the disputed measure "falls within the scope of an international agreement between them relating to the avoidance of double

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taxation" (e.g. a tax convention). If there is disagreement over whether a measure "falls within the scope" of such an international agreement, paragraph 3 goes on to provide that either State involved in the dispute may bring the matter to the Council on Trade in Services, which shall refer the dispute for binding arbitration. A footnote to paragraph 3, however, contains the important exception that if the dispute relates to an international agreement "which exist[s] at the time of the entry into force" of the Agreement, the matter may not be brought to the Council on Trade in Services unless both States agree.

(Added on 21 September 1995; see HISTORY)

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

(Added on 21 September 1995; see HISTORY)

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

(Added on 21 September 1995; see HISTORY)

44.5 Second, the phrase "falls within the scope" is inherently ambiguous, as indicated by the inclusion in paragraph 3 of Article XXII of the GATS of both an arbitration procedure and a clause exempting pre-existing conventions from its application in order to deal with disagreements related to its meaning. While it seems clear that a country could not argue in good faith[1] that a measure relating to a tax to which no provision of a tax convention applied fell within the scope of that convention, it is unclear whether the phrase covers all measures that relate to taxes that are covered by all or only some provisions of the tax convention.

(Added on 21 September 1995; see HISTORY)

1. The obligation of applying and interpreting treaties in good faith is expressly recognized in Articles 26 and 31 of the *Vienna Convention on the Law of Treaties*; thus, the exception in paragraph 3 of Article XXII of the GATS applies only to good faith disputes.

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

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

(Added on 21 September 1995; see HISTORY)

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

(Added on 21 September 1995; see HISTORY)

IV. Final observations

45. On the whole, the mutual agreement procedure has proved satisfactory. Treaty practice shows that Article 25 has generally represented the maximum that Contracting States were prepared to accept. It must, however, be admitted that this provision is not yet entirely satisfactory from the taxpayer's viewpoint. This is because the competent authorities are required only to seek a solution and are not obliged to find one (cf. paragraph 26 above). The conclusion of a mutual agreement depends to a large extent on the powers of compromise which the domestic law allows the competent authorities. Thus, if a convention is interpreted or applied differently in two Contracting States, and if the competent authorities are unable to agree on a joint solution within the framework of a mutual

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agreement procedure, double taxation is still possible although contrary to the sense and purpose of a convention aimed at avoiding double taxation.

(Heading renumbered on 21 September 1995; see HISTORY)

46. It is difficult to avoid this situation without going outside the framework of the mutual agreement procedure. The first approach to a solution might consist of seeking an advisory opinion: the two Contracting States would agree to ask the opinion of an impartial third party, although the final decision would still rest with the States.

(Renumbered on 23 July 1992; see HISTORY)

47. The provisions embodied in this Convention, as well as the Commentary related thereto, are the result of close international joint work within the Committee on Fiscal Affairs. A possibility near at hand would be to call upon the Committee on Fiscal Affairs to give an opinion on the correct understanding of the provisions where special difficulties of interpretation arise as to particular points. Such a practice, which would be in line with the mandate and aims of the Committee on Fiscal Affairs, might well make a valuable contribution to arriving at a desirable uniformity in the application of the provisions.

(Renumbered on 23 July 1992; see HISTORY)

48. Another solution is that of arbitration. This is the solution adopted by the Member States of the European Communities through their multilateral Arbitration Convention, which was signed on 23 July 1990 and which provides that certain cases of double taxation that have not been solved through the mutual agreement procedure must be submitted to an arbitration procedure. Also, some recent bilateral conventions provide that the Contracting States may agree to submit unresolved disagreements to arbitration.

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

Observation on the Commentary

49. *Belgium* expresses doubts about the interpretation given in paragraphs 9 and 10 above. In particular, where a convention does not include provisions corresponding to paragraph 2 of Article 9, Belgium believes that there is no provision in the Convention that appears to allow the enterprise the profits of

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which have been diverted, or the enterprise that has benefitted from this diversion, the right to make a request for adjustment under the mutual agreement procedure because the profits that have been abusively transferred may have been subject to economic double taxation. However, where the adjusted profits are also subject to juridical double taxation, e.g. where the profits transferred to the associated enterprise are subjected to a tax on dividends as a hidden distribution after having been included in the taxable profits of the other enterprise, nothing would prevent the application of Article 25.

(Added on 23 July 1992; see HISTORY)

Reservations on the Article

50. *Canada* and *Portugal* reserve their positions on the last sentence of paragraph 1 as they could not accept such a long time-limit.

(Renumbered on 23 July 1992; see HISTORY)

51. With respect to paragraph 1 of the Article, *Turkey* reserves the right to provide that the case must be presented to its competent authority within a period of five years following the related taxation year. However, if the notification is made in the last year of that period, such application should be made within one year from the notification.

(Added on 23 July 1992; see HISTORY)

52. The *United Kingdom* reserves its position on the last sentence of paragraph 1 on the grounds that it conflicts with the six year time-limit under its domestic legislation.

(Added on 23 July 1992; see HISTORY)

53. *Canada, Greece, Ireland, Italy, Mexico, Portugal, Spain, Switzerland* and the *United Kingdom* reserve their positions on the second sentence of paragraph 2. These countries consider that the implementation of reliefs and refunds following a mutual agreement ought to remain linked to time-limits prescribed by their domestic laws.

(Amended on 23 October 1997; see HISTORY)

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54. *Turkey* reserves its position on the second sentence of paragraph 2. Turkey's tax law provides that refunds of tax, like the assessment itself, must be made within a specific period. According to these provisions, if the administration finds an application for repayment acceptable, it must notify the fact to the taxpayer so that he can present his claim within a period of one year of such notification. If the taxpayer exceeds this time limit, his right to claim repayment lapses. The same procedure applies to the enforcement of judgements of courts under which repayments are required to be made. That is why Turkey is obliged to fix a time-limit for the implementation of agreed mutual agreement procedures as is done for all repayments. For this reason Turkey wishes to reserve the right to mention in the text of bilateral conventions a definite time-limit as regards their implementation.

(Renumbered on 23 July 1992; see HISTORY)

55. *Mexico* reserves its position on the second sentence of paragraph 3 on the grounds that it has no authority under its law to eliminate double taxation in cases not provided for in the Convention.

(Added on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Unchanged from the 1977 Model Convention.

Paragraph 4: Unchanged from the 1977 Model Convention.

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Included in the 1977 Model Convention. Paragraph 8 of the 1977 Model Convention was amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 88 *a*) of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986). In the 1977 Model Convention, paragraph 8 read as follows:

> "8. In practice, the procedure applies to cases — by far the most numerous — where the measure in question leads to double taxation which it is the specific purpose of the Convention to avoid. Among the most common cases, mention must be made of the following:
>
> — the questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of Article 7;
>
> — the taxation in the State of the payer — n case of a special relationship between the payer and the beneficial owner — of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph 4 of Article 12;
>
> — cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by an employee (paragraph 2 of Article 15)."

Paragraph 9: Replaced paragraph 9 of the 1977 Model Convention. Paragraph 9 of the 1977 Model Convention was deleted and new paragraph 9 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 79 and subdivision 115 *b*)(*ii*) of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982). In the 1977 Model Convention, paragraph 9 read as follows:

> "9. As regards adjustments to be made correlatively with the reinstatement of profits in the trading results of associated enterprises under the provisions of paragraphs 1 and 2 of Article 9, there is ground for considering that they may properly be dealt with through the mutual agreement procedure when determining their amount gives rise to difficulty."

Paragraph 10: Replaced paragraph 10 of the 1977 Model Convention. Paragraph 10 of the 1977 Model Convention was renumbered as paragraph 11 (cf. history of paragraph 11) and new

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paragraph 10 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of paragraph 79 of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982).

Paragraph 11: Corresponds to paragraph 10 of the 1977 Model Convention. Paragraph 11 of the 1977 Model Convention was renumbered as paragraph 12 (cf. history of paragraph 12) and paragraph 10 was renumbered as paragraph 11 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 12: Corresponds to paragraph 11 of the 1977 Model Convention. Paragraph 12 of the 1977 Model Convention was renumbered as paragraph 13 (cf. history of paragraph 13) and paragraph 11 was renumbered as paragraph 12 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 13: Corresponds to paragraph 12 of the 1977 Model Convention. Paragraph 13 of the 1977 Model Convention was renumbered as paragraph 14 (cf. history of paragraph 14) and paragraph 12 was renumbered as paragraph 13 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 14: Corresponds to paragraph 13 of the 1977 Model Convention. Paragraph 14 of the 1977 Model Convention was renumbered as paragraph 15 (cf. history of paragraph 15) and paragraph 13 was renumbered as paragraph 14 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 15: Corresponds to paragraph 14 of the 1977 Model Convention. Paragraph 15 of the 1977 Model Convention was renumbered as paragraph 16 (cf. history of paragraph 16) and paragraph 14 was renumbered as paragraph 15 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 16: Corresponds to paragraph 15 of the 1977 Model Convention. Paragraph 16 of the 1977 Model Convention was renumbered as paragraph 17 (cf. history of paragraph 17) and paragraph 15 was renumbered as paragraph 16 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 17: Corresponds to paragraph 16 of the 1977 Model Convention. Paragraph 17 of the 1977 Model Convention was renumbered as paragraph 18 (cf. history of paragraph 18) and paragraph 16 was renumbered as paragraph 17 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 18: Corresponds to paragraph 17 of the 1977 Model Convention. Paragraph 18 of the 1977 Model Convention was renumbered as paragraph 19 (cf. history of paragraph 19) and paragraph 17 was renumbered as paragraph 18 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 19: Corresponds to paragraph 18 of the 1977 Model Convention. Paragraph 19 of the 1977 Model Convention was renumbered as paragraph 20 (cf. history of paragraph 20) and paragraph 18 was renumbered as paragraph 19 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 20: Corresponds to paragraph 19 of the 1977 Model Convention. Paragraph 20 of the 1977 Model Convention was renumbered as paragraph 21 (cf. history of paragraph 21) and paragraph 19

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was renumbered as paragraph 20 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 21: Corresponds to paragraph 20 of the 1977 Model Convention. Paragraph 21 of the 1977 Model Convention was amended and renumbered as paragraph 22 (cf. history of paragraph 22) and paragraph 20 was renumbered as paragraph 21 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 22: Corresponds to paragraph 21 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention was amended and renumbered as paragraph 23 (cf. history of paragraph 23) and paragraph 21 was amended and renumbered as paragraph 22 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 116 *i*) of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982). In the 1977 Model Convention, paragraph 21 read as follows:

> "21. If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State. it will be incumbent on it, indeed it will be its duty—as clearly appears by the terms of paragraph 2—to set in motion the mutual agreement procedure proper."

Paragraph 23: Corresponds to paragraph 22 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 22 was amended and renumbered as paragraph 23 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 116 *i*) of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982). In the 1977 Model Convention, paragraph 22 read as follows:

> "22. A taxpayer is entitled to present his case under paragraph 1 to the competent authority of the State of which he is a resident whether or not he may also have made a claim or commenced litigation under the domestic law of that State. If litigation is pending, the competent authority of the State of residence should not wait for the final adjudication, but should say whether it considers the case to be eligible for the mutual agreement procedure. If it so decides, it has to determine whether it is itself able to arrive at a satisfactory solution or whether the case has to be submitted to the competent authority of the other Contracting State."

Paragraph 24: Corresponds to paragraph 23 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 23 was renumbered as paragraph 24 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 25: Corresponds to paragraph 24 of the 1977 Model Convention. Paragraph 25 of the 1977 Model Convention was renumbered as paragraph 26 (cf. history of paragraph 26) and paragraph 24 was renumbered as paragraph 25 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 26: Corresponds to paragraph 25 of the 1977 Model Convention. Paragraph 26 of the 1977 Model Convention was renumbered as paragraph 27 (cf. history of paragraph 27) and paragraph 25

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was renumbered as paragraph 26 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 27: Corresponds to paragraph 26 of the 1977 Model Convention. Paragraph 27 of the 1977 Model Convention was amended and renumbered as paragraph 28 (cf. history of paragraph 28) and paragraph 26 was renumbered as paragraph 27 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 28: Corresponds to paragraph 27 of the 1977 Model Convention. Paragraph 28 of the 1977 Model Convention was renumbered as paragraph 31 (cf. history of paragraph 31) and paragraph 27 was amended and renumbered as paragraph 28 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 116 *i*) of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982). In the 1977 Model Convention, paragraph 27 read as follows:

> "27. The purpose of the last sentence of paragraph 2 is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits. This provision does not prevent, however, such States as are not, on constitutional or other legal grounds, able to overrule the time limits in the domestic law from inserting in the mutual agreement itself such time limits as are adapted to their internal statute of limitation. In certain extreme cases, a Contracting State may prefer not to enter into a mutual agreement, the implementation of which would require that the internal statute of limitation had to be disregarded. Apart from time limits there may exist other obstacles such as "final court decisions" to giving effect to an agreement. Contracting States are free to agree on firm provisions for the removal of such obstacles."

Paragraph 29: Replaced paragraph 29 of the 1977 Model Convention. Paragraph 29 of the 1977 Model Convention was renumbered as paragraph 32 (cf. history of paragraph 32) and new paragraph 29 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraphs 116 (*iii*), (*iv*) and (*v*) of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982).

Paragraph 30: Replaced paragraph 30 of the 1977 Model Convention. Paragraph 30 of the 1977 Model Convention was renumbered as paragraph 33 (cf. history of paragraph 33) and new paragraph 30 was added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraphs 116 (*vi*), (*vii*) and (*viii*) of a previous report entitled "Transfer Pricing, Corresponding Adjustments and the Mutual Agreement Procedure" (adopted by the Council of the OECD on 24 November 1982).

Paragraph 31: Corresponds to paragraph 28 of the 1977 Model Convention. Paragraph 31 of the 1977 Model Convention was amended and renumbered as paragraph 34 (cf. history of paragraph 34) and paragraph 28 was renumbered as paragraph 31 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 32: Corresponds to paragraph 29 of the 1977 Model Convention. Paragraph 32 of the 1977 Model Convention was renumbered as paragraph 35 (cf. history of paragraph 35) and paragraph 29 was renumbered as paragraph 32 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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Paragraph 33: Corresponds to paragraph 30 of the 1977 Model Convention. Paragraph 33 of the 1977 Model Convention was renumbered as paragraph 36 (cf. history of paragraph 36) and paragraph 30 was renumbered as paragraph 33 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 34: Corresponds to paragraph 31 of the 1977 Model Convention. Paragraph 34 of the 1977 Model Convention was renumbered as paragraph 37 (cf. history of paragraph 37) and paragraph 31 was amended and renumbered as paragraph 34 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, on the basis of sub-paragraph 88 *b*) of a previous report entitled "Thin Capitalisation" (adopted by the Council of the OECD on 26 November 1986). In the 1977 Model Convention, paragraph 31 read as follows:

> "31. Under this provision the competent authorities can, in particular:
> — where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty;
> — where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes."

Paragraph 35: Corresponds to paragraph 32 of the 1977 Model Convention. Paragraph 35 of the 1977 Model Convention was renumbered as paragraph 38 (cf. history of paragraph 38) and paragraph 32 was renumbered as paragraph 35 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 36: Corresponds to paragraph 33 of the 1977 Model Convention. Paragraph 36 of the 1977 Model Convention was renumbered as paragraph 39 (cf. history of paragraph 39) and paragraph 33 was renumbered as paragraph 36 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 37: Corresponds to paragraph 34 of the 1977 Model Convention. Paragraph 37 of the 1977 Model Convention was renumbered as paragraph 40 (cf. history of paragraph 40) and paragraph 34 was renumbered as paragraph 37 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 38: Corresponds to paragraph 35 of the 1977 Model Convention. Paragraph 38 of the 1977 Model Convention was renumbered as paragraph 41 (cf. history of paragraph 41) and paragraph 35 was renumbered as paragraph 38 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 39: Corresponds to paragraph 36 of the 1977 Model Convention. Paragraph 39 of the 1977 Model Convention was renumbered as paragraph 42 (cf. history of paragraph 42) and paragraph 36 was renumbered as paragraph 39 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 40: Amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 40 previously read as follows:

> "40. Such exchange of opinions will normally take place by letter. However, if the competent authorities deem it useful, in order to reach an agreement more easily, they may also—as provided in the second sentence of paragraph 4—exchange views orally. They may, moreover, agree that such exchanges should take place in a commission consisting of representatives of the said authorities."

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Paragraph 40 corresponds to paragraph 37 of the 1977 Model Convention. Paragraph 40 of the 1977 Model Convention was renumbered as paragraph 43 (cf. history of paragraph 43) and paragraph 37 was renumbered as paragraph 40 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 41: Corresponds to paragraph 38 of the 1977 Model Convention. Paragraph 41 of the 1977 Model Convention was renumbered as paragraph 44 (cf. history of paragraph 44) and paragraph 38 was renumbered as paragraph 41 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 42: Corresponds to paragraph 39 of the 1977 Model Convention. Paragraph 42 of the 1977 Model Convention was amended and renumbered as paragraph 45 (cf. history of paragraph 45) and paragraph 39 was renumbered as paragraph 42 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 43: Corresponds to paragraph 40 of the 1977 Model Convention. Paragraph 43 of the 1977 Model Convention was renumbered as paragraph 46 (cf. history of paragraph 46) and paragraph 40 was renumbered as paragraph 43 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44: Corresponds to paragraph 41 of the 1977 Model Convention. Paragraph 44 of the 1977 Model Convention was renumbered as paragraph 47 (cf. history of paragraph 47) and paragraph 41 was renumbered as paragraph 44 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 44.1: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 44.2: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 44.3: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 44.4: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 44.5: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 44.6: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 44.7: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 45: Heading renumbered as "IV." by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. The previous heading number was "III.".

Paragraph 45 corresponds to paragraph 42 of the 1977 Model Convention. Paragraph 45 of the 1977 Model Convention was amended and renumbered as paragraph 48 (cf. history of paragraph 48) and paragraph 42 was amended and renumbered as paragraph 45 by the Report entitled "The Revision of

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the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 42 read as follows:

> "42. On the whole, the mutual agreement procedure has proved satisfactory. The most recent treaty practice shows that Article 25 represents the maximum that Contracting States are prepared to accept. It must, however, be admitted that this provision is not yet entirely satisfactory from the taxpayer's viewpoint. This is because the competent authorities are required only to seek a solution and are not obliged to find one (cf. paragraph 25 above). The conclusion of a mutual agreement depends to a large extent on the powers of compromise which the domestic law allows the competent authorities. Thus, if a convention is interpreted or applied differently in two Contracting States, and if the competent authorities are unable to agree on a joint solution within the framework of a mutual agreement procedure, double taxation is still possible although contrary to the sense and purpose of a convention aimed at avoiding double taxation."

Paragraph 46: Corresponds to paragraph 43 of the 1977 Model Convention. Paragraph 46 of the 1977 Model Convention was renumbered as paragraph 50 (cf. history of paragraph 50) and paragraph 43 was renumbered as paragraph 46 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 47: Corresponds to paragraph 44 of the 1977 Model Convention. Paragraph 47 of the 1977 Model Convention was amended and renumbered as paragraph 53 (cf. history of paragraph 53) and paragraph 44 was renumbered as paragraph 47 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 48: Corresponds to paragraph 45 of the 1977 Model Convention. Paragraph 48 of the 1977 Model Convention was renumbered as paragraph 54 (cf. history of paragraph 54) and paragraph 45 was amended and renumbered as paragraph 48 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 45 read as follows:

> "45. It might also be feasible to ask the opinion of certain persons acting as independent arbitrators. In the case of OECD Member countries, the Committee on Fiscal Affairs could, for example, periodically draw up a list of persons from among whom the competent authorities of the two States concerned could choose the third party to be asked to give an advisory opinion."

Paragraph 49: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 50: Corresponds to paragraph 46 of the 1977 Model Convention. Paragraph 46 of the 1977 Model Convention was renumbered as paragraph 50 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 51: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 52: Added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 53: Amended, by deleting Belgium from the list of countries making the reservation, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 53 previously read as follows:

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> "53. *Canada, Belgium, Greece, Ireland, Italy, Mexico, Portugal, Spain, Switzerland* and the *United Kingdom* reserve their positions on the second sentence of paragraph 2. These countries consider that the implementation of reliefs and refunds following a mutual agreement ought to remain linked to time-limits prescribed by their domestic laws.

Paragraph 53 was previously amended, by adding Mexico to the list of countries making the Reservation, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 53 corresponds to paragraph 47 of the 1977 Model Convention. Paragraph 47 of the 1977 Model Convention was renumbered as paragraph 53 and amended, by adding Belgium and Switzerland to the list of countries making the reservation, by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 46 read as follows:

> "47. *Canada, Greece, Ireland, Italy, Portugal, Spain* and *the United Kingdom* reserve their positions on the second sentence of paragraph 2. These countries consider that the implementation of reliefs and refunds following a mutual agreement ought to remain linked to time-limits prescribed by their domestic laws."

Paragraph 54: Corresponds to paragraph 48 of the 1977 Model Convention. Paragraph 48 of the 1977 Model Convention was renumbered as paragraph 54 by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 55: Added by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

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COMMENTARY ON ARTICLE 26
CONCERNING THE EXCHANGE OF INFORMATION

I. Preliminary remarks

1. There are good grounds for including in a convention for the avoidance of double taxation provisions concerning co-operation between the tax administrations of the two Contracting States. In the first place it appears to be desirable to give administrative assistance for the purpose of ascertaining facts in relation to which the rules of the convention are to be applied. Moreover, in view of the increasing internationalisation of economic relations, the Contracting States have a growing interest in the reciprocal supply of information on the basis of which domestic taxation laws have to be administered, even if there is no question of the application of any particular article of the Convention.

2. Therefore the present Article embodies the rules under which information may be exchanged to the widest possible extent, with a view to laying the proper basis for the implementation of the domestic laws of the Contracting States concerning taxes covered by the Convention and for the application of specific provisions of the Convention. The text of the Article makes it clear that the exchange of information is not restricted by Article 1, so that the information may include particulars about non-residents.

3. The matter of administrative assistance for the purpose of tax collection is not dealt with in the Article. This matter is dealt with in the Convention on Mutual Administrative Assistance in Tax Matters, a multilateral convention that entered into force on 1 April 1995. This Convention was drawn up within the Council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs and is open to the signature of the Member States of the Council of Europe and Member countries of the OECD. This matter can also form the subject of a separate bilateral agreement that can be negotiated between the Contracting States on the basis of the Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims adopted by the Committee on Fiscal Affairs on 29 June 1979; alternatively, provisions on assistance in the field of tax collection may be introduced in a double taxation convention, whenever Contracting States find it preferable.

(Amended on 21 September 1995; see HISTORY)

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4. Experience between 1963 and 1977 had shown that the text of the Article in the 1963 Draft Convention left room for differing interpretations. Therefore it was felt desirable to clarify its meaning in the 1977 Model Convention by a change in the wording of the Article and its Commentary without altering its effects. Apart from a single point of substance (cf. paragraph 13 below) the main purpose of the changes made has been to remove grounds for divergent interpretations.

(Amended on 23 July 1992; see HISTORY)

II. Commentary on the provisions of the Article

Paragraph 1

5. The main rule concerning the exchange of information is contained in the first sentence of the paragraph. The competent authorities of the Contracting States shall exchange such information as is necessary to secure the correct application of the provisions of the Convention or of the domestic laws of the Contracting States concerning taxes of every kind and description imposed in these States even if, in the latter case, a particular Article of the Convention need not be applied. Some countries replace "necessary" with "relevant" in their bilateral conventions, regarding this as a better way to express the sense of the provision; in the view of the Committee on Fiscal Affairs, either word may be used in that context. In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the taxation under the domestic taxation laws concerned is not contrary to the Convention.

(Amended on 29 April 2000; see HISTORY)

6. The following examples may clarify the principle dealt with paragraph 5 above. In all such cases information can be exchanged under paragraph 1.

7. Application of the Convention

a) When applying Article 12, State A where the beneficiary is resident asks State B where the payer is resident, for information concerning the amount of royalty transmitted.

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b) Conversely, in order to grant the exemption provided for in Article 12, State B asks State A whether the recipient of the amounts paid is in fact a resident of the last-mentioned State and the beneficial owner of the royalties.

c) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated companies in different States or the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State (Articles 7, 9, 23 A and 23 B).

8. Implementation of the domestic laws

a) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods with a view to a correct application of the provisions of its domestic laws.

b) A company in State A sells goods through a company in State C (possibly a low-tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between A and B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods.

c) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable it to check the prices charged by the company in State A by direct comparison (e.g. prices charged by a company or a group of companies in a dominant position). It should be borne in mind that the exchange of information in this case might be a difficult and delicate matter owing in particular to the provisions of sub-paragraph *c*) of paragraph 2 relating to business and other secrets.

9. The rule laid down in paragraph 1 allows information to be exchanged in three different ways:

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a) on request, with a special case in mind, it being understood that the regular sources of information available under the internal taxation procedure should be relied upon in the first place before request for information is made to the other State;

b) automatically, for example when information about one or various categories of income having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State (cf. the OECD Council Recommendation C(81)39, dated 5 May 1981, entitled "Recommendation of the Council concerning a standardised form for automatic exchanges of information under international tax agreements" and the OECD Council Recommendation C(92)50, dated 23 July 1992, entitled "Recommendation of the Council concerning a standard magnetic format for automatic exchange of tax information");[1]

c) spontaneously, for example in the case of a State having acquired through certain investigations, information which it supposes to be of interest to the other State.

(Amended on 29 April 2000; see HISTORY)

9.1 These three forms of exchange (on request, automatic and spontaneous) may also be combined. It should also be stressed that the Article does not restrict the possibilities of exchanging information to these methods and that the Contracting States may use other techniques to obtain information which may be relevant to both Contracting States such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information. These techniques are fully described in the publication *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices*[2] and can be summarised as follows:

— a simultaneous examination is an arrangement between two or more parties to examine simultaneously each in its own territory, the tax affairs of (a) taxpayer (s) in which they have a common or related interest, with a view of exchanging any relevant information which they so obtain (see the OECD Council Recommendation C(92)81, dated 23 July 1992, on an

1. These two recommendations are reproduced and discussed in *Tax Information Exchange between OECD Member Countries: A Survey of Current Practices*, OECD, Paris, 1994.

2. Id.

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OECD Model agreement for the undertaking of simultaneous examinations);

— a tax examination abroad allows for the possibility to obtain information through the presence of representatives of the competent authority of the requesting Contracting. This type of assistance is granted on a reciprocal basis. Countries' laws and practices differ as to the scope of rights granted to foreign tax officials. For instance, there are States where a foreign tax official will be prevented from any active participation in an investigation or examination on the territory of a country; there are also States where such participation is only possible with the taxpayer's consent;

— an industry-wide exchange of information is the exchange of tax information especially concerning a whole economic sector (e.g. the oil or pharmaceutical industry, the banking sector, etc.) and not taxpayers in particular.

(Added on 29 April 2000; see HISTORY)

10. The manner in which the exchange of information agreed to in the Convention will finally be effected can be decided upon by the competent authorities of the Contracting States.

11. Reciprocal assistance between tax administrations is feasible only if each administration is assured that the other administration will treat with proper confidence the information which it will receive in the course of their co-operation. At the same time maintenance of such secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph 1 that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

11.1 Before 2000, the paragraph only authorised the exchange of information, and the use of the information exchanged, in relation to the taxes covered by the Convention under the general rules of Article 2. As drafted, the paragraph did not oblige the requested State to comply with a request for information concerning the imposition of a sales tax as such a tax was not covered by the Convention. The

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paragraph was then amended so as to apply to the exchange of information concerning any tax imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, and to allow the use of the information exchanged for purposes of the application of all such taxes. Some Contracting States may not, however, be in a position to exchange information, or to use the information obtained from a treaty partner, in relation to taxes that are not covered by the Convention under the general rules of Article 2. Such States are free to restrict the scope of paragraph 1 of Article 26 by adopting bilaterally the following previous wording of the paragraph:

> "1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions."

(Added on 29 April 2000; see HISTORY)

11.2. Since the exchange of information concerning the application of custom duties is governed by other international conventions, the provisions of these more specialised conventions will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article.

(Added on 29 April 2000; see HISTORY)

12. 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 the taxes with respect to which information may be exchanged according to the first sentence of the paragraph. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses. The information received by a Contracting

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State may be used by such persons or authorities only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for other purposes than those referred to, that State may not use the information for such other purposes but it must resort to means specially designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance).

(Amended on 29 April 2000; see HISTORY)

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

(Added on 21 September 1995; see HISTORY)

13. As stated above, the information obtained can be communicated to the persons and authorities mentioned but it does not follow from this that it can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. The last sentence of the paragraph, however, opens up this possibility. Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this does not mean that the persons and authorities mentioned in paragraph 1 are allowed to provide on request additional information received. If either or both of the Contracting States object to the information being made public by courts in this way, or, once the information has been made public in this way, to the information being used for other purposes, because this is not the normal procedure under their domestic laws, they should state this expressly in their convention.

Paragraph 2

14. This paragraph contains certain limitations to the main rule in favour of the requested State. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. However, types of administrative measures authorised for the

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purpose of the requested State's tax must be utilised, even though invoked solely to provide information to the other Contracting State. Likewise, internal provisions concerning tax secrecy should not be interpreted as constituting an obstacle to the exchange of information under the present Article. As mentioned above, the authorities of the requesting State are obliged to observe secrecy with regard to information received under this Article. A Contracting State that under its domestic law is required to notify the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance.

(Amended on 21 September 1995; see HISTORY)

15. Furthermore, the requested State does not need to go so far as to carry out administrative measures that are not permitted under the laws or practice of the requesting State or to supply items of information that are not obtainable under the laws or in the normal course of administration of the requesting State. It follows that a Contracting State cannot take advantage of the information system of the other Contracting State if it is wider than its own system.

16. Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examination for their own purposes. This means that the requested State has to collect the information the other State needs in the same way as if its own taxation was involved, under the proviso mentioned in paragraph 15 above.

17. The requested State is at liberty to refuse to give information in the cases referred to in the paragraphs above. However if it does give the requested information, it remains within the framework of the agreement on the exchange of information which is laid down in the Convention; consequently it cannot be objected that this State has failed to observe the obligation to secrecy.

18. If the structure of the information systems of two Contracting States is very different, the conditions under sub-paragraphs *a*) and *b*) of paragraph 2 will

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lead to the result that the Contracting States exchange very little information or perhaps none at all. In such a case, the Contracting States may find it appropriate to broaden the scope of the exchange of information.

19. In addition to the limitations referred to above, sub-paragraph *c*) of paragraph 2 contains a reservation concerning the disclosure of certain secret information. Secrets mentioned in this sub-paragraph should not be taken in too wide a sense. Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Otherwise it is clear that too wide an interpretation would in many cases render ineffective the exchange of information provided for in the Convention. The observations made in paragraph 17 above apply here as well. The requested State in protecting the interests of its taxpayers is given a certain discretion to refuse the requested information, but if it does supply the information deliberately the taxpayer cannot allege an infraction of the rules of secrecy. It is open to the Contracting States to add further dispensations from the obligation to supply information to the items listed in sub-paragraph *c*), for example, information protected by provisions on banker's discretion. It has been felt necessary also to prescribe a limitation with regard to information which concerns the vital interests of the State itself. To this end, it is stipulated that Contracting States do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*).

Observations on the Commentary

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

21. Contrary to the interpretation put forward in paragraphs 14 to 16 above, *Japan* and the *United Kingdom* take the view that the Article imposes no obligation on them to carry out enquiries on behalf of a Contracting State in cases where no liability to their own tax is at issue, since to carry out such enquiries would be contrary to their laws and administrative practice.

(Replaced on 31 March 1994; see HISTORY)

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22. [Merged with paragraph 21 on 31 March 1994; see HISTORY]

Reservations on the Article

23. *Germany* reserves the right to propose in bilateral negotiations additional specific provisions on data protection.

(Replaced on 29 April 2000; see HISTORY)

24. *Switzerland* reserves its position on this Article. It will propose to limit the scope of this Article to information necessary for carrying out the provisions of the Convention.

(Amended on 23 October 1997; see HISTORY)

25. [Deleted on 29 April 2000; see HISTORY)

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

Paragraph 3: Amended, by replacing the words "which was opened for signature on 25 January 1988" by the words "that entered into force on 1 April 1995", by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995.

Paragraph 3 was included in the 1977 Model Convention but subsequently amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 3 read as follows:

> "3. The matter of administrative assistance for the purpose of tax collection is not dealt with in the Article. This matter often forms the subject of a separate agreement, whether bilateral or multilateral, between the Contracting States; alternatively, the provisions on assistance in the field of tax collection may be introduced in the double taxation convention, whenever Contracting States find it preferable."

Paragraph 4: Included in the 1977 Model Convention. Amended by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992. In the 1977 Model Convention, paragraph 4 read as follows:

> "4. Experience in recent years has shown that the text of the Article in the 1963 Draft Convention left room for differing interpretations. Therefore it was felt desirable to clarify its meaning by a change in the wording of the Article and its Commentary without altering its effects. Apart from a single point of substance (cf. paragraph 13 below) the main purpose of the changes made has been to remove grounds for divergent interpretations."

Paragraph 5: Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 5 previously read as follows:

> "5. The main rule concerning the exchange of information is contained in the first sentence of the paragraph. The competent authorities of the Contracting States shall exchange such information as is necessary to secure the correct application of the provisions of the Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention even if, in the latter case, a particular Article of the Convention need not be applied. Some countries replace "necessary" with "relevant" in their bilateral conventions, regarding this as a better way to express the sense of the provision; in the view of the Committee on Fiscal Affairs, either word may be used in that context. In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the national tax in question is covered by the Convention and the taxation under the domestic taxation laws concerned is not contrary to the Convention. An illustration may be cited in this connection: a request for information concerning the imposition of a sales tax need not be complied with by the requested State as it is not covered by the Convention."

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Paragraph 5 was included in the 1977 Model Convention but was subsequently amended, by adding the third sentence, by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 5 previously read as follows:

> "5. The main rule concerning the exchange of information is contained in the first sentence of the paragraph. The competent authorities of the Contracting States shall exchange such information as is necessary to secure the correct application of the provisions of the Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention even if, in the latter case, a particular Article of the Convention need not be applied. In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the national tax in question is covered by the Convention and the taxation under the domestic taxation laws concerned is not contrary to the Convention. An illustration may be cited in this connection: a request for information concerning the imposition of a sales tax need not be complied with by the requested State as it is not covered by the Convention."

Paragraph 6: Unchanged from the 1977 Model Convention.

Paragraph 7: Unchanged from the 1977 Model Convention.

Paragraph 8: Unchanged from the 1977 Model Convention.

Paragraph 9: Included in the 1977 Model Convention. Sub-paragraph *b*) was amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Sub-paragraph *b*) previously read as follows:

> "*b*) automatically, for example when information about one or various categories of income having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State (see OECD Council Recommendation C(81)39/Final (5 May 1981) ("Recommendation of the Council Concerning a Standardised Form for Automatic Exchanges of Information under International Tax Agreements") and OECD Council Recommendation C(92)50/Final (23 July 1992) ("Recommendation of the Council Concerning a Standard Magnetic Format for Automatic Exchange of Tax Information"), both of which are discussed in "Tax Information Exchange Between OECD Member Countries: A Survey of Current Practices", OECD, Paris, 1994);"

Sub-paragraph *b*) had been previously amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Sub-paragraph *b*) previously read as follows:

> "*b*) automatically, for example when information about one or various categories of income having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State;"

Paragraph 9.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 10: Unchanged from the 1977 Model Convention.

Paragraph 11: Unchanged from the 1977 Model Convention.

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Paragraph 11.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 11.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 12: Included in the 1977 Model Convention. Amended by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. In the 1977 Model Convention, paragraph 12 read as follows:

> "12. 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, the taxes covered by the Convention. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses. The information received by a Contracting State may be used by such persons or authorities only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for other purposes than those referred to, that State may not use the information for such other purposes but it must resort to means specially designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance)."

Paragraph 12.1: Added by amended by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September.

Paragraph 13: Unchanged from the 1977 Model Convention.

Paragraph 14: Included in the 1977 Model Convention. Amended, by adding the last sentence, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. Paragraph 14 previously read as follows:

> "14. This paragraph contains certain limitations to the main rule in favour of the requested State. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide information to the other Contracting State. Likewise, internal provisions concerning tax secrecy should not be interpreted as constituting an obstacle to the exchange of information under the present Article. As mentioned above, the authorities of the requesting State are obliged to observe secrecy with regard to information received under this Article. As mentioned above, the authorities of the requesting State are obliged to observe secrecy with regard to information received under this Article."

Paragraph 15: Unchanged from the 1977 Model Convention.

Paragraph 16: Unchanged from the 1977 Model Convention.

Paragraph 17: Unchanged from the 1977 Model Convention.

Paragraph 18: Unchanged from the 1977 Model Convention.

Paragraph 19: Unchanged from the 1977 Model Convention.

Paragraph 20: Unchanged from the 1977 Model Convention.

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Paragraph 21: Replaced paragraphs 21 and 22, which were merged, by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 21 previously read as follows:

> "21. With respect to paragraphs 14 to 16 above, *Japan* can only supply information obtained through special investigation or special examination as long as such investigation or examination is concerned with taxation in Japan."

Paragraph 22: Paragraph 22 was merged with paragraph 21 (cf. history of paragraph 21) by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 22 previously read as follows:

> "22. The *United Kingdom* takes the view that the Article imposes no obligation on it to carry out enquiries on behalf of a Contracting State in cases where no liability to United Kingdom tax is at issue, since to carry out such enquiries would be contrary to its laws and administrative practice (cf. the last sentence of paragraph 16 above)."

Paragraph 22, as it read after 23 July 1992 and before 31 March 1994, replaced paragraph 22 of the 1977 Model Convention. Paragraph 22 of the 1977 Model Convention had been renumbered as paragraph 23 (cf. history of paragraph 23) and a new paragraph 22 had been added by the Report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 23: Replaced by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 23 previously read as follows:

> "23. *Portugal* reserves the right to apply Article 26 of the 1963 version of the Draft Convention."

Paragraph 23, as it read before 29 April 2000, corresponded to paragraph 22 of the 1977 Model Convention. Paragraph 23 of the 1977 Model Convention was renumbered as paragraph 24 (cf. history of paragraph 24) and paragraph 22 was renumbered as paragraph 23 by the Report entitled "The 1977 Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 24: Amended by the Report entitled "The 1997 Update to the Model Tax Convention", adopted by the Council of the OECD on 23 October 1997. Paragraph 24 previously read as follows:

> "24. *Switzerland* reserves its position on this Article. When negotiating with other Member countries, Switzerland will propose to limit the scope of this Article to information necessary for carrying out the provisions of the Convention."

Paragraph 24 was previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 24 previously read as follows:

> "24. Under the *Swiss* concept a double taxation convention aims at avoiding international double taxation; the information necessary for the correct application and for the prevention of an abuse of such a convention can be exchanged already within the existing framework of its provisions on the mutual agreement procedure, the reduction of taxes withheld at the source, etc. Switzerland considers a particular provision on the exchange of information as unnecessary since even such an express clause could not, according to the purpose of the Convention, provide for more than for an exchange of information necessary for the correct

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application and prevention of an abuse of the Convention. Accordingly Switzerland has an express reservation on the Article on the exchange of information."

Paragraph 24 corresponds to paragraph 23 of the 1977 Model Convention. Paragraph 24 of the 1977 Model Convention was renumbered as paragraph 25 (cf. history of paragraph 25) and paragraph 23 was renumbered as paragraph 24 by the Report entitled "The 1977 Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

Paragraph 25: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 25 previously read as follows:

"25. *Mexico* and the *United States* reserve the right to extend the application of this Article to all taxes imposed by a Contracting State, not just taxes covered by the Convention pursuant to Article 2."

Paragraph 25, as it read before 29 April 2000, was amended, by adding Mexico to the list of countries making the Reservation, by the Report entitled "The 1995 Update to the Model Tax Convention", adopted by the Council of the OECD on 21 September 1995. After 31 March 1994, but before 21 September 1995, paragraph 25 read as follows:

"25. The *United States* reserves the right to extend the application of this Article to all taxes imposed by a Contracting State, not just taxes covered by the Convention pursuant to Article 2."

Paragraph 25 was previously amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 25 previously read as follows:

"25. The *United States* believes that this Article should apply to all taxes imposed by a Contracting State, not just taxes covered by the Convention."

Paragraph 25, as it then read, corresponded to paragraph 24 of the 1977 Model Convention, which was renumbered as paragraph 25 by the Report entitled "The 1977 Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992.

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COMMENTARY ON ARTICLE 27
CONCERNING MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

1. The aim of the provision is to secure that members of diplomatic missions and consular posts shall, under the provisions of a double taxation convention, receive no less favourable treatment than that to which they are entitled under international law or under special international agreements.

(Amended on 31 March 1994; see HISTORY)

2. The simultaneous application of the provisions of a double taxation convention and of diplomatic and consular privileges conferred by virtue of the general rules of international law, or under a special international agreement may, under certain circumstances, have the result of discharging, in both Contracting States, tax that would otherwise have been due. As an illustration, it may be mentioned that e.g. a diplomatic agent who is accredited by State A to State B and derives royalties, or dividends from sources in State A will not, owing to international law, be subject to tax in State B in respect of this income and may also, depending upon the provisions of the bilateral convention between the two States, be entitled as a resident of State B to an exemption from, or a reduction of, the tax imposed on the income in State A. In order to avoid tax reliefs that are not intended, the Contracting States are free to adopt bilaterally an additional provision which may be drafted on the following lines:

> "Insofar as, due to fiscal privileges granted to members of diplomatic missions and consular posts under the general rules of international law or under the provisions of special international agreements, income or capital are not subject to tax in the receiving State, the right to tax shall be reserved to the sending State."

(Amended on 31 March 1994; see HISTORY)

3. In many OECD Member countries, the domestic laws contain provisions to the effect that members of diplomatic missions and consular posts while abroad shall for tax purposes be deemed to be residents of the sending State. In the bilateral relations between Member countries in which provisions of this kind are operative internally, a further step may be taken by including in the Convention specific rules that establish, for purposes of the Convention, the sending State as the State of residence of the members of the diplomatic missions and consular

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posts of the Contracting States. The special provision suggested here could be drafted as follows:

> "Notwithstanding the provisions of Article 4, an individual who is a member of a diplomatic mission or a consular post of a Contracting State which is situated in the other Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if:
>
> *a*) in accordance with international law he is not liable to tax in the receiving State in respect of income from sources outside that State or on capital situated outside that State, and
> *b*) he is liable in the sending State to the same obligations in relation to tax on his total income or on capital as are residents of that State."

(Amended on 31 March 1994; see HISTORY)

4. By virtue of paragraph 1 of Article 4 the members of diplomatic missions and consular posts of a third State accredited to a Contracting State, are not deemed to be residents of the receiving State if they are only subject to a limited taxation in that State (cf. paragraph 8 of the Commentary on Article 4). This consideration also holds true of the international organisations established in a Contracting State and their officials as they usually benefit from certain fiscal privileges either under the convention or treaty establishing the organisation or under a treaty between the organisation and the State in which it is established. Contracting States wishing to settle expressly this question, or to prevent undesirable tax reliefs, may add the following provision to this Article:

> "The Convention shall not apply to international organisations, to organs or officials thereof and to persons who are members of a diplomatic mission or a consular post of a third State, being present in a Contracting State and not treated in either Contracting State as residents in respect of taxes on income or on capital."

This means that international organisations, organs or officials who are liable in a Contracting State in respect only of income from sources therein should not have the benefit of the Convention.

(Amended on 31 March 1994; see HISTORY)

5. Although honorary consular officers cannot derive from the provisions of the Article any privileges to which they are not entitled under the general rules of

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international law (there commonly exists only tax exemption for payments received as consideration for expenses honorary consuls have on behalf of the sending State), the Contracting States are free to exclude, by bilateral agreement, expressly honorary consular officers from the application of the Article.

Observation on the Commentary

6. *Belgium* and *France* are of the opinion that persons, who are not liable to comprehensive taxation (full liability to tax) or who do not bear on the taxable part of their income a tax which corresponds in percentage terms to the tax to which they would have been liable on their total income if it had not been partly exempt, should not be deemed to be residents. *France* would, after the words "sources therein" in the last sentence of paragraph 4 above, insert the phrase: ", or are not subject in a Contracting State to the same obligations with respect to taxes on income and on capital as the residents of that State,".

(Amended on 21 September 1995; see HISTORY)

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HISTORY

Paragraph 1: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 1 read as follows:

> "1. The aim of the provision is to secure that diplomatic agents or consular officers shall, under the provisions of a double taxation convention, receive no less favourable treatment than that to which they are entitled under international law or under special international agreements."

Paragraph 2: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 2 previously read as follows:

> "2. The simultaneous application of the provisions of a double taxation convention and of diplomatic and consular privileges conferred by virtue of the general rules of international law, or under a special international agreement may under certain circumstances, have the result of discharging, in both Contracting States, tax that would otherwise have been due. As an illustration, it may be mentioned that e.g. a diplomatic agent who is accredited by State A to State B and derives royalties, or dividends from sources in State A will not, owing to international law, be subject to tax in State B in respect of this income and may also, depending upon the provisions of the bilateral convention between the two States, be entitled as a resident of State B to an exemption from, or a reduction of, the tax imposed on the income in State A. In order to avoid tax reliefs that are not intended, the Contracting States are free to adopt bilaterally an additional provision which may be drafted on the following lines:
>
> > "Insofar as, due to fiscal privileges granted to diplomatic agents or consular officers under the general rules of international law or under the provisions of special international agreements, income or capital are not subject to tax in the receiving State, the right to tax shall be reserved to the sending State."

Paragraph 3: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 3 previously read as follows:

> "3. In many OECD Member countries, the domestic laws contain provisions to the effect that diplomatic agents and consular officers while abroad shall for tax purposes be deemed to be residents of the sending State. In the bilateral relations between Member countries in which provisions of this kind are operative internally, a further step may be taken by including in the Convention specific rules that establish, for purposes of the Convention, the sending State as the State of residence of the members of the diplomatic missions and consular posts of the Contracting States. The special provision suggested here could be drafted as follows:
>
> > "Notwithstanding the provisions of Article 4, an individual who is a member of a diplomatic mission, consular post or permanent mission of a Contracting State which is situated in the other Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if:
> >
> > *a*) in accordance with international law he is not liable to tax in the receiving State in respect of income from sources outside that State or on capital situated outside that State, and

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b) he is liable in the sending State to the same obligations in relation to tax on his total income or on capital as are residents of that State."

Paragraph 4: Amended by the Report entitled "1994 Update to the Model Tax Convention", adopted by the Council of the OECD on 31 March 1994. Paragraph 4 previously read as follows:

"4. By virtue of paragraph 1 of Article 4 the diplomatic agents and consular officers of a third State accredited to a Contracting State, are not deemed to be residents of the receiving State if they are only subject to a limited taxation in that State (cf. paragraph 8 of the Commentary on Article 4). This consideration also holds true of the international organisations established in a Contracting State and their officials as they usually benefit from certain fiscal privileges either under the convention or treaty establishing the organisation or under a treaty between the organisation and the State in which it is established. Contracting States wishing to settle expressly this question, or to prevent undesirable tax reliefs, may add the following provision to this Article:

"The Convention shall not apply to international organisations, to organs or officials thereof and to persons who are members of a diplomatic mission, consular post or permanent mission of a third State, being present in a Contracting State and not treated in either Contracting State as residents in respect of taxes on income or on capital."

This means that international organisations, organs or officials who are liable in a Contracting State in respect only of income from sources therein should not have the benefit of the Convention."

Paragraph 5: Unchanged from the 1977 Model Convention.

Paragraph 6: Amended, by adding the last sentence and by deleting the Netherlands from the list of countries making the Reservation, on 21 September 1995, reflecting a Report by the Committee on Fiscal Affairs entitled "The 1995 Update to the Model Tax Convention".

Paragraph 6 was amended by the report entitled "The Revision of the Model Convention", adopted by the Council of the OECD on 23 July 1992, by deleting Switzerland from the list of countries making the observation. Paragraph 6 previously read as follows:

"6. *Belgium*, *France*, the *Netherlands* and *Switzerland* are of the opinion that persons, who are not liable to comprehensive taxation (full liability to tax) or who do not bear on the taxable part of their income a tax which corresponds in percentage terms to the tax to which they would have been liable on their total income if it had not been partly exempt, should not be deemed to be residents."

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COMMENTARY ON ARTICLE 28
CONCERNING THE TERRITORIAL EXTENSION OF THE CONVENTION

1. Certain double taxation conventions state to what territories they apply. Some of them also provide that their provisions may be extended to other territories and define when and how this may be done. A clause of this kind is of particular value to States which have territories overseas or are responsible for the international relations of other States or territories, especially as it recognises that the extension may be effected by an exchange of diplomatic notes. It is also of value when the provisions of the Convention are to be extended to a part of the territory of a Contracting State which was, by special provision, excluded from the application of the Convention. The Article, which provides that the extension may also be effected in any other manner in accordance with the constitutional procedure of the States, is drafted in a form acceptable from the constitutional point of view of all OECD Member countries affected by the provision in question. The only prior condition for the extension of a convention to any States or territories is that they must impose taxes substantially similar in character to those to which the convention applies.

2. The Article provides that the Convention may be extended either in its entirety or with any necessary modifications, that the extension takes effect from such date and subject to such conditions as may be agreed between the Contracting States and, finally, that the termination of the Convention automatically terminates its application to any States or territories to which it has been extended, unless otherwise agreed by the Contracting States.

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.

Paragraph 2: Unchanged from the 1977 Model Convention.

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COMMENTARY ON ARTICLES 29 AND 30 CONCERNING THE ENTRY INTO FORCE AND THE TERMINATION OF THE CONVENTION

1. The present provisions on the procedure for entry into force, ratification and termination are drafted for bilateral conventions and correspond to the rules usually contained in international treaties.

2. Some Contracting States may need an additional provision in the first paragraph of Article 29 indicating the authorities which have to give their consent to the ratification. Other Contracting States may agree that the Article should indicate that the entry into force takes place after an exchange of notes confirming that each State has completed the procedures required for such entry into force.

3. It is open to Contracting States to agree that the Convention shall enter into force when a specified period has elapsed after the exchange of the instruments of ratification or after the confirmation that each State has completed the procedures required for such entry into force.

4. No provisions have been drafted as to the date on which the Convention shall have effect or cease to have effect, since such provisions would largely depend on the domestic laws of the Contracting States concerned. Some of the States assess tax on the income received during the current year, others on the income received during the previous year, others again have a fiscal year which differs from the calendar year. Furthermore, some conventions provide, as regards taxes levied by deduction at the source, a date for the application or termination which differs from the date applying to taxes levied by assessment.

5. As it is of advantage that the Convention should remain in force at least for a certain period, the Article on termination provides that notice of termination can only be given after a certain year, to be fixed by bilateral agreement. It is open to the Contracting States to decide upon the earliest year during which such notice can be given or even to agree not to fix any such year, if they so desire.

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HISTORY

Paragraph 1: Unchanged from the 1977 Model Convention.
Paragraph 2: Unchanged from the 1977 Model Convention.
Paragraph 3: Unchanged from the 1977 Model Convention.
Paragraph 4: Unchanged from the 1977 Model Convention.
Paragraph 5: Unchanged from the 1977 Model Convention.

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OECD Committee on Fiscal Affairs

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ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Pursuant to Article 1 of the Convention signed in Paris on 14th December 1960, and which came into force on 30th September 1961, the Organisation for Economic Co-operation and Development (OECD) shall promote policies designed:

- to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy;
- to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development; and
- to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations.

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INTRODUCTION

1. When, in 1991, the Committee on Fiscal Affairs adopted the concept of an ambulatory Model Tax Convention, it also decided that because the influence of the Model Tax Convention had extended far beyond the OECD Member countries, the ongoing process through which the Model Tax Convention would be updated should be opened up to benefit from the input of non-member countries.

2. Pursuant to that decision, the Committee on Fiscal Affairs decided, in 1996, to organise annual meetings that would allow experts of Member countries and some non-member countries to discuss issues related to the negotiation, application and interpretation of tax conventions. Recognizing that non-member countries could only be expected to associate themselves to the development of the Model Tax Convention if they could retain their freedom to disagree with its contents, the Committee also decided that these countries should, like Member countries, have the possibility to identify the areas where they are unable to agree with the text of an Article or with an interpretation given in the Commentary.

3. This has led to the inclusion in the Model Tax Convention of this section, which sets out the positions of a number of non-Member countries on the Articles of the Model and the Commentary thereon. It is intended that this document will be periodically updated, like the rest of the Model Tax Convention, to reflect changes in the views of participating countries.

4. This document reflects the following countries' positions on the Model Tax Convention:

Argentina	Belarus	Brazil	China
Estonia	Israel	Latvia	Lithuania
Malaysia	Philippines	Romania	Russia
Slovakia	South Africa	Thailand	Ukraine
Vietnam			

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5. While these countries generally agree with the text of the Articles of the Model Tax Convention and with the interpretations put forward in the Commentary, there are for each country some areas of disagreement. For each Article of the Model Tax Convention, the positions that are presented in this document indicate where a country disagrees with the text of the Article and where it disagrees with an interpretation given in the Commentary in relation to the Article[1]. As is the case with the observations and reservations of Member countries, no reference is made to cases where a country would like to supplement the text of an Article with provisions that do not conflict with the Article, especially if these provisions are offered as alternatives in the Commentary, or would like to put forward an interpretation that does not conflict with the Commentary.

1. China wishes to clarify expressly that in the course of negotiations with other countries, it will not be bound by its stated positions as they appear in this document.

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POSITIONS ON ARTICLE 1 (PERSONS COVERED) AND ITS COMMENTARY

Positions on the Article

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 2 (TAXES COVERED) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

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

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

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

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

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

Paragraph 2

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

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

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

9. [Deleted on 29 April 2000; see HISTORY]

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

Paragraph 7: Included when this section was added in 1997.

Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Paragraph 9 and its heading were deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 9 and the heading, which were included in 1977, previously read as follows:

> "*Paragraph 4*
> 9. *Argentina, China, Estonia, Latvia, Lithuania, Romania, Russia, South Africa, Thailand* and *Vietnam* wish to confine the obligation to exchange information to significant or important changes in tax laws as they occur from time to time."

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POSITIONS ON ARTICLE 3 (GENERAL DEFINITIONS) AND ITS COMMENTARY

Positions on the Article

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

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 4 (RESIDENT) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

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

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

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

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

Paragraph 3

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

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

7. *Belarus* reserves the right to replace paragraph 3 (if the other Contracting State does not agree to the use of the place of registration in this paragraph) by a provision that will refer to the mutual agreement procedure for the

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determination of the country of residence in the case of a dual resident person other than an individual.

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

Positions on the Commentary

Paragraph 2

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

Paragraph 3

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

HISTORY

Paragraph 1: Included when this section was added in 1997.
Paragraph 2: Included when this section was added in 1997.
Paragraph 3: Included when this section was added in 1997.
Paragraph 4: Included when this section was added in 1997.
Paragraph 5: Included when this section was added in 1997.
Paragraph 6: Included when this section was added in 1997.
Paragraph 7: Included when this section was added in 1997.
Paragraph 8: Included when this section was added in 1997.
Paragraph 9: Included when this section was added in 1997.
Paragraph 10: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 5 (PERMANENT ESTABLISHMENT) AND ITS COMMENTARY

Positions on the Article

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

Paragraph 2

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

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

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

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

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

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Paragraph 3

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

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

9. *Estonia*, *Latvia* and *Lithuania* reserve their position on paragraph 3 and consider that any building site, construction, assembly or installation project or a supervisory or consultancy activity connected therewith constitutes a permanent establishment if such site, project or activity lasts for a period of more than six months.

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

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

12. *Argentina* reserves the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services, through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than three months.

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

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connected project for a period or periods aggregating more than a period to be negotiated.

14. *Slovakia, South Africa, Thailand* and *Vietnam* reserve the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services, through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

(Amended on 29 April 2000; see HISTORY)

14.1 *Latvia* and *South Africa* reserve the right to deem any person performing professional services or other activities of an independent character to have a permanent establishment if that person is present in the State for a period or periods exceeding in the aggregate 183 days in any twelve month period.

(Added on 29 April 2000; see HISTORY)

14.2 *Estonia* reserves the right to deem an individual performing professional services or other services of an independent character to have a permanent establishment for the purposes of the Convention if they are present in the other State for a period or periods exceeding in the aggregate 183 days in any twelve month period.

(Added on 29 April 2000; see HISTORY)

Paragraph 4

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

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

Paragraph 5

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

Paragraph 6

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

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

Positions on the Commentary

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

Paragraph 7: Included when this section was added in 1997.

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Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Included when this section was added in 1997.

Paragraph 10: Included when this section was added in 1997.

Paragraph 11: Included when this section was added in 1997.

Paragraph 12: Included when this section was added in 1997.

Paragraph 13: Included when this section was added in 1997.

Paragraph 14: Amended, by adding Slovakia to the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 14, which was included in 1997, previously read as follows:

> "14. South Africa, Thailand and Vietnam reserve the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services, through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period."

Paragraph 14.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 14.2: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 15: Included when this section was added in 1997.

Paragraph 16: Included when this section was added in 1997.

Paragraph 17: Included when this section was added in 1997.

Paragraph 18: Included when this section was added in 1997.

Paragraph 19: Included when this section was added in 1997.

Paragraph 20: Included when this section was added in 1997.

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

Positions on the Article

Paragraph 2

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

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

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

Paragraph 3

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

5. *Estonia*, *Latvia* and *Lithuania* also reserve the right to tax income of shareholders in resident companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in their country and held by the company, where such right is based on the ownership of shares or other corporate rights in the company.

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 7 (BUSINESS PROFITS) AND ITS COMMENTARY

Positions on the Article

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

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

2.1 *Argentina*, *Brazil*, *Lithuania* and *Malaysia* reserve the right to maintain in their conventions a specific article dealing with the taxation of "independent personal services". Accordingly, reservation is also made with respect to all the corresponding modifications in the Articles and the Commentaries, which have been modified as a result of the elimination of Article 14.

(Added on 29 April 2000; see HISTORY)

Paragraph 1

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

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activities have been carried out for reasons other than obtaining a benefit under the Convention.

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

4.1 The *Philippines* reserves the right to adopt a length of stay and fixed base criteria in determining whether an individual rendering personal services is taxable.

(Added on 29 April 2000; see HISTORY)

Paragraph 3

5. With respect to paragraph 3, *Argentina* reserves the right to provide that a Contracting State shall not be obliged to allow the deduction of expenses incurred abroad which are not reasonably attributable to the activity carried on by the permanent establishment, taking into account the general principles contained in domestic legislation concerning executive and administrative expenses for assistance services.

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

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

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

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Paragraph 4

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

10. [Deleted on 29 April 2000; see HISTORY]

Paragraph 6

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 2.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 4.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

Paragraph 7: Included when this section was added in 1997.

Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Included when this section was added in 1997.

Paragraph 10: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 10, which was included in 1997, previously read as follows:

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

Paragraph 11: Included when this section was added in 1997.

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

Positions on the Article

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

Paragraph 1

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

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

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

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

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

Paragraph 2

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

(Amended on 29 April 2000; see HISTORY)

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Positions on the Commentary

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

Paragraph 7: Amended, adding Argentina and Estonia to the list of countries making the reservation, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 7, which was included in 1997, previously read as follows:

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

Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 9 (ASSOCIATED ENTERPRISES) AND ITS COMMENTARY

Position on the Article

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 10 (DIVIDENDS) AND ITS COMMENTARY

Positions on the Article

Paragraph 2

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

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

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

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

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

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

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

7.1 *Latvia* reserves the right to apply a 10 per cent rate of tax at source in the case referred to in sub-paragraph *b*).

(Added on 29 April 2000; see HISTORY)

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Paragraph 3

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

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

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

Paragraph 5

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

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

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.
Paragraph 2: Included when this section was added in 1997.
Paragraph 3: Included when this section was added in 1997.
Paragraph 4: Included when this section was added in 1997.
Paragraph 5: Included when this section was added in 1997.
Paragraph 6: Included when this section was added in 1997.
Paragraph 7: Included when this section was added in 1997.

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Paragraph 7.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Included when this section was added in 1997.

Paragraph 10: Included when this section was added in 1997.

Paragraph 11: Included when this section was added in 1997.

Paragraph 12: Included when this section was added in 1997.

Paragraph 13: Included when this section was added in 1997.

Paragraph 14: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 11 (INTEREST) AND ITS COMMENTARY

Positions on the Article

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

Paragraph 2

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

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

3.1 *Estonia* reserves the right to add a paragraph according to which interest arising in a Contracting State, derived and beneficially owned by the Government of the other Contracting State, including its local authorities, the Central Bank or any financial institution wholly owned by that Government shall be exempt from tax in the first-mentioned State (i.e., in the State of source).

(Added on 29 April 2000; see HISTORY)

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

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Paragraph 3

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

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

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

7.1 *Estonia, Latvia* and *Lithuania* reserve the right to amend the definition of interest to clarify that interest payments treated as distributions under its domestic law fall within Article 10.

(Added on 29 April 2000; see HISTORY)

Paragraph 4

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

Positions on the Commentary

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 3.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

Paragraph 7: Included when this section was added in 1997

Paragraph 7.1: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Included when this section was added in 1997

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POSITIONS ON ARTICLE 12 (ROYALTIES) AND ITS COMMENTARY

Positions on the Article

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

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

Paragraph 1

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

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

Paragraph 2

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

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

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

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

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

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

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

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

Positions on the Commentary

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

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

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HISTORY

Paragraph 1: Included when this section was added in 1997.
Paragraph 2: Included when this section was added in 1997.
Paragraph 3: Included when this section was added in 1997.
Paragraph 4: Included when this section was added in 1997.
Paragraph 5: Included when this section was added in 1997.
Paragraph 6: Included when this section was added in 1997.
Paragraph 7: Included when this section was added in 1997
Paragraph 8: Included when this section was added in 1997.
Paragraph 9: Included when this section was added in 1997.
Paragraph 10: Included when this section was added in 1997.
Paragraph 11: Included when this section was added in 1997.
Paragraph 12: Included when this section was added in 1997.
Paragraph 13: Included when this section was added in 1997.
Paragraph 14: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 13 (CAPITAL GAINS) AND ITS COMMENTARY

Positions on the Article

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

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

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

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

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

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

[All the positions on Article 14 were deleted when, on 29 April 2000, Article 14 itself was deleted from the Model Tax Convention pursuant to the report entitled "Issues Related to Article 14 of the OECD Model Tax Convention", which had been adopted by the OECD Committee on Fiscal Affairs on 27 January 2000.]

HISTORY

Title: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. The title previously read as follows:

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

Paragraph 1: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 1, which was included in 1997, previously read as follows:

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

Paragraph 2: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 2, which was included in 1997, previously read as follows:

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

Paragraph 3: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 3, which was included in 1997, previously read as follows:

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

Paragraph 4: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 4, which was included in 1997, previously read as follows:

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

Paragraph 5: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 5, which was included in 1997, previously read as follows:

> "5. *China, Romania* and *Slovakia* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on

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their territory for a period or periods exceeding in the aggregate 183 days in any twelve month period, even if they do not have a fixed base available to them for the purpose of performing such services or activities."

Paragraph 6: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 6, which was included in 1997, previously read as follows:

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

Paragraph 7: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 7, which was included in 1997, previously read as follows:

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

Paragraph 8: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 8, which was included in 1997, previously read as follows:

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

Paragraph 9: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 9, which was included in 1997, previously read as follows:

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

Paragraph 10: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 10, which was included in 1997, previously read as follows:

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

Paragraph 11: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 11, which was included in 1997, previously read as follows:

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

Paragraph 12: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 12, which was included in 1997, previously read as follows:

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

Paragraph 13: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 13, which was included in 1997, previously read as follows:

"13. *Estonia, Latvia* and *Lithuania* do not agree with the interpretation presented in paragraph 3 of the Commentary and interpret the provisions of Article 14, which was included in 1997, according to the provisions of their domestic laws."

Paragraph 14: Deleted by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 14, which was included in 1997, previously read as follows:

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

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POSITIONS ON ARTICLE 15 (INCOME FROM EMPLOYMENT) AND ITS COMMENTARY

Positions on the Article

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

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

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

Positions on the Article

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

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

Positions on the Article

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 18 (PENSIONS) AND ITS COMMENTARY

Positions on the Article

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

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 19 (GOVERNMENT SERVICE) AND ITS COMMENTARY

Positions on the Article

1. *Malaysia* reserves the right not to include subparagraph 2 *b*).

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 20 (STUDENTS) AND ITS COMMENTARY

Positions on the Article

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

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

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

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

5. *Malaysia* and *Thailand* reserve the right to provide that remuneration for services rendered by a student or business apprentice in a Contracting State shall not be taxed in that State if such remuneration does not exceed a certain amount to be negotiated, provided that such services are in connection with his studies or training.

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

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Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 21 (OTHER INCOME) AND ITS COMMENTARY

Positions on the Article

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 22 (CAPITAL) AND ITS COMMENTARY

Positions on the Article

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

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

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

Positions on the Article

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

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

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

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

5. *Argentina* and *Brazil* reserve their position on paragraph 4 of Article 23 A.

(Added on 29 April 2000; see HISTORY)

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Added by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000.

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

Positions on the Article

Paragraph 1

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

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

Paragraph 2

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

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

(Amended on 29 April 2000; see HISTORY)

Paragraph 3

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

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

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

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Paragraph 4

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

Paragraph 5

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

Paragraph 6

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Amended, by adding Estonia to the list of countries with the position, by the Report entitled "The 2000 Update to the Model Tax Convention", adopted by the OECD Committee on Fiscal Affairs on 29 April 2000. Paragraph 4, which was included in 1997, previously read as follows:

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

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

Paragraph 7: Included when this section was added in 1997

Paragraph 8: Included when this section was added in 1997.

Paragraph 9: Included when this section was added in 1997.

Paragraph 10: Included when this section was added in 1997.

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

Positions on the Article

Paragraph 1

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

Paragraph 2

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

Paragraph 3

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

Paragraph 4

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

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

Positions on the Article

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

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

Positions on the Commentary

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

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

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

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

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HISTORY

Paragraph 1: Included when this section was added in 1997.

Paragraph 2: Included when this section was added in 1997.

Paragraph 3: Included when this section was added in 1997.

Paragraph 4: Included when this section was added in 1997.

Paragraph 5: Included when this section was added in 1997.

Paragraph 6: Included when this section was added in 1997.

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POSITIONS ON ARTICLE 28 (TERRITORIAL EXTENSION) AND ITS COMMENTARY

Positions on the Article

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

HISTORY

Paragraph 1: Included when this section was added in 1997.

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PREVIOUS REPORTS RELATED TO THE MODEL TAX CONVENTION

This section reproduces a number of reports that were adopted after the publication of the 1977 Model Double Taxation Convention on Income and on Capital and that have resulted in changes to the text of the Articles of the Model Tax Convention or the Commentary thereon.

While these reports provide a useful background to the Articles and the Commentary, it should be noted that, unlike these, they are not periodically updated and may therefore no longer reflect the views of the Committee on Fiscal Affairs.

The reports that are reproduced in this section are the following:

Transfer pricing, corresponding adjustments and the mutual agreement procedure (adopted by the Council on 24 November 1982) ..... R(1)-3

The taxation of income derived from the leasing of industrial, commercial or scientific equipment (adopted by the Council on 13 September 1983)..... R(2)-1

The taxation of income from the leasing of containers (adopted by the Council on 13 September 1983) ..... R(3)-1

Thin capitalisation (adopted by the Council on 26 November 1986)..... R(4)-1

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TRANSFER PRICING, CORRESPONDING ADJUSTMENTS AND THE MUTUAL AGREEMENT PROCEDURE

(adopted by the OECD Council on 24 November 1982)

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INTRODUCTION

1. The topic briefly referred to as "corresponding adjustments" covers a broad area of problems which arise if the transfer prices or allocations of profit adopted by an enterprise in its dealing with an associated enterprise in another country are not accepted by the tax authorities of one or other of the countries concerned. If, in consequence, the prices or allocations are adjusted or are proposed to be adjusted for tax purposes in one of the countries, the question arises of whether or not a "corresponding adjustment" should be made in the other or whether the initial adjustment itself should be modified, with or without an appropriate corresponding adjustment in the second country. A further question arises as to what should happen if the two tax authorities cannot agree on this matter.

2. When drafting the 1979 Report on Transfer Pricing and Multinational Enterprises[1], the Committee on Fiscal Affairs, while recognising that the subject of corresponding adjustments was relevant to the subject of transfer pricing and created general problems for multinational enterprises, decided that it should not be taken up in the report at that stage (see paragraph 8 of the report). The Committee then took the view that the subject fell outside the boundaries of their task at the time. Moreover, it seemed possible that any discussion of the subject might call for a detailed consideration of the wording of existing provisions in the OECD Model Double Taxation Convention, not only those relating to corresponding adjustments but also those concerned with the mutual agreement procedures (Articles 9 and 25 of the 1977 OECD Model Convention, see Annex) and that this would call for separate study. In its Response to the 1979 Report, BIAC (the Business and Industry Advisory Committee to the OECD), which is generally responsible for representing the views of the private sector to OECD, felt, however, that this was too restrictive an approach and urged "that consideration of this subject be undertaken and concluded as rapidly as possible".

3. In preparing the present report the Committee considered it necessary to review the experience gained to date in this field, both by tax administrations and by multinational enterprises (MNEs), in relation to the making of corresponding adjustments (or obviating the need for them) as well as to consider what possible changes in, or from, the existing arrangements might be

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called for. They were greatly assisted by the evidence provided both orally and in writing by MNEs represented by BIAC and reference to this evidence is made in various parts of the report. Such references should not, however, be taken necessarily as an endorsement of their views.

4. The report is organised in the following way. After a brief summary of the situations in which the need for corresponding adjustments may possibly arise (Chapter II), the report reviews (in Chapter I) the experience of tax authorities in OECD Member countries in operating the provisions and procedures already available to them for the resolution of disagreements between them in transfer pricing and other matters arising under their double taxation agreements, and reviews also the problems arising for taxpayers in this context. In Chapter III the report deals with the particular suggestion that arrangements should be made for mandatory corresponding adjustments subject to an arbitration procedure, and in Chapter IV the report discusses a number of ways in which a more satisfactory use of the existing procedures might be made possible. In Chapter V the report summarises the main conclusions reached by the Committee in the course of its consideration of these matters.

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Chapter I

THE PROBLEM OUTLINED

5. Where a transaction takes place across international borders between two associated enterprises, and an adjustment is made to the transfer price for tax purposes by one of the States concerned, the adjustment, if it increases the profits taxable in that State, may result in some economic double taxation. That is to say it may result in the taxation by the two States of the same profits or income in the hands of two separate but associated persons[2]. More generally the same kind of result may occur where income which arises to an MNE and which is allocated by one State for tax purposes to a constituent part of that enterprise situated in that State is also allocated by another State to another constituent part situated in that second State. It is convenient to refer in this report simply, in most instances, to transfer pricing adjustments (or their "corresponding adjustments") but the phrase should be read, where appropriate, as encompassing also such allocations of profits (or their re-allocation).

6. However, economic double taxation will not necessarily be a consequence of these situations. It will perhaps not result if, for example, an adjustment is made to a transfer price in respect of a transaction which has passed through a third associated person in a country with no tax on income or profits (a tax haven). In this case the adjustment may merely bring more profits into liability in the State making the adjustment. Another situation in which economic double taxation will not occur is where profits, although taxable in principle in both States, do not actually bear tax in one of them because of an exemption or relief provided by the law of that State. Thus, it may be mitigated or eliminated if the State of the parent company credits against its own tax on a dividend received from a subsidiary, not only any withholding tax charged on the dividend, but also the tax charged on the subsidiary's profits which underlie that dividend. Nor, of course, will double taxation result if the State imposing tax on the profits or income of the other associated enterprise makes an adequate corresponding adjustment downwards, either to the taxable profits of that enterprise or to the tax chargeable on it.

7. The need for tax authorities to make transfer pricing adjustments and corresponding adjustments is in principle avoided if MNEs consistently adopt,

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for tax purposes, a transfer pricing policy based on the arm's-length principle and it is certainly not to be supposed that they never do this. It may be objected, however, that the admitted difficulties for tax authorities in the way of ascertaining the arm's-length price in a variety of circumstances may also be experienced by the MNEs themselves and that the genuine efforts of an MNE to follow the arm's-length principle may therefore not necessarily satisfy the tax authorities in all cases. Nevertheless, it seems clear that such efforts should at least limit very considerably the number of occasions on which adjustments by tax authorities are felt to be necessary.

8. So far as the tax authorities themselves are concerned, they too may hope to avoid the necessity of dealing with differences of opinion with other countries' tax authorities about transfer prices if they consistently follow the arm's-length principles set out in the 1977 Model Convention and the 1979 Report. In this context paragraph 15 of that Report may be of particular relevance. Here the point is made that "Since the assessment of an arm's-length price depends very often on careful judgement and the resolution of many, perhaps conflicting, considerations by negotiation between the tax authorities and the enterprise concerned, it follows that if the prices actually paid can be substantiated by acceptable evidence as being arm's-length prices there would be no justification for seeking to make merely minor or marginal adjustments to them for tax purposes. Similarly a tax authority should hesitate to disturb without good reason a pricing arrangement reasonably and consistently operated between associated enterprises if it is also reasonably and consistently operated in comparable dealings with independent parties."

9. However, if, for whatever reason, there is a difference of opinion between tax authorities about the need for a transfer pricing adjustment or its amount, then the questions whether the adjustment should be made, and if so, whether a corresponding adjustment should be made and what the amounts of the adjustment or corresponding adjustment should be, may well depend on the achievement of an explicit consensus between the two tax authorities. The achievement of this consensus may in many cases present no significant problems. But there is a variety of circumstances in which it may be difficult.

10. Thus, where there are no comparable prices for the same or similar transactions between unrelated persons, and the other evidence, if any, does not provide an obvious indication of the arm's-length price, then differences of

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opinion as to the proper arm's-length price are potential sources of difficulty. Divergences between the national laws of the relevant States, or even differences in their procedures may also give rise to difficulty.[3]

11. As a simple illustration one may take a royalty charged by a parent company in State B to its subsidiary company in State A which the tax authorities of State A decide is too high in relation to the royalty which would be fixed between enterprises dealing at arm's length. In that case the deduction of the royalty payment in arriving at the subsidiary's taxable profits in State A will be reduced (this may be defined as a "primary adjustment"). If State B, in spite of the fact that State A has made this adjustment, still treats the whole payment as an arm's-length royalty the whole amount will be taxed in State B as royalty income of the parent company and in effect therefore some part of the royalty may be taxed in both countries.

12. More complicated possibilities may, however, arise under the laws of some countries. State B, for example, may accept the correctness of the adjustment made by State A and regard only so much of the payment as a royalty as corresponds with the amount allowed as a deduction by State A, but may nevertheless treat the excess part of the royalty as a constructive dividend. If State A had the same approach then this might have the result that the excess over the arm's-length amount, instead of being payable without deduction of tax as a royalty, would as a dividend be treated as a payment from which withholding tax should have been deducted and State A might require payment from the subsidiary of the appropriate withholding tax. On the other hand State B might not be able to apply to the element of the payment treated by State A as a dividend any more advantageous rules applicable to dividends in State B or might be unable to give credit relief for the withholding tax levied by State A. In such circumstances, in order to recognise the fact that the excess of the actual royalty payment over the arm's-length royalty is nevertheless in the hands of the parent and not those of the subsidiary, appropriate "secondary" adjustments may be necessary if double taxation is to be completely relieved[4].

13. Similar problems may arise with other types of transaction. Thus, to take a simple case, if a parent company has made a loan to a subsidiary abroad, the tax authorities in the subsidiary's country may adjust the interest rate if they consider that it is not an arm's-length rate. The tax authorities in the country of the lending parent company may perhaps not accept that the adjusted rate is an

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arm's-length rate — the two countries perhaps may have different views as to the particular financial market in which they should look for evidence of arm's-length interest charges. A more complicated situation may arise if the country of the subsidiary takes the view that the loan is in reality a contribution to the subsidiary's equity capital and not an addition to its debt.

14. Payments of fees for services may also be viewed differently by the tax authorities of the country of the payer and those of the country of the receiver. Thus service fees from a subsidiary may be included in the taxable receipts of the parent company in full, while the tax authorities of the country of the subsidiary restrict the deduction allowable for the payment in arriving at the subsidiary's taxable profits on the grounds that it exceeds the arm's-length price, or possibly even refuse a deduction for the payment altogether on the basis that no real benefit has been conferred upon the payer.

15. Although the examples quoted above are mainly concerned with adjustments made to the tax liability of subsidiaries and the consequences of these adjustments for parent companies, the same sort of problems may, in general, also arise for subsidiaries as the result of adjustments made to the liability of parent companies or to the liability of other associated enterprises.

16. On the other hand, one type of problem may arise only in connection with companies which hold shares in other associated enterprises and receive dividends therefrom. If the country taxing the shareholder company gives a credit against its tax for the tax on the profits out of which the dividend is paid, then this obligation to give credit may be made more burdensome if the tax authorities charging the dividend-paying company do so on the basis of attributing more profits to it in relation to transactions with the shareholder company than do the tax authorities charging the latter — which they might of course do if they took a different view of the arm's-length price for those transactions.

17. Problems of double taxation resulting from the adjustment of transfer prices may also arise for MNEs because of their organisation and the arrangements which they make, in consequence, for intra-group transfers of goods and services, etc. and the payments for them. For example, if a cost contribution arrangement has been concluded within a group for research and development expenditure and if the tax authorities in the country of the parent

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company consider that the terms and conditions of the arrangement are not in line with the arm's-length principle, this could affect associated enterprises in several countries. Similar problems may arise in relation to costs incurred for the control, co-ordination and supervision of a group, for the provision of services "on call", or for central advertising activities. There could be particular scope for such problems in the situation of highly-integrated multinational groups where different functions, for example, different stages of manufacturing or the R & D functions or the activities of distribution, marketing, selling, transportation, etc., are carried out by different entities in different countries. If, for example, the prices for particular semi-finished products are not recognised in one country, this may have consequences for the transfer pricing system practised in the group as a whole which may in consequence have to be completely reconsidered. In addition, matters may be complicated by the package-deals and set off arrangements, which are sometimes encountered in dealings between entities within MNEs.

18. However, although it is clear that differences of opinion about transfer prices or the allocation of profits or income may arise in a variety of circumstances, it should not be assumed that serious disagreements between tax authorities are an inevitable consequence of transfer pricing adjustments or the re-allocation of profits or income, or indeed that in practice the inability of tax authorities to arrive at acceptable agreed solutions to their differences of opinion is a common cause of substantial complaint. Nevertheless because such differences of opinion are possible, this report, in the paragraphs which follow, seeks to consider how they may be dealt with or prevented.

19. Similar problems may obviously arise in dealing with the attribution of profits on an arm's-length basis to a permanent establishment in one State of an enterprise of another State. The 1979 Report did not deal specifically with this situation but in general what is said in the Report in relation to associated enterprises is also relevant, *mutatis mutandis*, to the situation of an enterprise and its permanent establishments.[5]

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Chapter II

EXPERIENCE WITH PROCEDURES CURRENTLY AVAILABLE FOR AVOIDING OR RELIEVING DOUBLE TAXATION

20. In practice it can be expected that in many cases any double taxation which might arise from transfer pricing adjustments made by one country will be readily alleviated in the other country without involving the tax authorities of the first country, either under domestic law or under provisions of a bilateral treaty corresponding to Article 9(2) of the OECD Model (which provides for relief in cases of economic double taxation) or in some other way.

21. However, it is undoubtedly necessary in a number of cases for there to be some discussion between the tax authorities of the two States concerned and, increasingly therefore, tax authorities are coming together for this purpose. Their discussions may be facilitated by provisions in their bilateral double taxation agreements on the lines of Article 25 of the Model Double Taxation Convention which provides a "mutual agreement procedure" which may be used by tax authorities as a means of seeking solutions to these and other kinds of problem within the scope of bilateral tax treaties. (This is sometimes known also as the "competent authority procedure" because the agreement which is to be sought under it is the agreement of the relevant "competent authorities" as defined in the relevant double taxation relief treaties.)

22. It may be helpful therefore to review here the application of Articles 9 and 25 in the light of the experience of tax authorities and taxpayers.

A. Corresponding adjustments

23. Article 9(1) provides the arm's-length rule for the tax treatment of transactions between associated enterprises. Article 9(2) provides that where one State taxes profits of an enterprise which feature also in the taxable profits of an associated enterprise in the other State and these doubly taxed profits are profits which would have accrued to the enterprise of the first State if the conditions which have been made between the two enterprises had been those which would have been made between independent enterprises, then the second State should make an appropriate adjustment to the amount of tax charged

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therein on those profits. This may be done either by recalculating the profits using the relevant revised price or by leaving the calculation to stand and giving the taxpayer relief against his own tax for the additional tax charged by the adjusting State.

24. In theory the adjustment to the arm's-length price under Article 9(1) should create no problems in arriving at the amount of relief due under Article 9(2), but as has been indicated above there are potential difficulties in practice. Moreover there are certain limitations to the scope of Article 9(2). In the first place, because of the requirement that the relief provided by Article 9(2) is to apply only where the doubly taxed profits are those which would have accrued to the first enterprise if it had been at arm's length from its associate, it must follow that, as stated in the Commentary (Paragraph 3), a corresponding adjustment is mandatory only if, and to the extent that, the relevant tax authorities agree with the adjustment of the price made by the tax authorities in the first State. The relief available under Article 9(2) may therefore not be complete if the two authorities have different views on what is the appropriate arm's-length price for a particular transaction. In addition, Article 9(2) makes no provision concerning secondary adjustments although the Commentary notes that nothing in the Article prevents such secondary adjustments from being made where they are permitted under domestic laws. Nor does Article 9(2) deal with the question whether there should be any obligation to make a corresponding adjustment within a specific period of time. Quite apart from this a number of Member States have made reservations concerning Article 9(2). This provision as it stands therefore does not provide, in practice, a complete answer to the problems with which this report is concerned.

25. In their comments on the 1979 Report, MNEs expressed the view that no topic was more directly concerned with the entire area of transfer pricing than the topic of corresponding adjustments and urged the OECD to set forth and endorse a mandatory system of corresponding adjustments binding on all Member countries. In their view, it was unsatisfactory to leave the matter as it stood. They feared that, as things are, taxpayers might be exposed to heavy burdens of tax and vulnerable to arbitrary and capricious pricing adjustments by examining revenue agents. They feared also that "the failure to deal adequately with the question of corresponding adjustments may raise the spectre of increasing cases of double taxation in non-OECD countries opting to follow the principles of the 1979 Report".

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26. It is fair to point out nevertheless that a number of OECD Member countries have demonstrated in their bilateral agreements, by articles on the lines of Article 9(2) of the Model Convention and in other ways, acceptance of the obligation to make corresponding adjustments, in the normal case, to relieve economic double taxation where they are satisfied that the original adjustment adequately reflects the arm's-length price.

27. It also seems fair to comment that the taxpayer must look primarily to the domestic tax appeal system of the relevant State or to the domestic law courts or other relevant domestic institutions for protection against arbitrary or capricious transfer pricing adjustments. Imposing a simple mandatory requirement on tax authorities to conform automatically to a transfer pricing adjustment made by the tax authorities of another country would not protect MNEs against arbitrary or capricious adjustment, although it might to some extent mitigate their total impact on an affected enterprise. But providing in this way that tax authorities must conform to the action of other tax authorities over whom they have no control would leave the conforming tax authorities themselves with no protection against any arbitrary or capricious adjustments which might be made in the first place by the other tax authorities concerned, and a provision of this sort is therefore clearly unacceptable for tax authorities.

28. If this expedient is therefore rejected, as it seems to the Committee that it must be, then there seem to be only two other basic possible alternatives. One is to oblige the tax authority, as Article 9(2) does, to make a corresponding adjustment but only to the extent that it can agree that the result of the original adjustment is to substitute the arm's-length price for the transfer price adopted by the taxpayer (so that if the overall result is to be satisfactory to the tax authorities as well as to the taxpayers there needs to be a voluntary agreement on this matter between the two tax authorities). The second is to compel both tax authorities, if they cannot agree, to submit the matter to a supra-national arbitration, and to abide by its decision. The problems involved in a system of compulsory arbitration are discussed in Chapter III below.

B. Mutual agreement procedure

29. As has already been indicated much difficulty in this area may obviously be avoided if the two tax authorities concerned can be brought together to discuss the issues and to seek to arrive at some agreement upon

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them. The Committee considers that tax authorities should therefore be encouraged to do this whenever it is appropriate and possible, and to do all they can in such circumstances to reach such agreement in order to eliminate double taxation as far as possible.

30. The amount of formality involved in instituting and pursuing discussions between tax authorities will vary from country to country. When less formal arrangements are possible, experience has shown them to be effective for preventing or relieving double taxation in many cases and the Committee does not suggest that the employment of these less formal arrangements should be discouraged.

31. The Commentary on Article 25 of the OECD Model Convention indicates, however, that "as regards adjustments to be made correlatively with the reinstatement of profits in the trading results of associated enterprises under the provisions of paragraphs 1 and 2 of Article 9, there is ground for considering that they may properly be dealt with through the mutual agreement procedure when determining their amount gives rise to difficulty". Article 25 is formally therefore in point in this context.

32. Article 25 sets out procedures for three different types of mutual agreement. The first is dealt with in paragraphs1 and 2 of the Article which apply to "taxation not in accordance with the provision of the Convention": here the taxpayer himself initiates the procedure. The other two, which do not necessarily involve the taxpayer, are dealt with in paragraph 3: the first sentence aims at resolving "difficulties and doubts arising as to the interpretation or application of the Convention"; the second sentence refers to the elimination of double taxation in cases not otherwise provided for by the Convention[6].

33. Competent authorities may obviously wish to discuss general problems arising in connection with adjustments to transfer prices, but so far as any particular taxpayers are concerned, the most important procedures are probably those in the first category — i.e. discussions about problems in particular cases initiated by the taxpayers concerned.

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34. An important limitation of the procedure is that the competent authorities have only a duty to negotiate; they are not required to reach an agreement, nor are they required to implement it when reached and, indeed, they may be unable to do so because of conflicting domestic law — such as that imposing time limits on the adjustment of assessments or on the making of refunds of tax. In the view of MNEs this is a serious weakness in the arrangements.

35. The Commentary to Article 25 of the OECD Model Convention recognises that competent authorities may need some outside help in reaching agreement and it suggests that they may agree to ask the opinion of an impartial third party in a particular case or, where it is a question of the correct understanding of the provisions of the Model Convention, to ask for the views of the OECD Committee on Fiscal Affairs. It does not appear that any use has yet been made of these facilities. Thus, while they remain a potentially valuable means of resolving differences between tax authorities there is no basis in experience for estimating how far they may be useful for this purpose.

36. MNEs practical experience of the operation of the mutual agreement procedure has been, moreover, that it is normally time consuming and uncertain in its results. It may be possible to reduce the amount of time involved in operating the procedure but it is difficult to see how to avoid uncertainty. The outcome of any discussions about a disputed matter must to some degree be uncertain and this is so whether the discussions are part of the process of seeking a negotiated settlement, or of securing a favourable decision, from a tribunal or from an arbitrator. MNEs indicate however, that an additional element of uncertainty arises because, in their view, tax authorities tend to lump together all current cases and to negotiate a general settlement on a very rough and ready basis. Thus, they fear the success of one taxpayer in his specific case may jeopardise the chances of another when States try to reach a global agreement for several open issues in a “broad-brush” approach.

37. This fear is perhaps a consequence of other features of the procedure which have also been criticised, *viz*. that the taxpayer himself has no rights in the matter beyond the right to initiate the procedure, and that he has in particular no right to be informed of the progress of discussions on his case or to submit his observation upon it.

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38. Overall, MNEs consider that owing to the protracted nature of this procedure and the risks involved, most enterprises look at the mutual agreement procedure only as a last resort.

39. Without necessarily accepting, or accepting in full, the strictures of enterprises or other critics of the procedure, it is possible to recognise that the mutual agreement procedure is in certain respects a less than perfect instrument for resolving the problems which may arise in the implementation of double taxation agreements. It is clear that, as the Commentary to Article 25 already points out (in paragraph 42), "the conclusion of a mutual agreement depends to a large extent on the power of compromise which the domestic law allows the competent authorities". It is perhaps necessary to underline the point that the legislatures of many countries may well be unwilling to give the tax authorities the discretion to decide the tax liabilities of individuals or companies by way of agreement with the tax authorities of another country, and that for this reason at least it is understandable that OECD Member countries have not been able to recommend more, in the Model Article 25, than that the competent authorities should be obliged to endeavour to reach agreement in the matters raised under the Article. For the same reasons, therefore, no change in this respect is recommended in this report. The possibility that particular bilateral conventions might contain provisions requiring the competent authorities to reach agreement is already, however, raised in paragraph 25 of the Commentary on the Article (that possibility of course remains open and is further discussed in Chapter IV).

40. Notwithstanding the criticisms which have been made of the mutual agreement procedure, it has been widely recognised as an efficient and flexible instrument in the interpretation, application and development of double taxation agreements and a suitable means for the elimination of both juridical and economic double taxation[7]. Certainly the experience of tax authorities within the OECD at least, is that, within its limitations, the mutual agreement procedure can be a very useful instrument in resolving difficulties arising in transfer pricing cases and that, up to the present, acceptable compromises have in practice nearly always been found. It does not appear that the experience of taxpayers has been significantly different.

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Chapter III

POSSIBILITY OF MANDATORY CORRESPONDING ADJUSTMENTS SUBJECT TO ARBITRATION

41. It is recognised that the attention of tax authorities to transfer pricing practices and their ability to challenge particular prices has been developed only in comparatively recent years, and that it is possible that the numbers of adjustments made to transfer prices for tax purposes may increase in the future and increase accordingly the incidence of unresolved disputes between tax authorities about the appropriateness of the adjustments. It seems to the Committee, however, that it would be wrong to exaggerate this possibility; many transfer pricing adjustments have in fact been made and comparatively few have resulted in such disputes. Nevertheless the Committee recognises that the fear of this possibility may be at any rate one important element in the desire of the representatives of MNEs that additional facilities should be provided or changes made in the existing arrangements for resolving inter-governmental disputes about transfer prices, and in particular has given rise to the suggestions which have been made by those representatives that there should be instituted a system of mandatory corresponding adjustments coupled with a formal arbitration procedure for this purpose.

42. From the taxpayer's point of view, it has been suggested, a binding arbitration procedure would have a number of important advantages. If recourse to arbitration was required in the absence of a settlement within a specific period, the taxpayer would be provided with the certainty of a decision and the reduction of delay in bringing the problem before a deciding authority (which, quite apart from avoiding the expense associated with delay, would enable the matter to be dealt with while the relevant information was still comparatively fresh in the minds of those concerned and thus enable it to be dealt with more effectively). These perhaps are the main advantages envisaged. Other advantages which it is suggested could be expected are as follows. The arbitration proceedings themselves could be expected to be expeditious — the absence of any need for administrative or procedural rules, it is thought, would speed the decision-making process. An arbitration process — provided that it allowed the taxpayer a full right to present evidence and arguments — would give the taxpayer the opportunity to deploy all the relevant information and to

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correct any misunderstandings or misinterpretation of the information by the tax authorities in the course of the argument — taxpayers would thus not need to fear that the result of the process might be distorted by the lack of an opportunity to correct such errors of understanding. The problem could be put before impartial experts who would understand the commercial or industrial situation at the time when the price was fixed and would be particularly able from their experience to interpret the pricing information put before them. Because of this there would be less need for elaborate preparation of the case and the process would thus be less expensive, it has been suggested, than the preparation of a case for competent authority procedure or for litigation in the courts. In practice, the suggestion has also been made, arbitration decisions could be expected to be based less on a strict interpretation of national pricing rules and regulations than on what the arbitrator considered in the light of his experience to be a fair and equitable solution. Moreover, an arbitration system would obviate any danger that the merits of a taxpayer's case would be ignored and his claim abandoned by a tax authority as an expedient in order to achieve more successful results on behalf of other taxpayers.

43. The support expressed by enterprises for the idea of a compulsory arbitration procedure for the resolution of inter-governmental disputes in the field of transfer pricing has been echoed elsewhere. Although it appears that the idea may not be unanimously supported by MNEs in general, it seemed clear to the Committee that the idea had received sufficient support to indicate that it needed to be given serious consideration.

44. An instance of support given to the idea is provided by the favourable reception given to a Draft Directive of the European Communities by the Assembly of the Communities and by the Economic and Social Committee set up under the Treaty of Rome. This EEC Draft Directive was therefore an important constituent of the evidence before the Committee and to a certain extent guided their thinking on the matter. The Draft Directive would, in brief, provide a mutual agreement procedure between tax authorities designed to relieve any double taxation which might persist in the absence of agreement. The procedure would be initiated by the taxpayer and would require a decision within a certain period, failing which the matter would have to be referred, again within a certain period, to a commission consisting of representatives of the competent tax authorities augmented by members of an independent panel. The taxpayers concerned would have the right to present their case to the

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commission and argue it before them. The Draft Directive envisages that the taxpayers and the tax authorities would then all be obliged to accept the decision of this commission. The Draft Directive remains as yet a draft however, and consequently it is not possible to draw any firm conclusions from it about how such arrangements would work in practice. It was, moreover, drafted for the particular circumstances of the member countries of the European Communities.

45. Nevertheless, a study of its details was instructive for the Committee. It indicated the problems which need to be solved in designing machinery of that sort and drew the attention of the Committee to a number of difficult questions. There can be no doubt that designing such machinery presents considerable problems.

46. There is the question for example whether it would in practice suffice to set up, as the EEC Draft Directive would do, a machinery which is merely an extension of the mutual agreement procedure — albeit an extension designed to produce a decision within a period of time. It has been argued that it is inappropriate for the tax authorities themselves to be part of the body which decides the issue, and that the taxpayer should be able to put the matter to a completely independent tribunal in which the tax authorities take no part. This approach, however, would leave the tax authorities in an odd situation — effectively a difference of opinion between two tax authorities would be litigated before an arbitrator on the initiative of a third party — admittedly a third party interested in the outcome but still, in the context, a third party and one interested, it is possible, only indirectly in the outcome. The system would need to provide adequately for the interests of both taxpayers and tax authorities and it is not easy to see how that could be achieved with this kind of arrangement.

47. Whatever system was adopted, there could also be the problem of how to deal with the taxpayer's rights of appeal to his own domestic courts. According to one view it would be inappropriate to allow the taxpayer the right to use the arbitration machinery as well as the domestic courts and thus perhaps have the opportunity of requiring the tax authorities to give him the benefit of whichever decision was most advantageous to him. As a practical matter, as well as to a certain extent one of equity, it could be strongly argued that before invoking an arbitration process the taxpayer should have exhausted or

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abandoned his domestic rights of appeal. As against this it may also be strongly argued that the taxpayer should not in any circumstances be required to give up his rights under domestic law, and indeed to require him to do so might well create constitutional problems in some countries. A possible compromise might be to allow, as the EEC Draft Directive would allow, some countries to require the taxpayer to exhaust or abandon his domestic legal rights before seeking arbitration, while allowing other countries not to impose such a requirement. Even this solution, however, could leave some problems of balance between the situations of different national tax administrations engaged in an arbitration procedure.

48. Then there is the further question whether the arbitration should be final or whether there should be a further right of appeal — either by way of re-trial of the case, or by way of a consideration of whether the arbitrators carried out their task in a proper manner or whether they could reasonably have reached the conclusion which they did. For some the virtue of arbitration would be its finality, that is to say its certainty and the speed of the decision, and, for those, a further right of appeal would to some extent counteract this advantage and would certainly add to the potential expense of the procedure. But it may also be argued that arbitrators should be subject to some possibility of a check on their activities if taxpayers and tax authorities are to be adequately protected from arbitrary decisions. If a further appeal were accepted as appropriate the question would of course arise of which court should be responsible for hearing and deciding it.

49. Then there would also be the question of what should be the object of the arbitrators. Should it be to relieve double taxation? There is an important general consideration here which needs to be looked at first — if the taxpayer were to be sure of complete relief from double taxation there would be no likelihood that any manipulation of transfer prices on his part for a tax advantage could, if the tax authorities corrected it by a transfer pricing adjustment, result for him in a tax penalty. Some tax authorities would regard this as, at the least, overgenerous and provision might well have to be made to deal with this point.

50. If the relief of double taxation were to be the issue the problem would remain of how to deal with the situation where double taxation did not arise because one or other or both of the enterprises concerned were making losses.

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There would then be no question, at least immediately, of any double taxation. Of course, where the taxpayer concerned is able to carry taxes forward to another year, double taxation may arise in that year (just as there could be a shift backwards of double taxation if the taxes could be carried backwards). But where the base can be carried forward it is likely to be difficult to foresee precisely whether double taxation will in fact arise. These problems might be avoided if the question for the arbitrators to decide was, instead, to be the amount of the transfer price — i.e. in the simplest form, what was the arm's-length price for the relevant transaction, or perhaps, in a more complicated form, what was the proper method to be adopted of arriving at the arm's-length price. But this, certainly in its simplest form, would narrow down, perhaps unsatisfactorily, the area of the arbitrators' consideration.

51. Connected with this question of what should be the object of the arbitrators is the question of the approach which they should adopt. Should they be mainly concerned to produce a pragmatic result, allowing them perhaps to do this by means of a simple compromise between the different views expressed, or would it be more satisfactory to require them to operate by analogy with a court of law, seeking to establish which of the claims put forward was the more correct or more in accord with natural justice? The adoption of the first approach might produce a result more quickly and perhaps less expensively than the second and, since the issues in such proceedings are likely to be very largely questions of fact and the relative weights to be given to different pieces of evidence, this could be seen to be a considerable advantage. However, careful consideration would need to be given to the effect which the adoption of such an approach might have on the ability of tax authorities to concede points to each other in attempts to negotiate solutions to such problems between themselves at an earlier stage. It would be most unfortunate if tax authorities feared to make such concessions because of a tendency on the part of arbitration simply to seek a middle way between the standpoints reached by the disputant tax authorities in their unsuccessful negotiations.

52. Then there are also questions concerning how the burden of costs should be borne and how the confidentiality of information produced for the purposes of the proceedings should be preserved.

53. These problems vary in difficulty and importance. They are cited not to suggest that an arbitration procedure is impossible but in order to show that

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the matter is one which would require much international consideration and co-operation if a satisfactory system were to be set up in which a large number of countries could participate, and that an arbitration procedure must inevitably therefore be a matter which tax administrations would have considerable hesitations about seeking to design even if it was recognised that there was an obvious and urgent need for one.

54. It is not in fact clear, however, that there is an obvious and urgent need for such an arbitration process.

55. At the same time it seems to the Committee that the setting up of such a scheme would involve an unprecedented surrender of fiscal sovereignty. Some Member countries have in fact made it clear already that they would find such a scheme quite unacceptable for this reason.[8]

56. It seems to the Committee that these are conclusive arguments against recommending such a scheme. Nevertheless, the case for an arbitration procedure has been pressed so strongly in some quarters that it seems necessary to expand the comment that the need for it has not been established. It is not in fact apparent that existing arrangements are working so unsatisfactorily that a new form of machinery is imperative. Indeed it seems at present that where there are double taxation agreements very few cases of transfer pricing adjustments lead to adjustments which give rise to unresolved disputes between the relevant tax administrations or leave the taxpayers suffering significant inequity. It has of course been argued that, up to the present, tax administrations have not in practice made a large number of transfer pricing adjustments but that the growing interest of tax authorities in the transfer pricing of MNEs increases the potential area for disputes of this kind. However, it does not follow that an increased interest by tax authorities will inevitably increase the number of disputes between tax administrations which cannot be resolved. This increase in interest in transfer pricing is paralleled by an increase in the interest of tax authorities in consultation and co-operation between each other which it may be hoped will enable them the more easily to resolve such difficulties as arise in this field. It may be hoped too that the 1979 Report will also help to engender a common approach by tax authorities to these problems, which in itself will reduce the occasion for disagreement between tax authorities.

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57. It has also been argued that some problems do in fact arise where the tax authorities of one country take a different view of a transfer pricing matter from that of the tax authorities of the other relevant country, but the problems are not brought to the surface. The argument is that double taxation is accepted by the taxpayer, though unwillingly, in such cases because the existing competent authority or mutual agreement procedures are seen as cumbersome or longwinded or unlikely, for one reason or another, to produce a useful result in a reasonable time. The comparatively small number of problems which in fact come to the surface by way of the mutual agreement procedure, it is argued, is therefore not a true guide to the seriousness of the problem. Factual evidence to support this view is obviously, however, difficult to identify, let alone quantify. It is certainly possible that some potential subjects for discussion under the mutual agreement procedure are not pressed by taxpayers because to do so would raise queries about other aspects of their international activities or would put in question the settlement of other aspects of their tax liability. But if such is the case it must be assumed that the overall result is satisfactory to the taxpayer. Possibly also in some cases the tax reliefs given to a parent company by its own domestic tax law in respect of foreign tax on dividends received from an affiliate or on the profits underlying those dividends, may mitigate the effect of a disagreement between the country of the parent and that of the affiliate about the allocation of profits from transactions between them and, as a result, persuade the parent company that it should not press as hard as it might otherwise press to get the disagreement resolved.

58. The suggestion has been made that if, in the last resort, problems which the mutual agreement system had failed within a certain time to solve could be put to a compulsory arbitration, more use might be made of the mutual agreement procedure and that in those circumstances either a different picture would be revealed of the extent of the problem, or the tax authorities would simply, because of the possibility of arbitration, be prompted to come to an agreed decision in more cases and to do so more quickly.

59. Notwithstanding these arguments, however, the fact remains that little evidence has been produced to show that in the absence of an arbitration system taxpayers are left in any significant number of cases to suffer inequity.

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60. Thus the immediate or compelling need for an arbitration system remains, in the view of OECD Member countries' tax authorities, still to be demonstrated.

61. Moreover, the advantages claimed for an arbitration system are not unqualified. Thus, if it were an essential requirement that cases must be considered speedily, this might have to be achieved at the expense of a full and proper consideration of all the issues. The absence of administrative or procedural rules, if this were in fact to be a feature of an arbitration process, and a reliance on the arbitrator's broad general view of what seemed fair, though possibly an advantage in some cases, could in other cases give one or other of the parties the impression that a full opportunity to argue the case had not been allowed or that for some other reason justice had not been done. The opportunity to put matters before independent and impartial experts with experience in the particular field could certainly be useful in some cases, but in the most difficult transfer pricing issues it may well be the case that the difficulties arise because of the special situation of the taxpayer concerned (how, for example, to determine the value of a particular patent which is not readily comparable with any other) and it may not be easy to find an expert in the particular matter who is not also connected in some way with the relevant enterprise.

62. This is not to say that the advantages claimed could not be achieved to some extent but they might only by achieved by accepting some corresponding disadvantages.

63. Bearing in mind the considerations set out above, the Committee does not therefore, for the time being, recommend a compulsory arbitration process for the resolution of disputes between tax authorities about transfer prices or the allocation of profits for tax purposes between the different components of an MNE.

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Chapter IV

POSSIBLE IMPROVEMENTS TO MORE SATISFACTORY USE OF EXISTING ARRANGEMENTS FOR AVOIDING DOUBLE TAXATION

64. It is, in consequence, a matter of some importance in this situation to look carefully at the criticisms which have been levelled at the existing arrangements provided in bilateral tax treaties for dealing with transfer pricing adjustments made by the tax authorities of a treaty partner country, and to consider how, if possible, these criticisms may be met and the system made more satisfactory.

65. In fact, although the Committee offers some comment and suggestions in this context in the paragraphs below, and makes a number of recommendations which ought, in its view, to improve the operation of the existing arrangements, it does not put forward any radical recommendations for change. The matter is, however, one in which practice is developing and it seems to the Committee that it might be kept under periodic review in the future.

66. Some of the criticisms which have been levelled at the existing arrangements for relieving or avoiding economic double taxation have been discussed already to a certain extent in Chapter II. The object of the following paragraphs is to go, in rather more detail, into the problems which would be raised in dealing with these and other criticisms, as well as to touch on a number of related items which have not already been mentioned.

67. But this discussion should be seen in its proper context. As has already been pointed out, there are a variety of ways in which tax authorities may without undue difficulty avoid or relieve the imposition of economic double taxation as a consequence of transfer pricing adjustments. There may, for example, be no difficulty in the one State about accepting a transfer pricing adjustment made by the other in a particular case and consequently no difficulty about using the adjusted price as the basis for the computation of tax liability under its own laws. If there is difficulty, the tax authorities may be able to come to an arrangement, under which the adjustment is modified by the State making it, so as to be acceptable to the other. In many cases the tax authorities

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will thus come to a mutually satisfactory agreement by employment of the existing arrangements. Moreover, tax authorities will be governed in the making of adjustments or corresponding adjustments by the need to be able to defend their decisions before their own domestic courts or other appeal bodies, and this too should reduce the occasions for disputes with the taxpayer.

68. There are, nevertheless, two aspects of the existing arrangements which need to be considered. One is whether the existing provisions in the OECD Model Convention (Articles 9 and 25) and their bilateral equivalents are adequate or should be changed or expanded. The other is whether the procedures and operation of the Mutual Agreement Procedure as provided by Articles on the lines of Article 25 in bilateral agreements could be improved.

A. Corresponding adjustments

69. As noted earlier, it has been pointed out as a matter for regret by some critics that "secondary adjustments" are not provided for under Article 9. If double taxation is to be fully relieved it is clearly desirable in theory that where a transfer pricing adjustment is made in one State the relief provision should so far as possible take account of both the primary and the secondary consequences of the adjustment. The current absence, however, of any general consensus as to what secondary adjustments are permissible or how relief should be given to take account of them makes it difficult to suggest how this may be done and, in the absence of any indication that many serious problems arise in this area which in practice are not satisfactorily resolved, no change is recommended here. The Committee considers, however, that it would be useful to return to this subject at some time in the future when practice in such matters has developed further.

70. It is necessary to consider also the question whether Article 9 of the Model goes far enough in the obligation which it imposes on treaty partners to make a primary corresponding adjustment. As paragraph 3 of the Commentary on Article 9 points out "an adjustment is not automatically to be made in State B simply because the profits in State A have been increased: the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been

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correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount". Clearly it would be unacceptable to commit State B to provide an automatic corresponding adjustment, whether or not it considered that the adjustment made in State A was justified in principle and amount, since this would be tantamount to requiring State B to give State A a blank cheque. (The Committee took the view moreover, that Article 9(2) did not in fact impose any obligation to match a corresponding adjustment where the original adjustment was made to correct the deliberate manipulation of a transfer price by the enterprise for the purpose of gaining a tax advantage.) Some possible protection for State B might be provided if the Contracting States were able to agree in some detail in their bilateral arrangements on rules about the way in which to ascertain arm's-length prices in particular cases — by for example agreeing on safe haven rules in specific kinds of case. In this way they might be reasonably assured that the result of accepting the other State's adjustments would be broadly equitable. Arrangements of this sort would be bound, however, to be a compromise and it would be difficult to devise them in such a manner that they did not conflict with the arm's-length principle itself. The Committee does not, therefore, recommend any change in Article 9(2) of the Model or in the Commentary on that Article.

B. Mutual agreement procedure

71. A second aspect of this enquiry must clearly be to what extent the mutual agreement procedure can be improved. Some of the criticisms, it will be obvious in the light of preceding paragraphs, cannot be met. There is no way of forcing the competent authorities to come to an agreed decision short of requiring them to submit to the decision of a supra-national authority and for the reasons already expressed this is not regarded as recommendable. Similarly they cannot otherwise be compelled to reach a decision by a certain time. But there may nevertheless be some scope for facilitating the reaching of agreement and for speeding up the process.

72. The aspects of the mutual agreement procedure discussed below concern in the first instance the resolution of specific transfer pricing cases. The extent and operation of Article 9(2) of the OECD Model Convention may be in point. But so may the extent and operation of Article 25. This is an area where some tax authorities feel that clarification may be desirable to enable

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taxpayers and tax authorities to know more certainly what may be done in this context and it has therefore been the subject of consideration by the Committee.

1. Clarification of the scope of Article 25 of the OECD Model Double Taxation Convention

73. The mutual agreement procedure provided by Article 25 is concerned with actions of the Contracting States which the taxpayer considers may or will result in taxation not in accordance with the provisions of the Convention. Thus, under a bilateral convention containing an article on these lines, the question whether a mutual agreement procedure can be undertaken depends on whether the action complained about may, or will, result in taxation not in accordance with the provisions of the convention. The Committee has come to the following conclusions.

74. When a convention contains provisions similar to those of paragraph 2 of Article 9 of the OECD Model Convention, those provisions relieve economic double taxation of profits by requiring a State which has collected excessive tax, as a consequence of transfer prices in dealings with a company of that State, to make a corresponding adjustment to the profits of the company, insofar as they were unjustifiably high. To that extent, taxation initially imposed by that State is "not in accordance with the convention" and the taxpayer is entitled, under the provisions of Article 25, paragraphs 1 and 2, to present his case to the competent authority of the State of which he is a resident (see paragraph 9 of the Commentary on Article 25), within three years from the first notification of the most recent decision or action (cf. paragraph 17 of the Commentary on Article 25). The competent authority which the taxpayer applies to is under the obligation to approach the competent authority of the other State, if the objection appears to it to be justified and it is not itself able to arrive at a satisfactory solution. The mutual agreement procedure therefore provides competent authorities with an adequate legal framework for consultation when the difficulty in determining the profit is due to difficulty in reaching agreement on the appropriate transfer price. In fact, consultation is such cases is expressly provided for in the second part of the last sentence of Article 9, paragraph 2, which, by itself, allows competent authorities to consult directly. Even when paragraph 2 of Article 9 does not include the second part of the last sentence, the mutual agreement procedure, as provided for under Article 25, paragraphs 1 and 2, should apply.

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75. The matter is less clear where the convention does not contain the equivalent of Article 9, paragraph 2. However, a number of countries have observed that, in substance, paragraph 1 of Article 9 does not, in itself, fulfil any necessary function, as it only formulates rules which already exist, in broadly similar language, in most domestic laws, which can be applied without conflicting with any provision of the convention, even where the convention does not contain any Article 9. Following this line of thinking, the inclusion of Article 9 (paragraph 1) in a convention would demonstrate the contracting parties' wish to cover economic double taxation in the convention. As a consequence, any economic double taxation arising from the adjustment of transfer prices would not be in accordance with — at least — the spirit of the convention, and would fall within the scope of the provisions of the mutual agreement procedure, under Article 25, paragraphs 1 and 2.

76. Some countries do not, however, share this view: according to a literal interpretation, they consider that, when Article 9 does not contain any paragraph 2, no provision in the convention imposes a requirement on the State which has included in its tax base profits unduly transferred to a company which is a resident of that State to revise its assessment in order to exclude such excess profits; taxation of such profits is therefore not contrary to the convention, and paragraphs 1 and 2 of Article 25 do not apply; strictly speaking, the taxpayer is accordingly not entitled to have his case reconsidered and he may not invoke the three-year time limit provided in Article 25, paragraph 1. Usually, such States, however, have the possibility of reconsidering a taxpayer's position, in case of economic double taxation, either on the basis of domestic provisions or by the exercise of discretionary power which some tax authorities possess to relieve the most severe cases. Such procedures are more flexible and do not always give to the taxpayers a formal right to submit claims; in practice, they help to alleviate double taxation in all cases when there is no doubt about the good faith of the companies concerned.

77. On the other hand, paragraph 3 of Article 25 of the Model would allow the competent authorities to consult about the elimination of double taxation in cases not provided for in the Convention and this may be sufficient authority, for at least a few countries, to consult on particular cases of transfer pricing adjustments.

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78. Some States have to some extent clarified the issue in their bilateral agreements by providing specifically, in the text of the equivalent of Article 25, that the mutual agreement procedure may be used for the resolution of problems of interpretation or application of the Convention related to transfer pricing. However, this is usually done in bilateral conventions containing provisions similar to Article 9(2) of the Model.

79. In order to avoid any doubt in cases where a convention does not contain provisions similar to those of paragraph 2 of Article 9, an additional paragraph should be inserted after paragraph 9 of the Commentary on Article 25 when the OECD Model Convention is next revised. The paragraph might read as follows:

> "When the convention between two Contracting States does not contain rules similar to those of Article 9, paragraph 2 (as is usually the case for conventions signed before 1977) the mere fact that contracting parties inserted in the convention the text of Article 9, as limited to the text of paragraph 1 — which usually only confirms broadly similar rules existing in domestic laws — indicates that the intention was to have economic double taxation covered by the convention. As a result, most members of the Committee on Fiscal Affairs consider that economic double taxation resulting from adjustments made to profits by reasons of transfer pricing is not in accordance with — at least — the spirit of the convention and falls within the scope of the mutual agreement procedure set up under Article 25. States which do not share this view do, however, in practice, find the means of remedying economic double taxation in most cases involving *bona fide* companies by making use of provisions in their domestic laws."

2. Procedural aspects

a) Time limits and the time factor

i) Time limits

80. An important difficulty in practice with the mutual agreement procedure seems to arise from time limits and the amount of time taken generally before agreement is reached.

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81. It may be convenient to take first the question of time limits. The date beyond which no alteration can be made to a taxpayer's liability for a particular period may be reached in one country before the taxpayer can establish the need for an adjustment corresponding to that made to an associate's liability in another country. However, there must obviously be some limit to the period during which claims to relief may be made. Tax liability must become final at some stage or there would be no certainty for the tax authorities or indeed for taxpayers. But the existence of such time limits and the fact that they vary from country to country does mean that in order to minimise the likelihood of unrelievable double taxation their potential impact needs to be borne in mind. Thus, if it is possible for a tax authority in one country to adjust a transfer price ten years after the end of the year in which the transaction took place and the tax authorities of the country of residence of the relevant associated enterprise have long ago finalised the computation of that enterprise's taxable profits, they may well be legally unable to make a corresponding adjustment.

82. The solution which is suggested in Article 25 of the Model Convention is that an agreement reached by the mutual agreement procedure should be implemented regardless of any time limits in the domestic law of the Contracting States. Thus if the mutual agreement procedure is invoked and results in agreement to make a corresponding adjustment it would be possible to do this regardless of any time limits in the relevant Contracting State, and the invocation of the mutual agreement procedure could overcome any difficulty arising in this way from the domestic time limits. If all countries could accept this, as some in fact do, then time limits would present less of a problem in this context. But a number of countries have reservations about overriding their domestic time limits in such a way.

83. Where a provision on these lines is not included in a bilateral treaty it would be necessary, in order to minimise the obstacles provided by time limits, for the discussions between the tax authorities to begin before any relevant time limits have run out and for those time limits to be effectively suspended until the discussions have been concluded. This in its turn indicates the need, in the circumstances, for tax authorities to consider the making of any transfer pricing adjustment at the earliest possible stage.

84. The suggestion has indeed been made that problems arising from time limits and the time lag between transactions and the adjustment of the relevant

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transfer prices might be avoided or at least reduced by the introduction of provisions into bilateral agreements which would prohibit the making of such adjustments after the expiry of an agreed period. This would be unacceptable to many countries. Tax authorities may need a long time to make the necessary investigations to establish the necessity and extent of an adjustment, and the indications even that an adjustment is necessary may only be brought to their notice late in the day. It would be difficult for many tax authorities to close their eyes to the need for an adjustment, however late in the day this need became apparent, provided that they were not prevented by their domestic time limits from making it. Nevertheless, where there was sufficient compatibility between the relevant time limits and other relevant elements (such as the procedure for imposing liability and the appeals system) in the tax structures of two Contracting States to ensure that this arrangement did not impose unequal sacrifices on one or other of the two States, it might prove to be a useful and acceptable expedient and some countries have apparently found it so. However, it does not seem to the Committee to be a suitable matter for a general recommendation.

85. Leaving these particular questions aside, the Committee does, however, recognise that it is desirable in principle to operate the system so as to minimise as far as possible the obstacles to the relief of double taxation which may result from the impact of time limits.

86. Article 25 of the Model Convention requires the taxpayer to invoke the mutual agreement procedure within three years from the first notification of the action complained of. This time limit does not itself create a great deal of difficulty (although some States consider that it provides too short a period for invoking the procedure while others have entered reservations against Article 25 because they regard it as allowing too long a period). The main difficulty in this context is in deciding what is the date of notification. As stated in the Commentary (paragraph 17), the time limit runs from the first notification of the most recent decision or action. It is desirable that tax authorities should take early steps to give the taxpayer clear formal notification of a proposal to make an adjustment if it seems that it is likely to provoke a request to another country for a corresponding adjustment.

87. The consideration of problems arising from time limits suggests in fact that, in order to minimise the possibility that time limits may prevent the mutual

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agreement procedure from effectively ensuring the relief or avoidance of double taxation, the procedure should be invoked at the earliest possible stage, that is to say as soon as an adjustment is seriously, even if only tentatively, proposed. If this were done, the process of consultation could be begun before any irrevocable steps were taken by either tax authority, with the prospect, therefore, that there would be as few procedural obstacles as possible in the way of achieving a mutually acceptable conclusion to the discussions.

88. Not all competent authorities would, even so, wish to be involved at so early a stage in practice. A proposed adjustment may not result in final action and even a concluded adjustment may not trigger a claim for a corresponding adjustment. Consequently too early an invocation of the mutual agreement process may create unnecessary work.

89. Nevertheless, on balance the Committee recommends that competent authorities should be prepared to enter into discussions under the mutual agreement procedure at as early a stage as is compatible with the economical use of their resources.

ii) The time factor generally

90. On the more general point that the mutual agreement procedure may turn out to be an unsatisfactorily lengthy one, the Committee recognised that international consultations in these sometimes very complex matters could very often take a long time. The occasion for the relevant officials to meet must inevitably be restricted by the long distances which may have to be travelled, correspondence is often an unsatisfactory substitute for face to face discussions, there are language difficulties, differences in procedures and legal and accounting systems to be understood and taken into account and so on. The problem may also be complicated in itself and delays provoked because the taxpayer is slow to provide necessary information — obviously if he has invoked the mutual agreement procedure he will usually be ready to provide information bearing directly upon the point, but for a full understanding of the transfer pricing situation of an enterprise, and thus for a fully satisfactory solution of the problem, the tax authorities may need more than this, and MNEs are often slow to provide information of this wider kind. It would, on the other hand, be wrong to assume that delays were always a feature of the procedure. In practice the consultations often result in a settlement of the problem in a

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relatively short time and it may be hoped that developing experience in such consultations may itself speed matters for the future.

91. Nevertheless, the Committee agreed that every effort should be made by tax administrations to seek to avoid delays in these matters, and to improve their practice insofar as their resources permit.

92. One way of doing this would be to encourage face to face or telephone discussion between competent authorities, to supplement the written procedures, which may inevitably be rather lengthy. Such personal contacts can often more quickly establish whether an adjustment by one country is likely to give rise to difficulty for another and can often more quickly resolve any such difficulties, and, although in themselves they may obviously be expensive, they may, if used judiciously, settle complicated matters more quickly and thus less expensively in the long run. The Committee thus recommends the development of these forms of co-operation.

93. The OECD's work on exchange of information for the purposes of preventing avoidance and evasion should be useful for improving the co-operation of tax authorities for this purpose as well, both on a bilateral and possibly in suitable cases on a multilateral basis. It seems likely that an increased willingness on the part of tax authorities to solve transfer pricing problems (and others) in oral discussion with each other and to adopt as flexible an approach as possible to the search for compromise would remove much of the delay and difficulty of which the MNEs have complained. In this context the technique of "simultaneous examination" which is currently being developed by some countries may help in suitable cases. This is a process by which the tax authorities of two countries engaged in the examination of the tax affairs of associated enterprises separately within their own jurisdictions can co-ordinate their examinations, using the exchange of information provisions in the relevant double taxation agreement so as to establish more effectively and economically the facts about such matters as the transfer pricing of transactions between the enterprises. In the process, differences in approach which might lead to double taxation can be identified and discussed at an early stage and, it may be hoped, be more readily reconciled. Moreover, such arrangements will obviate the problems caused by one country examining the affairs of a taxpayer long after the treaty partner country has finally settled the tax liability of the relevant associated enterprise. (The question whether the technique is suitable

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for adoption in any particular case would need, however, to be carefully considered before embarking upon it.)

b) Delegation of powers and joint consultation

94. The mutual agreement procedure has generally been regarded as a matter of consultation between high level officials of the relevant tax authorities. The reasons for this are sound; the fewer officials that are involved, the greater the likelihood of ensuring a consistent approach and the confidentiality of taxpayer information. Indeed, without the supervisory control of experts in a central position there would be some real danger of inconsistent decisions and, in consequence, of failure to achieve equitable results. Notwithstanding this need for central control there remains, however, the possibility of speeding up procedures by some delegation of the discussions to officials at a lower level (if the detailed examination of the taxpayers' transfer pricing is in fact in their hands) provided that the relevant exchanges of information are adequately controlled by the responsible competent authorities.

95. The experience of a number of countries shows that this can be a useful expedient once a mutual agreement procedure has been initiated between the competent authorities. For example, the following procedure has been practised successfully between some countries. The competent authorities in these cases have asked their case officers in the field to prepare a joint report on the case under investigation on, *inter alia*, the following lines: they are required to establish the facts and co-ordinate their findings so that both countries will base their decisions on the same facts and circumstances; they are then required to specify those questions of law (if any) on which the reporting authorities disagree, and, where problems of evaluation are involved, set up agreed lower and upper limits for the appropriate price, thus providing a range within which the competent authorities can reach a decision. In this way both delegation to lower levels and supervisory control by the central competent authorities have been satisfactorily achieved. This kind of procedure may not be appropriate in all cases but the Committee sees it as a useful technique which in the right situation may help to bring the competent authorities to a speedier decision. The Committee therefore recommends that in appropriate circumstances and under suitable controls competent authorities should be prepared to delegate some part of competent authority discussions on transfer pricing matters to the case officers concerned.

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c) Taxpayer participation

96. It has been suggested that taxpayers should have the right to submit a request for the mutual agreement procedure to be instituted and that the request should not be unreasonably denied. Paragraph 21 of the Commentary on Article 25 of the OECD Model Double Taxation Convention makes it clear that this follows from the inclusion of an article on the line of Article 25 in a bilateral tax agreement. The Committee fully endorses this interpretation[9]. The Committee was, however, presented with no evidence to suggest that such requests were in practice being unreasonably denied.

97. It has been argued that the taxpayer should have a right to take part in the mutual agreement procedure, and that he should have the right at least to present his case to both competent authorities, and to be informed of the progress of the discussions, and, some representatives of industry have suggested, he should also have a right to be present at face to face discussions between the competent authorities. The object would be to ensure that there was no misunderstanding by the competent authorities of the facts and arguments which are relevant to his case. The suggestion is based on the view that the mutual agreement procedure is a process resembling litigation and that in litigation affecting his interests the taxpayer would have a right to be heard.

98. The mutual agreement procedure envisaged in Article 25 and adopted in many bilateral agreements on the OECD pattern is not, however, a process of litigation between the taxpayer and the competent authorities: for such disputes the domestic courts are the appropriate forum. The mutual agreement procedure is (unless there is specific provision to the contrary in the relevant law of the countries concerned) simply a process of discussion between the competent authorities in which they seek to explore the possibility of a solution to the relevant problem which can be accepted by all concerned. If it is only possible to find a solution which is acceptable to the tax authorities the taxpayer may still have the opportunity to achieve a solution more satisfactory from his point of view by invoking the domestic appeal systems of one or other of the States concerned. The taxpayer will not, however, necessarily have an interest in every case. It might well be, for example, that the essential issue in the discussions is simply one of which country should tax and which should give relief for the tax, with the result being effectively the same whatever happens for the taxpayer or, in the case of an MNE, for the taxpaying group. Formal

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rights for the taxpayer to appear and be heard in the discussion between the competent authorities would therefore, in the view of the Committee, be out of place.

99. On the other hand if the procedure is to be useful and effective it would be sensible for the taxpayer to give the competent authorities all the information which is relevant to the issue and for the tax authorities to allow him every reasonable opportunity to present the relevant facts and arguments to them and to ensure as far as possible that the matter is not subject to misunderstanding.

100. In practice, it appears, taxpayers normally are given such opportunities, are kept informed of the progress of the discussions and are often indeed asked during the course of the discussions whether they can accept the settlements envisaged. The Committee recommends that these practices should be adopted as widely as possible. They would see no objection in principle moreover, in any case where this was convenient and appropriate and agreeable to both competent authorities, to allowing the taxpayer to present his case to them together at a joint meeting.

101. It has been pointed out that in many cases an MNE faced by the problems created by an adjustment of its profits in one State which has an effect on the tax liability of another part of the MNE in another State, has been able to resolve these problems by its own efforts. In fact, it seems likely that an MNE, when faced with an adjustment in State A which might require a counter-adjustment in State B, would thereupon examine the question of such a counter-adjustment under the laws of country B, make appropriate arrangements and seek to settle the case eventually by negotiations with the tax authorities of that State. There are obvious advantages in this procedure and Member country tax administrations would generally wish to encourage MNE's to seek to resolve their problems in this way before pressing for a formal mutual agreement procedures[10].

102. They would no doubt be so encouraged if each tax administration were prepared to notify a resident affiliate of an MNE, at an early stage, of the intention to adjust its profits, and to discuss with the domestic entity of an enterprise which has received such a notification in another country the problems connected therewith, including the possibilities of a counter-adjustment. In this way a taxpayer which was part of an MNE would have time

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to inform the relevant affiliate in the group, or the headquarters of the group, which could then take steps to settle the case before irrevocable decisions were made in the adjusting country. The adjusting administration would then have less reason to fear that it would have to face a future demand for a mutual agreement procedure. This would facilitate procedures. both for the MNE and the administrations concerned.

103. The obverse of this problem, however, is that a failure on the part of an MNE in one country to advise its affiliate in another country that it proposes to accept an adjustment proposed by the tax authorities of the first country may leave the tax authorities of the second country in difficulty if they come somewhat later to the issue and disagree with the adjustments. They may have to consider refusing relief for any additional tax involved or asking the tax authorities of the first country to upset a settlement which they have made with their own taxpayer. It would help to avoid this situation if those tax authorities contemplating the making of a significant transfer pricing adjustment which might have this kind of consequence were to alert their partner tax authority in adequate time. But if the taxpayer wishes to avoid double taxation it must be his responsibility to take the necessary steps.

104. It should be clearly understood, however, that a taxpayer, in negotiation with the tax authorities of one country, cannot speak for tax authorities of another (unless he is specifically empowered to do so). It is not intended in these paragraphs to suggest that the taxpayer should in any way be empowered to act for a tax authority.

d) Package deals

105. The Committee has seen no evidence that taxpayers have in practice suffered injury as a result of "package deals" between tax authorities in the course of which complaints put through the competent authority procedure are settled, not on the merits of each individual case, but on the basis of a balance of interest between the competent authorities themselves. Nevertheless, since it is clear that this result is feared by taxpayers, the Committee records the view that competent authority cases should each be settled on their own individual merits and not by reference to any balance of the results in other cases.

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e) Unilateral information procedures

106. It has been suggested that it would be helpful to taxpayers, enabling them to make more satisfactory use of the competent authority procedures, if competent authorities were to develop and publicise their own domestic rules or procedures in this field, so that taxpayers may more readily understand what they can do and how to go about it. This could also be helpful to tax authorities especially if they are faced with the possibility of a large or growing number of cases in which mutual agreement with other tax authorities may be necessary or desirable, possibly saving them the need to answer a variety of enquiries or work out procedures afresh in every case.

107. In publicising such rules and procedures it could, for example, be made clear how the taxpayer may bring a problem to the attention of the competent authority in order to start off a discussion with the other country's competent authorities. The publication could indicate the official address to which the problem should be referred, the stage at which the competent authority would be prepared to take the matter up, the nature of the information necessary or helpful to the competent authority in handling the case, and so on. It could be helpful also to give some indication of the way in which the competent authorities would normally approach the question of transfer pricing adjustment and corresponding adjustments and how they would normally handle such cases. The Committee recommends that this possibility should be explored unilaterally by competent authorities, and that, where appropriate, descriptions of their rules and procedures should be given suitable domestic publicity.

108. Unilateral rules or guidelines governing the operation of the procedure by one competent authority would not require agreement by the other competent authority, since they would be limited in effect to the competent authority's domestic relationship with its own taxpayers. However, it would seem appropriate to communicate such unilateral rules or guidelines to the competent authorities of the other countries with which mutual agreement procedures are usually entered into.

3. Other suggestions

109. A number of other suggestions which have been made for the improvement of the mutual agreement procedure under double taxation agreements should also be referred to in this report.

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110. One is that the procedure should not be used to review other tax matters not directly connected with the subject of the procedure. The Committee could not accept this as a general rule. Obviously it is easier for the mutual agreement procedure to be operated, both by taxpayers and by tax authorities, if the issues involved are narrowed down as far as possible. But it would be absurd if a request to a tax authority to initiate the mutual agreement procedure on one particular aspect of the taxpayer's affairs were to prevent the tax authorities from examining or exchanging information about other aspects of the taxpayer's affairs.

111. Another suggestion is that, if double taxation has occurred as the result of a court decision, this should not prevent the mutual agreement procedure from being operated or agreements which might be reached under it from being implemented. Again no evidence was produced to the Committee to indicate that this was a widespread problem demanding an urgent solution. The problem here is similar to that arising where time limits prevent the effective operation of the procedure, that is to say the objection in many countries to the substitution of the decision of officials for the domestic law as laid down in the statutes or as decided by the courts. If it is possible for agreements reached under the mutual agreement procedure to override the domestic law then clearly this will facilitate the operation of the mutual agreement procedure in some cases. But the Committee makes no recommendation on the point. The problem can, however, as with the time limit problem, be minimised perhaps if, supposing that the taxpayer concerned is not himself in a position to invoke the mutual agreement procedure, he can alert his associates in the other country, in adequate time, to the possibility that a court decision will affect a potential transfer pricing issue so that they can invoke the procedure at their end. Tax authorities may also consider it to be useful to alert the relevant treaty partner tax authorities if there is a significant chance that a court decision will provoke as a consequence a request for a mutual agreement procedure.

112. A connected suggestion which has also been made is that a taxpayer should not be obliged, as a condition of instituting the competent authority procedure, either to invoke the domestic remedies which are available to him or to have exhausted them. The Committee would not suggest that the legal remedies available to a taxpayer should be exhausted before his case was taken up for discussion under the mutual agreement procedure. Clearly this

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requirement would mean that in many cases there would be a possibility of conflict between the outcome of the mutual agreement procedure and the outcome of the domestic appeal proceedings with the result that the agreement reached by the competent authorities could not be implemented. So long as the domestic appeal proceedings are not finalised and can be abandoned or concluded by a compromise settlement there should be no difficulty about allowing them to continue parallel with discussions under the mutual agreement procedure. If no agreement results then in each country tax authority and taxpayer each have an equal chance before the domestic courts. (The situation where binding arbitration proceedings were in point would be different: here there would be a question of two different bodies both considering the same issue, and both having power to make a decision binding on the tax authorities but possibly leaving the taxpayer free to choose the one most favourable to him.)

113. The suggestion that taxpayers should not be required to invoke their domestic remedies as a condition of invoking the mutual agreement procedure is not one which permits easy acceptance. In some countries it would be necessary for the domestic appeal provisions to have been invoked, and for the appeal to be kept open, in order that the mutual agreement procedures could usefully operate at all. The Committee agrees nevertheless that it is desirable to keep to a minimum the formalities involved in the operation of the mutual agreement procedure and to eliminate any that are really unnecessary.

114. It has been suggested also that the result of consultations under the mutual agreement procedure and the general rules applied in specific taxpayers' cases should be published provided that the confidentiality of the relevant taxpayers' affairs was safeguarded. This is a possibility which may be worth further consideration at some time in the future. At present it seems that most cases have to be decided so much by reference to their own facts that it would be difficult to publish the details without breach of confidentiality and that little useful guidance would be provided by their publication in any event. However, as experience is gained by tax authorities in these matters it might well be useful for competent authorities to include, in any material publicising their domestic rules, procedures and guidelines in this field, not only some indication of the broad principles adopted by the competent authorities in the actual cases which have come before them, but possibly some indication of the limits within which it is necessary for them to work because, for example, of the incidence of

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other countries' tax laws (including time limits) or because of the availability or otherwise of evidence of prices and perhaps some indication of the relative usefulness of the methods which have had to be adopted in arriving at arm's-length prices, etc. The Committee recommends that this possibility should be borne in mind.

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Chapter V

CONCLUSIONS

A. General conclusions

115. *a) General comments on corresponding adjustments*

i) The responsibility for minimising as far as possible the likelihood of double taxation arising from transfer pricing adjustments is in the first place that of the MNE itself, which should, at any rate for tax purposes, arrange its transfer prices to conform with the arm's-length principle;

ii) Nevertheless, the Committee recognises the desirability in *bona fide* cases of ensuring as fully as possible the relief of any double taxation, whether juridical or economic, which would follow from adjustments to transfer prices made to bring them into conformity, for tax purposes, with the arm's-length standard;

iii) It fully endorses, however, the view expressed in paragraph 3 of the Commentary on Article 9 of the OECD Model Double Taxation Convention that a State should not be committed to make an adjustment to conform to that made by another State except when it can agree that the original adjustment was correctly computed on an arm's-length basis1l;

iv) On the other hand, the Committee recommends that tax authorities should do all they can to reach an agreement on disputed transfer pricing adjustments or corresponding adjustments in order that double taxation should not persist where it could, by agreement, be eliminated.

b) The mutual agreement procedure

i) The Committee regards the existing mutual agreement procedure provided by Article 25 of the 1977 OECD Model Convention as being a useful and, in general, very effective machinery for resolving disputes between tax authorities in this field as in others, notwithstanding the criticisms which have been levelled at it;

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ii) The Committee recommends, however, for the avoidance of doubt, that it should be made clear, by an addition to the Commentary on Article 25 of the Model Convention, that this Article provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation.

c) Compulsory arbitration

The Committee does not, for the time being, recommend the adoption of a compulsory arbitration procedure to supersede or supplement the mutual agreement procedure. In its view the need for such compulsory arbitration has not been demonstrated by the evidence available and the adoption of such a procedure would represent an unacceptable surrender of fiscal sovereignty.

B. Possible practical improvements to the mutual agreement procedure

116. The following summarises the proposals made by the Committee:

i) The Committee regards it as important that the duty imposed on tax authorities, by an Article on the lines of Article 25, to set in motion the mutual agreement procedure if it appears to the competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State[12] should be implemented as quickly as possible once the obligation is made clear, and that an application to set the mutual agreement procedure in motion should not be rejected without good reason;

ii) The Committee endorses the view that the adoption, in bilateral agreements, of the last sentence of paragraph 2 of Article 25 of the Model Double Taxation Convention — *viz.* "Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States" — would eliminate a wide range of problems. It recognises, however, as does the Commentary on Article 25, that some States are not, on constitutional and other legal grounds, able to override the time limits in their domestic law. In general therefore the Committee recommends that every effort should be made by tax administrations to ensure that as far as possible the mutual agreement procedure is not in any case frustrated

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by operational delays or, where time limits would be in point, by the combined effects of time limits and operational delays;

iii) The Committee in particular draws attention to the value, in transfer pricing matters, of ensuring as early and as full communication as possible on all relevant matters between tax authorities and taxpayers within their domestic jurisdiction and, across international frontiers, between the relevant associated enterprises themselves and the tax authorities concerned. Thus the Committee recommends that tax administrations should be prepared at as early a stage as possible to notify taxpayers of the intention to make a transfer pricing adjustment (and, where the date of any such notification may be important, to ensure that a clear formal notification is given as soon as possible);

iv) The Committee recommends that competent authorities should communicate with each other in these matters in as flexible a manner as possible, whether in writing, by telephone, by face to face or round the table discussion, whichever is most suitable, and should seek to develop the most effective ways of solving relevant problems by the use, where appropriate, of simultaneous examination procedures, the controlled delegation of functions to case officers, and such other techniques as are suitable for the purpose;

v) The Committee recommends that in the course of mutual agreement proceedings on transfer pricing matters, the taxpayers concerned should be given every reasonable opportunity to present the relevant facts and arguments to the competent authorities both in writing and orally, and, where this is convenient and appropriate and agreeable to both competent authorities, to do this in the course of a joint meeting of the competent authorities;

vi) The Committee recommends that the formalities involved in instituting and operating the mutual agreement procedure should be kept to a minimum and any unnecessary formalities eliminated;

vii) The Committee emphasises the view that mutual agreement cases should each be settled on their individual merits and not by reference to any balance of the results in other cases;

viii) The Committee recommends that competent authorities should, where appropriate, develop and publicise domestic rules, guidelines

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and procedures relating to the use of the mutual agreement (or competent authority) procedure.

C. Final remarks

117. The Committee proposes to keep under periodic review the question of how the effectiveness of the arrangements for corresponding adjustments and the use in this context of the mutual agreement procedure may be adapted to meet the needs of changing times or otherwise improved, and to return in the light of developing experience to the consideration of how secondary adjustments should be dealt with.

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NOTES AND REFERENCES

1. Transfer Pricing and Multinational Enterprises: report of the OECD Committee on Fiscal Affairs, 1979, hereinafter referred to as *the 1979 Report* or *the Report.*

2. The term "economic" double taxation is thus contrasted with "juridical" double taxation which is the taxation by two States of the same income or profits in the hands of the same juridical person.

3. This was recognised in the Commentary on the 1963 OECD Model Double Taxation Convention (paragraph 4 of the Commentary on Article 25, last sentence). The point was not repeated in the Commentary on the 1977 Model Convention but it remains valid.

4. See paragraphs 5 and 6 of the Commentary on Article 9 of the 1977 OECD Model Convention where an example is given and it is noted that the making of secondary adjustments would depend on the facts of the individual case.

5. In this context, however, it is also relevant to say as in footnote to paragraph 7 of the 1979 Report, that whereas the principle of arm's-length pricing is valid also for the taxation of permanent establishments, the considerations in this report need to be applied with care to the taxation of permanent establishments because of the special factors involved (for example, because of the limitations normally recognised on the acceptability for tax purposes of loan or royalty contracts between permanent establishments and the remainder of the enterprise of which they form part — see Commentary on Article 7 of the 1977 OECD Model Double Taxation Convention, and the report on the taxation of multinational banking enterprises contained in this publication).

6. These three provisions are sometimes described as the "specific case provision", the "interpretative provision" and the "legislative provision" respectively (see*:* "The legal nature of the mutual agreement procedure under the OECD Model Convention", *British Tax Review*, 1979, page 333, *et seq* and 1980 page 13 *et seq*).

7. For example, Resolution of the International Fiscal Association, September 1981.

8. It has been pointed out that tax authorities, by entering into treaties for the relief of double taxation, have already to some extent surrendered their taxing rights over taxpayers affected by the treaties. But the OECD Model Double Taxation Convention does not provide for decisions on matters of the tax liability of particular taxpayers arising out of the treaty to be imposed upon the tax administrations of the partner countries by a supra-national body.

9. Paragraph 21 of the Commentary on Article 25 reads as follows:

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> "If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed it will be its duty — as clearly appears by the terms of paragraph 2 — to set in motion the mutual agreement procedure proper."

10. Suggestions to this effect have in fact been incorporated in the guidelines of Germany and the United States.

11. The relevant passage reads as follows:

> "3. It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount."

12. Paragraph 21 of the Commentary on Article 25 of the 1977 Model Convention.

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Annex

EXTRACTS FROM THE 1977 OECD MODEL DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL

Article 9
ASSOCIATED ENTERPRISES

1. Where:

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 this Convention and the competent authorities of the Contracting States shall if necessary consult each other.

Article 25
MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which be is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

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

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with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities or the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. When it seems advisable in order to reach agreement to have an oral exchange of opinions, such exchange may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.

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THE TAXATION OF INCOME DERIVED FROM THE LEASING OF INDUSTRIAL, COMMERCIAL OR SCIENTIFIC EQUIPMENT

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I. INTRODUCTION

1. When adopting, on 11th April 1977, a Recommendation concerning the avoidance of double taxation, the Council recommended the Governments of Member countries to conform to the 1977 OECD Model Convention for the avoidance of double taxation with respect to taxes on income and capital, and instructed the Committee on Fiscal Affairs "to proceed to periodic reviews of situations where double taxation may occur, in the light of experience gained by Member countries, and to make appropriate proposals for its removal".

2. This report has been prepared by the Committee in that context, with a view to elucidating some of the issues related to the taxation of income derived from the leasing of industrial, commercial or scientific equipment (ICSE) under the Model Convention and under bilateral treaties and to suggest lines for possible future action by Member countries in this field.

II. GENERAL BACKGROUND

1. Economic aspects

3. While the leasing of industrial, commercial and scientific equipment (ICSE) was formerly of minor importance, it has, during the last two decades, become an important form of national and international business, fulfilling quite different economic functions in a great number of often complex contexts. It has developed in most industrialised nations into a recognised, self-contained industry in its own right and combines at the same time the professional techniques of accountants, bankers, lawyers, insurance underwriters and other specialists. The following paragraphs give a rough description of typical economic situations.

4. In many cases enterprises need ICSE only for short-term purposes. Such demand may be met casually by another enterprise, which holds such equipment permanently for its own purposes but may dispose of it for a limited period of time. Where such short-term demands by lessees occur with a certain

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regularity it may become the basis for an enterprise's activities as a regular lessor of ICSE.

5. The lease may become a specific form taken by the marketing of goods or merchandise or the rendering of commercial services. Thus the producers of advanced technical equipment or their customers often prefer to lease rather than to sell or buy such products. Likewise, in the field of transport, an enterprise may prefer leasing a container, a truck or a ship rather than asking the services of a transportation enterprise.

6. The leasing of ICSE may have a financial purpose. Thus, an enterprise which has a long-term need for ICSE may find financial advantages in leasing instead of purchasing such equipment, because in doing so it does not incur itself the burden of financing the purchase and may incur only a limited risk.

7. There are even less-well defined cases. Leasing may be used as a means to transfer assets from one enterprise of a group to another enterprise from the same group. It may even be a vehicle to shift income for tax purposes from one country to another.

8. In all these cases, the context, the motivation and the conditions of the lease may differ strongly.

2. Legal aspects

9. Lease contracts are based on the separation of the ownership of an asset and its usage. The contract legally establishes that the owner of the asset in question is the lessor (leasing company), and the user is the lessee. The lessor buys the goods and the lessee rents them. The length the lease will run (the term) is established, together with the amount of the rental payments, and the frequency of the payments. A large variety of payment methods may be used.

10. Furthermore, the contract normally states what happens to the equipment at the end of the term — whether it can be acquired by the lessee, or simply returned to the lessor. The terms and conditions of the lease may vary widely. Economic significance and legal aspects of leasing may, consequently, vary too. Basically two types of leasing can be distinguished:

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a) *Operating leases* are typically leases of equipment which can easily be moved from one lessee to another. The major categories involved are office equipment, motor cars, containers, computers and plant. The operating lessor's main business is usually in lease terms which do not cover overall amortisation and profits on the asset leased. His shorter terms entitle him to higher rates, and amortisation and the profits are spread over more than one lease;

b) *Finance leases* are leases where the leasing company is used as a financing institution: the user-lessee selects and specifies his equipment, the lessor pays for the whole and the capital is amortised during the course of the lease term. The lessor also takes his profit during this "primary term". Any subsequent lease term would be known as the secondary term. Frequently, even usually, the rentals in the secondary term are nominal and the lessee will often eventually acquire the leased asset.

11. One of the main advantages of operating leasing is that the lessor actually knows his equipment, and will provide maintenance and repair facilities, as well as replacements. He is directly interested in the asset, whereas the finance lessor is more concerned with the funding. Frequently, indeed usually, an operating lessor will have the assets funded by a finance lessor, a bank or a finance house. The lender may rely on the residual value of the asset at all times, and also in his faith in the operating lessor. Where the individual asset costs are larger, guarantees are usually required from lessees in favour of finance lessors.

3. Aspects of national and International tax law

12. During the last two decades, leasing in general has proved to involve difficult tax problems in many countries, and has been the subject of specific legislation or regulations in some of them. Problems include the following:

a) Operating leases are generally subject to classical tax rules, which were modeled on the situation of renting cars and similar equipment [see paragraph 10 *a)* above]. These rules often appear not to meet the situation in the case of financial leasing because here the lessee, rather than the lessor, may, from an economic point of view, be in an owner's

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position. This leads sometimes to specific regulations (e.g. treating the lessee as owner for tax purposes);

b) Once a specific regime is adopted in tax legislation for leases of the financial type, there arise a number of difficult problems regarding, *inter alia*, the structure of such solutions, their technical details and the differentiation between the two types of leasing;

c) Leasing may give rise to problems regarding transfer prices in cases when it takes place between associated enterprises;

d) Specific cases of leasing have given rise to problems, in some countries, under domestic tax legislation designed to counteract tax avoidance. It has also been reported that leasing is often being used for the purposes of so-called "tax-shelters";

e) Leasing originated in national economies but seems also to be used internationally today. It is to be expected that the special regulations adopted in many countries will also raise specific problems in international tax law. Likewise, the question of improper use of conventions may be raised in this context.

13. This report is limited to problems arising from the inclusion of income from leasing of ICSE in Article 12 of the 1977 OECD Model Double Taxation Convention. It refers to operating leasing and does not discuss the specific problems outlined above. It takes into account only leasing between independent persons and deals only with *bona fide* transactions.

III. THE TAXATION OF INCOME DERIVED FROM THE LEASING OF ICSE UNDER THE OECD MODEL CONVENTION AND BILATERAL TREATIES

1. Effects of existing rules

14. Income derived from the leasing of ICSE, falls in the first instance under Article 12 (Royalties) and, where it is received by an enterprise, falls also within the scope of Articles 7 (Business profits), and 5 (Permanent establishment). Article 12 contains a specific rule which provides for no

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taxation in the State of source except where royalties are attributable to a permanent establishment in that State. As a consequence, enterprises engaged in the leasing ICSE are, generally speaking, taxable in the State of residence.

2. Problems arising under Articles 5 and 7

15. Problems arising under Articles 5 and 7 with respect to equipment leasing — as well as possible answers to them — are provided in the table in the Annex. The Committee considers that although substantial in some cases these problems can be solved.

3. Problems related to non-zero rates of tax at source on royalties

a) The problem described

16. The Committee noted that many bilateral treaties within the OECD maintain a limited rate of tax at source on royalties. In fact, no fewer than 12 OECD Member countries have entered a reservation against the zero rate provided in Article 12 of the 1977 OECD Model.

17. Bilateral treaties providing for a non-zero rate of tax at source on royalties generally adopt the full definition of royalties in paragraph 2 of Article 12 of the 1977 OECD Model. Thus, the taxation at source provided in such treaties is generally applicable to income from the leasing of ICSE.

b) The Committee's considerations

18. The Committee has examined whether it seemed appropriate to subject income from the leasing of ICSE to taxation at source because a bilateral treaty provides for it in the case of royalties for copyrights, patents, know-how, etc. (royalties proper). In this connection a strong majority of the Committee noted that:

i) Income derived from the leasing of ICSE is usually of a different nature than royalties proper for which Article 12 of the 1977 OECD Model has been primarily designed, i.e. income from intangibles with a substantial intellectual content (see, however, paragraph 21 below);

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ii) Article 12 of the OECD Model has, in the same manner as for royalties, recommended a zero-rate of tax at source in the case of income from the leasing of ICSE, in order to give to such income additional protection from taxation in the country of source. The intention was not to recommend, for income from the leasing of ICSE, the levying of any tax in the country of source, even where double taxation treaties provide for such a tax on royalties generally;

iii) When extending taxation at source of royalties proper to income from leasing of ICSE, such income would be subject to taxation on a *gross* basis; this might easily result in an excessive tax, as expenses of the lessor (including depreciation or costs of financing the acquisition of the assets leased) are disregarded, and the tax at source may not be fully credited in the country of residence, where income is taxed on a *net* basis. Although relevant to royalties of any kind, these considerations are especially important in the case of the leasing of industrial equipment;

iv) Taxation on a gross basis would occur only in the absence of a permanent establishment: in the case of a permanent establishment, Article 7, in connection with paragraph 5 of Article 12, would lead to taxation on a net basis; thus, paradoxically, taxation where a permanent establishment does not exist might be far more burdensome than if one did;

v) Taxation would occur in those States which consider the residence of the payor as the source of the royalty even if the equipment is not situated in that State.

19. The large majority of the Committee agreed that the extension of taxation at source of royalties proper to income derived from the leasing of ICSE seemed inappropriate. In addition, this view is shared by a number of those countries who had entered a reservation on the zero rate on royalties provided by Article 12 of the OECD Model Convention.

20. The Committee therefore recommends that income from ICSE should not, in bilateral conventions, be included under an Article on royalties.

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c) Specific cases

21. Two groups of specific cases should be noted.

i) In some cases the rent for ICSE may include an element of royalty proper. A case in point would be the lease of a machine used to manufacture products protected by a patent, where the rent covers both a consideration for the lease of the machine as such, and a royalty for the use of the patent. It is clear that in such cases, when the view described in paragraphs 16 to 18 above is accepted, the rent would be treated as a royalty proper to the extent it could be attributed to the use of the patent. Cases of this kind are probably rare and should be decided upon on a case by case basis;

ii) It was pointed out that not all leases of tangibles might be covered by the wording of paragraph 2 of Article 12. In fact, a minority of the Committee argued that, for instance, in the leasing of containers, the service element is economically more important than the mere putting at disposal of the tangible asset and, therefore, that Article 12 of the OECD Model would not apply to it.

22. The Committee acknowledged that these were borderline cases which should be settled bilaterally by mutual agreement. The example of leasing of containers shows that reaching a multilateral agreement is difficult even among OECD countries. It is a further advantage of the proposal set out in the foregoing section that it avoids all such difficulties.

IV. SUGGESTIONS FOR A REVISION OF THE 1977 OECD MODEL

23. The above observations of the Committee suggest that the inclusion of income from the leasing of ICSE in the royalty definition would not be advisable, could lead to misinterpretation of the objectives of the OECD Model and may even create difficulties in the negotiation of bilateral tax treaties. The Committee therefore recommends that Article 12 and/or its Commentary should be amended when the OECD Model is next revised. There seem to be at least three possible alternatives:

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a) To delete the words "or for the use of, or the right to use, industrial, commercial or scientific equipment" in paragraph 2 of Article 12 of the OECD Model;

b) To propose a special clause to be inserted, e.g. in the texts of additional protocols, making clear that Article 7, not Article 12, applies;

c) To explain the situation and the view of the Committee on Fiscal Affairs in the Commentary on the OECD Model.

The Committee's preliminary view is that the first alternative would be preferable.

24. The Committee also noted that a few countries could not share the conclusions of the present report and would like to remain free to subject income from the leasing of industrial, commercial and scientific equipment to a withholding at source in all cases. It would then be appropriate to deal separately with such income, and to provide for taxation at source at a lower rate than that applicable to royalties generally.

V. CONCLUSIONS

25. Taking the foregoing into account, the Committee suggests that the Council may wish to take note of the present report and:

a) Recommend Member countries, when applying existing bilateral conventions providing for taxation at source of income from leasing of industrial commercial or scientific equipment, to take account of the considerations set out in Part III of the present report as a guideline:

i) for interpreting Articles 5, 7 and 12 in borderline cases, or

ii) for granting relief where possible, either under Article 25 of the OECD Model Convention or under their domestic laws, in order to avoid double taxation or other harmful effects caused by the taxation at source of such income;

b) Recommend Member countries, when concluding new conventions or revising existing ones, not to subject such income to provisions under which royalties may be subject to taxation at source.

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26. The Committee suggests that the Council may wish to instruct it to take into account suggestions made in this report with respect to the scope of Article 12 when the OECD Model Convention is next revised.

27. The Committee also suggests that the present report be published and given appropriate publicity by the OECD Secretariat.

VI. RESERVATIONS

28. *Australia* reserves the right to tax income derived from the leasing of industrial, commercial or scientific equipment as royalties under its double taxation agreements, where such income, under Australian law, has a source in Australia.

29. *Canada* reserves the right to subject income derived from the leasing of industrial, commercial or scientific equipment to a withholding tax at source at a rate equal to that on royalties.

30. *Italy* reserves the right to continue to include income derived from the leasing of industrial, commercial or scientific equipment in the definition of royalty as provided for in paragraph 2 of Article 12 of the 1977 Model Convention.

31. *Japan, New Zealand, Portugal, Spain and Turkey* reserve the right to tax at source income from the leasing of industrial, commercial or scientific equipment.

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Annex

PROBLEMS ARISING UNDER ARTICLES 5 AND 7 OF THE OECD MODEL WITH RESPECT TO EQUIPMENT LEASING

Comments	Activities in State S	
	Does P.E. exist?	Attribution of profits
A. Leased equipment operated, serviced, inspected and maintained by lessor's own personnel stationed permanently in State S	Yes, at least if these activities are carried out under the direction, responsibility and control of lessor	Attribution of the full profit of leasing deducting expenses of the head office
B. Leased equipment operated, serviced, inspected and maintained wholly by lessee	Generally no	None
C. Leased equipment operated, serviced, inspected and maintained by lessor by: a) own personnel stationed permanently in State R b) independent enterprises hired by lessor	No, if carried out under the direction, responsibility and control of lessee; otherwise disputable	If P.E. exists profits should be attributed for the leasing as such or only with respect to operation, service inspection and maintenance?
D. Leased equipment: — operated and serviced by lessee — inspected and maintained by lessor	Disputable, if inspection and maintenance are not under the direction, responsibility and control of lessee	If P.E. exists should profits be attributed to it only with respect to inspection and maintenance
E. Maintenance of an office in State S to be in contact with the market, conclude contracts, deliver the equipment, etc. but not participating in operation, servicing, inspection and maintenance of leased equipment	According to the principle of Article 5	Attribution of profits only for the services actually performed by the office *or* for the whole profit of leasing equipment in State S

State R = State of residence
State S = State of source

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THE TAXATION OF INCOME DERIVED FROM THE LEASING OF CONTAINERS

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I. INTRODUCTION

1. When adopting, on 11th April 1977, a Recommendation concerning the avoidance of double taxation, the Council recommended the Governments of Member countries to conform to the 1977 OECD Model Convention for the avoidance of double taxation with respect to taxes on income and capital, and instructed the Committee on Fiscal Affairs "to proceed to periodic reviews of situations where double taxation may occur, in the light of experience gained by Member countries, and to make appropriate proposals for its removal".

2. This report has been prepared by the Committee in that context, with a view to elucidating some of the issues related to the taxation of income derived from the leasing of containers[1] — whatever is the type of transportation of such containers — under the Model Convention or under bilateral treaties. The report also suggests lines for possible future action by Member countries in this field.

II. ECONOMIC BACKGROUND

1. General

3. The leasing of containers became an important activity during the 1970s. This was dependent on the "containerisation" of important parts of the world transportation system which took place in the previous decade. While in the first phase of this development, containers were generally owned by a carrier or ship-owner, in the second phase more and more containers were owned by separate enterprises and operated on a leasing basis. Today, container leasing enterprises (CLE) appear to own more than 50 per cent of the world container population[2].

4. This development took place because CLEs fulfil various functions in the complex environments of the world transportation system. Three functions can be clearly identified:

a) CLEs provide carriers and other participants with containers, thereby providing an essential asset for the transportation business;

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b) CLEs perform a clearing function where containers are in surplus at one point and scarce at others; the enterprises thus perform an important service for the world transportation system;

c) Leasing enterprises may participate in specific financial arrangements, e.g. in the case of fixed price buying options or full pay-out leases. They thus perform financial functions which are not necessarily essential to the world transportation system.

5. While all these functions are of relevance when considering a CLE, tax administrations are often concerned with some of these functions only, e.g. those performed by a specific establishment only having limited functions.

2. Business performances

6. The leasing of containers is a complex and world-wide activity. A single CLE normally handles tens of thousands of containers and may have to maintain more than 100 "depots" where its customers may pick up or re-deliver the containers.

7. The operation of such a vast "pool" of containers, their world-wide movements, the cash flows and other commercial operations involved is almost totally dependent upon electronic data processing. The computer systems — normally situated at the headquarters of the CLE — are therefore an essential element in operating, controlling and assessing its world-wide business.

8. Accordingly, the daily activities are for the most part highly centralised, though a vast network of "depots" exists. The contracts with customers are negotiated and concluded either by the leasing company or by a local agent or, in some cases, by the operator of the depot (the operator of such a depot may also conclude contracts with customers). A major problem confronting the industry is the unbalanced flow of containers which results in their accumulating in one place while there are shortages in others. Once more, this can only be solved by centralisation and computerisation.

9. For the purposes of analysis, three countries or groups of countries have to be distinguished:

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– The container leasing enterprise's *country of residence,* where this enterprise has the centre of its activities;

– *The countries of the various depots* between which containers move, being transported in an irregular way between different locations by a greater or lesser number of shipowners. The leasing enterprise may have specific installations in these countries, but it is more common for it to rely on wholly independent enterprises resident there;

– The *lessee's country* where a specific lessee has his residence or its head office; the leasing enterprise may or may not have a permanent establishment in this country for the conclusion of contracts or for the handling of containers reaching that country or for both.

3. Activities

10. The leasing of containers may assume various forms. The following seems a fair description and uses a terminology generally accepted in the industry:

i) Trip leases for one or more trips, including:
  – Single-trip leases: leases from one depot to another,
  – Round-trip leases: leases from one depot for a round-trip back to the same depot or another depot in the same country,
  – Possible "mixed" leases, e.g. single-trip leases with a round-trip option;

ii) Short-term leases, for terms of less than one year, including:
  – Fixed minimum leasing time with open termination (e.g. minimum time 20 days, 3 months, 6 months, 9 months),
  – Minimum leasing time with renewal option (e.g. for 6 months, 12 months, 2 years, 3 years, etc.),
  – Fixed leasing time (e.g. 30 days, 3 months, 9 months);

iii) Long-term leases for leasing terms of one year or more, including contracts with:
  – Minimum leasing time with open termination,
  – Minimum leasing time with renewal option,

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- Minimum leasing time with premature cancellation option after 4, 3, 2, 1 years,
- Fixed-price buying option or full pay-out leases (at the end of the leasing time the container automatically becomes the property of the leasing customer).

11. Leasing enterprises may also negotiate special agreements with their customers for leasing containers in certain operating areas, from and to certain depots, in certain quantities and at certain rates which are fixed for a specific period.

12. Generally speaking, rules of taxation are the same for all these activities. Problems may however arise where containers are leased in the context of specific financial arrangements or where special container equipment is being leased for exceptional purposes (e.g. atomic fuels transport). These cases are not dealt with in this report, but reference is made to the Committee's report on "The taxation of income derived from the leasing of industrial, commercial or scientific equipment".

III. RULES FOR THE TAXATION OF INCOME DERIVED FROM THE LEASING OF CONTAINERS UNDER THE OECD MODEL CONVENTION

1. Effects of existing rules

13. Income derived from the leasing of containers, being income from the leasing of industrial equipment, falls in the first instance under Article 12 (Royalties) and, where it is received by an enterprise, falls also within the scope of Articles 7 (Business profits), and 5 (Permanent establishment). Article 12 contains a specific rule which provides for no taxation in the State of source except where royalties are attributable to a permanent establishment in that State. As a consequence, enterprises leasing containers are, generally speaking, taxable in the State of residence. A number of countries have, however, entered a reservation on the exemption at source provided for under Article 12.

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2. Options for a future revision of the Model Convention

14. The Committee has studied three different possibilities. A first possibility would be for the profits from the leasing of containers to be subjected to a limited tax at source where a bilateral treaty provides for such a tax on royalties in general. The Committee, in its large majority, found that this alternative would create major difficulties for the leasing of containers and for the international transportation system generally. It therefore rejected this solution. In connection with this, reference is made to the report on the leasing of industrial, commercial or scientific equipment, which recommends the general exclusion of income from leasing of these assets from the scope of Article 12 of the OECD Model Convention.

15. Another possibility would be for profits from the leasing of containers to be, in the future, only subject to Articles 7 and 5 of the OECD Model. In order to avoid certain difficulties which have arisen from the fact that some countries have entered reservations on Article 12 and levy taxes at source on royalties under bilateral conventions, (cf. Part V below), income from container leasing should be clearly excluded from the scope of Article 12. This would be in line with the OECD Model as such income is derived from a business activity. It seemed adequate to subject enterprises leasing containers to taxation in States where they have permanent establishments, and to avoid double taxation in the State of residence by using the methods set out in Articles 23A and 23B of the Model. Any practical difficulties or doubts for applying Articles 7 and 5 of the Model Convention might be sorted out by an adequate interpretation of these Articles and by having recourse to the mutual agreement procedure (Article 25). The principles developed in Part IV of this report would in fact form the basis for this approach. Such a solution met with a large support in the Committee.

16. Finally, the profits from the leasing of containers might be treated on a similar basis as profits from the operation of ships in international traffic and be taxed in accordance with Article 8 of the OECD Model, i.e. only in the State in which the place of effective management of the enterprise is situated (cf. paragraph 10 of the Commentary on Article 8). Such a solution is premised on the view that, in the absence of such a rule, the requisite allocation of rental income among various source States is inherently subject to the application of inconsistent allocation rules in those States and to arbitrary approximations,

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which can lead to the imposition of a prohibitive multiple tax burden. Exemption at source ensures that a tax will be imposed only where the overall leasing operations of an enterprise are profitable. Granting the tax right to one State eliminates the need to develop complex rules for defining the profits to be taxed by each State, and the State in which the lessor is resident stands in the best position to account for the income and expense of a container leasing enterprise.

17. However, the Committee observed that, from the standpoint of principle, the problems raised by the taxation of income from container leasing differed little from the familiar problems that arose for implementing the principles of the OECD Model. A substantial majority of countries considered that container leasing was basically no different from the leasing of other industrial or scientific equipment, even if the containers were not used in the country of the first lessee. It would thus be unfortunate to create a precedent here that was contrary to the customary rules for taxation of this type of income. The Committee therefore does not recommend submitting container leasing income to the rules of Article 8, which might, however, be examined in the light of new experience when the OECD Model is fully revised. Pending this revision, countries which favour submitting income from container leasing to the rules of Article 8 are free to suggest this solution when entering into bilateral negotiations.

IV. APPLICATION OF THE OECD MODEL CONVENTION

1. General

18. While the OECD Model is in itself clear, it raises a number of practical problems.

a) A first problem relates to the question of whether the leasing enterprise has permanent establishments within the meaning of Article 5 of the OECD Model. This may be unclear, e.g. in States where depots are situated, when the activities of the enterprise are often so limited that it is difficult to establish whether or not these activities, taken in themselves, would qualify for exemption under paragraph 4 of Article 5 of the OECD Model. Likewise it may be doubtful whether there is or is not a permanent establishment in the State of a customer (e.g. carrier

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or other user of the containers) by the mere fact of the presence of containers there;

b) Determining which profits of an enterprise leasing containers are attributable to a permanent establishment qualifying as such under Article 5 of the OECD Model may be even more difficult.

2. Guidelines for the application of Article 5 of the OECD Model (existence of a permanent establishment)

19. The Committee decided to approach this problem by examining some basic cases often encountered in the operation of CLEs. The solutions proposed could constitute guidelines for policy-making and mutual agreement procedures regarding the application of bilateral treaties. This does not mean, of course, that the specific circumstances of each case should not be taken into account.

Case A: Simple depots

i) Case description

20. The leasing enterprise rents containers all over the world. The lessee may surrender his container to any one of more than 100 depots in 40 countries. Most depots are owned and operated by independent enterprises taking over the containers and delivering them to their new customers. The depot operator generally receives a lump sum plus a special fee depending on the actual use of the depot and the services actually performed. The operation of the depot will normally require the following activities:

- Being notified of the arrival of containers which will be put at the disposal of the leasing enterprise;
- Notification of demands for containers;
- Managing a deposit for containers which have to be kept at the port under the disposition of the leasing enterprise;
- Handling of containers, namely receiving them from shipping enterprises or delivering to them on demand;
- Control of containers returned to the enterprise or delivered by it;

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– Technical inspection establishing whether them is damage, informing the CLE in case of damage and auxiliary services to provide for repair through third parties.

The depot is normally used by several enterprises including container leasers, auto transporters, ocean carriers.

ii) Guidelines

21. The Committee suggests that a simple depot, as described above, does not normally give rise to a permanent establishment if operated by an independent enterprise. In cases where the operator serves as a depot for only one enterprise it might, however, be necessary to examine whether an operating depot as described in Case D below does not in fact exist.

22. A simple depot might, however, be deemed a permanent establishment in the meaning of Article 5, paragraph 1 of the OECD Model if owned and operated by the CLE itself. A strong majority of the Committee holds, however, that in these circumstances the establishment should not generally be deemed to be a permanent establishment under Article 5, paragraph 4 of the OECD Model. This appears to be justified because:

– Many activities of such establishments come under the wording of subparagraphs *a)* and *b)* of Article 5, paragraph 4;
– The remaining activities are generally so limited as to be regarded as being of an auxiliary character within the meaning of subparagraph *e*) of paragraph 4;
– The activity of a depot constitutes only a small part of that of the enterprise as a whole and it would hardly be possible to individuate more than an insubstantial amount of profits attributable to it;
– Consequently, the overall activity resulting from the combination of activities falling under subparagraphs *a), b)* and *e)* is of an auxiliary character within the meaning of subparagraph *f)* of paragraph 4.

23. The Committee therefore recommends applying the rules for exceptions provided in Article 5, paragraph 4 of the OECD Model in the cases mentioned above.

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Case B: Depot-Agence

i) Case description

24. The lessor maintains agencies which rent the containers to customers approaching them. The contracts are normally signed by the agent who will closely observe general guidelines, special instructions or specific orders of the lessor, as the case may be. The agent may be fully independent of the lessor and serve more than one enterprise leasing containers. There may, however, also be closer relationships with the lessor.

ii) Guidelines

25. Where a depot-agence is owned and operated by a third party having an independent status and acting in the ordinary course of its business, it is not to be deemed a permanent establishment under Article 5, paragraph 6 or the OECD Model. Otherwise, it should be deemed a permanent establishment under Article 5, paragraph 5 of the OECD Model.

26. After careful consideration the Committee, in its vast majority, recommends granting the status of an independent agent if the operator is dealing with more than one enterprise, since the criteria described in paragraph 35 of the Commentary are met in such circumstances. Other cases should be examined on a case by case basis in the light of paragraphs 36 and 37 of the Commentary on Article 5.

27. Where the depot-agence is owned and operated by the CLE itself, the Committee considers that a permanent establishment clearly exists.

Case C: Inspection and repair

i) Case description

28. Containers deposited in a depot are inspected and, in the event of unacceptable damage, repaired on request of the lessor. Normally, this will be done by independent inspectors and/or repair shops (normal technical inspection stating whether there is any damage at all will normally be carried out by the

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depot operator). In some cases the lessor may own a repair shop in ports of special importance.

ii) Guidelines

29. The Committee is of the opinion that inspection and repair through independent enterprises does not constitute a permanent establishment. Even in the special cases where this might be regarded as a fixed place of business, paragraph 4 *e)* and *f)* should lead to the conclusion that there is no permanent establishment.

Case D: Operational branches

i) Case description

30. The lessor maintains an office in a port to take care of all its operations in the region; this would include notification of arrival and demands, operating the depot for containers, handling them and carrying on inspection and repair. It would likewise include, under the supervision of the head office, the lessor's marketing and the acquisition of contracts. Such operational branches appear to be set up principally in order to co-ordinate the CLE's activity on a regional basis.

ii) Guidelines

31. In these cases, the application of Article 5 of the OECD Model will usually lead to the existence of a permanent establishment.

Case E: Mere presence of containers

i) Case description

32. Containers of the lessor are used in the country by, or on behalf of, the lessee or a third person.

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ii) Guidelines

33. It is clear that in such a case the mere presence of the containers does not constitute a permanent establishment as there is no fixed place of business nor any activity performed by the lessor.

3. Guidelines for the application of Article 7 of the OECD Model (profit allocation)

34. The guidelines for the application of Article 5 of the OECD Model as set out above will prevent the CLE's profits from being split up excessively. The Committee agreed therefore that relatively general guidelines would meet the situation from a practical point of view.

35. Only in exceptional cases would a simple depot and a depot-agence [Cases A and B] be regarded as permanent establishments. Allocation of profits should be based on the fact that the permanent establishment in these cases is not active in the business of leasing containers, but rather rendering limited services. Its profits, therefore, should be determined by:

a) The amount a distinct and separate enterprise would receive under similar conditions as a consideration for holding a depot (e.g. a lump-sum payment and/or a special fee dependent on the actual use of the depot);

b) Less: expenses incurred for the purposes of the depot;

c) Less: an appropriate share of the headquarters" expenses including executive and general administrative expenses (if not otherwise taken into account).

36. Problems may be different in the case of an operational establishment [Case D]. In calculating the profits attributable to it, functions between such a permanent establishment and the headquarters of the lessor should be carefully weighted. Expenses including executive and general administrative expenses incurred at the headquarters should be deducted. This would cover, *inter alia*, expenditure for financing containers, depreciation and management.

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37. In Cases A and B, the profits to be allocated to the permanent establishment would normally be small. This can only be ascertained at the headquarters. States taxing such profits might, under a mutual agreement procedure, rely on the amounts determined in the headquarters" books and the country in which the headquarters is located might, in such a case, undertake to examine these amounts when auditing the CLE and to advise the other State in the case of some serious deficiency being ascertained.

V. PROBLEMS REGARDING ARTICLES ON ROYALTIES IN BILATERAL CONVENTIONS

38. The application of articles on royalties in bilateral conventions does not give rise to difficulties as long as they provide for no taxation at source on payments (rents) for container leasing. This would be in line with Article 12 of the OECD Model which exempts royalties (including rents) for scientific, industrial or commercial equipment from taxation in the State of source.

39. There are, however, bilateral conventions which provide for a limited tax at source on royalties. Reference is made in this respect to the report on the report on the taxation of income derived from the leasing of industrial, commercial or scientific equipment, the conclusions of which also cover income from the leasing of containers. In that report, the Committee takes the view that income from leasing should not be subjected to taxation at source and, therefore, be excluded from the scope of provisions corresponding to Article 12. Furthermore, it recommends making appropriate amendments to that Article or the Commentary thereto in an eventual revision of the OECD Model.

40. The question may be asked whether it is cogent to apply the provision of bilateral conventions providing for a tax at source on royalties (including rents on industrial, commercial or scientific equipment) to rents from the leasing of containers. These bilateral conventions normally use the language of Article 12, paragraph 2 of the OECD Model in defining the term "royalties". No consensus on this question could be reached in the Committee.

a) One line of argument was that the leasing of containers is presently, according to the strict wording of such treaties, always to be regarded as "leasing of ... industrial equipment". This might be supported by the fact that the Commentary on Article 12 of the OECD Model appears to

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follow this line. As the wording of the Model is quite clear, only a change in the Model could alter the situation;

b) On the other hand, it has been argued that the economic reality of container leasing goes far beyond the simple lease of a tangible good. The advent of container leasing was not due to the wish of carriers to rent rather than own containers. The economic reason underlying this development was rather the wish to be able to pick up and leave a container wherever it is convenient for the carrier to do so. This is only made possible by the fact that the leasing enterprises have built up a world-wide network of installations and perform a kind of clearing function where there is a surplus of containers at one point and a scarcity at others. The enterprise thus performs a service in balancing supply and demand for containers on a world-wide scale; the lease is an instrument rather than an ultimate end in itself. As Article 12 of the OECD Model deals only with situations where the lease is the ultimate end, it is not applicable to container leasing.

41. While the majority of countries adhered to the first interpretation, a minority preferred the second alternative as a functional interpretative approach. The Committee as a whole stated that the problem was due to the fact that bilateral conventions deviate from Article 12 of the OECD Model and that a common solution could not be envisaged. However, it recommends that Contracting States make use of the mutual agreement procedure, where this is possible, in order to avoid double taxation or harmful effects caused by taxation at source on royalties.

42. In this context, difficulties in the application and in the interpretation of conventions which may arise where taxation at source may be imposed on payments for the leasing of containers have been considered by the Committee. Reference is made to paragraphs 16 to 20 of the above-mentioned report on the leasing of industrial, commercial and scientific equipment.

VI. CONCLUSIONS

43. The Committee has come to the conclusion that the approach adopted in the Model Convention does provide for satisfactory solutions and t hat there is no reason to depart from principles applicable to other enterprises. In order to

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facilitate the application of these principles to container leasing enterprises and having due regard to what is said in Part V above, the Committee suggests that the Council may wish to:

a) Recommend Member countries, when applying existing bilateral conventions to enterprises leasing containers:

i) To take account of the considerations set out in Parts IV and V of the present report for the interpretation of Articles 5, 7 and 12 of the OECD Model Convention,

ii) To resolve administrative difficulties of application of these Articles by way of mutual agreement,

iii) To grant relief where possible, either under Article 25 of the OECD Model Convention or under their domestic laws, in order to avoid double taxation or other harmful effects caused by the taxation at source of such income;

b) Recommend Member countries, when concluding new conventions or revising existing ones, not to subject income from the leasing of containers to provisions under which such income may be subject to taxation at source.

44. The Committee suggests that the Council may wish to instruct it to take into account suggestions made in this report regarding the scope of Article 12 when the OECD Model Convention is next revised.

45. The Committee also suggests that the present report be published and given appropriate publicity by the OECD Secretariat.

VII. RESERVATIONS

46. *Australia* reserves the right to tax income derived from the leasing of containers as royalties under its double taxation agreements, where such income, under Australian law, has a source in Australia.

47. *Canada* reserves the right to retain a 10 per cent rate of tax at source on income derived from the leasing of containers. However, Canada would be prepared to agree to apply, on a reciprocal basis, the rules of Article 8 to income derived from the leasing of containers used in international traffic.

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48. *Italy* reserves the right to continue to include income derived from the leasing of containers in the definition of royalty as provided for in paragraph 2 of Article 12 of the 1977 Model Convention.

49. *New Zealand*, *Portugal* and *Spain* reserve the right to tax at source income from the leasing of containers.

50. *Turkey* reserves the right to subject income from the leasing of containers to a withholding tax at source in all cases. In case of the application of the Articles 5 and 7 of the Model Convention to such income, Turkey would like to apply the permanent establishment rule to the simple depot, depot-agence and operational branches cases.

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NOTES AND REFERENCES

1. Shipping, inland waterways, air freight, rail or road transportation, etc.

2. For the purpose of this report, container leasing enterprises do not include shipping companies exploiting containers as an activity of an auxiliary character, in the meaning of Article 5 (paragraph 4) of the 1977 Model Convention (cf. paragraph 10 of the Commentary on Article 8).

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THIN CAPITALISATION

(adopted by the OECD Council on 26 November 1986)

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I. THE PROBLEM STATED

A. Options in corporate financing

1. The methods by which companies are provided with their capital affect the taxation of corporate income. This arises because the calculation of the taxable income of the company and also that of the persons providing the capital are both affected by the way in which that capital is provided. It is also the case that in countries which levy a tax on net wealth or capital, the way in which a company is financed may have a direct effect on the taxable capital of the company, since debt is usually deductible in arriving at the taxable amount. This report, however, deals only with the taxation of corporate income and profits.

2. There are broadly two ways in which a company may be financed. One is by the issue of shares in the equity of the company and the other is by borrowing. This report is mainly concerned with the taxation problems which may arise from the balance between these two methods of financing. These problems are sometimes referred to, though rather loosely, as problems of 'thin capitalisation'.

3. The differences between loan capital and equity capital may seem obvious but it is nevertheless pertinent to spell them out briefly. First, there are legal differences. The owner of shares is normally entitled to a proportion of the profits of the company. He is not normally entitled to recover his original investment except on the dissolution of the company and the risks he undertakes are normally limited to the amount of equity capital which he has subscribed or has undertaken to subscribe. He would usually however be able to sell his shares and thus recover the current value of his investment, which might be more or less than the amount he originally invested. The provider of loan capital, on the other hand, is normally entitled to a periodical amount of fixed interest on the amount lent, regardless of what profit, if any, is made by the company. He is normally entitled to recover his investment after a certain period. He may in some circumstances be able to make an earlier sale of his rights to another person, at which point, as with shares, he may recover either more or less than his original investment, although the factors affecting the sale value of a bond may well be different from those affecting the sale value of a

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share. The provider of a loan risks, as does the shareholder, the loss of his entire investment.

4. Second, there is an economic difference. The fact that loan creditors can look to a periodic fixed reward for the use of their loan capital, and to the return of that capital itself at the end of the loan period, while the subscribers of equity capital (or those who purchase their shares) can be expected to wait for their reward, within reason, until the directors of the company decide that profits can be spared for distribution rather than reinvestment, means that a company which is mainly financed by equity capital can operate in a very different way from one which is mainly financed by loans. For example it may be able to wait longer for the expected profits to materialise and may have a better prospect of receiving trade credits from suppliers, etc.

5. Perhaps the most important difference from the tax point of view is the fact that equity investment is designed to produce a return for the investor in the form of a distribution of taxable profits while the return on a loan investment is, for the payer, an expense which has to be met before the profits can be established.

B. The choice of financing and the implications for taxation

6. In practice companies are frequently financed partly by equity contributions and partly by loans. The proportion of a company's capital which is financed by each method may well be determined by considerations which arise from economic or commercial necessity or desirability and have nothing to do with tax, and, on this basis, tax authorities have generally tended, in the absence of contrary indications, to regard the way in which a company is financed, as primarily a matter for the judgement of the parties concerned.

7. As a consequence of the fundamental difference between loan and equity capital, however, the tax treatment of a company and the contributors of its capital also necessarily differs fundamentally according to whether the capital is equity or loan capital. As already pointed out, this may obviously be the case where the company's capital is itself the subject of taxation. With respect to the taxation of its income or profits, the basic difference is that the shareholder's reward — the distribution to him of profits, usually in the form of a dividend — is not deducted in arriving at the taxable profit of the company.

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Indeed, this follows from the fact that what the shareholder receives is a distribution of the profits themselves. Interest on a loan, however, is usually allowed as a deductible expense in computing the taxable profits of the company paying it (being effectively if not specifically regarded as an expense of earning those profits).

8. Thus, in the national context, the rewards of equity financing are first taxed in the hands of the company as profit as well as being subsequently taxed in the hands of the shareholders as dividends, though the economic double taxation may be mitigated (most commonly by giving a credit or some other relief to the shareholder in respect of the company's tax). In the international context, the company's profits are similarly likely to be subjected to tax in the country of source while shareholders also suffer source country tax on the dividend. In both the national and the international context, the shareholder's tax is likely to be withheld by the payer but, in the international context, the amount withheld is more likely to represent the shareholder's final tax liability to the tax of the source country on that income (though rate of the withholding tax may be limited under the equivalent in a bilateral treaty of Article 10 of the 1977 OECD Model Double Taxation Convention — hereinafter referred to as the "OECD Model", or "the Model"). In the case of loan financing on the other hand the payments of interest (except for excessive interest treated as constructive dividends) would effectively be free of corporate income tax. In both the national and the international contexts the lender is the only person likely to suffer tax on interest payments. In the international context, interest payments, like dividends, are often subjected to a withholding tax, though the rates of such taxes may, under tax treaties, be reduced (often to rates lower than those which would be charged on dividends) or the payments may be exempted from tax altogether.

9. In the international context further complications may arise, for both dividends and interest, by the tax treatment of the payments in the country of residence of the recipient, including the application of any provisions for relieving double taxation. Although some countries generally relieve double taxation by exempting income and others generally relieve it by crediting foreign tax against their own tax, this difference is not always important in the case of interest and dividends because most countries use the credit method in relation to both types of income. However, the distinction between interest and dividends is important in this context in some circumstances for two reasons:

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first, the rate of foreign tax creditable may differ according to whether the income is of the one or the other kind; second, a special relief is often given to a parent company which receives dividends from a subsidiary under what is sometimes described as a "parent/subsidiary regime", and this kind of relief is not given in the case of interest received by a parent company. Thus, while credit for the tax of the country of source in relation to interest is always limited to the tax charged on the interest itself, credit for source country tax in respect of dividends may sometimes extend under a "parent/subsidiary regime" to a part of the tax charged on the appropriate proportion of the underlying profits out of which the dividend was paid — credit for underlying tax, or "indirect credit". Similarly, countries which ordinarily operate the exemption method will generally, under a "parent/subsidiary regime", simply exempt a dividend rather than relieve its double taxation by way of credit. For a discussion of "parent/subsidiary regime" — see paragraph 42.

10. The broad effect of these two different tax treatments is that it may sometimes, from the tax point of view, be more advantageous to a particular combination of company and contributor to arrange the financing of the company by way of loans rather than by way of equity contributions. Less frequently it may happen that in particular cases a tax advantage arises from transferring funds as a distribution of profits rather than as a payment of interest. However, tax authorities, for the most part, have been more concerned hitherto about the tax advantages deriving from the use of loan capital rather than equity capital and the fact that these may induce the parties concerned to provide what is essentially equity capital in the form of a loan (sometimes described as "hidden capitalisation"). Tax motives — it is worth repeating — may not be the only factor leading to the decision of a multinational enterprise to use loan capital rather than equity capital in any particular case. The motive may be to preserve the mobility of funds: it may well be easier to repay a sizeable loan than to pay an equivalent amount in dividends, and such flexibility may seem desirable even where the underlying intention is to provide long term capital; there may be a need to ensure that capital is not unnecessarily tied up in one country if for example there is a possibility that, at some not too distant period, it can be more profitably used elsewhere or may be needed to meet an urgent and unexpected demand for funds. Other factors may also be relevant. Nevertheless, the desire to benefit from tax advantages may be the sole or most important motive in this context and tax authorities must therefore consider, in

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any particular set of circumstances, whether or not this should influence the way they regard the use of a particular method of financing.

11. "Hidden capitalisation" (more strictly perhaps "hidden equity capitalisation") may manifest itself in different ways. One such manifestation may be in the form of what is sometimes described as "hybrid financing". It is necessary at this stage to explain briefly what is meant by this term. It derives from the fact that the broad distinction between debt financing and equity financing, which is mentioned in paragraphs 2 to 4 above, may sometimes be blurred since, for example, creditors may at some stage be able to convert their debt into a participation in the equity of the company, or the interest which they are entitled to receive may be closely dependent on the profits made by the company. In such situations it is not always easy to classify the financing as purely debt finance or purely equity finance. As a result, what is essentially equity capital may possibly be disguised as debt. But the use of a hybrid type of financing does not inevitably mean that hidden equity capital is present. Nor is hybrid financing the only form which hidden capitalisation can take.

12. A description of various indications that hidden capitalisation may be present is contained in paragraphs 75 and 76 below. One of these should be mentioned at this stage however since the way in which it is very often described — i.e. as "thin capitalisation" — is often loosely used to describe the whole range of forms of hidden equity capitalisation, and is indeed, for brevity, so used in the title and frequently in the remainder of the body of this report. An indication of the possible presence of hidden equity capitalisation is a high proportion of debt to equity as a feature of the company's capital structure. In such a case the company is sometimes said to have a "high debt/equity ratio". It is not at all clear what relationship between debt and equity should be taken as the norm in deciding in any particular instance whether a company's debt is high in relation to its equity capital, but a high debt/equity ratio may be an indication of an effort to achieve tax advantages by a disproportionate use of debt. On the other hand, it may well be the consequence of decisions taken for purely commercial or economic reasons and not to obtain tax advantages. It constitutes therefore merely an indication, not proof, of hidden capitalisation.

13. Because the expression "thin capitalisation" is commonly used in its loose sense it has been so used in this report — i.e. to describe the whole range of hidden equity capitalisation. Where the text refers only to the specific

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phenomenon of a high debt/equity ratio or a high proportion of debt to equity, it uses these words and does not use the term “thin capitalisation”.

14. The possibility that tax considerations have been the main factor in influencing the capital structure of a company is perhaps more obvious where the capital is provided by majority shareholders or associated companies in a Group, but there could in some circumstances also be tax advantages for unconnected parties in contributing capital by way of a loan rather than as an equity participation.

15. The mechanism of hidden equity capitalisation may be exploited in a variety of ways by a multinational group. The basic advantage is that, other things being equal, a group consisting of a parent company in one country and a subsidiary in another may pay less tax in total if the profits of the subsidiary are transferred to the parent in the form of interest which is deductible in calculating the subsidiary's taxable profits than they would if the profits were transferred as a non-deductible dividend. The insertion into the group of an intervening holding company in a tax haven may combine this advantage with the deferral, perhaps indefinite, of any liability to tax on the income in the hands of the parent company. Alternatively, the insertion into the parent/subsidiary group of one or more holding companies in a country or series of countries linked by suitable tax treaties may enable the funds available to be transferred as tax free interest to the country where, for the group's purposes, they can be most usefully employed. If it should at some stage become more advantageous for the original profits to be transferred as a dividend, the capital structure may well permit the payment of a very large dividend (notwithstanding that the basic equity capital is very small) and it may be possible for interest payments to be waived at the same time. The mechanism of hidden equity capitalisation can thus be exploited to achieve a maximum of flexibility in the movement of funds within a multinational enterprise at a minimum tax cost to the enterprise as a whole. The tax cost of the various manoeuvres which are possible will however depend on the way in which the domestic tax and other laws of the countries concerned impinge upon them, and the presence or absence of appropriate relieving provisions in any tax treaties between them. Moreover, if for example the country of the parent exempts dividends from relevant foreign subsidiaries or gives the parent companies credit for underlying tax, it may be more advantageous for the subsidiary's profits to be transferred as a dividend.

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16. The transfer of profits in the form of interest may also be achieved by the use of abnormal or excessive rates of interest on funds which have unchallengeably been provided as loans, and this may also be a problem for tax authorities. It is sometimes dealt with by domestic law and also by provisions in tax treaties.

C. Tax policy aspects

17. Faced with the fact that the use of loan financing rather than equity financing may have consequences for tax revenue, those concerned with tax policy may have to consider a variety of factors in deciding what, if any, action should be taken in relation to particular cases of the use of loan financing. Some of these factors are detailed briefly below. It is not however the purpose of this description to indicate what importance should be given to each factor or what action should be taken in relation to them. At present, it is clear that they will be given different weights in different countries, and that there is no generally accepted international view about their relative importance or on the approach which should be adopted to the various problems involved:

i) The possibility that some investors may obtain tax advantages by artificially using loan finance rather than equity finance (for example the deduction of dividends in the form of artificial interest payments in the calculation of taxable profits, or the avoidance in full or in part of economic double taxation) whilst others may not have the same opportunity to obtain such advantages may make it necessary to consider whether the relevant law is adequately equitable between taxpayers or neutral between the choices of action available to them;

ii) The possibility that fiscal advantages gained by such artificial loan financing are increased if an associated lender is subject to tax at lower than normal rates or is exempt from tax (for example, by virtue of being a charity or a superannuation fund in some countries) or is able to offset the tax by reliefs (for example because of unused tax credits) or has no taxable profits (for example, because of the carry forward of losses) may make it necessary to consider whether the income is adequately taxed in total, taking the payer and recipient together;

iii) The possibility that foreign investors may obtain tax advantages in the country of source by artificially using loan rather than equity financing for associated enterprises may pose questions, for that country, about

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the adequacy of the total tax charged on the payment (taking into account any tax charged in the recipient's country of residence) and the adequacy of the share of that total tax received by the country of source. A wide variety of situations is possible, even, in the extreme case, double exemption (where for example the country of source exempts the payment from tax completely and for some reason no tax is charged in the country of residence of the recipient). Depending on whether the tax advantages in the source country derive from its domestic law or from a tax treaty, consideration may have to be given in that country to the introduction of amending legislation in the one case or the renegotiation of the treaty in the other;

iv) The possibility that tax advantages gained in the source country by a foreign investor from the artificial use of loan financing may be received through a base company situated in a tax haven may raise similar questions but in a possibly more acute form;

v) In any case where a payment is treated as interest for tax purposes instead of as a dividend as a result of an artificial use of loan finance, and this reduces the share of the total tax which is received by the country of source, that country may legitimately consider whether it is receiving an adequate share of the total tax;

vi) The possibility that the artificial use of loan finance rather than equity finance may benefit a foreign enterprise operating through a subsidiary while it does not benefit such an enterprise operating through a branch or other permanent establishment (because interest paid to another company is deductible while interest paid to the head office of the same enterprise is not deductible except in special cases such as banks) may raise the question whether the law in this context is adequately neutral between subsidiaries and branches;

vii) It is also possible to consider, from the viewpoint of neutrality, whether a foreign parent company which is unable to benefit from an imputation system because the tax credit is confined to domestic shareholders, may not try, by the artificial use of loan finance, to obtain an advantage equivalent to that provided by the operation of an imputation system to a domestic parent company;

viii) The possibility that the capacity to derive tax advantages from the artificial use of loan capital may overbalance the scales against equity capital, and may even in consequence worsen the position of trade

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creditors in general or undermine the stability of national or international investment, may also need to be taken into consideration by the country concerned.

18. Where foreign investment is concerned, the action, if any, which is taken in the light of these or other relevant considerations by the source country of any relevant payment, may affect the tax revenue of the country of residence of the recipient of the payment. It is appropriate therefore to consider the ways in which tax treaties may be involved.

D. Scope of the report

19. The 1979 Report on "Transfer Pricing and Multinational Enterprises" dealt briefly with thin and hidden capitalisation in paragraphs 183 to 191 inclusive but it dealt with them only briefly because they were not central to the issues with which that section of the Report was primarily concerned. In that section the main problem for consideration was how interest payments should be dealt with — i.e. the transfer pricing of loans. Thin or hidden capitalisation rules deal however with a preliminary question — i.e. whether or not the payment concerned derives from a loan. This preliminary question was left for possible detailed treatment at some later date. The purpose of this report is to clarify some of the main issues involved. It does not seek to define for international purposes acceptable proportions of debt to equity capital. Still less does it seek to harmonise the domestic laws of OECD Member countries in the context of thin or hidden capitalisation. Its purpose is simply to consider the elements of these phenomena, to study the international effects of the varying national approaches to them, to note how the relevant national legislation may be affected by tax treaties (in particular those adopting the provisions of the OECD Model Convention) and to study how far unjustifiable juridical or economic double taxation may be relieved, and how bilateral treaties might be drafted so as to avoid such double taxation.

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II. COUNTRY PRACTICES

20. This section examines briefly the ways in which the domestic legislation of Member countries deals with the problems arising from thin or hidden capitalisation or other situations facilitating the transfer of profit under the guise of interest. Few countries, however, have a comprehensive set of rules or practices in this field.

21. As already indicated, in normal circumstances there is usually no difficulty about accepting that a payment which is ostensibly interest is in fact what it claims to be. But in some circumstances tax authorities feel obliged to question whether the form of the payment reflects its true nature. In some countries therefore there are specific rules either to deem certain interest to be a distribution of profit or to deem the relevant capital to be an equity contribution and not a loan. These rules normally apply only or mainly in the context of enterprises making payments to foreign associated enterprises.

A. Excessive payments of interest

22. Where a payment between associated enterprises is unchallengeably interest but the rate of interest charged is higher than the arm's length rate, the question of thin capitalisation does not in strictness arise but the situation is one in which it may be possible to regard the excess interest as effectively a transfer of profit (see Article 9 and Article 11(6) of the Model). Some countries therefore, in addition to refusing a deduction for the excess interest in such cases, would also treat it as a dividend. But this is not a universal practice.

B. Hybrid financing

23. Where the nature of the financing is, on the face of it, not clearly either debt or equity, rules may be necessary to decide the issue. Such cases of "hybrid financing" may include participating loans (i.e. loans where the interest payable depends in whole or in part on the profits of the borrowing enterprise) or convertible loans (i.e. loans which can at some stage entitle the lender to exchange his right to interest for a right to a share in profits) or in some cases sleeping partnerships, or securities where either the right of ownership or the

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rights attaching to the securities themselves are closely connected with the ownership of shares in the same company. Country practice is not uniform. Participating loans are sometimes, but not usually, treated as equity contributions. Convertible bonds are usually treated as loan capital until they are actually converted but in some cases are automatically treated as equity. Sleeping partners may or may not be treated as shareholders.

24. Rules which have been introduced to treat interest arising from hybrid financing as a distribution of profit have, moreover, sometimes themselves been artificially exploited to give either debtor or creditor a tax advantage, creating a necessity for additional, often complex legislation[1].

C. Approaches to the treatment of interest as a distribution of profit

25. Where the nature of the financing is ostensibly debt and even where the rate of interest is not excessive and the nature of the financing is not hybrid, the laws in some countries, however, treat interest paid as a distribution of profit for tax purposes, under certain conditions, as a consequence of approaching the matter in one or other of a variety of ways. In the use of these approaches the emphasis on different factors or combinations of factors often varies from country to country.

i) General anti-abuse approach — arm's length principle

The basis of many of these approaches is to look at the terms and nature of the contribution and the circumstances in which it has been made and to decide, in the light of all the facts and circumstances, whether the real nature of the contribution is debt or equity. Some countries apply particular rules in this connection. Others would use more general rules if these are available, such as general anti-avoidance legislation, provisions against 'abuse of law', provisions allowing the substitution of substance for form, or enabling abnormal acts of management to be disregarded. Another example of this kind of approach may be described as an arm's length approach. Under this the decision is based on the size of the loan which would have been made in the arm's length situation. The underlying thought is that if the loan exceeds what would have been lent in the arm's length situation then the lender must be taken to have an interest in the profitability of the enterprise and his loan, or at any rate the excess of it over the arm's length amount, must be taken to be effectively designed

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to procure a share in the profits. Some countries in fact employ this particular kind of approach. Others think that it could be used in appropriate circumstances. A high debt/equity ratio would clearly be one factor to be taken into account in using any of these approaches but would not necessarily be the deciding factor. It does not appear that such approaches have been used very extensively in practice as a basis for treating interest as a distribution for tax purposes. The main difficulty in using any of these approaches is the absence of any clear guidelines as to what are the practices adopted by independent parties, and thus the difficulty of devising any consistent practice (where the parties to a suspected artificial use of loan rather than equity capital are in fact at arm's length, then evidence as to what is normal between other parties at arm's length may carry little weight in any case);

ii) Fixed ratio approach

In an effort presumably to overcome these difficulties some countries have adopted what may perhaps be described as a "fixed ratio" approach. Under this, if the debtor company's total debt exceeds a certain proportion of its equity capital, then the interest on the loan or the interest on the excess of the loan over the approved proportion is automatically disallowed or treated as a dividend. A few countries employ such a fixed ratio in relation to associated enterprises, usually in fairly restricted circumstances, as the sole determinant of the issue. Others use it as a safe haven rule, giving the taxpayer the option of showing that the relevant company's own debt/equity ratio is an arm's length ratio or is otherwise acceptable.

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III. RELEVANCE OF TAX TREATIES

A. The problems stated

General

26. When, in seeking to counter any tax advantages which the taxpayer may derive from thin or hidden capitalisation, or to protect the revenue against tax loss from these phenomena, tax law or practice treats a prima facie payment of interest as a dividend, the consequence of this treatment is usually to deprive the payer of a deduction for the payment and possibly also to apply, in connection with the payment, the rules which deal with dividends instead of those which deal with interest. Where the payment is to a non-resident the question then arises of how this adjustment is affected by any relevant tax treaty. Whether any particular bilateral tax treaty affects the issue will of course depend on the terms of that treaty. In the following paragraphs this report considers the questions which arise under treaties using the provisions of the 1977 OECD Model, with occasional reference to provisions which, though not in the Model, may in fact appear in a number of bilateral treaties. A number of articles of the Model may be of relevance and each of them is considered in turn.

Article 9 of the Model — arm's length principle

27. Article 9(1), in the case of associated companies where "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" allows "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" to be "included in the profits of that enterprise and taxed accordingly". The relevance and application of Article 9 in this context raises a number of complex issues. There are four main questions.

28. The first is whether Article 9 itself provides any rules to decide whether a payment which is prima facie interest should be treated as a distribution of profit, i.e. whether under this Article it is possible to deem the

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nature of the payment to be something other than interest. The Article is concerned with the adjustment of profits which have ostensibly arisen to one person but which, in the arm's length situation, would have arisen to another. It is not in terms concerned with the adjustment of distributions of those profits, or the definition of interest and distributions. The basic question seems to be therefore whether, in the arm's length situation, the interest which is deemed to have been a distribution of profit would have been a profit of the ostensible debtor, and, if so, whether Article 9 is apt to allow it to be attributed to him. Article 9 is clearly applicable in deciding the amount of any payment which should be regarded as deductible in arriving at the profits of one or other associated person, and thus in deciding the rate of interest which should be allowed in calculating the amount of the relevant deduction for the payment in arriving at the debtor's taxable profits. The question is whether part or all of the payment can be disallowed as a deduction under Article 9 on the grounds that, in the arm's length situation, it would have been a distribution of profit and thus not a deductible expense. An extension of this question is whether the disallowed payment can then be treated in all other respects as a distribution.

29. On the assumption that Article 9(1) does apply there is a further question as to how it applies — i.e. does it limit any adjustment made under domestic thin capitalisation rules to the amount necessary to bring the relevant taxable profits to the "arm's length" profit. In this context it is relevant to consider whether Article 9(1) is:

a) Restrictive or limitative in its scope (in the sense that it prohibits adjustments of profits in circumstances which are not strictly in accordance with the conditions which it enumerates — e.g. prohibits the adjustment of profits to an amount exceeding the arm's length amount); or is

b) Illustrative or exemplary (in the sense that it tends only to provide a "conventional" or "treaty" framework for adjustment of profits, and would not prevent a country from making, in accordance with its domestic law, an adjustment to the taxable profit which would bring it to an amount exceeding that which would correspond with the arm's length profit).

30. The "illustrative" interpretation would, it has been suggested, enable a country to make adjustments to profits on the basis of its domestic legislation

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without having to demonstrate that the conditions of Article 9 were being complied with, provided that it was clearly understood that the country would adjust only the profits of its residents and that the adjustments would not be contrary to any other express provision of the relevant tax treaty.

31. If, in principle, a deduction can be refused under Article 9(1) on the grounds that the payment would be a distribution if in similar circumstances it was paid to a person at arm's length, there is nevertheless a third question. This is whether, in applying Article 9, the tax authority

a) has to be governed in deciding on the nature of the payment by other definitions of dividends and interest contained in the Model, i.e. those in Articles 10 and 11 respectively; or

b) may, under Article 3(2) of the Model apply its own domestic rules. (Article 3(2) provides that "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 which it has under the law of that State concerning the taxes to which the Convention applies").

32. The fourth question in relation to Article 9 is, assuming that the Article does apply, what practical guidelines or standards are available to assist in the application of whatever interpretation of Article 9 is accepted.

Articles 10 and 11 of the Model

33. The Model defines "dividends" and "interest" in Articles 10 and 11 respectively. A basic question is therefore whether those definitions require payments which are prima facie interest to be treated as interest even if the domestic thin capitalisation rules of the country of source treat them as dividends.

34. These definitions are specific to the particular Articles — i.e. the term "dividends" is defined by Article 10 as it is used in Article 10 and the term "interest" is defined in Article 11 as it is used in Article 11. A preliminary question is therefore whether the definitions apply outside the Articles in which they appear.

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35. The term “dividends” as used in Article 10 is defined by Article 10(3) as “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”. The phrase “not being debt-claims” has raised the question whether income from something which purports to be a debt claim is precluded by Article 10 from being treated as a dividend. If it is not, a further question arises, *viz*. whether the income arises from a “corporate right”.

36. The Commentary on Article 10 envisages, however, it has been argued, that disguised distributions of profit which are treated as dividends by the State of which the paying company is a resident, may be included as dividends (see paragraph 27 of the Commentary which says explicitly that payments which are regarded as dividends may include, *inter alia*, disguised distributions of profits). The Commentary also, it has been argued, recognises (in paragraph 15 d) — which, however, is concerned with the meaning of the term “capital” rather than with what is meant by any particular type of capital) that interest may be treated as a dividend. Paragraph 15 d) says that “when a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when, on the basis of internal law or practice ('thin capitalisation' or assimilation of a loan to share capital) the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as 'capital' within the meaning of sub-paragraph 2 a) of the Article”.

37. The term “interest” as used in Article 11 is defined in Article 11(3) as “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”. It has been argued that the phrase “whether or not carrying a right to participate in the debtor's profits” prevents the interest on participating bonds and other interest closely related to the company's profitability from being treated as a dividend under the Convention even though it may be treated as a dividend under the domestic thin capitalisation rules of the country of source.

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38. The Commentary on Article 11 elaborates this phrase as follows: "Debt claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest. In the contrary case, where the participation in profits rests upon the provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan and Article 11 does not apply".

39. Article 10 and Article 11 are, however, mainly concerned with the tax treatment of recipients of dividends or interest by the country of source. They do not, directly at any rate, deal with the question of deductibility [which is explicitly dealt with in Article 24(5)]. They do, nevertheless, where interest is treated as a dividend in the source country for the purpose of calculating the paying company's profits, pose two questions. One is how the payment should be treated in the source country for the purposes of that country's tax on the recipient — some countries would treat it in all respects as a dividend for this purpose; others might merely disallow it as a deduction while continuing to treat it in every other way as interest. The other is whether the recipient's country of residence is obliged to accept the treatment as a dividend and give relief accordingly, e.g. by way of credit for the dividend rate of withholding tax, or by way of relief under a special "parent/subsidiary regime".

40. Paragraph 6 of Article 11 provides that "Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed :upon by the payer and the beneficial owner in the absence of such relationship, the 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". This paragraph therefore raises the question of whether or to what extent it coincides or conflicts with Article 9 of the Model where interest is paid between associated persons, and especially in cases affected by rules dealing with thin capitalisation.

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Article 23 of the Model (with particular reference to parent companies and other substantial shareholders)

41. It may be important in applying under a bilateral treaty the equivalent of Article 23 of the Model, to decide whether or not a payment of interest which has been disallowed as a deduction and perhaps treated in all other respects as a dividend by the source country is to be regarded as interest or as a dividend by the country of residence of the recipient. As mentioned earlier, this could be important for one of two reasons — either because the rate of source country withholding tax which is creditable may differ according to whether the payment is treated as interest or as a dividend, or because of the possibility that, as a dividend, the payment may attract relief under a "parent/subsidiary regime". Article 23 of the Model does not provide any guidance in the matter.

42. Article 23 of the Model in fact does not provide for any special relief for dividends paid by a subsidiary company to its parent company. But paragraphs 49 to 54 inclusive of the Commentary on that Article indicate that Contracting States are free to choose their own methods of providing such a relief, and many do, either unilaterally or in accordance with bilateral treaties. The relief may take the form of credit for underlying tax (indirect credit) or it may take the form of complete exemption of the dividend (where in the case of other dividends credit would be given for tax deducted from it). The first form is likely to be used by countries generally operating the credit system of relief for double taxation while the second is likely to be used by countries generally operating the exemption system for this purpose. A third form is to assimilate the treatment of a dividend from a foreign subsidiary to that of a dividend from a domestic subsidiary. In countries where dividends from domestic subsidiaries are exempted this may, in effect, be indistinguishable from the second form. What constitutes a "parent/subsidiary relationship" for this purpose may however vary from country to country.

Article 24 of the Model (non-discrimination)

43. A further question is whether the non-discrimination Article (Article 24) may prevent the treatment of interest as a distribution of profit under thin capitalisation or hidden capitalisation rules if the treatment applies only in respect of payments to non-residents. Paragraphs 5 and 6 of Article 24 may be of relevance in answering this question.

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44. Paragraph 5 of Article 24 provides that "Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 4 of Article 12, apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State". If paragraph 1 of Article 9 applies to enable interest to be treated as a dividend under thin capitalisation rules, this paragraph accordingly appears not to prevent it.

45. Paragraph 6 of Article 11 allows an excessive payment of interest to be reduced for the purposes of the Article in certain circumstances to the amount which would have been paid if the parties to the transaction had been at arm's length. (The relationship between this arm's length provision in Article 11(6) and the main arm's length rule in Article 9 is discussed in a later paragraph of this report). The excess amount of the interest remains taxable according to the laws of the two Contracting States "due regard being had to the other provisions of the Convention". It has been argued that some, if not all, of an interest payment treated as a dividend under thin capitalisation rules could thus remain liable to be so treated notwithstanding paragraph 5 of Article 24. The Commentary on this paragraph does not, however, throw any further light on this aspect.

46. Paragraph 6 of Article 24 provides that "Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected". On the face of it this provision might, it has been argued, prevent the operation of rules which disallow the deduction of interest paid to non-resident shareholders of companies controlled by non-residents if under similar circumstances, the interest would be deductible for a company which was not controlled by non-residents. The Commentary on this paragraph does not deal with the point.

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Article 25 of the Model (mutual agreement procedure)

47. If one country treats an interest payment as a dividend and the treaty partner country continues to regard it as interest, the question arises of whether it may be possible to arrive at a solution to any consequent problems of double taxation under Article 25 (mutual agreement between tax authorities).

B. Consideration of the effect of tax treaties

Article 9 of the Model — Impact in general

48. It was generally accepted by the Committee that Article 9 of the Model is relevant to the question of thin capitalisation. It was accepted that the Article itself did not draw a clear line in positive terms between what was interest and what was a distribution of profit. It was agreed however that the Article is relevant not only in determining whether the rate of the interest concerned is an arm's length rate but also in determining whether a prima facie loan can be regarded as a loan or should be regarded as some other kind of payment (depending on whether or to what extent the funds would have been contributed as a loan in the arm's length situation).

49. The basis for this view is as follows. Article 9(1) allows the tax authority of a Contracting State to adjust the taxable profit of an enterprise of that State to include profits which have not accrued to it in its accounts but which would have accrued to it in the arm's length situation. Thus, if profits have not accrued to the enterprise in its accounts because it has paid what it has described as interest to an associated enterprise and this payment has been deducted in arriving at the profits shown in the accounts but, in the arm's length situation, the payment would not have been deductible, then, in adjusting the taxable profits of the enterprise to include the payment, the tax authority would be acting in conformity with Article 9(1). Provided therefore that the re-categorisation of interest as a distribution of profit under domestic thin capitalisation rules has the effect of including in the profits of a domestic enterprise only profit which would have accrued to it in the arm's length situation there is nothing in Article 9 to prevent operation of those rules.

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Article 9 — Whether restrictive or illustrative?

50. If however the effect of such re-categorisation goes beyond this and includes more than the arm's length profit in the taxable profit of the domestic enterprise, the answer to the question whether Article 9 may inhibit the operation of the relevant thin capitalisation rules may depend on whether Article 9 is held to be "restrictive" or merely "illustrative" in its scope. There is some diversity of opinion about this. One group of countries takes the view that where a provision similar to Article 9(1) is included in the convention, it simply prohibits an adjustment of the profits of the resident company to any amount exceeding the arm's length profit. Another group of countries takes the view that while Article 9(1) permits the adjustment of profits up to the arm's length amount it does not go beyond that to prohibit the taxation of a higher amount in appropriate circumstances. A third group, while accepting that there is an absence of such a prohibition in the language used, nevertheless takes the view that the practical effect of Article 9 must often be to impose such a restraint. They point out that the other Contracting State is not obliged to accept an adjustment which is not in conformity with the arm's length principle and would be entitled to include, in its own tax charge on the profits of its own resident associated entity, the portion of the adjustment in the paying country which exceeds the arm's length profit in that country. It may do this in order to bring the profits of its own entity up to the arm's length profit in its own country, with the result that, under Article 9(2), the associated company in the other country whose profits were adjusted in the first place would be able to initiate a claim to a corresponding adjustment to reduce its profits for tax purposes to the arm's length amount. The Committee generally agreed that, in principle, the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to any amount greater than the arm's length profit, that this principle should be followed in applying existing tax treaties, in particular in the operation of the mutual agreement procedure under the equivalent of Article 25 of the Model, and that it should also be followed in the negotiation of bilateral treaties in the future.

Article 9 — Whether definitions in Articles 10 and 11 apply

51. If, in seeking to apply Article 9, it was thought necessary to decide whether a payment should be regarded as a dividend or as interest, the fact that Article 9 does not itself provide a definition of either term raises the question

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whether it would be appropriate to apply the definitions in Articles 10 and 11, with the result that, for example, a payment which was clearly interest as defined in Article 11(3) would have to be treated as interest for the purposes of Article 9, notwithstanding that domestic thin capitalisation rules treated it as a distribution of profit. The fact that these Articles specifically define "dividends" as the term is used in Article 10 and "interest" as the term is used in Article 11 may be thought to imply that the definition in each of these two Articles does not apply in relation to any other Article of the Model. However, under the legal practice of some countries this would not prevent the definitions from being used in relation to other Articles if definitions were required for the purpose of interpreting those other Articles. Under such legal systems, indeed, the definitions in Articles 10 and 11 might well be preferred to other definitions, on the basis that Articles 10 and 11, being Articles of the treaty in question, provided definitions in the closest relevant context. It may be important in consequence to consider these definitions, in thin capitalisation cases, where Article 9 is concerned, as well as where Articles 10 or 11 themselves are concerned. The basic question in relation to Article 9 would however be not so much whether an ostensible payment of interest was a dividend as such, but whether it was a part of the arm's length profit of the paying entity.

52. Where the Contracting States would not be obliged under their domestic law to use the definitions in their equivalents of Articles 10 and 11 of the Model in the application of other provisions of their bilateral treaty, it seems that they would be under no obligation to follow such definitions in deciding whether a payment (and the amount of any deduction allowable for it) could be adjusted under Article 9. Indeed it seems likely that the Contracting States would be able to use the definitions of interest and dividends in the relevant provisions of their domestic law and thus, if appropriate, those provided by their rules about thin capitalisation (whether Article 3(2) would help them in this context is not clear: there is no use of the term "interest" in Article 9 of the Model).

53. Where the law of one or other of the Contracting States would regard the definitions in Articles 10 and 11 as valid in deciding whether or not the amount of a deduction for such a payment could be adjusted under Article 9, it may be necessary for the Contracting States to vary the wording of the equivalent of Article 11(3) in their bilateral treaty so as to protect the operation of their thin capitalisation rules, and to ensure, if appropriate, that payments of

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interest which are treated as dividends under those rules are treated as dividends for the purposes of those corresponding to articles 10 and 11 of the Model and are also treated as dividends for the purposes of other provisions in the treaty such as those corresponding to Articles 9 and 23. Indeed this may be the most satisfactory course for them to follow in the circumstances.

54. On the other hand, the Model does not specifically require that any payment defined as interest must ipso facto be deducted in arriving at the taxable profits of the payer. Although the Model does provide [in Article 24(5)] that, in certain circumstances, if interest is deductible when it is paid to a domestic resident it must also be deductible when paid to a resident of the other Contracting State, this leaves open the question whether the interest would be deductible in the first place. The answer to this question should be the same where the interest is paid to a resident as it is where the interest is paid to a non-resident. However, unless the payment is capable of being regarded as an expense of earning the relevant profits there seems to be no necessary reason why it should be deducted in arriving at the taxable amount of those profits. If in fact the payment is not an expense of earning the profits but is a distribution of profit, it may be arguable therefore that it may be added back to the taxable profits of the paying entity notwithstanding that it is defined as interest and may indeed be treated in the same way as interest under Article 11. In such a case the automatic application of the definitions in Articles 10 and 11 to the remainder of the treaty may not create difficulty where the domestic thin capitalisation rules of the Contracting State are consistent with Article 9 of the Model.

Article 9 — Practical Guidelines

55. The question of what practical guidelines and standards are available to assist in the application of Article 9 is dealt with in more detail in Section IV below.

Articles 10 and 11 of the Model

56. In considering the terms of the definitions of dividends and interest in Articles 10 and 11 of the Model in this context, the following points were made. The majority opinion was that the specific exclusion of income from debt-

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claims from the definition of "dividends" in Article 10(3) did prohibit the treatment of interest as dividends under thin capitalisation rules, except where the relevant payments could be regarded as "income from other corporate rights which is subjected to the same taxation treatment as income from shares" by the laws of the relevant country. There seem to be two possible but divergent interpretations of this phrase. A narrow interpretation, based on the fact that interest is defined in Article 11(3) as including income from debt-claims of every kind, would exclude income arising from a debtor-creditor relationship as well as income from all other financial relationships not clearly constituting a participation in the membership of a corporate body. On this view the reference in Article 10(3) to "other corporate rights" is to rights which are not themselves debt-claims (rights which are debt-claims having already been excluded, on this view, from the scope of the definition by the reference to shares etc. "not being debt-claims"). A broader interpretation would include income arising from any financial relationship which is treated as constituting a corporate right under national law. In fact it might be said that the reference to income from such other corporate rights would make no sense if it was limited to income from shares or other corporate rights already covered in other parts of the definition, and it seems clear also (e.g. from paragraph 15(d) of the Commentary on Article 10) that the Model was not designed to frustrate domestic rules for the countering of abusive arrangements such as might be the effect of thin capitalisation. In deciding this question therefore the majority of the Committee felt that it would in certain cases be appropriate to regard as a dividend a payment which had been treated as a dividend under national rules dealing with thin or hidden capitalisation.

57. In seeking to define the circumstances in which it would be appropriate to do this, the Committee was guided by that part of the Commentary on Article 11 which indicates (see para. 37 above) that debt-claims which carry a right to participate in the debtor's profits are regarded as loans if the contract, by its general character, clearly evidences an interest-bearing loan but, where the participation in profits rests on the provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan. The conclusion reached therefore was that Articles 10 and 11 of the Model did not prevent the treatment of interest as dividends under national rules dealing with thin or hidden capitalisation where the contributor of the loan effectively shared the risks of the company's business.

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58. The fact that the contributor of the loan does share the risks of the borrowing company's business will normally have to be established by reference to all the relevant circumstances. The absence of any legal obligations to pay other debts of the company will not necessarily dispose of the matter. A strong risk that a major creditor may not be able to recover his loan may, from the economic point of view, mean in certain circumstances that, effectively, he shares just as much in the risks of the debtor's business as if he was a shareholder. An indication that the risks of the business may perhaps be regarded as effectively shared by the creditor in this way may be derived from the fact that the loan very heavily outweighs any other contribution of capital to the debtor company (or replaces a substantial proportion of other capital which has been lost) and is substantially unmatched by redeemable assets. This may not be a sufficient indication under the laws of every country — it might be necessary, for example, to show that the creditor would participate in any profits of the business or that the repayment of the loan was subordinated to claims of other creditors or to the payment of dividends, or that the level or payment of interest would depend on the profits, or that there were no fixed provisions for repayment of the loan by a definite date. However, there could well be other indications that the creditor effectively shared in the risks of the enterprise's business.

59. In the light of the inclusion of income from participating bonds in the definition of interest in Article 11(3), it was also agreed that interest on participating bonds was not normally to be regarded as a dividend, and it was further agreed that interest on convertible bonds was not normally to be regarded as a dividend until such time as the bonds were actually converted into shares.

60. It was agreed, however, that, in order to remove any danger of ambiguity or overlap between the types of income dealt with respectively by Articles 10 and 11, it should be made clear that the term "interest" as used in Article 11 did not include items of income which were dealt with under Article 10. It was also agreed that it would be desirable to remove the possible ambiguity in Article 10(3) which may support the narrow interpretation described in paragraph 56 above.

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Article 9(1) and Article 11(6) of the Model

61. It was generally agreed that Article 9(1) and Article 11(6) may both apply in certain circumstances to allow a tax authority to adjust the rate of interest to that which would have been paid between independent parties and that, in this respect, both provisions had the same effect. It was also agreed, however, that Article 11(6) permits only the adjustment of the interest rates and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under Article 11(6) it would be necessary to substitute other words for the phrase "having regard to the debt claim for which it is paid". (Article 11(6) excludes, from the operation of Article 11, interest which "having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon" in the arm's length situation. In some bilateral treaties the Contracting States have, in fact, in order to overcome this difficulty, excluded instead interest which "for whatever reason" exceeds the amount which would have been agreed upon in the arm's length situation). It was agreed, nevertheless, that Article 11(6) could affect not only the recipient but also the payer of excessive interest, and, if the laws of the source country permitted, the excess amount could be disallowed as a deduction, due regard being had to the other provisions of the Convention.

62. As Article 11(6) is drafted in the Model moreover it creates some possibility of conflict with Article 9, even if the more precise definition of interest in Article 11(3) is not regarded as conclusive for the purposes of Article 9 — the amount of interest might be adjusted under Article 9 but it might nevertheless still be argued that the unadjusted amount should be treated as interest for the purposes of withholding tax etc. under Article 11.

Article 23 of the Model (parent/subsidiary regime, etc.)

63. Since Article 23 of the Model gives no guidance as to whether interest treated as a dividend under thin capitalisation rules in the country of source should also be treated as a dividend in the country of residence of the recipient, the problem ordinarily has to be solved by reference to the particular terms of any relevant bilateral treaty or by the domestic law of the country of receipt.

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64. Where a bilateral treaty provides reliefs under an Article equivalent to Article 23 of the Model, the Committee agreed that, in the case of interest treated as a dividend under the partner country's thin capitalisation rules, the country of residence of the lender would, in certain circumstances, clearly be obliged by the treaty to give these reliefs as if the payment was in fact a dividend (e.g. credit for withholding tax suffered at the rate applicable to a dividend, and, where the bilateral treaty provides it, relief under a parent/subsidiary regime) if the text of the Article in question gave the reliefs in respect of "income defined as dividends in Article 10" or even as "items of income dealt with in Article 10". This obligation would arise to the extent that the relevant rules conformed to the provisions of Articles 9, 10 and 11 of the Model as interpreted in the previous paragraphs of this Report (i.e. if the contributor of the loan effectively shared the risks of the borrowing company's business, and the profit as adjusted in consequence did not exceed the profit which would have been made at arm's length).

65. If the text of the relevant Article simply gave the relief in respect of "dividends" without referring to Article 10, and if there was no generally applicable definition of dividends elsewhere in the relevant bilateral treaty, the meaning of "dividends" for this purpose would depend on the domestic law of the country of residence of the lender, which would not necessarily accept any extended definition of "dividends" provided by the thin capitalisation rules of the country of the paying company. Nevertheless, the Committee felt that the country of the lender ought to give the reliefs due under the relevant Article, if need be by way of the mutual agreement procedure, in three situations where adjustments had been made under thin capitalisation rules: *viz*

a) Where the interest was treated as a dividend in the country of source by the operation of Article 9 — in such a case the country of residence of the recipient would, if it agreed that the original treatment of the payment as a dividend was justified, be obliged under Article 9(2) to make a corresponding adjustment and it would be in accordance with the spirit of this obligation to accept the treatment of the payment as a dividend for the purposes of its own tax. Logically this rule should also apply to payments considered by the source country under Article 11(6) not to be interest (because excessive) and thus treated as a dividend;

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b) Where the country of residence of the lender operated similar thin capitalisation rules and would treat the payment as a dividend in a reciprocal situation, i.e. if the payment were made by a company in its territory to a shareholder in the partner country;

c) Where in any other case the country of residence of the lender recognised that it was proper to treat the interest as a dividend.

Article 24 of the Model (non-discrimination)

66. *a)* The Committee agreed that, if interest is treated as a dividend under thin capitalisation rules in conformity with Article 9(1) or Article 11(6), then Article 24(5) does not operate to prohibit that treatment. If, however, the treatment is not in conformity with these rules and at the same time the thin capitalisation rules apply only where the creditor is non-resident, then Article 24(5) would prevent interest being treated as a dividend under the rules;

b) So far as concerns Article 24(6), the Committee took the view that this paragraph is relevant to thin capitalisation but is worded in very general terms and aims broadly at preventing "tax protectionism" — i.e. the deterrence by tax measures of investment from outside the country. It had not, the Committee considered, been designed to deal with measures introduced to prevent the transfer of profits in the guise of interest. Because it is in such general terms, the Committee concluded, it must take second place to more specific provisions in the treaty. Thus Article 24(5) [referring to Article 9(1) and Article 11(6)] takes precedence over it in relation to the deduction of interest;

c) The Committee noted that, notwithstanding the provision of Article 24 of the Model, France has in this context, reserved the possibility of applying the provisions in its domestic laws relative to the deduction of interest paid by a French company to a foreign parent company.

Article 25 of the Model (mutual agreement procedure)

67. The Committee agreed that Article 25 provided an appropriate framework for the solution of problems which arose out of the application of measures dealing with thin or hidden capitalisation and which produced taxation

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contrary to the letter or spirit of the Convention including otherwise unrelievable double taxation, whether juridical or economic.

68. It is necessary, however, to distinguish between the three different categories of cases dealt with by Article 25. Article 25 provides, in brief, as follows:

i) Paragraphs 1 and 2 provide for the elimination, by mutual agreement between the competent tax authorities of the Contracting States, of taxation which is not in accordance with the Convention, such as double taxation which might arise from different approaches by the two Contracting States to the interpretation of the Convention in particular cases;

ii) Paragraph 3 of the Article provides, in its first sentence, for the resolution by mutual agreement between those competent authorities of general doubts or difficulties arising as to the interpretation of application of the Convention;

iii) Paragraph 3, second sentence, authorises the competent authorities to consult together for the elimination of double taxation in cases not provided for in the Convention.

69. The Committee agreed that:

a) In relation to the first category — taxation in individual cases — the text of Article 25 enabled adjustments to be made by mutual agreement to eliminate double taxation not in accordance with the Convention in the same way where thin capitalisation rules were in point as in other types of cases, provided that the relevant adjustment was based on the application of a substantive provision of the Convention, for example, the application of Article 9, Article 11(6), Article 23, or Article 24(5) of the Model;

b) In relation to the second category — general problems of interpretation or application of the Convention — Article 25 enabled the competent authorities to endeavour to resolve by mutual agreement, for example, the general problem of whether interest which was treated as a dividend under thin capitalisation rules in a country (being the country of source) could qualify for reliefs under a parent/subsidiary regime granted by the other country (being the country of residence of the

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recipient) when these reliefs were provided by the relevant bilateral treaty;

c) The third category of relief providable under Article 25 (i.e. relief for double taxation not otherwise provided by the Convention) offered wide opportunities for the competent authorities to resolve problems arising from the operation of thin capitalisation rules only if the domestic law of the countries concerned (i.e. specific legislation, the rules of the constitution or the general principle of the laws) empowered them to relieve double taxation not specifically covered by tax treaties.

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IV. PRACTICAL APPLICATION OF ARM'S LENGTH PRINCIPLE IN RELATION TO THIN CAPITALISATION

70. It is clear from what has been said in Section III above that in cases where thin capitalisation rules have international implications it is important that their application should accord with the arm's length principle as delineated in Article 9(1) of the Model Convention. Consideration is therefore given in the following paragraphs to the practical application of this principle in such circumstances. It is recognised however that it is difficult to provide precise guidelines for drafting national legislation on these questions. The comments in the following paragraphs may nevertheless, it is hoped, be helpful in this context.

71. The matter was considered briefly in the 1979 report on "Transfer Pricing and Multinational Enterprises" (paragraphs 183 to 191 inclusive) (referred to hereafter as "the 1979 Report"), and it is pertinent to refer now to what was said then. The 1979 report indicated that thin capitalisation could create problems for tax authorities and described the different ways in which some Member countries sought to deal with these problems. It pointed out that the operation of different rules by different countries created a distinct possibility that the same financial transaction could be treated as a loan by one country and as an equity contribution by another. This, it commented, was an unsatisfactory situation which it would be desirable to improve. The report posed the question whether, in time, Member countries could move in directions which would achieve such an improvement by effectively harmonising their domestic legislation in this field. But it did not provide any but the most tentative guidelines as to how this might be done. Its Recommendations are contained in paragraph 191 which it is appropriate to quote here in full. The paragraph reads:

> "191. It is generally recommended that a flexible approach should be adopted in which the special conditions of each individual case would be considered, although it is realised that such an approach would call for sufficient qualified staff to carry out a somewhat sophisticated analysis and could, if cases were numerous, thus raise problems for some tax administrations. A hard and fast debt-equity rule would, however, not be appropriate for the solution of problems raised by the determination of

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the nature of a financial transaction. Financing practices differ too widely from one country to another, and, within a given country, between different categories of enterprises. Most of the countries whose practices are described in the previous paragraphs, therefore, refer to a number of factors which are of significance in distinguishing a loan from an equity contribution. On the same reasoning, it is considered that a rule based on the fact that the owner of the shares was non-resident would not be appropriate for general adoption either."

72. As has already been pointed out, the arm's length principle is relevant in deciding whether or not a *prima facie* payment of interest derives from a loan or from an equity contribution because, if more than the arm's length profit on the relevant transaction is charged to tax, economic double taxation may arise as a result. This would create a situation in which Article 9(2) or some similar provision might be invoked to secure a reduction of the tax charged in the first country to tax on the arm's length profit there. More generally, however, the Committee takes the view that, at any rate in cases where fraud or abusive avoidance arrangements are not concerned, it would be inconsistent with the spirit of Article 9 of the Model if the arm's length principle which is expressed in that Article was not followed in answering the question whether or not a prima facie payment of interest derives from a loan or from an equity contribution.

73. Article 9 may not however be strictly applicable. If the loan which is being treated as an equity contribution is a loan between ostensibly independent persons, and Article 9 therefore does not apply, as may possibly be the case if the thin capitalisation rules attack abusive arrangements designed to conceal the fact that the real parties to the transaction are associated enterprises, then it is very doubtful whether the tax authorities of the paying entity would be able to adjust the payment, but also very doubtful, if they did adjust it, whether they should be obliged to make any special effort to relieve double taxation arising from the operation of such measures.

74. Where Article 9 is, in terms, applicable, i.e. broadly, where the relevant transaction is one between associated persons, it is relevant to consider how far the various methods of deciding whether a payment should be treated for tax purposes as interest or as a dividend, are consistent with the Article. As

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already indicated, these methods generally follow one or other of two main approaches.

75. The first main approach depends very much on the particular facts and circumstances of each case. The authorities would seek to decide what is the real nature of the payment in the light of reason and the general observation of commercial activity. In such an examination a variety of factors would be relevant including evidence of what happens or could reasonably be expected to happen between independent parties. It could thus be relevant, *inter alia*, that the borrowing enterprise was a company which had a high debt/equity ratio either before the loan was granted or as a result of it, that the loan was designed to finance the long term needs of the borrower, that the loan was contributed proportionately to existing shareholdings or as a condition of such shareholdings, that the loan was designed to improve the financial situation arising from heavy losses, that the interest payable was dependent on the result of the company's business, that the loan was convertible at some stage into a share of the company's equity, or that the interest exceeded a reasonable commercial return on the money lent. Another relevant factor might be that the payment of interest on the loan or the repayment of the amount lent was subordinated to the rights of other creditors, and yet another might be the absence of fixed provisions for repayment of the loan by a definite date or the presence of provisions making repayment dependent upon the level or timing of profits. The presence of any one of such factors by itself would not necessarily be conclusive evidence, though it might be an important indication, of hidden equity capitalisation, but the presence of several such factors would be more indicative and clearly the indications would be stronger the more such factors were present.

76. In considering these factors the question may be asked whether an independent person would have provided such a high proportion of the capital of the enterprise in the form of a loan. In some cases it could perhaps be shown that no independent person would be satisfied with the fixed interest return envisaged in the relevant transaction, bearing in mind the risk involved and the profit potential of the enterprise, but would require a share in the profits as a condition of providing the funds. Or it might perhaps be shown that no independent person, bearing in mind the poor economic condition of the enterprise, would make a loan to it at all. It may be necessary indeed to adopt an approach comparable to that which a banker would adopt, and to ask

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whether, considering the borrower's financial and economic condition, an independent bank would have provided the funds as a loan on the terms actually agreed between the parties. Too rigid a reliance on this approach may not however be wholly satisfactory since it is possible that a parent company might have a better understanding of the profit potential of its own subsidiary than would a banker looking at the matter from the outside, and it might in consequence be reasonable to accept (if such was in fact the case) that an independent person who was as fully informed as the parent company might lend where a bank would hesitate to do so. Where it is a question of the supply of additional capital by way of loan it may be appropriate to ask — again looking at the subsidiary's economic situation with a banker's eye — whether in the circumstances an independent person would perhaps lend to protect his original investment, or, on the contrary, would decide to cut his losses.

77. There is a considerable amount of evidence about the forms of financing which are in fact used in particular cases in the open market. But it may sometimes be very difficult to discern what adjustment should be made in any particular case of arrangements between associated enterprises in order to bring those arrangements into line for tax purposes with the arrangements which would be made by independent parties in the relevant circumstances. This is because a wide range of open market forms of financing may be available and appropriate for any particular type of case, depending to a certain extent on varying market conditions. Nevertheless there may be sufficient general evidence of the ratios between equity and loan prevailing in the market place to indicate any very wide divergence from the normal in any particular case.

78. Much would obviously depend, in the operation of such an approach, on the judgement of the tax authorities in the first place and, in the last resort, on the judgement of the courts or tribunals deciding appeals against the decisions of the tax authorities. Nevertheless, methods of deciding questions which follow from such a facts and circumstances approach are clearly consistent, it seems to the Committee, with the arm's length principle to the extent that they use evidence of transactions between independent persons and apply this evidence in a reasonable manner.

79. Another approach is to deem ostensible payments of interest to be distributions of profit if the debt/equity ratio of the paying company exceeds a fixed ratio. Such a ratio is bound to be arbitrary to some degree, even though it

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might be fixed by reference to the kind of ratio commonly found in the open market. Where however such a ratio is employed merely as a kind of 'safe haven' rule, leaving the relevant company the option of showing that the actual ratio of the company's debt to its equity capital is an arm's length ratio (perhaps, for instance, by demonstrating that it corresponds to the ratio which is characteristic of independent companies in the same kind of business in the same country) then this too could be regarded as compatible with the arm's length principle. It is relevant to point out however that the availability of such an option nevertheless imposes on some taxpayers a burden of proof which may be quite heavy. It is important therefore that any safe haven ratio which is adopted by a tax authority should allow as high as possible a proportion of debt to equity or should be otherwise so flexible as to minimise the number of taxpayers who are obliged to make use of the option. Where, on the other hand, a fixed debt/equity ratio is employed by the tax authorities without allowing such an option, then the majority of countries consider that the results would undoubtedly be inconsistent with the arm's length principle. The lower the ratio of debt to equity permitted by such a rule, and the more rigid the practice followed in applying it, the more serious may be the danger of producing a result which is both inconsistent with the arm's length principle and disadvantageous to the taxpayer. Moreover the lower the ratio the greater may be the risk of economic double taxation and the possibility that the tax authorities of the country of the lender will find it difficult to accept the result and give satisfactory relief from double taxation. Similarly the higher the ratio the greater will be the likelihood of producing a result which unduly favours the taxpayer.

80. Where abusive arrangements are relevant in this context and general anti-evasion or anti-avoidance rules (such as those against "abuse of law" or those substituting substance for form) are invoked to deem interest to be a distribution of profit, it is for consideration whether or not the tax law should require the authorities to ensure that taxation arising from the impact of such measures conforms with the arm's length principle. The Committee however makes no comment on the point.

81. The preceding paragraphs deal with questions relating to the taxation of income and profits. It seems to the Committee that where, in accordance with the arm's length principle, a loan is effectively recategorised as an equity

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contribution for those purposes, it might prima facie be similarly recategorised for the purposes of the taxation of the capital of the company.

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V. CONCLUSIONS AND SUGGESTIONS

A. General

82. The conclusions of paragraph 191 of the 1979 report still represent the view of the Committee. While the Committee in 1979 generally recommended flexible methods of deciding the question whether a prima facie payment of interest should be treated for tax purposes as interest or as a distribution of profit and recommended against using hard and fast debt/equity ratios, or rules based on the fact that the shareholder receiving such interest payments was a non-resident, the 1979 report essentially left Member countries to devise and implement whatever rules seemed appropriate to each individual country in these matters. In this, paragraph 191 reflected the absence of any firm international consensus on how thin capitalisation problems should be dealt with.

B. Summary of conclusions concerning the application and interpretation of tax treaties

83. The Committee has nevertheless now reached conclusions on a number of points concerning the relationship between tax treaties and domestic rules about thin capitalisation. These are summarised below.

84. As regards Article 9 of the Model, the Committee is of the opinion that:

a) The Article is relevant when countries are applying their domestic rules about thin capitalisation (see paragraph 48);

b) The Article is not only relevant in adjusting the rate of interest, but also, in appropriate circumstances, in determining whether what is presented as a loan should be considered as a contribution to equity capital (see also paragraph 48);

c) The Article does not prevent the application of national rules on thin capitalisation insofar (but only insofar) as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits

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which would have accrued in an arm's length situation (see paragraph 49).

85. As regards Articles 10 and 11 of the Model, the Committee is of the following opinion:

a) Article 10 deals not only with dividends as such but also with interest on loans insofar as the lender effectively shares the risks run by the company. When interest of this kind is in point Articles 10 and 11 do not prevent the treatment of interest as dividends under the national rules on thin capitalisation of the borrower's country (see paragraph 57);

b) *i)* In the light of the definition of interest in Article 11(3), interest on participating bonds should not normally be regarded as a dividend,

ii) Interest on convertible bonds should not normally be regarded as a dividend until such time as the bonds are actually converted into shares,

iii) Article 11(6) enables the amount of interest to be corrected but not the recharacterisation of the relevant loan as a contribution to equity capital (see paragraph 59);

c) It is desirable to remove a possible danger of ambiguity or overlap between the types of income dealt with respectively by Articles 10 and 11 (see paragraph 60).

86. As regards Article 23 of the Model and certain additions to that Article which appear in a number of bilateral treaties, the Committee is of the opinion that:

a) When by the application of its national rules about thin capitalisation, the country of the borrower has assimilated a payment of interest to a distribution of profit, the country of the lender would in certain circumstances clearly be obliged under particular bilateral treaties, as the result of a combination of Articles corresponding generally to Articles 10 and 23 of the Model, to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend (such as credit for tax withheld at the source at the rate appropriate to a dividend and, possibly, application of a parent/subsidiary regime) (see paragraph 64);

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b) In other cases also (see paragraph 65), the country of the lender ought to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend, if need be by way of the mutual agreement procedure, in three situations, *viz:-*

i) Where the interest has been treated in the country of source as a dividend or distribution of profit under rules which are in accordance with Article 9(1) or Article 11(6) and where the country of the creditor agrees that it has been properly so treated and is prepared to apply a corresponding adjustment as provided for article 9(2),

ii) Where the country of residence of the lender, also having provisions against thin capitalisation, would apply these provisions (i.e. would assimilate the payment to a dividend) in a reciprocal situation (i.e. when the payment was made in the same circumstances by a company established in its territory to a resident in the other Contracting State),

iii) In all other cases where the country of residence of the lender agrees with the adjustment made by the country of residence of the borrowing company.

87. *a)* As regards Article 24(5) of the Model the Committee came to the conclusion that it follows from the wording of Article 24(5) that the country of the borrower is not prohibited from assimilating interest to dividends under thin capitalisation rules which are consistent with Article 9(1) or Article 11(6). However, if interest is assimilated to dividends under rules which are not consistent with these Articles, and if the rules apply only to non-resident lenders (and not to resident lenders) then Article 24(5) does prohibit such an assimilation [see paragraph 66(a)];

b) As regards Article 24(6) of the Model the Committee came to the conclusion that Article 24(6), though relevant in principle, is worded in such general terms that it must take second place to more specific provisions in the treaty and that Article 24(5) would, in particular, take precedence over it in relation to the deduction of interest [see paragraph 66(b)];

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c) France has entered a general reservation on the effect of Article 24 in the context of rules about thin capitalisation [see paragraph 66(c)].

88. As regards Article 25 of the Model, the Committee (see paragraph 69) concluded that:

a) Paragraphs (1) and (2) of Article 25 enable adjustments to be made by mutual agreement in individual cases, to eliminate double taxation not in accordance with the Convention, in the same way where thin capitalisation rules are in point as in other types of cases, provided that the relevant adjustment is supported by a provision of the Convention corresponding for example to Article 9, Article 11(6), Article 23, or Article 24(5) of the Model;

b) Insofar as paragraph (3) of Article 25 offers the possibility of generally resolving difficulties and doubts encountered in the interpretation or application of the Convention, it enables the Contracting States to endeavour to resolve by mutual agreement the question of whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when such relief is provided by the relevant bilateral treaty);

c) In certain circumstances Article 25, which offers the competent authorities of certain countries the possibility to resolve problems of double taxation not foreseen by the convention, may also provide for the possibility to solve problems arising from the operation of thin capitalisation rules.

C. Final remarks

89. The Committee emphasises that the application of rules designed to deal with thin capitalisation ought not normally to increase the taxable profits of the relevant domestic enterprise to an amount greater than the profit which would have accrued in the arm's length situation, that this principle should be followed in applying existing tax treaties, in particular, for example, in the operation of the mutual agreement procedure under the equivalent of Article 25 of the Model, that it should also be followed in the negotiation of bilateral

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treaties in the future, and that it should be taken into account in any future revision of the Model. It should be noted, however, that Germany has certain reservations on the way in which the report uses the "arm's length principle" (see note 2).

90. The Committee urges that national thin capitalisation rules should provide sufficient flexibility to allow the relief of any consequent double taxation where such relief is appropriate, and, further, that where double taxation arises because of a conflict of view between tax authorities about the nature of a prima facie payment of interest, or the impact of rules about thin capitalisation, the tax authorities concerned should endeavour to resolve the conflict by mutual agreement under the relevant bilateral tax treaty.

91. The Committee also suggests that the considerations set out in the above Report should be taken into account by OECD Member countries in the application of existing bilateral tax treaties and in the negotiation of new such treaties.

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NOTES AND REFERENCES

1. Thus in the United Kingdom until recently certain companies seeking new finance found it advantageous to borrow from banks in such a way that the interest was treated, under United Kingdom law, as a distribution of profit for tax purposes. This was achieved by giving the lending bank a connected right to a small participation in the company's profits. The companies were induced to make this kind of arrangement because they were unlikely to derive any benefit from a deduction for interest for some years to come and were open to an offer of a substantially reduced rate of interest in return for providing the banks with an advantage. The companies were unlikely to make any taxable profits for some years to come because, quite apart from any possible deductions for interest paid, they were carrying forward heavy losses or massive reliefs for capital investment or large reliefs for inflationary increases in the prices of new stock. The banks could benefit from the receipt of distributions rather than interest because they could use the advance corporation tax (ACT) paid in respect of the "distributions" as a credit against the ACT which they would have to pay on making distributions to their own shareholders, and could effectively pass the distributions directly on to their own shareholders without first including them in the total of their taxable profits. The banks thus paid no tax on the remuneration which they received for making the loans and in consequence were able to make the relevant loans at a lower rate of interest than they would otherwise have felt the need to charge. For the companies the immediate benefit of a lower gross rate of interest outweighed the more or less indefinitely deferred benefit of a possible tax deduction for a larger gross amount even if this might have produced a lower net expenditure.

2. The Federal Republic of Germany welcomes the report as a highly important contribution to understanding problems of thin capitalisation but cannot accept it without a general reservation, essentially with respect to the way it makes use of the "arm's length principle". In this context the Federal Republic of Germany

   — Takes note, that the report is based rather on the notion of an "arm's length profit" rather than on the generally accepted notion of an "arm's length price";

   — Points out that the consensus regarding the actual application of the "arm's length principle" is extremely vague and precarious;

   — Regrets that the report might lead to diminishing the protection provided for under Article 25 of the OECD Model against discrimination, namely where a state's thin capitalisation rules are justified by a one sided claim to stay within the "arm's length principle".

   The Federal Republic of Germany, furthermore, reserves its attitude to the report's interpretation of the dividend definition. It is, however, ready to co-operate in the spirit of the report in order to avoid double taxation by mutual agreement.

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DOUBLE TAXATION CONVENTIONS AND THE USE OF BASE COMPANIES

(adopted by the OECD Council on 27 November 1986)

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I. THE PROBLEM STATED

A. Base companies

1. For a number of years taxpayers have made increasing use of so-called "base companies". Such companies, which are predominantly situated in low tax countries, are used for the purposes of sheltering income there and thus reducing taxes in the home country of the taxpayer. This report examines how these tax advantages operate, the measures taken by various countries to combat such devices and safeguard the equity and neutrality of their tax systems and the international implications of these measures, especially with reference to double taxation conventions. It is clear that the problem of "base companies" should be seen against the background of the overall tax system in the country concerned. Thus, as discussed in paragraph 13 et seq. of the Introduction to this volume, the concept of neutrality may have a different meaning when applied to income in respect of which the country of residence operates a credit mechanism than when applied to income in respect of which an exemption mechanism is operated by the residence country.

2. Possibilities for international tax avoidance may be opened up by certain features of domestic tax laws. Double taxation conventions — the positive aspects of which are recognised — may, as a side effect, increase these possibilities. The same tax effects may, under certain circumstances, be the result of features in domestic laws, while, under other circumstances, they will result from tax treaties. Similarly, counteracting measures may be taken either under domestic law or under a tax treaty.

B. Relevant considerations

3. With regard to the frame of reference of this report three points should be kept in mind.

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1. Relationship to other issues

4. The main issue dealt with in this report is the compatibility of domestic anti-abuse measures with, and their consequences for, the existing system of international tax relations. The OECD Model Convention which sets internationally-accepted standards in this field is used as a yard-stick. The report should also be considered in connection with the general framework of OECD activities on the improper use of tax treaties and in particular the work on "conduit" companies, which constitutes the next report in this volume. The "conduit company" concept is focused on tax advantages to be secured in the country of source of the sheltered income, whereas the "base company" is concerned with minimisation of tax in the country of residence of its controllers. Often the same corporate structure is designed to achieve both of these results and in those cases the problems can be regarded as different sides of the same coin.

5. The subject of this report is also related to the problem of international tax avoidance and evasion through the use of tax havens, a matter dealt with separately in the previous report in this volume. The emphasis of the present report, however, is on the implications for double taxation conventions.

2. Economic aspects

6. This report does not deal with the economic merits or demerits of base companies. Although there may be in some cases valid economic reasons or personal motives for making use of base companies, in practice, they are often used primarily for the purpose of reducing taxes chargeable to the person using the device. There are even instances where the wish to facilitate or to veil criminal activities is one of the motives behind the tax-saving arrangement. Whatever the main motive, where a tax advantage is obtained by using base companies the question arises whether, and to what extent, that advantage should be eliminated to ensure equity and neutrality of taxation in a country whose taxpayers make use of such companies.

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3. Territorial aspects ("tax havens")

7. As noted above, the concept of base companies is often related to so-called "tax-haven countries". Even though a territorial clustering of base companies in such countries evidently occurs, base companies may also be found in so-called high-tax countries, either because the taxation there is acceptable for the taxpayers concerned due to the respective effective rates of tax in the country of the base company and in the country of their residence, or to advantages taken of special regimes or to the unintended consequences of domestic tax laws. This point is illustrated by the use of so-called "stepping-stone strategies", where income is sheltered in a low tax country and then channelled through a high-tax country to its final destination, the real origin of the income being concealed from the tax authorities of the latter.

C. Terminology

8. Terms such as "base company", "passive income" and "low taxation" are used throughout this report and typically encountered in discussions on this topic. However, no definitions of these terms are put forward in the report because they are flexible and relative notions depending upon the facts of particular cases and the policy attitudes in the taxing jurisdiction. The schematic presentation of typical situations given in Annex I and the description of legislation in six countries and the examples in the text should be sufficient to provide an understanding of the concepts involved. The following abbreviations are used in this report:

Country of	*Referred to as:*	*Abbreviation*
Residence of a base company's shareholder	Residence country	R
Residence of the base company itself	Base country	B
Source of the base company's income	Source country	S

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II. ANALYSIS OF FUNCTIONS AND USES OF A "BASE COMPANY"

A. Sheltering of income

9. For tax purposes, the most important function of a base company is to collect income which otherwise would flow directly to the taxpayer. The taxpayer, therefore, does not normally become liable to tax on the income received by the base company, though economically he is entitled to such income and may well be able to direct its disposition. Thus, in the absence of counteracting measures, the base company would be able to shelter in a low tax jurisdiction such income from taxation in the taxpayer's residence country.

1. Primary sheltering

10. Initially, the income is sheltered from taxation in the taxpayer's country of residence by the mere fact that the base company is an entity of its own and is recognised as such in the residence country. By shifting the respective income from the taxpayer to the base company it is no longer covered by the normal taxation of world income to which the taxpayer is subject in most countries. This advantage is not offset by taxation in the country of the base company, since by carefully choosing the place of incorporation and arranging the affairs of the base company, the latter is subject to no tax or a very modest tax there. It is true that income may be taxed in the country of source (which may well be the same as the taxpayer's country of residence) under a "limited tax liability" criterion. But for a number of reasons this taxation is often non-existent or very low with respect to the type of income which is selected by taxpayers for sheltering in base companies as noted in the next report in this volume "on conduit" companies. Important net savings of taxes may accordingly result.

11. The tax advantage exists only as long as the sheltered income is not distributed. Taxpayers, therefore, often claim that this is merely a tax deferral. As the taxpayer may avoid such distributions by deferring them indefinitely and as strategies against their taxation can often be successfully deployed

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(cf. paragraph 12 below), the tax advantage may, in practice, be frequently equivalent to a permanent one.

2. Secondary sheltering

12. When income sheltered in a base company is distributed or otherwise transferred to the taxpayer it becomes taxable, usually as a dividend. Thus, the initial tax advantage of the sheltering would normally be eliminated. However, this taxation which offsets the original tax advantage may also be avoided or reduced by "secondary sheltering". The main strategies are:

- Distribution as income of a type which is tax-exempt, the exemption being granted under tax treaties or specific domestic rules (director fees, salaries, dividends distributed by a subsidiary to its parent where an affiliation exemption applies in the latter's country);
- Reinvestment abroad of income sheltered in the base company or ploughing back as a loan to the shareholder company;
- Alienation of the capital holding in the base company, with the shareholder thereby realising a gain which is tax exempt or taxable at reduced tax rates.

Secondary sheltering is dealt with specifically in Part VI of this report.

B. Types of base companies

13. Base companies may be classified under different criteria. The following represents one possible classification.

1. Asset administration

14. This is the most common type of base company: the taxpayer transfers an income-generating assets to the company, thus sheltering from tax in the country of residence the income arising from those assets.

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Example 1:

T, resident in country R, owns shares and debentures which he transfers to a base company in country B. The base company uses the sheltered income to buy other assets of the same kind.

Example 2:

T has developed a new product. It is patented in favour of a base company in country B which gives licences to third parties in countries S1, S2, S3 and shelters the income arising from them (or lends it to T against the payment of interest which is deducted from T's taxable profits).

2. Financial pivots

15. Some base companies are used to form financial pivots for broad international activities. This usually concerns holding companies, e.g. the regional centres for multinational enterprises, and companies formed to issue loans or to centralise similar activities. Companies of this kind may also centralise banking or insurance activities and it may then be doubtful whether one can still regard them as "base companies" receiving passive income.

Example 3:

A multinational enterprise based in country R holds its participation in South America through a holding company set up in country B which is also the pivot for the whole intra-group financial relationships with respect to the area. A second base company in the Bahamas issues international loans and pays interest on them free of withholding tax.

Example 4:

A multinational enterprise centralises its insurance contracts in an "off-shore" captive corporation, which insures the risks within the group and covers them by reinsurance contracts.

3. Operational base companies

16. Base companies of this kind are used in connection with business or professional activities some of which are carried on outside the country where they have been set up. Thus, the base company "feeds" on the profits derived

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from these activities exercised elsewhere, so that the income derived can at least partly be sheltered in the base company.

Example 5:

T carries on an enterprise producing cars in country R and selling them in countries S1, S2, S3. The cars are sold to wholesalers in these countries or in others via a base company set up in country B which acts as a sales company and shelters part of the income.

Example 6:

An artiste acts as an employee of a base company owned by himself ("rent-a-star"). The base company thus "feeds" on his professional income (the artiste receives only a relatively small salary) and shelters it.

Where operational base companies are used, the consequences of the avoidance devices are frequently aggravated by the manipulation of transfer prices.

4. Other types of base companies

17. Other types of base companies may be used for the purpose of channelling income only, for hiding activities or for other purposes (cf. for example the following report on the use of conduit companies).

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III. COUNTERACTING MEASURES IN NATIONAL TAX LAWS

Preliminary remarks

18. There are two different approaches that national tax laws may take with respect to base companies. Adequate taxation may be sought:

- In the context of taxation of world-wide income in the State where the taxpayer is resident ("taxation from the top"), or;
- In the context of territorial taxation in the country of origin of the base company's income ("taxation from below"),

Annex I gives a schematic presentation of the situation.

19. It has often been claimed that "taxation from below" is the appropriate response to the base company problem. Experience of the major States concerned has shown, however, that while adequate "taxation from below" is indispensable, legislative measures "from the top" are also necessary. This report deals only with the "measures from the top" of the taxpayer's country of residence. The problems of "taxation from below" are dealt with in the following report on conduit companies.

A. General surveillance measures

20. Under this heading two main groups of rules may be mentioned.

a) Transfer pricing

Transfer pricing is the subject of special provisions in most domestic tax laws. It is also covered by Article 9 of the OECD Model, and thoroughly treated in the 1979 and 1984 OECD reports on the topic. Transfer pricing rules are necessary to prevent income from being shifted artificially to base companies, especially in the case of operational companies. However, the arm's-length rules may not always be sufficient to prevent income shifting, as for instance, in the case of asset administration. Furthermore, problems which are difficult to solve may arise where the activities of the base company cannot clearly be ascertained or evaluated. This may be because there is a complex and intricate relationship between that company and an

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enterprise of the taxpayer or because the company is allegedly carrying on a real economic activity which it cannot effectively sustain given the limited scope of its actual activities or resources (cf. paragraphs 47-49 and 92-98 of the preceding report on tax havens);

b) Special procedural rules
Tax laws may impose special information requirements on taxpayers operating in foreign countries. More far-reaching requirements may be applied to taxpayers relationships with companies having the characteristics of a base company. In some States the burden of proof is shifted to the taxpayer in such cases (see paragraphs 86-91 of the preceding report on tax havens).

B. "Substance-over-form" provisions

21. Substance-over-form provisions and courts' attitudes to them are discussed in paragraphs 52-54 and 81-85 of the preceding report on tax havens. In the context of this report it is noted that they are generally — but not exclusively — applied in the context of "taxation from the top" and reflect one of the following approaches:

a) The legal personality of the base company may be disregarded;

b) The base company may be regarded as a resident in the taxpayer's country, e.g. because its place of effective or central management is situated there;

c) The base company may be deemed to have a permanent establishment in the taxpayer's country of residence, e.g. because it has a place of management there;

d) The sheltering of the income may be disregarded, i.e. the activity of the base company or the income derived from it may be regarded as an activity or as income of the taxpayer himself.

22. These approaches presuppose that the economic reality of the base company and its economic motives can be fully evaluated. In the view of some countries this is very difficult, especially in the absence of any exchange of information with the country where the base company is situated. Other countries, however, (e.g, the Netherlands) which have quite general legal

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provisions and/or case law which permit the application of substance over form, are of the opinion that they are able to effectively combat tax avoidance through base companies. Even in cases where there is no exchange of information with the base country, it may be possible for the tax authorities of the residence country to determine the reality of the base company's operations when, under the residence country's rules, the taxpayer has the burden of proving that the base company carries on real economic activities. One advantage of this approach may be that overreaction can be better avoided by applying substance over form on a case by case basis than by introducing generally-applicable and complicated counteracting measures.

C. Subpart-F type counteracting legislation

1. General

23. As outlined in paragraphs 62-64 of the report on tax havens, several countries have adopted specific legislation against the sheltering of income in low-taxed base companies situated abroad. Such legislation provides that, under certain conditions, a resident shareholder (e.g. a parent company) may be taxed on the profits of a foreign-controlled company which are not distributed to the shareholder (the term "subpart-F type" defence legislation, as used in this report, refers to provisions of that type). Such legislation is not normally applicable where base companies are made use of for non-tax reasons, i.e. where their use is fully justified on purely economic grounds.

2. Taxation of sheltered income in the hands of the resident taxpayer

24. Counteracting legislation provides for the taxation of the resident shareholder on the income sheltered in the base company which he controls. The base company itself seems in no case to be subjected to tax or obligations connected therewith. The shareholder's taxation rests on the assumption that the sheltered income is deemed:

i) To be distributed ("fictive dividend" approach); or

ii) To have arisen in the hands of the shareholder, i.e. that the company's activities are to be attributed to him ("piercing the veil" approach); or

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iii) To have improved the ability of the shareholder to pay taxes because economically it is at his disposal, thus constituting a capital yield of a special nature.

In practice counteracting legislation seems to have proceeded in a pragmatic way rather than by following rigidly any one of these theoretical approaches.

3. Relevant technical aspects

25. Only a few characteristics of the extremely technical provisions can be mentioned here:

i) Generally counteracting legislation aims at a level of taxation which is no more burdensome than if the sheltered income had arisen directly to the taxable shareholder;

ii) Specific problems arise with respect to dividends distributed by the base company to its shareholders; in these cases counteracting legislation prevents an internal double taxation (namely as income sheltered and as a dividend);

iii) Taxes levied on the sheltered income, whether in the country of source or in the country of the base company, are usually credited;

iv) All such legislation aims at covering base companies held indirectly (e.g. through a chain of base companies), though these often highly-technical provisions have to vary widely between countries;

v) Further problems concern the treatment of pure holding companies, and of companies with both active and passive income.

4. International implications

26. States with a counteracting legislation evidently regard the effects of base companies as unbalancing the equity and neutrality of their tax systems. Tax advantages obtained through such companies seem improper to them, even if they are used for valid reasons or understandable motives. Opinions about what is improper or not may differ. Counteracting measures nevertheless have to respect the general principles underlying the OECD Model Convention, as discussed further in paragraphs 47 and 48.

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IV. IMPLICATIONS OF A CONVENTION BETWEEN THE STATE OF THE TAXPAYER AND THE STATE OF THE BASE COMPANY

A. Treaty implications of general surveillance measures

1. Transfer pricing

27. Article 9 of the OECD Model Convention applies to relationships between the taxpayer and the base company. Therefore, transfer prices which differ from those which would be agreed upon between unrelated parties may be adjusted under that provision.

28. The considerations to be taken into account in this examination do not differ basically from those to be taken into account in other cases, so that the principles set out in the 1979 OECD report "Transfer Pricing and Multinational Enterprises" are valid in these cases. The actual economic function of the base company has to be carefully analysed (paragraph 17 of the 1979 report). The mere fact that the base company is able to shelter its profits under a low tax systems would, in any case, not lead independent parties to concede price advantages to it. Thus, its actual activities, risks and responsibilities have to be ascertained. Where the base company has no economic functions of its own but serves exclusively to channel assets to, or income through, a low tax area, it would normally not be able to realise profits in acting between independent parties and this would be the guideline in examining its transfer prices. No, or only a minimal, profit might thus be expected to arise to a base company in a low-tax country formally acting as a seller of merchandise produced by the taxpayer to customers outside that country, if the company actually does not carry out the delivery or other substantial commercial activities (paragraph 59 of the 1979 report). A base company with limited functions, responsibilities or risks corresponding to that of a broker, standby or subcontractor could, if acting between independent parties, obtain a profit only for its actual economic contribution and its transfer prices would normally be examined on a cost-oriented basis (e.g. based on a fee or on the cost-plus method). This basis would normally apply where mere marginal or auxiliary activities are exercised by the base company; where such arrangements do not correspond to normal business practice, no additional profit could be attributed to the base company by reference to what, under normal circumstances, would be the exercise of

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sound commercial judgement, or by reference to a specific allocation mechanism, e.g. the centering of cost-sharing arrangements in the base company.

2. Special procedural rules

29. The question arises whether special procedural rules are consistent with Article 9 (Associated enterprises) and Article 24 (Non-discrimination) of the OECD Model Convention:

a) Procedural rules and transfer pricing

30. As noted in paragraph 25 of the 1979 OECD report, transactions between related parties should be supported by relevant documentation. It is clear from the report that this applies in a specific way to arrangements aiming at minimising taxes in low tax areas. In this context it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes to be found in the context of national laws on base companies are contrary to the arm's-length principle. These questions are not confined to base company situations, and have to be considered in a wider context. It should be noted, however, that a number of countries interpret Article 9 in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of that Article and that it has the function of raising the arm's-length principle at treaty level, thus enabling the Contracting States to deal with it under mutual agreement procedures and to give rise to corresponding adjustments. This is a topic dealt with in the 1984 OECD report on transfer pricing (see bibliography to this volume) and which might be reconsidered again by the Committee on Fiscal Affairs at some later date.

b) Procedural rules and non-discrimination

31. Even if the country of residence of the taxpayer imposes information requirements on him in respect of his relationship with the base company which are more stringent than the normal requirements, or even if the burden of proof is reversed in this respect, Member countries, subject to one dissenting view, consider that there is no discrimination within the meaning of Article 24 of the OECD Model. First of all, the different treatment is not based on nationality (cf. paragraphs 1 and 3 of Article 24). Secondly, the different treatment does

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not depend on whether or not the taxpayer is controlled by a non-resident (cf. paragraphs 4 to 6 of Article 24). In addition the circumstances under which the information requirements are imposed are not "the same" within the meaning of Article 24, because it follows from the very nature of foreign relationships which cannot be explored effectively by the national tax authorities that information requirements have to be more burdensome than for the purely domestic context. However, if applied indiscriminately to all situations (including non-tax havens), these requirements could constitute an obstacle to international investment.

3. Conclusions

32. It appears then that general surveillance measures are not curtailed by a tax treaty between the country of residence of the taxpayer and the country of the base company. The internationally agreed principles of the 1979 OECD report on "Transfer Pricing and Multinational Enterprises" provide valid guidelines for an effective application of the arm's-length principle in the case of base companies. In any future revision of the OECD Model Convention this aspect might however be stressed in the Commentaries on Article 9.

33. On the other hand, general surveillance measures may lead to differences in applying the Convention. Any such difficulties should be solved in accordance with the mutual agreement procedure as set out in Article 25 of the Model Convention.

B. Treaty implications of "substance-over-form" provisions

1. The concept of person

34. Normally the base company will be regarded as a person (cf. Article 3 of the OECD Model) if it has been set up according to the laws of a given country. There may be specific situations in which a base company has to be treated as non-existent, e.g. because:

- The treaty exceptionally does not treat it as a company; or
- It has to be denied legal personality under the rules of international private law; or

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– The act of setting-up the base company is invalidated in itself under the laws of the country where it is established.

Leaving aside these very special situations, the base company cannot be treated as non-existent under the Convention. The question however arises of whether or not the company is a resident of the low-tax country where it has been set up.

2. Definition of residence

35. For treaty purposes a company is a resident of the Contracting State in which its place of effective management is found, and this is so irrespective of where its place of incorporation is situated (cf. paragraphs 1 and 3 of Article 4 of the OECD Model). The country of residence of the taxpayer could therefore tax the income of the base company if the place of effective management were situated there. This will sometimes be the case in practice. On the other hand, deeming under national law that the place of effective management is situated in the taxpayer's country would not overrule the provisions of the Convention.

36. Article 4, paragraph 1, second sentence of the OECD Model, excludes from the term "resident of a Contracting State" any person who is "liable to tax in a Contracting State in respect only of income from sources in that State or capital situated therein". This exclusion relates clearly to specific privileges granted by reason of the international relations of a person and gives such a person in effect the status of a non-resident rather than that of a resident. The Commentaries on the OECD Model give as an example the case of certain diplomatic personnel. The exclusion would, nevertheless, apply according to its wording and spirit where, for example, foreign-held companies are exempted from tax on their foreign income by privileges tailored to attract base companies. There are, however, difficulties inherent in this approach which are discussed in paragraph 14 of the following report on conduit companies.

3. Permanent establishment of the base company

37. While the place of effective management is normally situated in the country where the base company has been set up, it could be questioned whether or not a permanent establishment of the base company is situated in the taxpayer's country of residence, thus enabling that country to tax the income attributable to the permanent establishment, for example, because it has a place

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of management there [cf. Article 5, paragraph 2 *a)* of the OECD Model]. This is a question of fact but it also involves difficult problems of interpreting these provisions. Here again, the use of a deeming provision under the national law of that country would not suffice if there is no factual basis for recognising a permanent establishment. Even if a permanent establishment in the form of a place of management were present, it has to be kept in mind that the tax regime of a permanent establishment differs to a large extent from that of a company having its place of effective management in the country. Only profits attributable to the permanent establishment are taxed. Sometimes, there are different tax rates, taxation of distribution is differently effected, etc.

4. Attribution of activities and/or income

38. While recognising that the base company as a legal entity has its place of effective management in the country where it has been set up and does not have a permanent establishment in the country of residence of the taxpayer, the latter country could at least, under its national tax law, attribute to the taxpayers the activities and/or the income of the base company. This approach would clearly not be contrary to the OECD Model if the base company acted as a mere intermediary, an agent, a fiduciary or nominee of the taxpayer (cf. for example, the notion of beneficial owner in Articles 10 to 12 of the OECD Model). However the question arises as to whether, quite generally, domestic rules as to who is regarded as the recipient of specific income for tax purposes are compatible with treaties. This question especially arises in the case of "anti-abuse" or "substance-over-form" rules according to which it is not the base company itself but its shareholder, who is regarded as the true recipient of the income shifted to the base company.

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

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hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use.

40. It is not easy to reconcile these divergent opinions in theory, nor in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. On the dissenting view, to give domestic rules precedence over treaty rules as to whom, for tax purposes, is regarded as the recipient would erode the protection of taxpayers against double taxation (e.g. where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable. The problems arising here are very similar to those arising in the case of specific counteracting measures (see paragraph 47 below).

5. Conclusions

41. Tax treaties set limitations to technical rules though these limits are not very well defined. Furthermore, there are certain doubts as to their implications for the "substance-over-form" provisions. This adds to the well known practical difficulties of implementing national provisions of this type. Further clarification therefore seems to be necessary. In any case, where States feel that difficulties might arise in this area, they would try to settle them by inserting specific safeguards in their bilateral treaties.

42. A certain danger remains that technical and "substance-over-form" provisions could lead to double taxation even where a convention exists. Therefore, States applying provisions of this type should endeavour to alleviate any such double taxation in accordance with the letter and if possible with the spirit of their double taxation treaties.

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C. Treaty implications of counteracting measures

1. General outline of the problem

43. Under existing counteracting measures, the country imposes a tax on residents who are shareholders in the foreign base company. The foreign company as such is not taxed; generally the income which gives rise to the taxation does not originate in the country of the base company but in the taxing country itself or in a third country. A tax treaty between the country using the counteracting legislation and the country of the base company usually protects, however, income flows only between these two countries. The first-mentioned country may therefore claim that the tax imposed under the counteracting legislation does not come under the scope of the said tax treaty.

44. This attitude has sometimes been challenged as being contrary to the general structure and the spirit of tax treaties, except where a specific saving clause acknowledges the counteracting measures. It is said that counteracting measures implicitly disregard the company as a person, which is contrary to the treaty (cf. paragraph 34 above).

45. There seems to be several answers to that contention:

a) On the technical level, counteracting measures can attribute activities — and thus income — to a shareholder, which is not contrary to tax treaties (cf. paragraph 40 above). If the counteracting measures have the effect of taxing a deemed dividend of the base company, this is well within the taxing rights conferred on the taxpayer's country of residence under the rules of tax treaties regarding taxation of dividends (cf. Articles 10, 23A and 23B of the OECD Model);

b) On the tax policy level, counteracting measures pierce only the "umbrella effect" of the taxpayers' arrangements. This effect and the consequent possibilities for an indefinite deferral are not guaranteed by tax treaties which were never intended to prohibit national safeguards for the equity and neutrality of a country's tax law;

c) On the international level, as long as some countries regard it as a sovereign right to shape their fiscal system in a way which might negatively affect other countries, tax authorities in these other countries must safeguard their sovereign right to preserve the equity

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and neutrality of their tax systems. It has never been intended that tax treaties would replace national sovereign rights with international co-operation to safeguard the integrity of tax systems.

46. It is evident that these are the views of States adopting counteracting measures and a very large majority of OECD Member countries have supported them. However, while counteracting measures as described above are not inconsistent with the spirit of tax treaties, there is agreement that Member countries should carefully observe the specific obligations clearly evidenced in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be adequate to grant him the protection which the treaty network would have provided if the taxpayer had not used the base company.

47. Whilst the majority of OECD Member countries thus accepts counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, it firmly adds that such measures should be used only for this purpose. It would be contrary to the general principles underlying the OECD Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer. It is also of relevance that a country's willingness to co-operate effectively with other tax administrations will normally be a strong deterrent to use base companies in that country.

48. However, there is no easy way of drawing clear-cut rules from these guidelines. An international consensus should be established, to which States newly introducing counteracting measures might refer. In this respect, the OECD Committee on Fiscal Affairs has played and could continue to play a role which would be helpful, vis-à-vis both Member countries which already apply

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counteracting measures or are considering adopting measures of this kind, and those Member countries which view such measures taken in other countries as infringing their own tax sovereignty, or going against their tax policy or being contrary to international commitments. The Committee would accordingly appear to constitute the appropriate forum for discussion of such policy issues.

2. Paragraph 5 of Article 10 of the 0ECD Model

49. It might be argued that where the taxpayer's country of residence, pursuant to its counteracting measures, seeks to tax profits which have not been distributed it is acting contrary to the provisions of paragraph 5 of Article 10. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under a counteracting legislation. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

3. Treatment of the taxable amount

50. The appropriate treatment of the taxable amount under a tax convention between the country of the base company and the country of the taxpayer depends on how the relevant counteracting legislation is regarded. If it attributes the activities or the income of the base company to the taxpayer, one has to look to the composition of the income; it may be composed of different items of income (business profits, interest and royalties) derived from the country of the base company or from any other country and the provisions that are relevant for these items have then to be applied. If the taxable amount is, however, a deemed dividend or a particular capital yield, it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 of the OECD Model or as other income within the meaning of Article 21 of the OECD Model. At least under some counteracting measures the taxable amount is treated as a dividend with the result that an exemption, provided for by a tax convention, e.g. an affiliation exemption, is also extended to it (for instance, in Germany). It is doubtful whether the treaty requires this to be done. If the country of residence considers that this is not the case — and consequently refuses the affiliation exemption for "deemed dividends" —it may face the allegation that it is obstructing the

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normal operation of the affiliation exemption, by taxing the dividend (in the form of "deemed dividend") in advance.

4. Treatment of dividend distributions of the base company

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

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V. IMPLICATIONS OF CONVENTIONS WITH THIRD STATES

52. Base companies often shelter third country income. There exists no apparent tax-relevant relationship between the country of source (S) and the home country (R) of the taxpayer as long as the latter does not take protective measures. Only when that country recoups its taxation in ways described in Chapter III, does its system have an effect on taxation in country S. By doing so, country R may in specific situations even produce effects of tax significance for other countries (cf. subchapter C below). The present chapter deals with the relevance and implications of such relationships for taxation.

A. Third country income: basic approaches

53. In the case of third country income, the following problems may arise.

a) In the absence of a treaty between country R and country S, should country R allow a credit for the taxes which are imposed by country S?

b) Where a tax treaty exists between these two countries:

i) Should country S limit its taxation under the treaty provision?

ii) Should country R credit the taxes of country S and, if so, should it credit the full amount or only the amount due under treaty limitations?

iii) Should country R exempt income if the treaty provides for such an exemption in case of direct flows of income from country S?

54. It seems clear that the answer in each case should normally be negative as, from a legal point of view, it is assumed that two separate relationships exist between countries S and B on the one hand, and between countries B and R on the other hand, and the base company's own separate entity prevents any direct tax relationship between country S and country R. The answer would be positive only if a tax-relevant direct relationship existed between those two countries.

55. Whether a tax-relevant relationship exists between country S and country R depends on how the legislative measures in country R are legally construed. Basic situations may be illustrated, by three examples.

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Example A:
Country R regards the base company as a resident because, under its domestic law, that company has a place of central management there. Country R thus treats the base company as any other resident. Consistently, the companies' dealings with country S should be treated as any other direct relationship, so that double taxation reliefs available in R domestically or under the treaty between S and R have to be granted. Treaty protection should also be given by country S since it depends (under Article 4 of the OECD Model) only on the law of country R whether the base company is a resident thereof for the purposes of the treaty and falls, consequently, under its personal scope (Article 1 of the OECD Model).

Example B:
Country R regards the base company as a foreign resident. However, it considers, under its national tax law, income sheltered in the base company to be income arising directly to its resident shareholder (e.g. by a substance-over-form approach). Again, viewed from country R, there is a direct relationship because one of its residents receives income from country S. Country R will, therefore, grant relief against double taxation which is available domestically or under its treaty with country S. The situation may, however, be viewed quite differently by country S which may maintain that, according to its law, the income was received by the base company and that seizure of that income by country R cannot change this. In fact, if country R allocates, under its domestic law, income to the resident shareholder, it does not, under the OECD Model, automatically follow that the income is covered by the treaty as country S may allocate the income, independently, on the basis of its own domestic law (with the exception mentioned in paragraph 58 below).

Example C:
Country R has a counteracting legislation under which the income of the base company is deemed to be distributed to the shareholder resident in country R at the time when it accrues to that company. From a legal point of view, there then exists no tax-relevant relationship between country S and country R. The base company is recognised by both countries as a resident of country B and as recipient of the income, land this bars any direct relationship between countries S and R. Neither

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country would, therefore, grant domestic or treaty protection against double taxation.

56. Even though the situation may be very similar in all three cases from an economic point of view, i.e. income sheltered in a tax haven has been recouped by country R, the relationship between country R and country S depends on the specific kind of counteracting measures in country R and varies, therefore, from one example to another. It may seem adequate to take into account in some way the taxation in country S and treaty relationships with that country. This is suggested, inter alia, by the fact that the tax administration of country R will frequently be dependent, for the implementation of its counteracting measures on co-operation with the tax administration of country S on the basis of the treaty between these countries. This may be a reason why even countries with legislation of the kind referred to in Example C above often on their own account grant their taxpayers the benefits of treaties with source countries, though they would not formally be obliged to do so.

B. Third country income: conclusions and recommendations

1. Credit in the country of residence for foreign taxes paid at source

57. Tax authorities — and especially, subject to one dissenting view, those of countries which apply "subpart F" type defensive provisions — concur with the view that country R should credit in all cases the taxes of country S where this is provided for generally by its domestic law or by its treaties in case of direct flows of income from country S. This is evidently based less on technical or legal considerations than on the acceptance of a general principle. As set out in paragraphs 46-48 of this report, counteracting measures should comply with the spirit of international tax law by seeking to avoid double taxation. To follow this in the relationship between country R and country S should be generally encouraged.

2. Limitation of source taxation under double taxation treaties

58. As a general principle, it cannot be accepted that the source country is obliged to waive or reduce its tax under a treaty with the country of residence. Such an obligation would result clearly from the OECD Model only where the

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base company is resident in country R by the criteria of Article 4. Whether this is the case will often be difficult to ascertain, and Contracting States will normally need a mutual agreement procedure to make the necessary findings. It would not be acceptable, for instance, that the base company itself asks for some reduction of S's tax under the convention between S and R without showing that it is treated as a resident of country R.

59. In all other cases, the country of source will normally treat the income in question as income of the base company itself. There is, then, no basis in the treaty between country R and country S for the base company to claim a limitation of source taxation. It may, of course, happen that pursuant to country S's domestic law it is possible to allocate income under a "substance-over-form" approach to a person other than the one formally receiving it. Country S, however, may well argue that such approaches are designed to combat the avoidance of taxes of its own country. In the present context, however, treaty application would not serve to counteract tax avoidance in the country of source but to protect country R's revenue or the interests of its taxpayers.

3. Amount of credit to be granted in the country of residence

60. It has been argued above that country R should, according to its domestic law, credit the taxes of country S in the same way as it would credit taxes levied at source on direct flows of income (cf. paragraph 57); there are even more reasons for doing so where a treaty exists between country S and country R. It may, however, occur that taxation at source levied by country S is relieved or reduced under such convention in the case of income arising directly to a resident of country R. Would country R then be entitled to deny its credit or limit its amount of tax to treaty levels? The answer, in principle, should be in the negative as the source country is normally not obliged to relieve or reduce its tax (cf. paragraph 58 above). Where, in specific cases, country R and country S agree that source taxation on the base company income should be limited under the treaty between them, this would of course affect the credit granted in country R. The tax authorities of country R may also reasonably expect the taxpayer to take advantage of any tax treaty which might exist between country B and country S. In order to find a general guideline and to simplify an already complex situation, it is suggested that residence countries, as a general rule, should give full credit for taxes effectively levied at source.

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4. Application of the exemption method by the country of residence

61. Country R may, in its treaty with country S, have adopted the exemption method for relieving double taxation. This will not affect passive income like dividends, interest and royalties which normally give rise only to credit for tax at source. However, exemption may be applicable to income arising to the base company from immovable property or permanent establishments in State S, where the treaty between R and S would provide for exemption in the case of similar income derived directly from S by residents of R.

62. It seems clear from the text of the convention that the exemption method has to be applied in the Examples A and B (see paragraph 55 above). In Example C, no such obligation exists but some States seem to be inclined to grant the application of the exemption method for special reasons under their domestic law (e.g. because it simplifies matters and prevents more tax being levied in cases of tax avoidance than in other cases). The application of treaties in such cases requires international co-operation in order to prevent the income being exempted twice, but otherwise no general recommendation can be given.

5. Holding companies

63. A characteristic situation is the one where a base company receives income from an active subsidiary. This is often the case when base companies are used by internationally-operating enterprises as a regional centre or as a financial pivot.

64. In a situation where a participation in a company of S were held directly by a resident of R, the dividends would mostly be relieved from recurrent corporate taxation by an indirect tax credit, or by an exemption (affiliation exemption) in country R, either under domestic law or under the treaty with country S. The question whether these reliefs should be granted where a counteracting measure applies has to be answered in principle in the same way as the question whether an exemption under a treaty between countries R and S should be applied for direct income flows originating in S (cf. paragraph 62).

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C. Relationships with non-source countries

1. Implications of tax conventions on second-tier base companies

65. Since counteracting measures also include second-tier base companies, situations may arise where two different measures of this kind are imposed simultaneously on the same income. Thus a German parent holding a Bahamas base company (sub-subsidiary) via a Canadian base company (subsidiary) may be taxed on the undistributed income of the Bahamas base company while the same amount may be taxable under the Canadian defence legislation in the Canadian company. Though the second-tier base company (sub-subsidiary) is outside the personal scope of the convention between the country of the parent and the country of the first-tier base company (subsidiary), Member countries having adopted subpart F type legislation agree that both the country of the parent and the country of the first-tier subsidiary may apply their counteracting measures in this situation, unless there is a saving clause on this in the convention between the country of the parent and that of the subsidiary.

66. From a legal point of view, situations may, once more, vary according to what kinds of measures are used by both States applying counteracting measures. It may well be that there is a direct tax relationship between them, e.g. if both consider the base company as resident. In this case, treaties or domestic laws generally would avoid double taxation. Where no such direct relationship exists (e.g. when both countries use the mechanism of Example C), fully-fledged double taxation might result, thus creating an overreaction by measures designed to counter international tax avoidance. While this may not be in conflict with the Model Convention, States in which this problem arises should endeavour, in appropriate circumstances, to solve it either by domestic law or in their treaties. Germany and Canada have resolved it in the Protocol to their tax treaty by inserting the following provision: ...in cases where the same income is subject to the special tax referred to in ... and the special tax referred to in ..., the contracting State of which the controlling shareholder is a resident shall give credit for the special tax of the other Contracting State."

2. Shareholders (of base companies) with double residence

67. Where the taxpayer who is subject to counteracting measures in country R, (of which he is a resident under that country's domestic laws), is at

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the same time a resident of X (under the latter's domestic laws), and his personal and economic relations are closer to country X (cf. paragraph 2 of Article 4 of the OECD Model), the application of the counteracting legislation may be barred on the grounds that income derived from a third country is taxable only in the country of residence within the meaning of the Convention (i.e. country X), unless there is a permanent establishment in the other country (R) with which the participation in the base company is effectively connected. This seems to be justified because the taxable amount, though possibly not considered as income in country X constitutes income within the meaning of the Convention (cf. Article 21 and Article 3, paragraph 2, of the OECD Model) and thus has to be treated accordingly. This becomes even more evident if both country R and country X impose counteracting legislation of a "subpart-F" type.

3. Participation in a base company held in a permanent establishment

68. Where the participation in the base company is effectively connected with a permanent establishment situated in a third country, a similar question arises if the Convention with that country provides for exemption of the permanent establishment's income (cf. Article 23 A of the OECD Model). There can hardly be any doubt that the country of residence has in this case to exempt the income. However, it will be rather exceptional in practice that the participation is in fact effectively connected with the permanent establishment, i.e. that the base company has relations exclusively with the permanent establishment and not with the enterprise as a whole.

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VI. QUESTIONS OF SECONDARY SHELTERING

69. As indicated in paragraph 12 of this report, when income sheltered in a base company is distributed or otherwise transferred to the taxpayer, it becomes subject to tax, normally as a dividend. Thus, the initial tax advantage of the sheltering would normally be eliminated. However, this taxation which offsets the original tax advantage may also be avoided by "secondary sheltering", the main strategies of which have already been described. In the following paragraphs, the main issues arising in an international context are briefly discussed, with respect to countries who do not have counteracting measures as described in the foregoing chapters.

70. The cases of secondary sheltering may be summarised by saying that income is disposed of by the taxpayer in such a way that it is either:

a) Not taxable under the domestic law of his country of residence, which will be the case, for instance, when it is accumulated and reinvested in the base country or in a third country; or

b) Ploughed back in the taxpayers' enterprise in country R, as a loan giving rise to interest payments which are normally deductible from taxable profits of that enterprise; or

c) Exempted from normal taxation in country R under special rules of domestic law or of a double taxation treaty, the most frequent cases being the following:

i) Base company income is distributed to the parent company resident in country R, where an affiliation exemption applies to relieve recurrent corporate taxation either under domestic rules or under a treaty;

ii) The taxpayer (an individual) receives income from the base company as salaries or directors' fees, which are exempt in R under a treaty; or

d) Enjoying a special tax treatment in country R, e.g. where, at the liquidation of the base company, income accumulated there is distributed to the parent-company in country R as profits from

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liquidation and subject there to a lower rate of tax applicable to capital gains.

1. Reinvestment in a country other than the country of residence

71. In this case, it will be difficult for the country of residence to combat secondary sheltering. Countries wanting to counteract this type of strategy should rather have recourse to counteracting measures described in the foregoing chapters.

2. Reploughing by loans to the shareholder company

72. Though a naive and rather straightforward form of tax avoidance, reploughing by loans is not easy to counter once a tax administration has accepted the use of base companies as a bona fide arrangement. The authorities in the country of residence may endeavour to show that the loan operation is an artificial one. They may want to argue that, on the facts, no interest deduction is to be allowed to the taxpayer's enterprise (if any "interest" is paid) because the funds are in reality not those of the base company but belong to the taxpayer. Demonstration of this will be easier if the domestic laws of country R contains "substance-over-form" provisions.

73. However, proving that the loan is effectively a distribution under a substance-over-form standard will often be difficult if the argument is restricted to the "loan arrangement" itself (because the background arrangement has been accepted). Even in the case of a highly artificial arrangement, it will often be difficult to ascertain facts and intentions (such as, when it is part of the arrangement, the lack of intent to repay the "loan"). It may be easier if the "loan arrangement" is regarded as part of a series of interdependent stages in a scheme which, looked at as a whole, can be regarded as a single composite transaction. The loan might be disregarded if the transaction as a whole, or a single part of it, does not meet "substance-over-form" criteria. It is, however, clear that such arguments might imply that not only the "loan" and the secondary sheltering but the use of the base company and the primary sheltering are abusive.

74. United States law contains a provision which includes as income of United States shareholders of base companies certain loans by the base

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company to United States persons. However, when the income of the base company has already been included in the United States shareholder's income under subpart F, these rules would not operate to impute additional income to the shareholders. No other specific domestic measures are known against reploughing through loans. They would probably have to take into account the whole series of transactions rather than only the "loan". Once more efforts against secondary sheltering would require similar legislation and administrative machinery to those against primary sheltering.

3. "Repatriation" as dividends or other tax-exempt income

a) Repatriation as tax exempt dividends

75. Where the income sheltered in the base company is "repatriated" as dividends paid to the parent company, such income will frequently be exempted under an affiliation exemption. The country of residence (of the parent company) should examine closely whether the dividends received would unconditionally qualify for the affiliation exemption, if there is no, or very low, corporate taxation in the country of the base company. Clearly, the exemption creates a void in tax terms and, as it were, transfers the low tax level of the tax haven country into the tax system of the country of residence. Countries which wanted to avoid such secondary sheltering have limited their exemptions in their domestic law, or in their treaties, to cases where recurrent corporate taxation really occurs. This may be done, among other things, by:

- Providing for an "activity clause" which prevents dividends from "non-active" companies from being exempted;
- Excluding from the exemption, dividends distributed by companies subject to low taxation;
- Switching from the exemption system to a system of indirect tax credit.

A further solution may be to adopt a more severe "substance-over-form" approach.

76. The measures described above may be difficult to apply and add to the complexity of a country's tax system, as it might be necessary to draw a dividing line between active and passive income and/or to define low taxation. In order to remain flexible, a special regime countering secondary sheltering

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may have to combine both elements in some way. Similar technical difficulties to those which exist under more comprehensive counteracting measures (especially those of the subpart-F type) would then have to be solved. It may, therefore, be better to adopt counteracting measures described in the foregoing chapters (i.e. one already designed to counter primary sheltering) rather than to set up a complicated system for the sole purpose of countering secondary sheltering.

b) Other tax-exempt payments

77. Where there is a convention between the base country and the country of residence and the latter applies the exemption method to avoid double taxation, “repatriation” of sheltered income sometimes takes forms such as wages or directors' fees. In these cases, the authorities of country R may endeavour to show, as the case may be, that such income does not have the character of wages, or of directors' fees, within the meaning of the relevant articles of the convention between country B and country R, (corresponding to Articles 15 and 16 of the OECD Model) but rather constitutes “dividends” or “other income” (under Article 21) thus being fully taxable in the taxpayer's country of residence.

78. For example, if dependent services were not carried out on behalf of the base company but on behalf of the taxpayer himself or of his enterprise, exemption might be denied. Likewise, amounts paid as directors' fees would be treated as dividends insofar as they exceed the amount which would have been paid in the absence of the taxpayer's own interest in the base company. No tax exemption would be due where, according to Article 4 of the 1977 OECD Model, the base company is to be regarded as a resident in country R. The exemption should also be denied if the taxpayer has claimed tax exemption or reduction in the country of the base company by pretending that the payment had not the character of a salary of director's fees. For doing so, the tax authorities of country R may obtain information from the tax authorities of country B (cf. Article 26 of the Convention) in order to show that the taxpayer did not exercise in country B, an activity sufficient to justify the payment of the income; country R may also wish to enter a mutual agreement procedure with country B.

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79. There may remain artificial arrangements which cannot be solved in this way. The problem then arises as to whether the exemption can be denied in another way, e.g. by showing that the payment is a part of a series of interdependent transactions in a prearranged scheme which, as a whole, has no other purpose than securing a tax advantage.

80. Where it seems necessary, tax treaties should take into account situations of the kind discussed in paragraphs 75 to 79 above. This may best be done by excluding certain companies from their scope or by adopting the credit method for eliminating double taxation, either generally or for certain items of income.

4. Extraction of income as capital gain

81. In a number of countries capital gains are subject to lower taxation than ordinary income. There are therefore substantial tax benefits to be obtained by arranging to convert income into a capital gain through a base company. This can be done by accumulating the income, and then extracting it by either disposing of part or all of the holding in the base company or liquidating the company altogether.

82. This is a common tax avoidance route. One area in which it has been exploited is that of collective investment institutions such as offshore mutual funds (referred to in paragraph 108 of the foregoing report on tax havens). A number or countries have specific counteracting measures to ensure that a proper tax charge is levied on the investor's share of the base company's income.

83. In such cases, the country of residence will have to make use of any safeguards, provided under domestic law, for not granting the special tax regime applicable to capital gains where the circumstances in which the company has been liquidated suggest that artificial arrangements have been made for the purpose of enjoying the benefit of the special regime. If no such safeguards exist in its law, country R could introduce provisions under which capital gains from the disposal of a participation in a base company would be taxable as ordinary income.

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5. Final remarks

84. Amending domestic laws with adequate provisions for dealing with secondary sheltering may be difficult in practice, and the efficacy of such counteracting measures cannot be guaranteed. These considerations may therefore lead the country of residence to consider introducing counteracting measures as described in the foregoing sections which may be directed both at primary and secondary sheltering.

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VII. COMBATING TAX AVOIDANCE AND TAXPAYER PROTECTION

85. When a taxpayer tries to avoid taxation by sheltering income in a base company, he enters a "tax triangle" formed by his home country, the base country (the tax haven) and the country of source. While this may give rise to considerable tax advantages, the taxpayer risks running unexpectedly into tax charges he would not otherwise have borne. Thus, the taxes in the country of source may be unexpectedly high, especially if a treaty between the base country and the country of source cannot be invoked because one or both Contracting States regard its use as improper by reason of the artificiality of the arrangement. It is possible that unexpected changes in taxation procedures and domestic laws of the base country may cause difficulties for the taxpayer. Counteracting measures deployed by the home country may definitely aggravate the situation. It is clear that the taxpayer using a base company has to bear the risks inherent in the situation which he has created.

86. Another danger is that of double taxation (especially economic double taxation). A number of such situations have been described in the foregoing chapters and still others may occur. This results from three risks inherent in the "tax triangle":

- Counteracting measures are by their nature unilateral measures of a State which finds that its tax has been avoided; those countries in the "triangle" whose tax has not been avoided (or avoided in a specific way) and which deploy no such measures, have no reason to recognise them, because to do so might even have undesirable tax effects for them;
- International tax relations are based on the assumption of *bona fide* situations and not adapted to specific measures such as counteracting measures, especially in a triangular situation;
- The tax authorities concerned may be reluctant to rectify a situation created by the taxpayer for his own advantage.

Taxpayers should therefore always be aware of such risks and realise that tax authorities cannot be expected to be as anxious to avoid the consequences of the situation as they might be in normal cases.

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87. There is even doubt whether, in the base company situation, double taxation should be avoided in a systematic way. Two lines of thinking have been expressed:

- It is argued, on the one hand, that the taxpayer has to bear the full risks of an arrangement which he has voluntarily entered into with a view to obtaining a tax advantage. Tax authorities could not safeguard him in any way from the unexpected consequences that such arrangements may have. In addition, such protection may not be desirable, as the residual risk of double taxation could act as a certain deterrent against artificial arrangements;
- On the other hand, it is argued that the taxpayer may ask for fair treatment, once tax administrations have successfully deployed their counteracting measures. Letting him incur double taxation in cases where this could be avoided would clearly lead to an additional tax burden which has the character of a penalty. However, this cannot be justified, as penalties would normally be imposed by the domestic laws of the countries concerned and should be under the safeguard of their normal courts.

These diverging views cannot readily be reconciled. They are not based on well-defined legal principles but rather reflect different general attitudes towards tax avoidance. These divergences and the fact that they will often be difficult to reconcile are matters that taxpayers should be aware of.

88. The nearest one can come to a conclusion is that, while tax administrations cannot offer any guarantee against the risks inherent in base company arrangements, they should certainly try to avoid over-reacting. For this, it is advisable that:

- Residence countries should observe the general principles set out in paragraphs 46-48 when shaping and deploying their counteracting measures;
- Countries which have co-operated through an exchange of information in order to combat tax avoidance should be willing to co-operate in appropriate circumstances for the avoidance of double taxation in the same case.

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89. There are, however, limits to this. Co-operation will presuppose that the taxpayer has given full information and that tax authorities are sufficiently convinced that they have under view the full scope of the taxpayer's tax avoidance strategies, so that no other income of considerable amount has been sheltered from their taxation. In practice such a presupposition may often be ill-founded. Furthermore, the taxpayer cannot justifiably expect to have the taxation imposed in the base country reduced, when he voluntarily used this country as a means of sheltering his income from taxation in his country of residence.

90. Finally, in the context of taxpayers' protection, mention should be made of the mutual agreement procedure provided for by Article 25 of the OECD Model. As a principle, OECD States generally agree that Article 25 applies to double taxation resulting from the application of defensive measures described above. This was made explicit when the OECD Model was completed, in 1977, to cover cases of economic double taxation, with the scope of the mutual agreement procedure being extended accordingly (see paragraph 8 of the Commentary on Article 9 and paragraphs 8 and 9 of the Commentary on Article 25). In practice, and except in one State where the courts have taken an opposite view, tax authorities do consider that taxation under counteracting measures is within the scope of the mutual agreement procedure.

91. However, the mutual agreement procedure does not guarantee to the taxpayer that double taxation will be fully avoided. A taxpayer whose attempts to avoid tax have been successfully frustrated by counteracting measures cannot expect his tax authorities to be anxious to enter into a mutual agreement procedure. More generally, Article 25 lays on tax administrations a mere duty to negotiate but in no way an obligation to reach agreement, as no procedure, for arbitration or otherwise, is available to the taxpayer in cases where tax administrations still disagree on the way double taxation should be remedied.

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VIII. FINAL REMARKS

92. After consideration of the problems arising from tax avoidance and evasion through the use of base companies, it does not seem possible to formulate recommendations which would be applicable in all cases and acceptable to all Member countries. However, a number of tentative conclusions have emerged:

a) Counteracting measures against the use of tax havens are a relatively novel feature in both domestic laws and in international tax relations, which are sensitive to the extent that such counteracting measures deal with situations where conflicts arise between the legal form and economic realities;

b) In the view of the States which have introduced them, counteracting measures constitute an essential instrument against tax avoidance practices, which in their absence would probably have become more widespread. Subject to one dissenting view, these measures are regarded as generally consistent with the principles underlying the OECD Model Convention and the spirit of international tax treaties. Solutions to possible difficulties should be found either in the text or by observing the spirit of the Model. However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot be fully safeguarded by tax authorities;

c) The use of base companies exploits national legal systems for the diversion of income out of the reach of national taxation. It is therefore inevitable that counteracting measures go against the general structure of legal systems in Member countries, such as territoriality of taxation and the recognition of juridical persons. By doing so, counteracting measures may create uncertainties as far as legal positions and business environments are concerned. States should avoid as far as possible bringing inconveniences to "*bona fide*" economic activities and should not infringe upon the tax sovereignty of other States;

d) Counteracting measures should therefore focus on clearly-identified fields of abuse. They should not be extended to activities such as production, or normal rendering of services or trading, of companies

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engaged in real industrial or commercial activity when they are clearly related to the economic environment of the country where they are resident and these activities are carried out in such a way that no tax avoidance can be suspected. Technical aspects of such legislation also should be consistent with the spirit of tax treaties. It is desirable that States which have introduced, or will introduce, measures of that type be ready to discuss any problems created in a bilateral or, where appropriate, a multilateral context;

e) Matters dealt with in this report tend to evolve over time. The Committee on Fiscal Affairs, which is the appropriate body for discussions on such measures, will therefore be closely following developments in this area, and will be prepared to take the matter up again as required, with the possibility that amendments to the 1977 Model Convention may result.

93. In conclusion, the Committee has expressed the wish that:

a) Member countries which introduce measures to counteract the use of base companies, should design such measures in accordance with both the principles of international taxation generally agreed upon among OECD Member countries and the spirit of double taxation conventions and take account of the undesirable consequences that such measures might have for other countries;

b) Member countries, when applying any such measures, should, to the maximum extent possible keep this application consistent with their obligations arising from their double taxation conventions;

c) Those Member countries which consider that counteracting measures taken in other countries infringe their tax sovereignty, or are contrary to international commitments and their tax policy, or create other problems, should take up the matter in the Committee with a view to finding appropriate solutions.

94. The Committee also intends:

i) To continue to explore problems so raised and recommend solutions to them;

ii) To discuss new developments in this field; and

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iii) To take up the topic again when next considering possible amendments to the 1977 Model Convention.

Observations by Switzerland:

95. The counteracting measures described in this report, notably in paragraphs 29 to 38 and 39 to 40, are contrary to the spirit of bilateral double taxation conventions signed between OECD Member countries as they result, in effect, in an extra-territorial application of domestic tax legislation.

96. These measures hamper international economic relations and result in an additional administrative burden for both taxpayers and tax authorities. As divergences of view exist as to what extent some provisions (cf. paragraphs 30, 38 and 39 above) are contrary to the 1977 OECD Model Convention (Article 7, paragraph 1 and Article 24 especially), legal provisions of that kind should not be implemented without prior consultation of partner countries; the latter's interests should then be taken into consideration.

97. Finally, Switzerland considers that the interpretation given in paragraph 36 of the report, concerning paragraph 1 of Article 4 is not in conformity with the meaning and purpose of that provision.

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ANNEX I

INTERNATIONAL COUNTERACTING MEASURES: AN OVERVIEW

Country of:	General surveillance measures - Arm's-length rules - Procedural rules	Substance-over-form provisions	Defence legislation	Measures "from the top"
Residence of shareholder				

TAXPAYER

↓

Base company

↑ ↑ ↑

Income sheltered

Base company

Source of income	General measures -Arm's-length rules -Procedural rules	Specific approaches: - Look-through approach - Exclusion approach - Subject-to-tax approach - Channel approach - *Bona fide* provisions	Taxation at source (e.g. withholding tax)	Measures "from below"

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DOUBLE TAXATION CONVENTIONS AND THE USE OF CONDUIT COMPANIES

(adopted by the OECD Council on 27 November 1986)

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I. THE PROBLEM STATED

A. General

1. In its Commentary on Article 1 of the 1977 OECD Model Convention, the Committee on Fiscal Affairs expressed its concern about improper use of tax conventions (see paragraph 9) by a person (whether or not a resident of a Contracting State), acting through a legal entity created in a State with the main or sole purpose of obtaining treaty benefits which would not be available directly to such person.

2. This report deals with the most important situation of this kind, where a company situated in a treaty country is acting as a conduit for channeling income economically accruing to a person in another State who is thereby able to take advantage "improperly" of the benefits provided by a tax treaty. This situation is often referred to as "treaty shopping". The "conduit company" which is characteristic of such schemes is usually a corporation, but may also be a partnership, a trust or a similar entity. The tax advantages with which this report is primarily concerned occur to the detriment of the country of source of income. Whilst there is some brief consideration of taxation in the country of residence of the person to whom the income economically accrues, this is dealt with mainly in the foregoing report on "base companies".

3. Though not dealt with in this report, it is noted that a legal entity is sometimes created in an intermediary country for other than tax purposes (such as access to capital markets, currency regulations, political situations or the need to be present in the country of investment under the "flag" of the intermediary country), and that does, of course, have tax consequences.

B. Conduit companies

4. The treaty benefits referred to above may be obtained in two principle ways, either by the use of direct conduit companies or through a "stepping-stone" strategy. The essence of these manoeuvres is described below and represented diagrammatically in Annex 1.

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1. Direct conduits

A company resident of State A receives dividends, interest or royalties from State B. Under the tax treaty between States A and B, the company claims that it is fully or partially exempted from the withholding taxes of State B. The company is wholly owned by a resident of a third State not entitled to the benefit of the treaty between States A and B. It has been created with a view to taking advantage of this treaty's benefits and for this purpose the assets and rights giving rise to the dividends, interest or royalties were transferred to it. The income is tax-exempt in State A, e.g. in the case of dividends, by virtue of a parent-subsidiary regime provided for under the domestic laws of State A, or in the convention between States A and B.

2. "Stepping stone" conduits

The situation is the same as in example 1. However, the company resident of State A is fully subject to tax in that country. It pays high interest, commissions, service fees and similar expenses to a second related "conduit company" set up in State D. These payments are deductible in State A and tax-exempt in State D where the company enjoys a special tax regime.

In either case the use of the "conduit company" does not give rise to substantial taxation in the conduit States. This is normally essential for the scheme, as otherwise the advantage of using the tax treaty would mostly be compensated for by taxation in that State.

C. Examples

5. The following are some illustrative examples:

a) Example 1

A person X, resident of a State which has not concluded any tax treaties, derives interest from bonds of a number of States, which under the laws of these States is subject to withholding taxes therein. X sets up a company in State A, which has an extended network of tax treaties; he transfers the bonds to the company. The interest flowing now to that company is subject to no, or very low, taxation in State A due to specific tax exemptions provided for companies of that kind. On the basis of State A's treaty network, the company claims

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exemption from or reduction of withholding taxes in the States where the interest arises. The interest received by the company which is a resident of State A is then transferred to X as a loan.

b) Example 2

A company Y resident of State 0 has developed a patent and intends to enter into license agreements with licensees in a number of countries. Y transfers the patent to a company set up in State A. As in example 1, the royalties are subject in State A to no, or very low, taxation; and exemption from, or reduction of, withholding taxes is claimed in the States of source. The royalties may then be transferred to Y as a dividend and may often be exempted by a participation exemption in the State of residence of Y.

c) Example 3

A company Z is a parent company with wholly-owned subsidiaries in States C_1, C_2, C_3. The State of residence of Z has no treaties with C_1, C_2 or C_3. Z transfers its participations to a company in State A. The dividends received are not subject to a tax because of a participation exemption or a system of indirect credit existing in that State. Exemption from withholding taxes in the States of residence of C_1, C_2, C_3 is claimed on the basis of the treaty network of State A. The dividends are reinvested by Z in new subsidiaries.

d) Example 4 (stepping-stone)

A tax haven company plans to invest funds as a loan in a high tax State A. The funds are channelled through a company set up for this purpose in a high tax State B. This company receives interest from State A at a rate of, say, 12 per cent and pays interest to the tax haven company at a rate of 11.5 per cent. State A levies a withholding tax on interest which is reduced to nil under the convention between States A and B. State B does not levy withholding tax on interest under domestic law. In such a case the tax haven company benefits from a treaty between the high tax States A and B though it is subject to tax in the latter State only to an insignificant degree (i.e. paying a normal tax only on the marginal 0.5 per cent of the interest).

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D. Main characteristics of "conduit configurations"

6. Through the configurations described above, the conduit company takes advantage of the treaty provisions under its own name in the State of source; economically, however, the benefit goes to persons not entitled to use that treaty. A net tax advantage results because little or no taxation occurs in the State(s) of conduit. The advantage arises in the source country. As its tax laws deal adequately with the situation (it generally taxes all non-residents including the conduit company) the problem is created exclusively by the treaty itself and therefore can only be dealt with under the treaty.

7. This situation is unsatisfactory in several ways:

a) Treaty benefits negotiated between two States are economically extended to persons resident in a third State in a way unintended by the contracting States; thus the principle of reciprocity is breached and the balance of sacrifices incurred in tax treaties by the contracting parties altered;

b) Income flowing internationally may be exempted from taxation altogether or be subject to inadequate taxation in a way unintended by the Contracting States. This situation is unacceptable because the granting by a country of treaty benefits is based, except in specific circumstances, on the fact that the respective income is taxed in the other State or at least falls under the normal tax regime of that State;

c) The State of residence of the ultimate income beneficiary has little incentive to enter into a treaty with the State of source, because the residents of the State of residence can indirectly receive treaty benefits from the State of source without the need for the State of residence to provide reciprocal benefits.

These considerations endorse the Committee on Fiscal Affairs' general view that the use of treaties is improper where a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State primarily to obtain treaty benefits which would not be available directly to such person (cf. paragraph 1 above). They will be of relevance in deciding in which actual situations treaty benefits should be denied under existing treaties in order to cope with cases of "treaty shopping" and which new provisions should be included in bilateral treaties or in amendments to the OECD Model.

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E. Other aspects of the problem

8. This report focuses on taxation in the State of source. There are also tax advantages in the State of residence of the taxpayer who economically benefits from the treaty benefits. In fact, in the examples set out in paragraph 5 above, that State cannot, or does not, tax the income, though in all cases the taxpayer has its full economic benefits (by receiving it as a loan or as a dividend or by using it for investment in other subsidiaries). However, these tax advantages raise quite different issues: they have their source in national law, and treaty aspects usually arise only as secondary problems. These issues are considered in the separate reports contained in this volume which deal with "tax havens" and "base companies". Similar considerations apply to problems arising from the issue of bonds through conduit companies set up in countries which have no withholding tax on interest.

F. Bona Fide transactions

9. The configurations described above occur in many normal transactions of enterprises operating internationally. Thus a group's parent company in State X may have an operation subsidiary in State A which develops a patent in connection with its production activities and which licenses the patent to an enterprise in State B from which it receives royalties. It is clear that tax exemptions provided for such royalties in the treaty between State A and State B should not be denied because there is no such treaty between the State of source of the royalties (B) and the State of the parent company (X). Such bona fide transactions do not fall within the scope of this report, for they clearly involve no improper use of tax treaties. This is, generally speaking, true in all cases in which the assets or rights giving rise to income for which treaty benefits are claimed are effectively connected to activities like producing, rendering of services or trading in the market of State A.

G. Similar cases

10. The foregoing discussion is based on the assumption that improper use was made by a person resident in a State which had no treaty with the State of source. Similar problems may arise where there is a treaty between the State of residence and the State of source, but:

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a) This treaty offers less protection than the treaty between the State of source and the State of conduit;

b) The use of a conduit company can avoid the disclosure of information to the State of residence;

c) Both treaties offer equal protection but use is made of the conduit company in order to avoid taxation in the State of residence [e.g. because, by using the conduit company, income such as royalties is transformed into dividends to be exempted by a participation exemption (see example 2 of paragraph 5).

The principles set forth in this report are applicable to such cases.

H. Search for solutions

11. The existence of "conduit companies" has long been perceived to be a problem in treaty negotiations. It may also become a problem in the application of existing treaties if the treaty partners were not aware of the existence of "conduit companies" when negotiating the treaty or if it only becomes a problem subsequently (e.g. by reason of changes in domestic laws or by the emergence of new tax avoidance schemes, as in the case of "stepping-stone strategies").

12. In seeking a response to this problem this report considers:

a) Certain provisions of existing OECD Model Convention and their implications for conduit companies (Part II);

b) Specific provisions currently found in bilateral treaties (Part III), and;

c) The problems of applying existing tax treaties (Part IV).

On the basis of these studies the report sets out suggestions for future action (Part V).

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II. THE 1977 OECD MODEL CONVENTION: GENERAL APPROACH AND SPECIFIC PROVISIONS

A. The general situation

13. Normally under the OECD Model the conduit company is regarded as a person [Article 3, paragraph 1 *a)* and *b)*] resident in the State of conduit (Article 4). It is therefore entitled to claim the benefits of the treaty in its own name. There are of course situations where specific circumstances exclude the company from treaty benefits, but it is rarely possible to verify that such circumstances are present. This is the case, for example, where:

- The entity used as a conduit is not recognised as a juridical person (being, for example, a partnership, or a trust which may not be a "person" under the treaty provisions);
- The company is not liable to tax in the State of conduit on the basis of its domicile, place of management or other criterion of a similar nature (e.g. because its Board of Directors does not meet in that State);
- The assets and rights giving rise to the dividends, interest and royalties have not effectively been transferred to the company so that it acts as a mere nominee when receiving payments of such income.

In cases of doubt the conduit company should, at the request of the tax administration of the State of source, give the necessary information. It is, however, often found that these approaches are generally not sufficient to counteract the improper use of treaties in the conduit situation.

B. Anti-avoidance provisions

14. The OECD has incorporated in its revised 1977 Model provisions precluding in certain cases persons not entitled to a treaty from obtaining its benefits through a "conduit company".

a) Article 4, paragraph 1, second sentence excludes from the term "resident of a Contracting State" any person who is "liable to tax in a Contracting State in respect only of income from sources in that State or capital situated therein". This provision relates clearly to specific

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privileges granted by reason of the international relations of a person and giving such a person, in effect, the status of a non-resident rather than that of a resident. The commentaries on the 1977 OECD Model give as an example the case of certain diplomatic personnel. The provision would, however, apply according to its wording and spirit where, for example, foreign-held companies are exempted from tax on their foreign income (as viewed from their State of residence) by privileges tailored to attract conduit companies. It has, however, inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, so that there is an element of uncertainty concerning its application against conduit companies. Furthermore, to be effective, such provisions should also apply where the conduit company is fully exempt from tax under specific privileges, even though they cannot cover the stepping stone situation (see paragraph 4 *b)* above and paragraph 36 of the previous report on base companies) or cases where the special status is not based on an exemption of income.

b) Articles 10 to 12 of the OECD Model deny the limitation of tax in the State of source on dividends, interest and royalties if the conduit company is not its "beneficial owner". Thus the limitation is not available when, economically, it would benefit a person not entitled to it who interposed the conduit company as an intermediary between himself and the payer of the income (paragraphs 12, 8 and 4 of the Commentary to Articles 10, 11 and 12 respectively). The Commentaries mention the case of a nominee or agent. The provisions would, however, apply also to other cases where a person enters into contracts or takes over obligations under which he has a similar function to those of a nominee or an agent. Thus a conduit company can normally not be regarded as the beneficial owner if, though the formal owner of certain assets, it has very narrow powers which render it a mere fiduciary or an administrator acting on account of the interested parties (most likely the shareholders of the conduit company). In practice, however, it will usually be difficult for the country of source to show that the conduit company is not the beneficial owner. The fact that its main function is to hold assets or rights is not itself sufficient to categorise it as a mere intermediary, although this may indicate that further examination is necessary. This

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examination will in any case be highly burdensome for the country of source and not even the country of residence of the conduit company may have the necessary information regarding the shareholders of the conduit company, the company's relationships to the shareholders or other interested parties or the decision-making process of the conduit company. So even an exchange of information between the country of source and the country of the conduit company may not solve the problem. It is apparently in view of these difficulties that the Commentaries on the 1977 OECD Model mentioned the possibility of defining more specifically during bilateral negotiations the treatment that should be applicable to such companies (cf. paragraph 22 of the Commentary on Article 10).

15. The new provisions of the 1977 OECD Model thus deal with the conduit situation in a rudimentary way, expressing only a general concern that improper use of treaties should be avoided. Although it is clear that all necessary information should be exchanged between the two Contracting States for the application of these clauses, this is not sufficient to preclude a person from acting through a legal entity created in a State in order to obtain treaty benefits which would not be available directly to them, and from obtaining unjustifiable tax advantages (paragraphs 8 and 9 of the Commentary on Article 1).

16. Opinions may differ as to whether the absence of an overall solution to the conduit problem was at the time a serious flaw in the 1977 OECD Model. It was understood, as pointed out in the OECD Commentaries, that Member countries were free to insert adequate solutions in their bilateral treaties. However, the problem has become more acute over recent years and calls for further study. Improvements seem advisable in several respects:

a) OECD should set out policies regarding conduit companies in more detail in order to prevent improper use of tax treaties. Consequently the Commentaries should in some way (e.g. in a summarised form or by citing this report) take into account the conclusions reached by the Committee on Fiscal Affairs in Part III below;

b) Recently new strategies seem to have been developed for the use of conduit companies based in many countries. The OECD Model or its

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Commentaries should accordingly offer solutions to this problem taking into account the considerations under Part IV;

c) The provisions mentioned in paragraph 14 above and/or the Commentaries should be revised in order to solve any existing difficulties and doubts.

These problems will be considered in any revision of the OECD Model.

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III. BILATERAL TREATIES: PROBLEMS FOR NEGOTIATIONS

A. General policy approaches

1. Treaty policy vis-à-vis low-tax countries

17. The conduit problem is normally generated by the fact that treaty benefits are not balanced by corresponding tax in the country where the conduit company has its residence, because under that country's system no tax (or no significant tax) arises. In such a situation, a radical solution would be not to conclude treaties with countries which are especially prone to becoming a base for conduit companies (e.g. because they have no income tax or offer specific tax exemptions for such companies). Basically this policy in many cases is sound as the slight double taxation which may occur may be dealt with satisfactorily under provisions of domestic law.

2. Specific provisions relating to low-tax countries

18. Refraining from treaties with such countries is, however, not always feasible for other countries, for example, because important normal business relationships exist between the two countries concerned which should be protected against double taxation, or because of other overriding treaty objectives (e.g. improving the climate for private investment in developing countries). Furthermore, the conduit situation may even occur between countries whose taxation has no special features, especially in the case of stepping-stone strategies (see paragraph 4(2) above).

19. In such situations it would correspond to sound treaty policy to take special care that bilateral treaties form an instrument for avoiding international double taxation while counteracting improper use of its provisions. A treaty partner may, if it wishes to be protected against international tax avoidance schemes:

– Ask that the other State be prepared to co-operate by exchange of information and in any other way in order to prevent international tax avoidance;

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– Take the necessary measures to be able in practice to give information [cf. Recommendation 833 (1978) of the Parliamentary Assembly of the Council of Europe, paragraph 11 *i)*].

Reference may also be made to that part [paragraph 11 *ii)*] of the Recommendation cited above according to which States should refrain from creating special tax laws which tend in practice to give undue tax favours to certain companies in respect to foreign-earned income.

20. Difficulties with conduit companies may occur between all OECD Member countries, as specific tax avoidance schemes may use even a so-called "high tax country" as a basis for an improper use of tax treaties (e.g. by "stepping-stone companies" — cf. paragraph 4(2) above). Most OECD Member countries are ready to co-operate in such situations in the way described in the foregoing paragraph. As bilateral treaties of an OECD country with other countries may be made use of by residents of other OECD countries there is a common interest among many OECD Member countries that adequate policies are developed.

B. Specific provisions relating to conduit companies

21. An important method for finding adequate solutions to problems caused by conduit companies is the insertion of specific clauses dealing with this special situation. In this section, several specific approaches are discussed under the headings "general description", "scope and limitations" and "evaluation". These are:

1 . The "look-through" approach (paragraphs 23-25);
2. The exclusion approach (paragraphs 26-28);
3. The subject-to-tax approach (paragraphs 29-36);
4. The channel approach (paragraphs 37-41);
5. Bona fide provisions (paragraph 42).

Examples of such provisions used in certain tax treaties between OECD Members are set out in Annex II.

22. The Committee on Fiscal Affairs has refrained from drafting definitive texts, from making strict recommendations as to the circumstances in which they should be applied and from giving an exhaustive list of such possible

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counter-measures. The texts quoted below are merely intended as suggested benchmarks which treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:

- The degree to which there may be actual tax advantages obtained by conduit companies;
- The legal context in both Contracting States, and;
- The scope of bona fide economic activities that might unintentionally be covered by such provisions.

1. The "look-through" approach

a) General description

23. The most radical solution to the problem of conduit companies would be to allow treaty benefits to a company only insofar as the company is owned by residents of the State of which the company is a resident. For example, such a provision might have the following wording:

> "A company which is a resident of a Contracting State shall be entitled under this Convention to relief from taxation in the other Contracting State with respect to any item of income, gains or profits, only to the extent that it is not owned directly or through one or more companies, wherever resident, by persons who are not residents of the first-mentioned State."

b) Scope and limitations

24. The "look-through approach" ("piercing the veil of the company") is the most direct way of attacking the conduit problem. While it is relatively simple and straightforward, there are, however, evident disadvantages:

i) Such provisions are incompatible with the principle of the legal status of corporate bodies, as recognised in the legal systems of all OECD Member countries, and except in cases of abuse, in the OECD Model;

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ii) Such provisions would require extensive bona fide amplifications (cf. paragraph 4(2) below). This may lead to rules which are complicated and burdensome to administer;

iii) The provisions do not prevent "stepping-stone" strategies [cf. paragraphs 42 and 5 (d) above];

iv) There would have to be machinery to apply the clause in a simple and secure way. This may require the shift of the burden of proof;

v) Implementation of the provision would be very difficult in countries where companies' stock is mainly made up of bearer shares.

c) Evaluation

25. The "look-through approach" seems an adequate basis for treaties with countries which have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it would be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities. What is said in paragraph 19 above would be relevant to such modifications.

2. The exclusion approach

a) General description

26. Often conduit situations can be created only by the use of tax-exempt (or nearly tax-exempt) companies which may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies. The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident. As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause such as the following:

> "No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as

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> defined under Section ... of the ... Act, or under any similar provision enacted by ... after signature of the Convention."

The scope of this provision, as far as income paid by the company is concerned, could be limited by referring only to specific types of income, such as dividends, interest, capital gains, directors' fees, etc.

Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information),

b) Scope and limitations

27. An exclusion provision would cover companies which, under the tax law of the State of residence, have in practice the status of a non-resident, rather than that of a resident. Such a provision should, however, apply not only in cases of full exemption, but also in the case of a reduction of tax to levels lower than the expected overall treaty benefits. On the other hand, an exclusion provision would not exclude from treaty benefits charitable institutions enjoying tax exemption as a consequence of the specific purpose for which they are organised and operated. Such an exclusion provision, however, is of a very limited scope and cannot deal with more advanced techniques of improper use of tax treaties.

c) Evaluation

28. Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State which has created special privileges in its tax law may prevent these privileges from being used in connection with the improper use of tax treaties concluded by that State.

3. The subject-to-tax approach

a) General description

29. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the respective income is subject to tax in the

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State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the OECD Model does not recommend such a general provision. While this seems adequate with respect to normal international relationships a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

> "Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:
>
> *i)* Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and
>
> *ii)* Exercise directly or indirectly, alone or together, the management or control of such company, any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income which is subject to tax in the last-mentioned State under the ordinary rules of its tax law."

The concept of "substantial interest" may be further specified when drafting the Convention. Contracting States may express it, for instance, in terms of a certain percentage of the capital or of the voting rights of the company.

b) Scope and limitations

30. The subject-to-tax approach, although somewhat similar to the exclusion clauses, covers cases in which it is not possible to give a strict definition of the excluded situation. Thus, the "taxation under ordinary rules" test would exclude from treaty benefits companies enjoying:

- Specific privileges granted to "base companies", "domiciled companies", etc.;
- Waivers of tax under specific arrangements between the conduit company and the tax administration;
- Substantial reduction of tax as well as complete exemption.

31. On the other hand there are advanced techniques of improper use of tax treaties which could not be covered by the subject-to-tax approach. This is

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especially so with the "stepping-stone strategies", where the company incurs expenses it can offset against income in accordance with normal rules of tax laws.

32. Moreover, the subject-to-tax approach would exclude from the benefit of tax treaties companies enjoying:

- Tax privileges granted to charitable organisations, pension funds or similar institutions;
- Tax privileges granted with a view to fostering the economic development of the country of the conduit company ("tax holidays").

In circumstances such as those derogations from such provisions may be envisaged.

c) Substantial participation

33. Special attention should be given in this context to the holding of a substantial participation in a company through an intermediary as illustrated by the following diagram:

State A	State B	State C
O	O	O
Parent	Intermediary	Subsidiary
	Tax treaty	

In this case State B will grant dividends received by the intermediary from the subsidiary an exemption or an underlying tax credit tantamount to an exemption or near exemption.

34. As this exemption or credit is granted with a view to the tax borne by the subsidiary in its State of residence on the distributed profits (State C), many States will regard it as part of their normal rules for avoiding double taxation rather than a specific tax privilege. This approach would recommend that it be regarded as a tax under ordinary rules for the purposes of the foregoing paragraphs. Situations of this kind may, however, involve elements which would make it improper for the intermediary company to invoke the benefits of a tax treaty. This may, *inter alia*, be true if the intermediary company:

- Is not the beneficial owner of the dividends;

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– Has to be regarded as a mere channeling company as referred to under paragraphs 37 to 41, or;

– Where such companies are used to shield off a low-taxed company against taxation in the country of the parent.

35. On the other hand, there is certainly no reason to regard the use of the treaty as improper, if the participation is effectively connected to a bona fide commercial activity carried on by the intermediary. Contracting States should consider cases of that kind with a view to their specific situation.

d) Evaluation

36. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (cf. paragraph 42 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies".

4. The channel approach

a) General description

37. The approaches dealt with in the foregoing sections are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision which would single out cases of improper use with reference to the conduit arrangements themselves. Such a provision might have the following wording:

> "Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State:

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i) Have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, and

ii) Exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, depreciation of any kind of business assets including those on immaterial goods, processes, etc.)."

b) Scope and limitations

38. This approach would be satisfactory in covering a broad spectrum of cases typically involving improper use of tax treaties like:

- Cases of mere administration of assets;
- The so-called "stepping-stone strategies";
- Other cases where income is merely transmitted through conduit companies with a view to minimising taxes.

39. On the other hand it could cover normal business activities or cases where the assets from which the income in question arises is effectively connected with a genuine activity like the carrying on of a trade or business or the exercise of independent personal services. Therefore, it would seem necessary to supplement such a provision by a bona fide clause (cf. paragraph 42 below).

40. Also this solution is of a very general nature, which might lead to administrative difficulties and doubts in its application such as the types of expenses to be covered and the linkage, both in amount and in time, to be made between the income received and the expenses paid. This is evident in the case of substantial holding (cf. paragraph 33 above), as well as in cases where assets are held by a bank or an insurance business. The interpretation would certainly depend largely on standards the Contracting States have developed internally to counter unjustifiable tax advantages (like the principle of "substance-over-form", general anti-abuse clauses, etc.).

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c) Evaluation

41. The solution proposed in paragraph 37 above appears the only one to be effective against "stepping-stone" devices. It is not found as such in bilateral treaties but its principle seems to underlie the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. Contracting States which consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause. Moreover, because of the administrative difficulties referred to above, it seems advisable to include it only in specific cases, where the use of "stepping-stone devices" frequently occurs or is likely to occur.

5. Bona Fide provisions

42. The solutions described above are of a general nature. In connection with them, it will be necessary to provide specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

i) General bona fide provision
"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and thus do not have as primary purpose the obtaining of any such benefits."

ii) Activity provision
"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income which is connected with such operations."

iii) Amount of tax provision
"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

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iv) Stock exchange provision

"The foregoing provisions shall not apply to a company resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned — directly or through one or more companies each of which is a resident of the first-mentioned State — by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

v) Alternative relief provision

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that such expression "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

The determination of those provisions which are regarded as necessary in a specific treaty depends on the general approach taken in that treaty.

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IV. APPLICATION OF EXISTING TREATIES

A. General considerations

43. Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of "*pacta sunt servanda*" even if considered to be improper. The Contracting States should, however, be prepared to grant all possible help by exchange of information (cf. paragraph 19 above) and to remedy the situation by adequately revising the treaty (cf. Part III above).

B. Handling of artificial tax avoidance

44. It may be asked, however, whether artificial tax avoidance schemes could not be countered by applying certain domestic measures available to Contracting States to fight domestic tax avoidance. Two types of situations may be identified:

a) A State may wish to protect itself against "abuse of law" by applying the general provisions in its domestic laws: it will then deny the benefits of the convention to income paid by a resident of that State to a company situated in the other State when it has reasons to suspect an improper use of the convention. The question arises as to whether the denial of treaty benefits in such cases is compatible with treaty obligations. This relates to the issue of the priority accorded to international law in relation to domestic law, a matter on which opinions differ among States, some taking the view that where the beneficiary of the income fulfils the conditions set in the convention (beneficial ownership, residence), the provisions of the convention should apply, notwithstanding the domestic provisions of the State of source (see also paragraphs 43 to 48 in the foregoing report on "base companies") others taking the contrary view.

b) A State may be led to take steps to protect its partners from the result of the interaction of special characteristics of its domestic laws with the use of conduit companies situated in its territory. Switzerland is a case

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in point. The question of the impact of these unilateral measures in the State of source may arise in such situations. For instance, if Switzerland, as State of residence of the conduit company, finds that the company, while fulfilling the conditions set in the convention, does not meet the requirements of its domestic laws and, accordingly, refuses to certify and transmit to the tax authorities of the State of source a request for relieving tax withheld at source, it may be questioned whether the State of source has the right to refuse relief.

45. A special difficulty increasingly encountered by tax authorities under existing conventions is the use of highly artificial arrangements called "stepping-stone" devices [cf. paragraphs 4(2) and 5 *d)*]. Such arrangements make sense of the fact that two high taxing countries:

- Have differing tax laws (one levies a withholding tax on interest, the other does not);
- Respect the taxation rights of the tax haven country, and;
- Regard anti-abuse clauses in their treaties as unnecessary.

Improper use of tax conventions in such cases may be counteracted by changing one of these basic conditions. It is, however, evident that this may require a change of policies which could affect bona fide economic activities. This might also lead to complicated rules, highly burdensome to tax administrations. It may therefore be preferable to counteract such highly complex arrangements by recourse to the principle of "substance over form".

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V. FINAL REMARKS

46. The Committee considers that competent authorities in charge of negotiating or revising conventions and of implementing existing ones:

i) Should pursue their efforts and foster co-operation against improper use of tax conventions through "conduit companies" and, for this purpose

ii) Take account of the considerations set out in Parts II to IV of this report.

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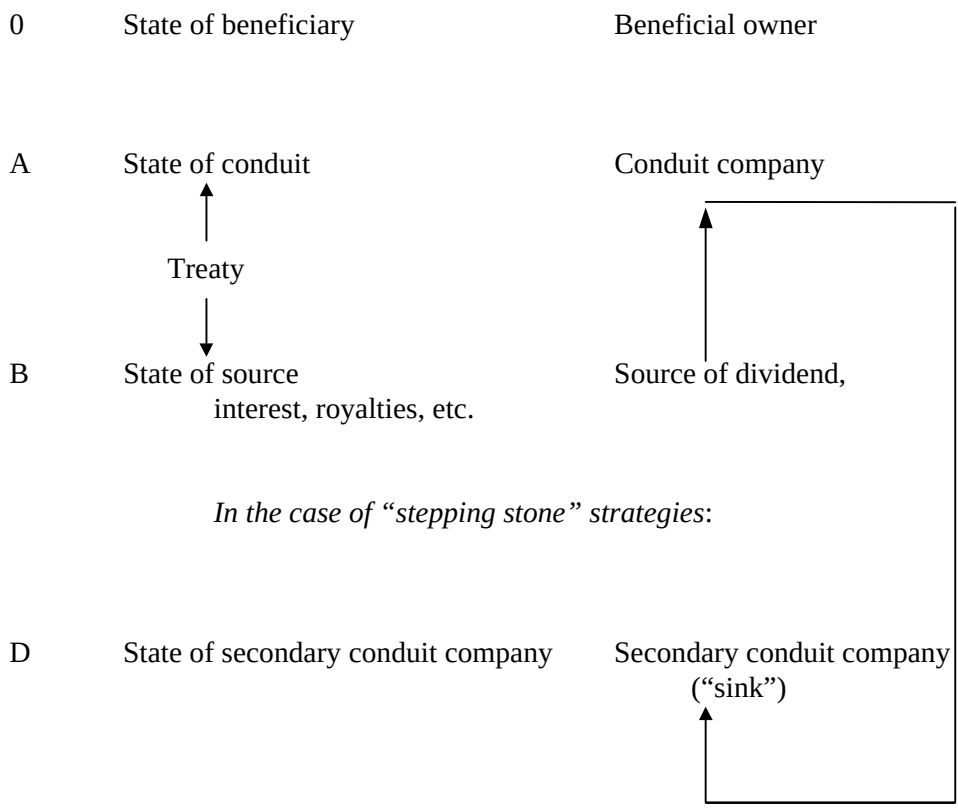
Annex I

DESCRIPTION OF "CONDUIT" SITUATIONS



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Annex II

EXAMPLES OF BILATERAL CLAUSES

A. THE "EXCLUSION" APPROACH

1. Type related exclusion (German-Luxembourg Agreement*)*

Article 1

1. The Agreement shall not apply to holding companies within the meaning of the special Luxembourg laws (currently the Acts of 31st July 1929 and 27th December 1937). Neither shall it apply to income derived from such holding companies by a person domiciled in the Federal Republic of Germany or to shares in such companies belonging to such person.

2. The Agreement shall not apply to non-recurrent taxes on fortune or on capital gains.

3. If any doubts arise with respect to the future taxes to which the Agreement shall apply, the competent authorities of the Contracting States shall come to an understanding with a view to interpreting or amending the Agreement as may be considered necessary.

2. Tax status related exclusion (German-Canadian Agreement)

Article 29 Miscellaneous rules

1. With respect to income taxable in a Contracting State, the provisions of this Agreement shall not be construed to restrict in any manner any exclusion, exemption, deduction credit, or other allowance accorded:

a) By the laws of a Contracting State in the determination of the tax imposed by that State, or;
b) By any other agreement entered into by a Contracting State.

2. It is understood that nothing in the Agreement shall be construed as preventing:

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a) Canada from imposing its tax on amounts included in the income of a resident of Canada according to Section 91 of the Canadian Income Tax Act;
b) The Federal Republic of Germany from imposing its taxes on amounts included in the income of a resident of the Federal Republic of Germany according to Part 4 of the German "*Aussensteuergesetz*".

Where such imposition of tax gives rise to a double taxation, the competent authorities shall consult for the elimination of such double taxation according to paragraph 3 of Article 25.

3. Articles 6 to 23 of this Agreement shall not apply to non-resident-owned investment corporations as defined under Section 133 of the Canadian Income Tax Act, or under any similar provision enacted by Canada after the signature of this Agreement, or to any income derived from such companies by any shareholders thereof.

B. THE "SUBJECT TO TAX" APPROACH

B1 (Germany-United Kingdom treaty)

Article V1

1. Dividends paid by a company resident in one of the territories to a resident of the other territory may also be taxed in the former territory. Tax shall not, however, be charged in that former territory at a rate in excess of 15 per cent on the gross amount of such dividends provided that those dividends either are subject to tax in the other territory or, being dividends paid by a company which is resident in the United Kingdom, are exempt from Federal Republic tax under the provisions of subparagraph *a)* of paragraph 2 of Article XVIII.

2. Notwithstanding the provisions of paragraph 1 of this Article Federal Republic tax on dividends paid to a company resident in the United Kingdom by a company resident in the Federal Republic at least 25 per cent of the voting shares of which are owned directly or indirectly by the former company may be charged at a rate exceeding 15 per cent but not exceeding 25 per cent if the rate of Federal Republic corporation tax on distributed profits is lower than that on

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undistributed profits, and the difference between those two rates is 28 per cent or more: where the difference between the two rates is 20 per cent or more but less than 28 per cent Federal Republic tax on such dividends may be charged at a rate exceeding 15 per cent but not exceeding 20 per cent.

3. Where a company which is a resident of one of the territories derives profits or income from sources within the other territory, there shall not be imposed in that other territory any form of taxation on dividends paid by the company to persons not resident in that other territory, or any tax in the nature of an undistributed profits tax on undistributed profits of the company, whether or not those profits represent, in whole or in part, profits or income so derived.

B2 (Germany-Switzerland treaty)

Article 23

2. Even though a company meets the conditions provided in paragraph 1, a company resident in Switzerland in which persons who are not residents of Switzerland have, directly or indirectly, a substantial interest in the form of a participation, may only claim the benefit of the reduction of taxes imposed by the Federal Republic of Germany on German source interest [Article 11, paragraph 1], royalties [Article 12, paragraph 1], and on capital gains [Article 13, paragraph 3], if these interests, royalties, or capital gains are subject, in the canton in which this company has its seat, to the cantonal tax on income under the same or similar provisions as are envisaged in regarding the federal defence tax.

3. A family foundation resident in Switzerland may not claim the benefit of the reductions of tax imposed by the Federal Republic of Germany on, German source dividends [Article 10, paragraph 2, through 4], interest [Article 11, paragraph 1], and royalties [Article 12, paragraph 1], and capital gains [Article 13, paragraph 3], if the founder, or the majority of the beneficiaries are non-residents of Switzerland and more than one-third of the relevant income is not, or will not benefit persons which are residents of Switzerland.

4. If the competent authority of the Contracting State, from which the items of income originate, has reasonable grounds to cast doubt on the

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declarations made by the recipient of the items of income in his effort to obtain a tax reduction, which are confirmed by the competent authorities of the other State, then the competent authority of the first-mentioned State shall communicate these grounds to the competent authority of the other State; this authority shall then undertake a new investigation and inform the competent authority of the first-mentioned State of the conclusions reached. In case of disagreement between the competent authorities of the two States, Article 25 shall apply.

C. THE "CHANNEL" APPROACH

German-Swiss tax treaty

Article 23

1. A company which is a resident of a Contracting State, and in which persons who are not residents of that State have, directly or indirectly, a substantial interest in the form of a participation, or otherwise, may only claim the tax reductions provided for in Articles 10 through 12 with respect to dividends, interest, and royalties, derived from sources in the other State, as provided for in Articles 10 through 12, where:

a) The interest-bearing debts to persons who are not residents of the first-mentioned State are not higher than six times its equity capital and reserves; this restriction does not apply to banks and similar institutions;

b) The interest paid on loans agreed upon with non-resident lenders is not paid at a higher rate than the normal interest rate; the normal interest rate means:

i) With respect to the Federal Republic of Germany: the rate of the current yield of interest-bearing securities from inland issuers plus two percentage points,

ii) With respect to Switzerland: the average interest rate on debt obligations issued by the Swiss Confederation plus two percentage points;

c) Not more than 50 per cent of the relevant income derived from sources in the other Contracting State is used to satisfy claims (interest, royalties, development, advertising, initial and travel expenses,

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depreciation on any kind of business asset including on immaterial goods, processes, etc.) by non-residents of the first-mentioned State;

d) Expenses connected with the relevant income derived from sources in the other Contracting State are met exclusively from that income;

e) The corporation distributes at least 25 per cent of the relevant income derived from sources in the other Contracting State.

Additional measures already taken, or to be taken by one of the Contracting States, against abuse of the use of tax relief relating to withholding tax levied at source in the other Contracting State, are not prejudiced hereby.

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THE TAXATION OF INCOME DERIVED FROM ENTERTAINMENT, ARTISTIC AND SPORTING ACTIVITIES

(adopted by the OECD Council on 27 March 1987)

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INTRODUCTION

1. This is the second study that the Committee on Fiscal Affairs has undertaken on the problems that arise in the taxation of itinerant activities[1]. It examines the tax treatment of resident and non-resident artistes and athletes.

2. The report is based upon 19 country submissions[2] and, unless otherwise indicated, the descriptions provided refer to 1986. The replies were analysed by the Working Party on Tax Evasion and Avoidance and the tax treaty aspects of the report were prepared by the Working Party on Double Taxation of the Committee on Fiscal Affairs.

3. The purpose of the report is to describe the main problems which arise in taxing income from entertainment, artistic and sporting activities at the national and international level and to suggest ways in which these problems can be overcome.

4. The structure of the report is as follows: Part 1 outlines the problem; Part II examines the information needs of tax authorities; Part III looks at the assessment and collection of tax and Part IV at the influence of double taxation conventions. Some concluding comments and suggestions for improvement are provided in Part V.

5. Since the main focus of the report is on the tax treatment of "artistes and athletes", it may be as well to define these terms. For the purpose of the report, these terms are taken to cover any person engaged, either individually or as a member of a group, in public entertainment or sporting activities (see Part IV B *i)* for an elaboration of this definition). The terms "artistes and athletes" are also used in the title of Article 17 of the 1977 Model Convention on Income and Capital (hereafter referred to as the 1977 Model Convention). A number of countries, however, prefer the term "entertainer" to "artiste" and "sportsmen" to "athlete" and the text and commentary of Article 17 used the terms artiste and entertainer almost interchangeably. To simplify matters, however, this report uses the terminology "artiste and athlete", though it has been agreed that in any general revision of the 1977 Model, the term "sportsmen" will replace "athletes". Sometimes the term "performer" is used as a shorthand term for persons carrying out public entertainment, artistic or sporting activities.

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Part I

THE PROBLEM STATED

6. The world of entertainment is characterised by: short-term activities (frequently one-off performances); an increasingly blurred distinction between dependent and independent services and business activities; sophisticated tax avoidance schemes. There are no reliable quantitative estimates available of tax non-compliance in this area, whether in terms of the amount of income involved or revenue forgone. Nevertheless, where countries have undertaken systematic audits (e.g. in Canada and the Netherlands) of these activities, they have shown clear evidence of non-compliance in this area. Studies undertaken a few years age in Canada, for example, indicated a practice of not reporting income, whether consciously or unconsciously, amongst performers at the low end of the income scale whose activities are particularly transient in nature. The United Kingdom has a similar experience. Performers in the lower ranks rarely disclose casual earnings from jobs outside their profession. With the co-operation of management, club entertainers frequently understate their earnings.

7. Sophisticated tax avoidance schemes, many involving the use of tax havens, are frequently employed by top-ranking artistes and athletes. Whilst some countries do not consider such activities of major importance, given the limited number of persons involved in international activities of this sort and the relatively small amounts of revenue involved, there is general agreement that where a category of — usually well-known — taxpayers can avoid paying taxes this is harmful to the general tax climate, which therefore justifies coordinated action between countries[7].

A. The business

8. The problems of effectively taxing artistes and athletes are rooted in the diverse forms their activities take. Success can be sudden but ephemeral. Relatively unsophisticated people — in the business sense — can be precipitated into great riches, income sources can be many and varied. Travel, entertainment and various forms of ostentation are inherent in the business and there is a tendency to be represented by adventurous but not very good accountants. These activities have evolved rapidly in recent years, taking new

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presentational and organisational forms. The established performer operating with an easily defined role is still common but the industry is increasingly characterised by loosely and multi-aspect groups. The best examples of this are seen in the pop-music industry which operates through complicated chains of limited companies, partnerships, joint ventures and sole trading enterprises.

9. Apart from the performers themselves, the industry covers a large entourage, including managers, various administration and publicity staff and road crews. Some members of a group receive music and/or writing royalties and fees; they all receive different types of record and broadcasting royalties. Frequently sources of income in different parts of the world are taken through different companies. Such forms of organisation have developed in response to the needs of a business which crosses international and occupational boundaries. It is likely that the inventiveness and complexity of the industry will continue to expand, and perhaps extend into other aspects of the entertainment business.

B. Scope of the report

10. The diversity of situations described above makes it difficult to cover in a single report all the relevant taxation aspects. The emphasis in the present report is on issues which are specific to the industry. General domestic problems relating to any dependent or independent services which were already dealt with in an earlier report (see note 1) are therefore not dealt with here. A case in point is sportsmen employed permanently in a country (such as professional soccer players) who are normally considered as employees of their clubs[4].

11. The distinction between professionals, semi-professionals or amateurs is often a fine one in practice, and is not elaborated upon in this report. There are obviously cases — potentially numerous — where, for instance, amateurs obtain compensation for their expenses (or more), and where professionals exercise some undeclared activities when they are not officially working. Problems related to these casual earnings are not limited to the entertainment field and are subject to the usual checks required on “black” activities.

12. Performers may receive a wide variety of types of income, whether directly or indirectly, and not all of which are related to actual performances. Artistes, for example, will frequently receive copyright royalties or other

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income related to the sales of records; they may benefit from free advertising, or even receive fees for advertising their own name. Sportsmen may receive remuneration from manufacturers of sports equipment on condition that they use the manufacturer's brand or publicise the products of the same brand. Payments for advertising goods not related to the entertainer's activities are not infrequent. For the most famous, the variety of contracts and types of income call for worldwide financial and tax planning with the assistance of specialised advisors. From the tax authorities' point of view, this diversity of income sources raises a number of assessment problems.

13. In a number of cases, artistes and athletes may make more money from these related activities than from their activities as performers. However, this report concentrates, in the first instance, on income related to actual performances, even though this distinction may be artificial in some cases.

C. Main principles

14. The main principle which underlines this report is that income from entertainment and sporting activities should be taxed in the same way as income from any other activities. Exceptions to this principle should be kept to a minimum. Problems can arise because some governments may accept that a particular event is a "cultural exchange," and, therefore, no tax should be imposed on profits arising from it. Nevertheless, in practice, such events are generally staged for the purpose of profit and granting special treatment to some events of this kind makes it more difficult to resist similar claims from other domestic circles on the grounds of fair competition. Country experiences suggest that some tax authorities are better able to resist the "cultural exchange" pressure groups than others, or are better placed to check that the income generated is taxable in the residence country. Similar problems arise in the context of "charitable events" (where it is assumed that there is no "income" produced by the event), or tax-free performances by State-supported troupes. In all such cases, the Committee considers that tax privileges should be limited to genuine, justified cases, for instance, to events organised as part of an official "cultural exchange programme".

15. The second principle upon which this report is drafted is that artistes and athletes are, as are other taxpayers, fully liable to tax in their country of residence and, ideally, should be taxed accordingly. Whilst certain countries

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provide for exemption of foreign income, the amount of income earned abroad should be known when, under the general income tax, this affects the progressive rate that is applied to other income sources.

16. However, as is usually the case with itinerant activities, the country of residence has difficulty in identifying the activities of its residents abroad. It will therefore have to rely mostly on information provided by the country where the activities are exercised. For this reason, and also in order to avoid practical difficulties, it is felt that the principle on which Article 17 of the 1977 Model Convention is based should be followed. The main purpose of this report is therefore to help Member countries to establish a system by which the income of artistes and athletes could effectively be taxed in the country of performance.

17. In taxing artistes and athletes, tax authorities encounter problems first in obtaining information about the performances taking place and secondly in the assessment and collection of tax which arise from the nature of the trade or the use of legal avoidance schemes.

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Part II

THE NEED FOR INFORMATION

18. It is in the nature of the trade that entertainment, artistic and sporting activities should be advertised, so as to attract the public. However, such publicity very much depends on the importance of the event and experience shows that, in many cases, a large part of these activities do not come to the attention of the tax authorities. Furthermore, even when an activity is noticed, problems often arise in identifying the performers themselves.

A. Country experiences

19. The experience of countries participating in the study shows that, generally speaking, relying on the taxpayers themselves to report accurately the amount of income earned at home and abroad is even less realistic in the entertainment area than in other areas, considering how easy it is for a number of performers to conceal such income. Also it is commonly believed in the entertainment world of some countries that all sums earned abroad are free of domestic tax, and returns and accounts frequently reflect this belief. In the absence of other checks, the tax authorities will therefore not be able to impose tax on such activities.

20. Where artistes and athletes perform dependent services in most countries, they will come under PAYE or a wage-tax system and their employers (if situated in the country) will report that part of their income. Where, however, the employer is a controlled limited company, the importance of the case may often not be realised by the tax authorities. The PAYE file may contain only the entertainer's real name, not his stage name, and the name of the company may not suggest an association with the entertainment business. This problem is accentuated where, as increasingly occurs, a multiplicity of controlled limited liability companies are created to receive various streams of income. Additional problems can occur if the employer is situated abroad (e.g. non-compliance with PAYE regulations). In the absence of any PAYE system, information obtained through the usual reporting system for wage earners may

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not be useful, as a lot of time may elapse since the income was earned, and the entertainer's position (or residence) may have changed.

21. Most difficulties arise with self-employed artistes and athletes, and it is mainly for them that an elective information-gathering system is desirable. Yet, it is usually difficult to identify and locate such people, even in cases where written contracts exist, because of a number of factors: the use of pseudonyms or stage names on agency contracts; the use of false social security numbers where these are noted on entertainment contracts, the fact that payments for services are made in cash, after deductions for agents' fees; the difficulty inherent in tracing and locating people two or three years following the rendering of the service.

B. Sources of information

22. The difficulties set out above require early receipt of information concerning the performance itself, preferably before it takes place. Countries have reported a number of possible non tax-related sources, general sources information, such as newspaper and other advertising, specialised magazines and periodicals. Prize monies earned by major athletes sometimes also appear in the specialised press (Ireland). Most reputable concert agents, radio and television companies give advance notice of visits to the United Kingdom; so do major impresarios in the Netherlands. In some countries (such as France), authors' or artistes' associations are useful sources of information on forthcoming or past performances. Advance information concerning incoming foreign entertainers may also be obtained through immigration or other Government departments (Sweden, United Kingdom), although work permits do not necessarily specify where the entertainer is to appear, nor when or how often (Sweden). As regards athletes taking part in international tournaments, another important source of information may be the national sports federations, which in the context of sanctioning the arrangements of sports events in their country, may be able to identify foreign athletes participating at such events. Finally, in some countries information will be given in advance for tax reasons (e.g. to obtain a reduction of withholding tax in Canada, or a "tax card" in Denmark).

23. In most countries, however, information is usually available only after the event through contacts with local tax offices (Belgium, where a local tax is

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levied), reports by entertainment agencies, theatres, broadcasting authorities etc. As noted earlier, the information will frequently be available too late for an effective taxation of the performer. Also, in many cases, the promoter is a non-resident, so that the possibility of obtaining information even after the event is rather slight (cf. Part IV).

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Part III

ASSESSMENT AND COLLECTION OF TAX UNDER DOMESTIC LEGISLATION

24. Although countries' experience in assessing and collecting tax on artistes and athletes vary, a number of difficulties in this area have been reported. The following paragraphs briefly describe problems arising in assessing or collecting tax on non-resident and resident performers, as well as some existing counteracting measures.

A. Problems in taxing non-resident artistes and athletes

1. Dependent services

25. In some countries, tax does not have to be paid on income earned by non-residents in respect of dependent services in the country if the employer is a foreign company which does not maintain a permanent establishment in that country. This opens up wide avenues for tax avoidance, the most famous one being known as "slave agreements" with foreign employers. Other countries whose tax systems are not restricted in this way and which can tax domestic source income providing it relates to duties undertaken in that country also find that "slave agreements" are used to negate or reduce the tax charge. Payment is made to the artistes or athletes from abroad to convert the income to an overseas source. This may remove the income from the scope of charge completely (this is, for example, the case in Australia).

26. In a typical case of a "slave agreement", the performer receives a salary from a foreign employer for services undertaken in the country of performance. There is no legal relationship between the domestic promoter of an event and the entertainer. The foreign company enters into a contract with the promoter. This provides for a lump-sum payment which represents the fee for the entertainer's appearance as well as a fee for the company for planning and organisation. This payment is usually made abroad often before the performance is given. As contracts are signed and other business is done abroad, it is not possible to contend that the company is carrying on a trade or

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business in the country of performance. Quite often the salary due to the performer from the company paid outside the country of performance. Many of these foreign employers are companies controlled by the performers themselves and are based in tax havens (rent-a-star companies). There are also organisations[5] which specialise in entering into employment agreements with artistes and athletes.

27. Another problem experienced by tax authorities which retain domestic taxing rights despite the interposition of a "slave company" is determining what proportion of the entertainer's salary relates to his or her performance in the country. The obvious method — time apportionment of the remuneration provided in the service agreement — is clearly open to abuse having regard to the "sham" nature of the agreement[6].

28. When dependent services are performed directly for the domestic promoter, tax assessment raises in principle less difficulties. Artistes and athletes will frequently be subject to the PAYE or wage tax (or *précompte)* on income paid to them, and the income tax legislation may well provide for a legal liability for the person paying the remuneration (Austria, Belgium, Germany, Netherlands, for instance)[7]. However, although the control problems involved are similar in nature to those arising for other dependent activities, they are increased by the itinerant character of the activities performed and the difficulty in obtaining adequate information (see Part II above) so that the usual assessment and collection instruments (e.g. withholding) cannot in practice be used effectively.

2. Independent services

29. Problems arising in taxing independent services provided by artistes and athletes are substantially similar to the problems usually met in this general area. However, they are aggravated by the mobility of the taxpayers involved, including the case with which they may change status at will, as between dependent or independent services. Frequent changes of employers or contractors, who themselves often have a rather elusive character and are subject to more lenient reporting requirements, and the fact that they can frequently leave a country without notice, open up wide possibilities of evasion and make assessment and collection of tax problematic in the absence of any withholding tax (see paragraphs 45 to 47 below).

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30. A particular problem which arises in assessing income from the self-employed where no withholding tax exists is the basis and timing of assessments. The assessment of tax on the professional income of the self-employed is established during the year after the receipt of the income and in the majority of cases, the tax would not be collectable until after the person concerned had left the country.

31. Even where a withholding tax exists on payments made to non-residents in respect of services performed in the country, some avoidance problems may arise. For example, if there is no requirement that a promoter withholds tax when the payment is to a domestic company (e.g. in Canada), non-resident performers will form such a company, which they will use for contracting to appear in the country, with a domestic address (generally that of a lawyer) to receive the income. The money is then deposited in a bank account in the country and immediately thereafter withdrawn by the non-resident performer.

3. Other

32. Business income from entertainment, artistic and sporting activities of a non-resident will usually be taxed only if a permanent establishment is maintained in the country. In some countries certain income received by artistes and athletes is considered under domestic law to be business income. Opportunities for tax avoidance or non-taxation are rather wide in this cases[8].

33. In some cases, the entertainer's performance is "sold" to local organisers as part of a complete show. As the contract for the "package" does not refer to any particular performer and includes various types of services, the "package" may hardly be considered as performance of artistic activities. It would then avoid taxation in the country as there is no permanent establishment there.

34. Another case of possible abuse by non-residents is that relating to liability in respect of payments made for recordings. The United Kingdom noted, for example, that these are assessed to tax on the basis of "royalties" paid on sales in a year in which the performer is present in the country provided the recording was made in that country under a contract with a resident company.

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Liability is very easily avoided especially where the recording is for a large multinational corporation by, for example, making the contract with a non-resident subsidiary.

B. Problems in taxing resident artistes and athletes

35. Although the taxation of resident performers raises mainly problems of enforcing existing, more general, domestic legislation, this is also an area of widespread non-compliance. Resident performers exercise, in effect, itinerant activities within the country. Problems in taxing them are, in many respects, not dissimilar to the ones arising for taxing non-residents.

36. As mentioned earlier in the report, a major administrative problem is obtaining information about the activities — combating understatement or non-disclosure of earnings and income splitting amongst controlled limited companies and ensuring that data are available to the tax authorities at the right place at the right time — artistes and athletes are notoriously dilatory about their financial affairs and there is always the danger of the tax authorities being left with an empty basket.

37. Tax authorities experience special difficulties where the legislation does not provide for withholding tax in respect of services performed by self-employed persons who are residents. Even where performers are provided by agencies, contracts are sometimes considered as “contracts for services” rather than “employment contracts” (Canada). In some countries, problems arise due to the fact that a large number of organisers are non-commercial and not taxable; they have therefore no tax interest in keeping accounts or giving information to tax authorities.

38. Tax administrations are particularly vulnerable in respect of overseas engagements and they have to rely heavily on the individual declaring the income. The entertainer's remuneration is often paid in respect of activities which are partly exercised abroad without specification of the share of remuneration which is attributable to domestic activities. Practical difficulties therefore arise as to the appropriate tax base. Furthermore, extravagant deductions for “business” expenses are frequently claimed.

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39. Special mention should be made of arrangements by which resident — usually well known — performers endeavour to take themselves out of the self-employed status into a dependent one. This is in general for the purpose of accumulating income abroad, by setting up a sham company in a tax haven, or by using specialised "employer" agencies abroad and the problems discussed in paragraphs 30 and 31 above then arise.

40. However, this may also have purely domestic reasons. Canada and the United States, for example, experienced difficulties with individuals who are involved in entertainment activities and who have entered into corporate arrangements whereby they incorporate a company (usually the performer holds the shares himself) which then contracts with the performer, as its employee, for his services. The tax advantages of such corporate arrangements lie in the fact that the corporate rate of tax is usually less than that of a high-income individual. Also, the corporation may "employ" the performer's spouse, thus achieving a splitting of income. Certain expenses such as agent's fees may be written-off by the corporation against the amounts received. These expenses would not be allowable to an individual as a deduction from employment income.

C. Measures taken or under consideration

41. The present section sets out various measures which have been tried, or are being considered, to improve compliance in the area of entertainment, artistic and sporting activities[9]. The fact that similar problems arise in different countries in taxing effectively artistes and athletes, wherever the activities are exercised, points to the necessity of having proper domestic procedures both for domestic tax purposes and for assisting other countries. This section therefore also considers some wider policy issues involved when trying to devise efficient instruments for taxing resident and non-resident artistes and athletes on the one hand, and other performers of dependent or independent services, on the other.

1. Measures mainly directed at improving compliance by residents

42. Certain countries (e.g. France, United Kingdom) have general powers to call for returns of payments (fees, commissions, etc.) made by residents to people not in their employment (whether resident or non-resident). Given the

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known low level of voluntary compliance by those in the entertainment, artistic and sporting worlds, such information is considered by these countries to be essential to combat tax avoidance and evasion. Administratively, such legislation will be more effective where machinery exists to ensure that the information reaches the tax file of the person concerned at the earliest opportunity. In the United Kingdom's experience, these arrangements need to be backed up by monitoring new developments and the emergence of new talent with a view to taxing them before they spend their money. Moreover, a centralised approach is considered essential to ensure that they are dealt with satisfactorily, i.e. by bringing together all the relevant personal and associated company files. An uncoordinated action, where various offices are unaware of the whole picture, invariably proves to be less successful.

43. Another measure which has been adopted by both France and the United Kingdom is the ability to "look through" controlled overseas companies set up by residents to receive income relating to their activities, and over which they retain control. In neither case are the provisions restricted to the entertainment and sporting fields. The French scheme, which now also applies to non-residents, is outlined in paragraphs 55 and 56 below. The United Kingdom legislation has not proved of significant practical value in this particular field although its existence does serve as a deterrent to blatant abuse.

2. Measures concerning non-residents

a) Income tax provisions

44. In the absence of special legal instruments concerning artistes and athletes (or self-employed generally), some countries (e.g. the United Kingdom until recently) have adopted a centralised approach to deal with the liability to tax of foreign visitors. Such an approach requires direct links between the tax office and the industry and that the tax office is kept informed of visits by major non-resident performers.

45. Most countries feel however that tax authorities need special techniques for assessing and collecting tax on artistes and athletes. In principle, an effective instrument available under domestic legislation to deal with situations where income is paid to itinerant people is withholding taxes. While they can usually be levied on income from dependent services, withholding

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taxes are also levied on income from independent services paid in some countries to non-residents (e.g. Austria, Belgium, Canada, Germany, Japan, United Kingdom). Similar techniques are used under the special "artiste taxes" referred to in paragraphs 48 to 53 below.

46. In some countries, specific rules apply to artistes and athletes. In countries where non-residents are liable to income tax only if the income is derived through a permanent establishment or a fixed base, some improvement can be made by deeming the income paid to non-resident artistes or athletes as being earnings derived from employment (Netherlands) or by providing that the taxation right can be exercised even if the performer does not maintain a permanent establishment in the country (Austria and Germany). In Portugal and Spain, non-resident artistes are subject to a 5 and 18 per cent withholding respectively. In Switzerland, income tax is levied at source on income paid to non-resident performers, according to a graduated four-band tax schedule, after deduction of expenses.

47. Considering the aim of taxing effectively income from entertainment, artistic and sporting activities in the country of performance, the Committee considers that, in the context of the general income tax, domestic legislation should ideally provide for tax to be withheld at source on payments to non-resident artistes and athletes[10]. In order to be most effective, this should apply also where the artiste or athlete has no fixed base or is an employee of a foreign company having no permanent establishment the country. Also for the sake of effectiveness, the rate of such withholding should probably be set at a rather high level. Finally, where withholding tax is levied, the payer of the income could be held responsible for the payment of the tax (as is presently the case in Austria, Belgium, Germany, Netherlands and the United Kingdom with effect from 6th April 1987).

b) Special taxes on artistes and athletes

48. Special artiste taxes are levied instead of general income taxes Norway and Sweden on non-resident artistes and athletes performing services in these countries. The basic object of these taxes is to ensure payment of tax where the remuneration of the artiste and athlete is paid, i.e. at source, under a technically convenient form[11]. As they are constructed, these taxes are often

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considered as a tax on the organiser, which gives rise to claims for exemptions, taking the system further away from its starting, basic principles.

49. In both Norway and Sweden these taxes are final taxes and are fixed at a certain percentage of the estimated gross income derived by the performer (30 and 15 per cent in Sweden and Norway, depending upon whether the performer just takes part in a performance, or arranges it himself). These taxes, which are therefore a simplified form of, and a substitute for, ordinary income tax, are always taken as income tax for double taxation convention purposes.

50. The organiser of the event is responsible for the payment of the tax, whether or not he is the artiste or athlete. In Norway, he is also liable to file a detailed statement on the arrangement with the collecting authority, and to present contracts on request. In Sweden, a prior authorisation for the performance is necessary in most cases, but after an amendment in 1977 failure to request authorisation does not entail any fine.

51. Experience shows that in certain respects, such special taxes also are open to abuse. Detecting the activities is a major issue; especially so as work permits, which should in principle be issued prior to the performance, are not required for citizens of Nordic countries. Assessment problems arise, such as the use of foreign controlled companies and of double contracts. Finally, collection problems may also arise where, as in Norway, collection takes place only after the performance, no prepayment or security for payment being required. The combination of a low rate of tax on artistes and athletes and of the requirement that, after six months in the country, the performer is subject to ordinary income tax, opens up possibilities of evasion and creates administrative difficulties[12].

52. A major problem, as seen in Norway and Sweden, arises from the fact that the tax is perceived as a tax on the organiser, not on the artiste or athlete. The impression prevails that the income of non-resident performers is not taxed. It is argued that the tax is an unjustified additional levy on domestic cultural activities and is inequitable because substantial exemptions are provided for in practice (in Sweden by way of tax relief for performances which form part of cultural exchanges).

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53. It is noted that these provisions are under review and that suggestions have been made to improve information gathering through stronger reporting obligations (Norway), as well as assessment and collection of the tax. In Sweden, special attention is being paid to the problems connected with imposing tax on a gross remuneration without taking into account the variety of expenses attributable to different kinds of performances. Experience in these countries seems to indicate that implementing such a tax requires special care if it is to be effective. It also raises policy questions of a wider nature to which paragraphs 60 to 63 below are devoted.

3. Counteracting the abusive use of "artiste" companies

54. Counteracting the use of "slave" contracts with "artiste companies" is rather difficult where there is no domestic provision to "pierce" the corporate veil (e.g. as is the case in the Netherlands). Special measures to deal with situations like these have been taken in countries like Austria, France, Germany and the United Kingdom and some United States provisions are also of relevance. The Austrian income tax legislation provides (since 1972) that independent personal services income of non-resident artistes and athletes in respect of performances exercised in Austria is subject to withholding tax even if diverted to a third person (e.g. an artiste company). The recent United Kingdom provisions are similar in effect.

55. Since 1972, the French legislation contains special provisions, which are not restricted to the entertainment area, and under which income received by a person outside France as remuneration for services rendered in France by another person shall be liable to tax there under certain conditions. These provisions were originally limited in scope to income received by companies registered outside France for services performed in France or abroad by individuals resident of France if the latter had "direct or indirect control" of the companies, or when such companies have no industrial or commercial activity other than the provision of services or, in any event, where the companies were registered in a country which had no general income tax treaty with France. The wording of these 1972 provisions left to the tax administration the burden of showing that the person was a resident in France, and investigations encountered a number of practical difficulties. T he main virtue of the provision was reported to be its dissuasive aspect.

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56. The French provisions were revised in 1980 to cover performers of services who are non-residents as well as residents of France, and companies as well as individuals. They apply in all cases where the person receiving the payment is situated in a low-tax country. In other cases they apply unless the performer shows that he has no control over the person, or that the latter exercises mainly an industrial or commercial activity. Finally the person receiving the remuneration is jointly responsible for the payment of the tax and the tax authorities may now collect the amounts necessary for the payment of the tax from third parties (e.g. organisers).

57. On 20th December 1985 a provision of the German Income Tax Law went into effect which classifies as taxable domestic income from trade or business, income derived from artistic, athletic or similar performances exercised in Germany or from their exploitation, including income derived from other services connected with these services. This applies regardless of to whom the income accrues. It is not necessary for there to be a permanent establishment or permanent representative in Germany. In addition, income tax shall be withheld from such income regardless of to whom the income accrues.

58. In the United States, the Internal Revenue Service has ruled (Revenue ruling 74.330) that where, among other things, the artiste or athlete retains control over the detained organisation of his work, an employer-employee relationship does not exist. This ruling helped defeat the improper use of a tax convention by claiming exemption under the 183-day rule. Also in the United States, foreign personal holding company provisions extend to income from the performance of certain personal service contracts. Thus a United States artiste or athlete who is a 25 per cent or more shareholder. in a foreign personal holding company cannot avoid United States tax by performing services for that entity.

59. Although experience as to the efficiency of some of these measures is still limited the Committee considers that they constitute a useful means of counteracting the use of shadow-companies within the framework of income tax legislation[13].

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4. Some policy issues

60. When discussing possible suggestions for improving domestic legislation generally rather far-reaching policy questions arise. Even though agreeing that taxation should in principle take place at the place of performance and that distortions in tax treatments should be avoided, countries vary in the ways their systems are devised, which has a bearing on answers to the following two questions:

1. How far should resident and non-resident artistes and athletes be treated alike or differently?
2. How far should artistes and athletes be treated differently from other performers of dependent, or independent services?

61. On the first point, differences in treatment which exist in some countries distort competition and produce claims for a harmonised system whereby resident and non-resident artistes and athletes would be treated alike and pay the same tax. This would also eliminate all incentive to engage in tax avoidance by altering the residence status and would avoid some administrative difficulties (e.g. where a resident performer is a member of a non-resident band, which may be unknown to the organiser of an event). More generally, it could be argued that given the nature of the trade, and the fact that some tax problems (e.g. for detecting the activities) arise in both situations, a similar system should apply to residents and non-residents.

62. Setting up special systems for taxing artistes and athletes, however, necessarily divorces them from other categories of taxpayers, whether resident or non-resident. 1n some countries, it seems that this could create difficulties, even though special systems could be devised to deal with certain other categories (e.g. sub-contractors). There is a feeling, in these countries, that counteracting tax avoidance and evasion in this area should preferably use ways and means which would not divorce the artiste or athlete from the main categories of taxpayers to which they belong, i.e. providers of dependent or independent services.

63. It may be noted that, in order to avoid any differences in treatment, a withholding tax can be made to cover all the self-employed, not only self-employed artistes or athletes, or independent contractors. It could apply both to residents and non-residents. Also, as seen under French legislation, some

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counteracting measures in the case of dependent services (foreign "artiste company"), can be made to apply to all types of services concerned. Such more general instruments would be of use in dealing with income from other types of itinerant activities.

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Part IV

THE INTERPRETATION AND APPLICATION OF BILATERAL DOUBLE TAXATION CONVENTIONS

A. Introduction

64. There are many provisions in the 1977 Model Convention which can affect the taxation of artistes and athletes. Such persons are often in the position of receiving income of various kinds and from several sources as the circumstances in which they carry on their activities can vary widely.

65. However, the taxation of their incomes is governed essentially by the provisions of Article 17 of the Model Convention which stipulates:

> "1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State may be taxed in that other state.
>
> 2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised".

66. The reasons for these provisions in the Model are set forth in the five paragraphs of the Commentary, on which an observation was made by Canada and the United States.

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B. "Personal Scope" of Article 17

1. Definitions of "artistes" and "athletes"

67. The first issue considered was whether the terms "artistes" (as it appears in the title of Article 17), "entertainers" and "athletes" were sufficiently broad to cover all the persons it is wished to tax under Article 17.

68. As far as "artistes" are concerned, it was noted that paragraph 1 of the Article included examples of persons who would be regarded as such. However, these examples should not be considered as exhaustive. It was agreed that it was not possible to give any precise definition of "artiste", and that a wide variety of situations could arise. On the one hand, the term clearly includes the stage performer, film actor, actor (including for instance a *former* athlete) in a television commercial. Article 17 may also apply to artistes and athletes participating in activities which are of a political, social, religious or charitable nature, if an entertainment character is present. On the other hand, conference lecturers and persons interviewed on television are clearly not "artistes" in the meaning of Article 17. There is however a variety of intermediate situations where say, appearance on television or in public could generally be seen as "acting" for entertainment purposes, thereby falling under Article 17. In this grey area, it is necessary to review the overall balance of the activities of the person concerned.

69. A discussion was held on whether and how Article 17 applied to the intermediate case of the "actor/producer" (or the television presentator/producer, or the dancer/choreographer). The conclusion was that in such cases, it is necessary to look at what the individual predominantly does in the country where the performance takes place. If his activities in that country are predominantly of a performing nature, Article 17 will apply to all the resulting income he derives in that country. If, on the other hand, the performing element is a negligible part of what he does in that country, the whole of the income will fall outside Article 17. In other cases, an apportionment might be necessary.

70. As far as athletes are concerned, it was agreed that the intention was to cover sportsmen in the broad sense of the word. The term is not restricted to what are traditionally thought of as athletic events (e.g. running, jumping, javelin throwing). It also covers, for example, footballers, golfers, jockeys, cricketers and tennis players, as well as racing drivers.

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71. Article 17 also applies to other participants in public entertainment such as billiard players, and participants in chess or bridge tournaments.

2. Support staff, impresarios

72. Consideration was given to whether, under the present wording of Article 17, there was some scope for covering "support" staff of artistes and athletes. There was agreement that a narrow interpretation should prevail and that both the intention and the language of Article 1 7 do not presently allow the taxation under Article 17 of producers, film directors, choreographers, technical staff, etc. Other Articles of the 1977 Model Convention would apply to such support staff (generally Articles 14 or 15 and in certain cases Article 7).

73. While income received by impresarios, etc. for arranging the appearance of an artiste or athlete is outside the scope of Article 17, any income they receive on behalf of the artiste or athlete does of course come within the Article.

74. It was therefore agreed that income of intermediaries could be covered only by supplementing the text of the Article, for example along the following lines:

> "The rule laid down in paragraph 1 shall apply to income from the personal activities exercised, in an independent capacity or as an employee, by any person participating in the organisation or carrying out of such performances by artistes or athletes".

3. Interpretation of the expression "personal activities"

75. The expression "personal activities" in paragraph 1 of the Article seems to indicate that the paragraph applies to income accruing to the individual "performer". However it is usual for orchestras, choral societies and sports teams to be incorporated. The question therefore arises as to whether only the income received by the members of the incorporated orchestra, etc. come within paragraph 1, or whether income that accrues to the company as "company earnings" is also covered by, that paragraph.

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76. The conclusion reached on this question was that paragraph 1 applied to income derived directly or indirectly by an individual artiste or athlete. In some cases the income will not be paid directly in the State where the performance takes place to the individual or his impresario or agent. For example, a member of an orchestra may be paid a salary rather than receive payment for each separate performance. In this case the Contracting State where a performance takes place is entitled, under paragraph 1, to tax an appropriate proportion of the musician's salary. Similarly, where an artiste or athlete is employed by e.g. a one person company, the State of source may tax an appropriate proportion of any remuneration paid to the individual. In addition, where its domestic laws "look through" such entities and treat the income as accruing directly to the individual, paragraph 1 enables the State where the performance takes place to tax income derived from appearances in its territory and accruing in the entity for the individual's benefit, even if the income is not actually paid as remuneration to the individual (see paragraphs 85 to 93 below for the interpretation of the provisions of paragraph 2).

C. Income covered by Article 17

1. Income other than remuneration accruing to artistes or athletes

77. In view of the difficulties inherent in taxing artistes and athletes who receive a large variety of types of income from different sources, from the viewpoint of double taxation, the first question which arises concerns the scope of Article 17, i.e. what types of income are, or may be, subject to its provisions.

78. One possible interpretation, the narrowest, is that only income deriving directly from an exhibition — normally in public or on television, in respect of live performance or of the first transmission of a recording — of the artistes or athletes talents falls under Article 17, and all other types of income should be taxed in accordance with other relevant rules of the 1977 Model Convention. The argument advanced in support of this interpretation is that, subject to the provisions of Article 17, artistes or athletes should not in principle be taxed differently from those in other professions, whether self-employed or in dependent employment.

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79. Thus, income derived from contracts for the reproduction of an artiste's work (for example, on record, cassette or videocassette), being in the nature of a royalty, should be governed by Article 12 (cf. paragraph 13 of the Commentary on Article 12). Income from other independent personal services would come under Article 14. This would apply in particular to income from sponsorship and to remuneration received from commercial enterprises for using, and therefore promoting, sports equipment and clothing. As to business income not expressly mentioned in Article 17, it would come under Article 7.

80. The contrary opinion is that the links which exist between the different activities of performers, the complexity of the contracts (often so-called package deals) governing the exercise of these activities and the forms of payment received (frequently qualified as "royalties" for tax avoidance purposes) make it impossible for tax authorities to identify each of them separately, and since the payments are connected, they should all be brought within the scope of Article 17.

81. The Committee recognised that the complexity of such situations does indeed give rise to serious difficulties even though some of the problems were not specific to this area. It felt that resorting systematically to the solution proposed in paragraph 80 above would however render meaningless many of the provisions — in particular Articles 12 and 14 — dealing with other indirect income habitually received by artistes and athletes over and above monies paid as direct remuneration. Moreover, there will frequently be substantial administrative difficulties in taxing such indirect income in the country where the performance takes place, as contracts concluded with a firm in one country (for example, for advertising) will very often cover the exercise of activities throughout the world. The country where the performance takes place will frequently not be informed of the existence of such income and any apportionment of it (e.g. on the basis of the relation to a specific performance) would be problematic, with a risk of double taxation.

82. The Committee considered that it would not be appropriate to bring genuine royalties into the scope of Article 17. It was noted that the definition of "royalty" under Article 12 was rather restrictive and a number of countries would not consider advertising and sponsorship fees as royalty income. Countries would of course be able to check that what was described as a royalty

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by the taxpayer really was a royalty in the meaning of Article 12: if it were not, then Article 17 might apply.

83. It was therefore agreed that, with regard to the application of Article 17, account should be taken of the extent to which the income was connected with the actual activity of the artiste and athlete in the country concerned. In general, Articles other than Article 17 would apply whenever there were no direct link between the income and a public exhibition by the performer in the country concerned. On the contrary, advertising or sponsoring income paid especially in connection with a performance (whether before or after the event) or a series of performances, would fall under Article 17.

84. Finally, it was agreed that compensation paid to an artiste and athlete when a performance had to be cancelled by the organiser came under Article 21 dealing with "other income". Such compensation is therefore taxable only in the artiste's or athlete's country of residence.

2. Income paid to a person other than the artiste or athlete

85. As noted in paragraph 76, paragraph 1 of the Article applies to income derived directly or indirectly by an individual artiste or athlete from his/her personal activities. In some cases, the State where the performance takes place will be in a position to tax at source at least part of such income. However, it will not always be so, e.g. when income has been paid by the organiser to a management company for the appearance of a group of sportsmen, or when a team, troupe. orchestra, etc. is itself constituted as a legal entity.

86. In the case of incorporated teams, orchestras etc., income for performances will normally be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the country in which a performance is given, on any remuneration or other income directly or indirectly accruing for their benefit as a counterpart of the performance. The question arises as to whether and how the profit made by the legal entity itself from the performance is taxable.

87. Because of the reference to "personal activities" in paragraph 1 of Article 17, the consensus was that this paragraph was not applicable to such

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profit of the legal entity, which raised the question whether paragraph 2 of the Article was applicable.

88. Paragraph 2 of Article 17 provides that when income in respect of personal activities exercised by an artiste or athlete "in his capacity as such" accrues to another person, that income may be taxed in the country in which the activities of the artiste or athlete are exercised. The original purpose of the provision was "to counteract certain tax avoidance "schemes" by an artiste or athlete under contract with a company which is in effect under his control. The artiste might claim exemption from tax at source under the 183-day rule, the company paying him not being taxable in the absence of a permanent establishment (see paragraph 4 of the Commentary on Article 17 of the 1 977 Model Convention).

89. The Committee found that there was nothing in the text of paragraph 2 to preclude its application to incorporated teams, troupes, etc., even though the original intention was different. It was therefore agreed that the provisions in Article 17 enabled tax to be levied on:

> The amounts paid to artistes or athletes through a separate entity, but accruing to them;
>
> The amounts allocated to an entity, but not paid to the artiste or athlete, which has the effect of indirectly taxing the profit element kept by the entity.

90. A few countries, however, considered that paragraph 2 should apply only in cases of abuse, especially bearing in mind the text of paragraph 4 of the commentary to Article 17.

91. The Committee noted that the legislation of some countries makes it possible to "look through" arrangements involving entities and to deem the income to be derived by the artiste or athlete: where this is so, paragraph 1 enables them to tax income resulting from such activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits such counties to impose tax on the profits directed from the income of the artiste or athlete to the entity. It may be, however, that the domestic laws of some countries do not enable them to apply such a provision. Such countries are free to agree to alternative solutions or to leave

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paragraph 2 out of their bilateral conventions (cf. paragraph 5 of the commentary).

92. Having earlier considered the application of paragraph 2 to payments made to an entity in respect of artistes' and athletes' performances where they do not control the entity or benefit from that income (see Paragraphs 89 and 91 above), the Committee agreed that there are even stronger reasons for allowing the country of source to tax the whole of the income paid to a performers own entity. The Committee also noted that similar considerations are set out in paragraph 83 above as regards the nature of the income covered by the Article also apply here.

93. In the German view the taxation of income derived by a company resident in a third country for activity exercised in Germany by artistes employed by it should take account of the legal relationship between the German organiser and that company. If there is no Double Taxation Agreement with the third country, the Federal Republic of Germany under its domestic legislation (see paragraph 57) can fully tax such income. Withholding tax is levied on gross receipts at the rate of 15 per cent. The same applies to third countries with whom there is an Agreement containing a provision corresponding to paragraph 2 of Article 17 of the OECD Model Convention.

D. Other relevant issues

1. Computation of income

94. The Committee noted that Article 17 says nothing about how the income concerned is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic Laws differ in this area, and some provide for taxation at source at on appropriate rate based on the gross amount paid to artistes and athletes. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc.

2. Allocation issues

95. The Committee considered whether allocation issues arising for the application of Article 17 called for special solutions. As noted earlier, only that

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part of the amounts paid to an incorporated troupe, orchestra, etc., which accrues to artistes and athletes from the "personal" exercise of their talents is taxable under the terms of paragraph 1. It will therefore often be difficult to determine the assessment basis for a specific performance — particularly when the members of the troupe are paid salaries by the company, receiving remuneration covering the "world-wide" activities of the troupe. Only estimates will be possible, and the tax authorities of the country of source and of the country of residence may not agree on the estimate.

96. Similar difficulties will arise for the application of paragraph 2 of the Article where it is difficult to isolate the proportion of "artistic" income e.g. in a lump sum payment made to a non-resident company that is attributable to service, which are recognised as not falling under Article 17.

97. The Committee recognised the difficulties involved in separating out, where necessary, "artiste income" and "income from other services", or in apportioning an artiste or an athlete's salary, or sponsoring income, in order to assess the sums taxable in the country of source. As noted earlier (cf. paragraph 94), the Article says nothing as to how the income concerned is to be computed and domestic laws apply. The Committee agreed that the problems involved did not differ from other "classical" allocation problems and did not call for special comments.

3. Cultural events such as those supported from public funds

98. The Committee noted an increasing trend in the organisation of cultural events, with related claims for tax exemption, which have sometimes led to abuse. The decision as to whether special concessions should be granted to artistes or organisers of such events should best be left to bilateral agreement between Contracting States. However it seems desirable that a standard provision be suggested for insertion in bilateral conventions. Such exemptions should be based on clearly definable and objective criteria to ensure that they be given only where intended. Discretionary expressions such as "cultural exchange" may easily result in obscurity as to what exactly should be covered by the exemption. For instance, exemption could he limited to events specifically funded by government or where specific conditions are fulfilled (e.g. activities of non-profit organisations). Such a clause might read as follows:

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"The provisions of paragraphs 1 and 2 shall not apply to income derived from activities performed in a Contracting State by artistes or athletes if the visit to that State is substantially supported by public funds of the other Contracting State or a political subdivision or a local authority thereof."

4. Subsidiary right to tax for the country of residence

99. The provisions of Article 17 could lead to double non-taxation where, on the one hand, the country of the artiste's or athlete's performance cannot exercise the taxing powers afforded it under the convention (for example, because under domestic law the income is not taxable or is specifically exempted) and, on the other hand, the country of residence applies the exemption method to relieve double taxation. This is seen as a major tax compliance issue in the countries of residence. The problem is of direct concern only to those countries of residence which apply the exemption method for relieving double taxation (either under internal law or under a convention). The problem arises not only where the income is not taxed at source; even when income is taxed in the country in which it is earned, the rate is often considerably lower than that of a progressive scale of taxation which would be applied by the country of residence. Some countries are very dissatisfied with this situation and resort to the use of the credit method in such cases.

100. The Commentary on Article 17 refers to this problem when dealing with the special case of artiste companies (in paragraph 5 of the text) and suggests as a solution, that either the credit method be used, or a subsidiary right to tax for the country of residence should be recognised. That country would be allowed to tax the income in question when this has not been done in the country where the performance takes place. The first of these solutions is also referred to in a more general context in paragraphs 32 and 47 of the Commentary on Article 23A. In cases where a country is unable to use the credit method, it should of course adopt the second solution.

101. The Committee's conclusion on this point is that there is nothing to prevent two Contracting States from adopting one or other of these two possible solutions in a bilateral convention. They should endeavour to do so when there is a high risk of double non-taxation, tax avoidance or evasion.

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5. Triangular cases

102. A number of difficulties experienced by countries involve three-country situations. One case is where the artiste resides in State A, performs in State S and is employed under an exclusive "slave" contract by a "shadow company" situated in a non-treaty country B (e.g. a tax haven) and which supplies the entertainer's services to a producer in State S against payment of a fee. The question then arises as to whether State S may tax remuneration in respect of the entertainer's performance. An affirmative answer should be given to this question since Article 17 of the convention between A and S, which applies to the artiste resident in A, confers on State S the power to tax, and furthermore this power is not circumscribed by any convention between A and B.

103. In another three-country situation, the artiste is resident in a third State B, while the "shadow company" is established in State A. Even if there is a convention between A and S, the "shadow company" in State A could not argue that the remuneration paid by the producer of the performance in State S constitutes business income received without the intervention of a permanent establishment, since paragraph 7 of Article 7 stipulates that the Article does not apply to "items of income which are dealt with separately in other Articles" of the convention between A and S.

104. Consequently, it appears to matter little where the performer resides since this will either be in a State that has signed a convention with State S (where the activity is performed), under the terms of which State S has the right to tax, or else in a State which has not a convention with State S, whose right to tax therefore cannot be limited.

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Part V

CONCLUSIONS

A. Suggested improvements in the domestic sphere

105. This survey of the difficulties encountered by tax administrations in taxing effectively artistes and athletes, as well as discussions on country experience with counteracting legislation, led the Committee to suggest some tentative recommendations. Having agreed on the principle that activities should be taxable in the country of performance, it was found that there were many instances where, for practical or legal reasons, such taxation was presently not possible or was ineffective. Improvements should therefore be looked for in the first instance in the domestic sphere. Admittedly, in providing for domestic changes, countries may have different approaches as to the proper way of dealing with resident and non-resident artistes and athletes, or with performers and other taxpayers and these are referred to in the next section. However, the following suggestions for improvements can be offered:

a) *Exemptions* from tax for artistic or athletic events vary in degree among countries and depend on sovereign rights. Where they exist, however, they may lead to considerable inequalities, thereby discouraging tax compliance. Also from a technical point of view special concessions to some parts of the industry may be detrimental to the good functioning of the tax system;

b) *Information:* an effective and comprehensive information-gathering system is required. Setting-up specific units for this purpose would facilitate centralising the information available and communicating with foreign partners (see section B below);

c) *Assessment and collection:* in addition to stricter accounting and reporting obligations on organisers, withholding tax systems at fairly high levels could be set up to cover payments to self-employed artistes and athletes and persons (including, companies) providing the services of artistes and athletes. Although special taxes constitute a useful system for taxing such people, they appear to have drawbacks especially in an international context. From the investigation point of

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view, a centralised approach to deal with larger domestic cases or with the liability of foreign artistes and athletes is desirable.

B. Suggested improvements in the international sphere

1. Increased exchange of information

106. It emerges from country experiences that, with the exception of a few countries, little information is obtained through the exchange of information article of double taxation conventions. The Committee recommends that Member countries make a more intensive use of such exchanges, either upon request, or preferably spontaneously, when tax authorities of a Contracting state come to learn that some of their residents are about to visit the other State, or when a resident of that State has performed services in the first-mentioned State. It is suggested that competent authorities could usefully issue special instructions or guidelines for dealing with exchanges of information in this area. In the absence of effective exchanges, income of artistes and athletes is likely to go very lightly taxed, or even not taxed at all when exemption is provided for in the State of performance.

107. Admittedly it may be difficult for a State to inform the other of impending visits there. However, some countries with a sophisticated (possibly centralised) information system on artistic and sporting activities may be in a position to send such advance information. As to information which the State of residence of the performers would need for its domestic taxation, there are quite a few details the transmission of which could be agreed upon and organised: information necessary to verify the facts about the performance, the amounts paid (both remuneration and tax levied at source), the nature of the tax at source, the residence claimed by the entertainer etc. The Committee noted that in countries where special taxes existed (Norway and Sweden), these taxes were covered under bilateral conventions but exchanges of information provisions did not operate in practice, because such taxes were handled by authorities or agencies outside the ordinary tax administration, who were not familiar with exchange of information procedures under double taxation agreements. Although quick, automatic or spontaneous exchanges would be desirable, the relevant procedures are therefore difficult to establish in this case.

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2. Assistance in collection

108. As seen when reviewing domestic aspects of taxing entertainment activities, substantial tax collection problems arise by reason of the mobility of artistes and athletes, especially for countries where artistes and athletes are taxed by assessment. Also, it is in the nature of the industry that large tax bills relating to a period of popularity and affluence sometimes arrive at a time when popularity has waned and the money gone. Some countries appear to be reasonably successful in ensuring compliance which combines a monitoring system on the movements of artistes and athletes with tax arrears together with a centralised approach to deal with such people visiting the country. In most cases, however, international co-operation is required also in this area. Countries which have, or could have, domestic powers to enforce payment of taxes levied abroad should therefore be encouraged to conclude conventions providing for assistance in the recovery of tax claims, whether bilaterally (cf. OECD Model) or multilaterally.

109. Finally, it should be noted that in cases where different national interpretations of the relevant provisions in double taxation agreements lead to double taxation, countries should be prepared to use the mutual agreement procedure to resolve such differences.

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NOTES AND REFERENCES

1. The first was entitled, "Trends in International Taxation: Leasing of Equipment and Hiring-out of Labour", OECD, 1985.

2. Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Japan, Luxembourg, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and the United States.

3. Only Switzerland reported no particular problem in this area.

4. Unreporting of income may of course happen there too (e.g. partial payments "off the books") but again, the same problem arises for other professions.

5. Reported to be mostly situated in Switzerland and Liechtenstein.

6. This also creates problems under double taxation conventions which are dealt with in Part IV.

7. For practical reasons, the wage tax is sometimes taken as a final tax (e.g. in Germany and the Netherlands).

8. Another interesting case of avoidance is the following:

   > A restaurant makes a contract with a foreign company, according to which the musicians, show-stars, etc., employed by the company, perform in the restaurant. The restaurant only supplies the space and does not itself pay any performance or other fees. The foreign company receives the proceeds from the admission fees. There is a great temptation for the company to leave the proceeds undeclared in its home country.

9. Measures which exist in certain countries for counteracting general tax avoidance are *not* referred to in this Section, although they may well be of use in certain instances.

10. Problems may arise where tax is withheld only on payments to non-residents (see Canadian experience, paragraph 31 above).

11. A similar tax was imposed until 1982 in Denmark. When the period of performance exceeded 14 days, or in case of total engagement of at least one week payments to non-resident artistes were characterised as income subject to limited taxation in Denmark, and were subject to a 20 per cent gross tax it source. A recent change in jurisprudence now prevents tax authorities from levying the tax: the income is now taxable only if the artiste stays in Denmark for more than 6 months,

12. Following an increase in the rates of the special tax on entertainers in Norway from 1 January 1983 (from 10 to 20 per cent to 15 to 30 per cent on gross payments), experience suggests that an appropriate balance in tax levels has now been found, thereby reducing the speculation seen earlier in the advantages of paying special tax instead of the ordinary income tax.

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13. It is also worth mentioning that measures of this kind may apply, as in the case of France, to the performance of services of any kind, not only to that of artistes and athletes.

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Annex

ARTICLE 17

ARTISTES AND ATHLETES

1 Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer athlete himself but to another person, that income may, notwithstanding the provisions of Articles 7. 14 and 1 5, be taxed in the Contracting State in which the activities the entertainer or athlete are exercised.

COMMENTARY ON ARTICLE 17 CONCERNING THE TAXATION OF ARTISTES AND ATHLETES

1. Paragraph 1 provides that entertainers and athletes who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of an independent or of a dependent nature. This provision is an exception to the rules in Article 14 and to that in paragraph 2 of Article 15, respectively.

2. This provision makes it possible to avoid the practical difficulties which often arise in taxing entertainers and athletes performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to independent

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activities by adding its provisions to those of Article 14. In such a case, entertainers and athletes performing for a salary or wages would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

3. The provisions of the Article do not apply when the entertainer or athlete is employed by a government and derives the income from that government. Such income is to be treated under the provisions of Article 19. Certain conventions contain provisions excluding entertainers and athletes employed in organisations which are subsidised out of pubic funds from the application of Article 1. The provisions of the Article shall not prevent Contracting States from agreeing bilaterally on particular provisions concerning such entertainers and athletes.

4. The purpose or paragraph 2 is to counteract certain tax avoidance devices in cases where remuneration for the performance of an entertainer or athlete is not paid to the entertainer or athlete himself but to another person, e.g. a so-called artiste-company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the entertainer or athlete nor as profits of the enterprise in the absence of a permanent establishment. Paragraph 2 permits the State in which the performance is given to impose a tax on the profits diverted from the income of the entertainer or athlete to the enterprise where for instance the entertainer or athlete has control over or rights to the income thus diverted or has obtained or will obtain some benefit directly or indirectly from that income. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to alternative solutions or to leave paragraph 2 out of their bilateral convention.

5. Where in the cases dealt with in paragraph 2 the exemption method for relieving double taxation is used by the State of residence of the person receiving the income, that State would be precluded from taxing such income even if the State where the activities were performed could not make use of its right to tax. It is therefore understood that the credit method should be used in such cases. The same result could be achieved by stipulating a subsidiary right to tax for the State of residence of the person receiving the income, if the State where the activities are performed cannot make use of the right conferred on it

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by paragraph 2. Contracting States are free to choose any of these methods in order to ensure that the income does not escape taxation.

Observation on the Commentary

6. *Canada* and the *United States* are of the opinion that paragraph 2 of the Article applies only to cases mentioned in paragraph 4 above and these countries will propose an amendment to that effect when negotiating conventions with other Member countries.

Reservations on the Article

7. *Greece* and *Portugal* reserve the right to apply the provisions of Article 17, not 19, to income of government entertainers and athletes.

8. *Japan* reserves the right to apply the provisions of this Article to income derived in connection with trade or business by entertainers or athletes who are employed by the government.

9. The *United States* reserves the right to limit paragraph 1 to situations where the entertainer or athlete is present in the other State for a specified period or earns a specified amount.

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TAX TREATY OVERRIDE

(adopted by the OECD Council on 2 October 1989)

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I. THE PROBLEM

1. Double taxation agreements (tax treaties)[1] are an essential element in facilitating economic relations between States and encouraging flows of capital and labour. They form a firm and reliable basis for tax relations between States. They limit and regulate the taxing jurisdiction of the States entering into them so as to ensure the orderly application of the domestic tax laws of what are often quite different systems. Their importance is underlined by the large numbers that are currently in force and the fact that international organisations and the business community repeatedly recommend the enlargement and improvement of the treaty network.

2. The certainty that tax treaties bring to international tax matters has, in the past few years, been called into question, and to some extent undermined, by the tendency in certain States for domestic legislation to be passed or proposed which may override provisions of tax treaties. In this note, which looks at the consequences of such action by national legislatures, the term "treaty override" refers to a situation where the domestic legislation of a State overrules provisions of either a single treaty or all treaties hitherto having had effect in that State. Legislation may take the form of a provision that treaty provisions are to be disregarded in certain circumstances (e.g.. in cases of treaty shopping or other forms of abuse). Legislation can also have the effect of overriding treaties, even where no reference is made in the legislation to treaty provisions as such, because the domestic interpretation of the effect of that legislation in relation to treaty provisions has the same effect in practice. Some hypothetical examples of treaty override are given in Section IV of this note.

3. This note proceeds to analyse treaty override from three different points of view. First, it examines the relevant rules of international and domestic law and the relationship between them. Secondly, it considers the possible legal remedies when override occurs. Thirdly, it analyses different practical cases, including the motivation for treaty override in any given situation. The note then presents the position of the Committee on Fiscal Affairs on the question and makes suggestions for action at the international and domestic levels including ways in which particular situations which States have tried to resolve by treaty override can be dealt with.

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4. At the outset, however, the kind of treaty override primarily addressed in this note should be distinguished from other situations, which either involve or are similar to treaty override and may have the same effects. Three of these situations are described below and comments are made on them either below or later in this note.

a) A State may legislate to reverse the effect of a court decision which deviates from the common interpretation, explicitly accepted or tacitly implied by the treaty partners, of a provision based on the text of the treaty. In this case, it is not considered that any injury is done to the basis of international tax relations If the competent legislative and administrative organs of the States concerned are in agreement that the court decision is contrary to their intentions. Indeed it is the Court's decision in the first place which may be seen as overriding the treaty;

b) A State may change the definition of a term used in its domestic legislation which is also used in treaty provisions but which is not specifically defined for the purposes of the treaty. In this case there is no override where the treaty contains a provision essentially similar to that embodied in Article 3, paragraph 2, of the 1977 OECD Model Double Taxation Convention which provides that, as regards the application of a treaty by a Contracting State, any term not defined in the treaty shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the treaty applies. It cannot have been contemplated that, having once entered into a treaty, a State would be unable to change definitions of terms used in its domestic law provided such changes were compatible with the context of the treaty;

c) Finally, newly adopted domestic legislation may be incompatible with a treaty provision, without the competent organs intending, or even being aware of, such an effect.

5. In summary, the type of treaty override primarily addressed in this note is the enactment of domestic legislation intended by the legislature to have effects in clear contradiction to international treaty obligations.

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II. THE LEGAL ANALYSIS OF TREATY OVERRIDE

i) Preliminary remarks

6. The legal effect of a treaty override has to be examined both in the light of international and of domestic law.

7. Under a treaty the Contracting States mutually undertake the obligation to respect and apply the treaty provisions. This is the principle of *"pacta sunt servanda"*. Treaty override implies that a State by legislative action gives preference to domestic law over international law, and thus refuses to fulfil certain obligations arising out of the contractual nexus on grounds that the treaty obligations conflict with domestic law. When a treaty override occurs there is, therefore, a breach of the treaty. It should be noted that a breach of the treaty occurs when the overriding legislation is passed by the legislature and not only when it is applied to actual cases. Any breach of a treaty has an effect on the international relationships of the State concerned with other States, and the rights and obligations arising out of such action have to be determined under the rules of international law.

ii) The obligation to perform treaties under international law

8. Tax treaties are international agreements concluded between States in written form and governed by international law. The Vienna Convention on the Law of Treaties, which came into force on 27th January 1980, contains the rules applicable to treaties concluded after it came into force between States that are parties to the Convention. As at 31st December 1988, 56 States were parties to it, including the following OECD Member countries: Australia, Austria, Canada, Denmark, Finland, Germany, Greece, Italy, Japan, the Netherlands, New Zealand, Spain, Sweden and the United Kingdom. Luxembourg and the United States have signed, but not ratified, the Vienna Convention. As concerns States which are not parties to the Vienna Convention, or as concerns treaties concluded before its entry into force, the principles applicable are those of customary international law. However, since most of the principles embodied in the Vienna Convention have been derived from customary international law, it is the principles set out in that Convention to which this note will refer.

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9. The obligation "*pacta sunt servanda"* is one of the fundamental, universally recognised principles of the law of treaties, which has been codified in the preamble and in Article 26 of the Vienna Convention, which reads as follows: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith".

10. "Binding on the parties" means that the treaty is binding on the subject of international law as such, i.e. the State as a whole. It does not matter which organ represented the State when entering into treaty commitments, nor whether the procedure by which the State became bound involved parliamentary approval or not. The State is bound even if its consent in that respect was expressed by an organ beyond its competence or under violation of constitutional procedures, unless this violation was evident to the other parties (cf. Article 46 of the Vienna Convention). It "must be performed in good faith" means that international law requires States to implement the provisions of a treaty. It depends on each individual State the particularities of its constitutional and legal system, and the nature of the treaty itself how such implementation takes place. International law, however, is not concerned with the ways and means by which performance is obtained, but exclusively with the result.

11. Article 27, stressing that internal law cannot serve as justification for non-compliance with treaty obligations, reiterates a principle which might be seen as already implicit under Article 26. This can apply to the case where national legislative or administrative organs adopt measures contrary to existing treaty obligations. According to Article 27, such internal difficulties or even impossibilities may not be presented as a legally valid excuse in relations between States, i.e. under international law.

12. In summary, it can be said that under international law treaties have to be observed by the parties as long as they are valid, and unless they have been formally denounced. Domestic legislation (whether subsequent to signature or otherwise) or other reasons in no way affect the continuing existence of that international obligation. All other parties to a treaty are entitled to insist on compliance by a party not performing its obligations.

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iii) The rank of treaty obligations under domestic law

13. Under the provisions of Article 1, the Vienna Convention has effect only *between States*. The source for rights and obligations for individuals and organs *within a State* is its domestic law. While Article 27 of the Vienna Convention does not admit provisions of domestic law as an excuse for not complying between States, it implicitly admits that conflicting domestic law may exist. This is in accordance with the two main doctrines explaining the relationship between international and domestic law: while the "dualist" doctrine believes that international and domestic law are two completely independent systems, each governing different relations and having different sources, the "moderate monist" doctrine sees international and domestic law as part of one overall system, but admits nevertheless the valid existence of domestic law in conflict with international law.

14. It depends on each State's legal system how, and at what level, international law (treaties, customary law and general principles) is given effect domestically. The level attributed to treaty obligations, as incorporated in domestic law, determines whether derogations therefrom are unconstitutional or not. In the end, the choice is between giving priority either to a State's international obligations, or to the sovereignty of decision of a country's elected representatives. "Treaty override" under domestic law can be automatically avoided if, under a State's Constitution, a higher value is attributed to a treaty obligation than to domestic law or if a State regards treaty law as "*lex specialis*" to which priority is to be given in domestic law. If treaty obligations are considered as having -- at most -- the same rank as that of domestic law, they may, within some national legal systems be subject to the rule "*lex posterior derogat legi priori*" (i.e. later law overrides prior law). However, the situation is less simple to determine in practice since this principle applies only when inconsistencies arise between the new law and the prior law and it is well known that courts are reluctant to construe treaties as inconsistent with domestic law (and vice versa).

15. In this respect, OECD Member countries find themselves in different positions. For example, Article 55 of the French Constitution of 1958 provides that treaties regularly ratified or accepted shall possess, from the moment of publication, superiority over ordinary laws[2]. A similar principle is embodied in Article 94 of the Dutch Constitution. Here, the treaty obligations prevail, also under domestic law, over any conflicting provisions of prior and posterior laws.

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On the other hand, the United States has chosen, in accordance with Article VI, paragraph 2, of its Constitution, to give treaty obligations equal rank with domestic law and thus to make such obligations subject to the "*lex posterior*" rule in the case of irreconcilable conflicts. In the Federal Republic of Germany Article 59, paragraph 2, of the Fundamental Law provides for the transformation of the treaty into domestic law and treaties so transformed normally have precedence over national law. In the United Kingdom domestic legislation implementing treaty obligations is subject to amendment or repeal by later legislation. Under the Constitution of Finland, treaties which may conflict with prior domestic law require approval by Act of Parliament and after such approval will have the same rank as that Act.

16. Mention should also be made in this context of the fact that many OECD Member countries are also member States of the European Community. For them, European Community law adopted on the basis of the EEC Treaty, the ECSC Treaty, the EURATOM Treaty and the other Community treaties occupies a special place in the legal hierarchy. Directly applicable EC provisions are, in effect, law which operates directly in the domestic legal system and overrides conflicting domestic law. It should however be noted that the European Communities themselves, in their regulatory activities, are bound by the rules of international law.

17. If a constitutional system does not exclude the adoption of legislation contrary to the State's international obligations, this does not mean that those international obligations are considered as having no importance. If they have such power, the legislative organs must consider carefully whether or not to exercise it. In some States, the outcome of such reflexion may almost always be in favour of respecting those international obligations. In others, legislators may, in occasional cases, consider certain national interests as of such overwhelming importance that the State has no other choice but to override its treaty obligations.

18. In summary, the rank of treaty obligations depends on each State's legal system. The latter may allow for derogation, under domestic law, from those obligations. Such derogation is internally perfectly valid, and binding on a State's organs and citizens. It does not, however, alter the obligations of the State towards other States under international law.

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iv) Interpretation and application of treaties

19. The rules of interpretation embodied in Article 31 of the Vienna Convention[3] are stated in quite general terms and can be applied only on a case-by-case basis. However, some general remarks are called for:

a) First, Article 31 requires States to interpret treaties in the light of their object and purpose. Tax treaties aim primarily at the avoidance of double taxation and the prevention of fiscal evasion but also have the objective of allocating tax revenues equitably between the two Contracting States. Thus, any interpretation achieving these objectives would be preferable to one leading to double taxation or to an inappropriate double exemption. However, since double taxation is a result of taxation in two States, the interpretation of the treaty on the basis of its object and purpose requires a high degree of co-ordination between the Contracting States;

b) Secondly, the general rule of interpretation should be based on the terms of the treaty in their context. This corresponds to the approach taken in Article 3, paragraph 2, of the OECD Model Convention where the context of the treaty takes precedence over an interpretation derived from national laws. Interpretation should thus aim at a co-ordinated application in both States in order to avoid double taxation or no taxation;

c) Thirdly, in describing the context, the Vienna Convention refers to agreements, whether prior or subsequent to the treaty, as well as to practices; in the case of tax treaties, these will normally require continuous co-ordination between the tax administrations concerned.

20. All this leads to the conclusion that the interpretative process should, in the case of tax treaties, rely on the co-ordination of approaches by the tax authorities in order to achieve the main objectives, namely the avoidance of double taxation and the prevention of fiscal evasion. For this reason, a mutual agreement procedure between the tax authorities has been incorporated in tax treaties not only to solve specific cases but also to deal with any other difficulties or doubts arising as to the interpretation or application of the treaties[4]. This does not mean that treaties can be interpreted only by formal mutual agreement procedure or by negotiation, since the decisions of courts clearly have an important part to play. Coordination should nevertheless be regarded as the guiding element in the interpretative process.

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III. THE REMEDIES UNDER INTERNATIONAL LAW IN CASE OF NON-COMPLIANCE BY A PARTY WITH ITS TREATY OBLIGATIONS

21. If non-compliance consists in one party enacting legislation violating treaty obligations, international law gives the other party the right to require repeal, or at least, non-application of such legislation. The first step which can and should be taken by an injured party is the filing of an official protest in writing, immediately after the government learns of the possibility of treaty override, to the government of the defaulting party stating the details of the treaty override (i.e., the breach of the treaty) and insisting that it complies with its treaty obligations.

22. If this fails, a remedy for non-compliance -- termination of the treaty or suspension of its operation by the other party (parties) as a consequence of the breach -- is codified in Article 60 of the Vienna Convention. This Article embodies customary international law and practice. It is to be noted that the Article contains separate provisions relating to a bilateral treaty (paragraph 1) and a multilateral treaty (paragraph 2).

23. It is also important to note that the breach of a treaty by one of the parties must be a "material" one as defined in paragraph 3 of Article 60, i.e. consisting in the violation of a provision essential to the accomplishment of the object or purpose of the treaty. If one party is in breach of the treaty the other party may respond but only in a way which is proportionate to the breach. The Vienna Convention in fact provides for suspension in whole or in part of the treaty, thus offering various possibilities of dealing with a breach. Whether a "treaty override" by domestic legislation constitutes such a "material breach" depends on the circumstances of each case.

24. It should also be noted that the words "to invoke the breach as a ground for terminating" has been used and not the words "may terminate". Under the Convention, the injured party must follow the procedures set out in Articles 65 to 68 in order to terminate the treaty.

25. As concerns the overriding party, the so-called "*clausula rebus sic stantibus*" (concept that a fundamental change of circumstances may be invoked as a reason for terminating the treaty) may be mentioned, as it might be

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relied on in order to justify overriding provisions. This is dealt with in Article 62 of the Vienna Convention. However, it does not justify treaty override as such, in particular not a partial one, but only provides a basis for an extraordinary termination of the treaty as a whole. Treaty override provisions typically do not aim at a complete termination of the tax treaty. On the contrary, they aim at suspending unilaterally the operation of certain treaty provisions in one State while in the other State the treaty would remain applicable in its entirety. Moreover, the "change of circumstances" must be determined from an objective point of view, i.e. a fundamental change of the situation prevailing at the time of conclusion of the treaty, and can not consist in a mere change of national policy. A treaty override, consequently, cannot normally be justified on the basis of the "*clausula rebus sic stantibus*".

26. It should be added that the provisions of Article 61, paragraph 2, on supervening impossibility of performance read as follows: "Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from, or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty."

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IV. CASES OF NATIONAL TREATY OVERRIDE

27. It may be useful to give some hypothetical examples to illustrate national overriding legislation. These examples are not intended to reflect specific overriding legislation in Member countries but they may bear some resemblance to actual cases.

CASE 1

28. State A introduces a new withholding tax on specific items of income such as interest or royalties. State A's tax treaties provide that interest and royalties shall be exempt from tax in the State of source. For internal reasons State A legislates that the new tax will be levied, and that no refund will be provided, notwithstanding its tax treaty obligations to ensure an exemption.

29. This is an outright material breach -- not simply because the unilateral action imposes a new tax, but because the effect of the new tax is material -- of State A's contractual obligations which would deeply erode the confidence of the international community in State A's trustworthiness in fulfilling its obligations and even in concluding treaties.

30. The breach being a material one, the treaty partners of State A would be justified in terminating their tax treaty relationship with State A. However, termination could do even more harm economically and endanger the possibility of finding an acceptable solution in the future. Any wilful treaty override could thus have very serious implications.

CASE 2

31. State B taxes gains from the alienation of immovable property. Taxpayers have found a way to avoid paying the tax by interposing. in State B, a company between themselves and the property and by selling the shares in the company rather than the immovable property itself. State B cannot tax the gain from the sale of the shares as its tax treaties follow Article 13 of the OECD Model Convention. State B legislates that the sale of shares in any real estate company is deemed to be a sale of immovable property for the purpose of the application of its tax treaties.

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32. The effect of such legislation is in contravention of State B's tax treaty obligations, even though the overriding measure is clearly designed to put an end to the improper use of its tax treaties. There may be cases where State B could successfully argue that there is such an improper use and deny the treaty benefits but this must be done under existing rules. This type of case might be the object of a mutual agreement procedure but it might also cause State B to give notice of termination[5] of its treaties (at least those with States whose tax laws are such that a double exemption would be achieved).

33. Override of the kind described in paragraph 31 above could justify termination by State B's tax treaty partners under Article 60 of the Vienna Convention. However, as in Case 1, this route may do more harm than good. Partial suspension under that Article (restricted to the provision State B is not respecting) by State B's partners might be an adequate response but it would only leave things as they are. As an alternative, partners of State B could show willingness to solve the problem by an adequate and quick revision of the treaties.

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V. THE POSITION OF THE COMMITTEE ON FISCAL AFFAIRS

34. The Committee has considered the arguments that might be put forward to defend the use of overriding legislation and recognised that in a number of cases the legitimacy of the objective pursued -- in particular where they aim at counteracting abuse of conventions -- is well founded but the Committee remains strongly opposed to overriding legislation. Member countries have so far refrained from taking retaliatory measures (which all agree would not be conducive to better understanding in the international tax field) against overriding legislation but the Committee noted that there is growing dissatisfaction with the continued use of such legislation which could erode confidence in the international tax treaty network as a whole.

35. The Committee cannot agree that breaches of international obligations freely entered into are the proper ways to modify tax treaty obligations and feels that it is becoming urgent to concentrate on other ways to address the problems that overriding legislation aims at solving.

36. When substantial changes are introduced in domestic legislation (for example introduction of new withholding taxes or taxes on capital gains or on wealth) it is to be expected that the new domestic policy will be incorporated in the tax treaty policy of the State concerned. If there is a conflict with that State's tax treaty obligations the only internationally acceptable way to remove the conflicting provisions is by negotiating appropriate amendments to its tax treaties, not by way of unilateral overriding legislation.

37. It might be argued that this is a long process and that some treaty partners may refuse to enter into negotiations. The Committee recognises that treaty negotiations, and renegotiations, are indeed time consuming but this is a factor which is common to all bilateral negotiations where a proper balance of advantage to both sides has to be found. Any unilateral abrogation of specific obligations destroys such balance and must be condemned. The Committee does not subscribe to the argument that Member countries are unwilling to renegotiate tax treaties. A number of factors such as manpower shortages, budget limitations, or even a lack of counter-balancing proposals, might give the appearance of some unwillingness to renegotiate but all Member countries are committed to avoiding double taxation and do so as evidenced by the large number of tax treaties already in force. Such unwillingness could however

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develop if a State repeatedly does not respect its international obligations as it would be meaningless to agree on changes which may not be respected.

38. Where, in the situation described in paragraph 4 *a)* above, a court interpretation reverses the intended effect of a specific treaty provision, or where there is abuse of tax treaties, the Committee is of the view that swift action should be taken to redress the situation. This could be achieved through domestic legislation but the State concerned should first ensure that there is a broad consensus that the intended legislation does not injure international tax relations. In the event that there is no such consensus, the Committee considers that only renegotiation of the relevant tax treaties is acceptable. The time consideration referred to above is also relevant in this case but treaty partners are likely to reach agreement more rapidly in this type of situation since the object is essentially to clarify what was already intended.

39. The Committee considers that its Working Party No. 1 on Double Taxation might be used as a forum for early consultations on any effects a Member country feels are improper, for the elaboration of adequate interpretation of the treaties and for securing that there is a broad consensus that intended legislation does not injure international tax relations.

SUGGESTIONS FOR ACTION

i) The Committee on Fiscal Affairs strongly urges Member countries to avoid any legislation which would constitute a treaty override as defined in section I above.

ii) The motive for enacting legislation that overrides treaties can be less strong if all countries agree that they will promptly undertake bilateral or multilateral consultations to address problems connected with treaty provisions, whether arising in their own country or raised by countries with which they have tax treaties. Working Party No. I of the Committee on Fiscal Affairs is an appropriate forum for facilitating such consultation.

The Committee intends to follow developments closely in domestic legislation of Member countries and publicly and forcefully to condemn any action which would constitute a breach of international obligations, including bringing such situations to the attention of the OECD Council.

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NOTES AND REFERENCES

1. This note is directed primarily at treaty override in the context of income and corporation taxes but the considerations identified in the note and the recommendations to the Council based on them have general application to the taxes and duties covered by the OECD Model Convention on Estates and Inheritances and on Gifts.

2. Subject to application by the other Party, as concerns each treaty.

3. Article 31 of the Vienna Convention reads as follows:

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

   2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:

      a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

      b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

   3. There shall be taken into account, together with the context:

      a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;

      b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

      c) any relevant rules of international law applicable in the relations between the parties.

   4. A special meaning shall be given to a term if it is established that the parties so intended."

4. See Article 25(3) of the OECD Model Convention.

5. As provided under Article 30 of the OECD Model Convention.

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Annex A

RECOMMENDATION OF THE COUNCIL CONCERNING TAX TREATY OVERRIDE

(Adopted by the Council on 2 October 1989)

THE COUNCIL,

Having regard to Article 5 b) of the Convention of the Organisation for Economic Co-operation and Development of 14th December 1960;

Having regard to the Recommendation of the Council of 11th April 1977 concerning the avoidance of double taxation;

Having regard to the Recommendation of the Council of 3rd June 1982 concerning the avoidance of double taxation with respect to taxes on estates and inheritances and on gifts;

Having regard to the report of the Committee on Fiscal Affairs of 29th June, 1989 on Tax Treaty Override;

Considering that double taxation conventions contribute to the removal of obstacles to the free movement of goods, services, capital and manpower between Member countries of the OECD and that the network of conventions brings certainty into international tax matters;

Considering that such certainty has been called into question, and to some extent undermined, by the enactment of legislation which is intended to nullify unilaterally the application of international treaty obligations;

Considering that bilateral or multilateral consultations are the first course of action in dealing with problems arising from conflicts between domestic legislation and treaty provisions;

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I. RECOMMENDS Member countries:

1. To undertake promptly bilateral or multilateral consultations to address problems connected with tax treaty provisions, whether arising in their own country or raised by countries with which they have tax treaties;

2. To avoid enacting legislation which is intended to have effects in clear contradiction to international treaty obligations.

II. INSTRUCTS the Committee on Fiscal Affairs to follow developments in this area and to bring to the attention of the Council any action which would constitute a material breach of Member countries' international treaty obligations.

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THE 183 DAY RULE: SOME PROBLEMS OF APPLICATION AND INTERPRETATION

(adopted by the OECD Council on 24 October 1991)

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I. INTRODUCTION

1. The international exchange of goods and services has increased substantially over the last decade. The OECD Model Convention provides relatively simple rules which were primarily designed to encourage such exchanges. The Model Convention has, however, become the object of difficulties in its application both for the taxpayers and the tax authorities. The Commentary to Article 15 of the Model Convention does not give much guidance for the resolution of those difficulties and there is therefore a need to clarify the interpretation of Article 15 in several respects but particularly as regards the way in which the 183 day period is calculated. This note reviews this question and offers suggestions as to how it should be dealt with.

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II. THE 183 DAY RULE IN THE MODEL CONVENTION

A. The rule

2. The general rule of taxation of income from employment is embodied in the 1977 Model Convention in paragraph 1 of Article 15. According to this rule, income from employment is taxable in the State in which the employment is exercised. However, paragraph 2 of that Article contains an exception (the so-called 183 day rule) to this general rule.

3. Three conditions must be met before the exception can apply:

a) the taxpayer must not be present in the State of activity for a period or periods exceeding in the aggregate 183 days in the fiscal year concerned;

b) the remuneration must be paid by, or on behalf of, an employer who is not a resident of the State of activity, and

c) the remuneration must not be borne by a permanent establishment or a fixed base which the employer has in the State of activity.

4. The State of residence, the State of activity and the taxpayer may have divergent views on whether the State of activity has the right to tax or not. In the event of a disagreement between the tax authorities of the State of activity and the taxpayer, the latter has recourse to the mutual agreement procedure by making a request to the tax authorities of his State of residence. A mutual agreement procedure should lead to the avoidance of double taxation but in the absence of a general agreement as to the interpretation of the rules, it may end up in excessive taxation or in no taxation.

5. The use of different methods, or of the same method applied differently, is unimportant except when the State of residence and the State of activity have opposite views on whether or not the employee qualifies for the exemption in the State of activity. The difficulties thus arise only at the margin and the Committee is conscious of the fact that the divergencies in the application of the rule are used by some simply as a planning device to obtain a double exemption. A simple solution to that problem which would solve both

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double taxation and double exemption problems would be to specify in the Commentary that, in the case of conflict, the State of residence would accept the calculation made by the State of activity. However, the Committee considers that such a solution may open the door to abuse and may also need to be adapted in the context of relations with non-member countries. It has consequently rejected it.

6. However, it is important, for practical reasons, to maintain this rule since, even though domestic legislation allows a number of Member countries to tax any activities, however short, exercised on their territory, in practice it may not be possible to tax people working for a short duration, either because of lack of information or because the costs of collection would be exorbitant compared to the return. It is also important for the taxpayer who finds it easier to deal with only one tax system, i.e. that of his State of residence with which he is familiar. The State of residence should, nonetheless, be in a position to exercise its taxing right when the State of activity abandons its own right.

B. Persons to whom the 183 day rule applies

7. According to the Commentary on paragraph 2, this rule "is mainly intended to facilitate the international movement of qualified personnel, as in the case of firms which sell capital goods and are responsible for installing and assembling them abroad". The wording of paragraphs 1 and 2 of Article 15 of the Model Convention does not entirely correspond to this statement as it does not refer to "qualified personnel".

8. There is general agreement that the wording of the Commentary, which could be interpreted as a limitation, needs to be amended to remove any ambiguity as regards the meaning of "qualified personnel". It is suggested that, in line with the practice of most Member countries, this could be achieved by deleting the reference to "qualified personnel" and by clearly stating that the provision applies to all individuals rendering dependent personal services (sales representatives, construction workers, engineers, etc.) unless their remuneration falls under another Article of the Convention.

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C. Calculation of the 183 day period

9. The Commentary to Article 15 does not specify the way the 183 day period should be calculated. Since the rule has been in existence for several years, Member countries have individually (or as a group, which is the case with the Nordic countries) defined their own way to make the calculation. Two main methods have been designed: one which uses the actual stay in the other State (i.e. the number of days in the fiscal year that the taxpayer is physically present in the other State) and the other which uses the actual duration of the activity (i.e. the number of days that the individual has performed the activity without regard to short breaks in the taxpayer's stay which are spent at home or in a third country).

10. Member countries were asked to reply to a questionnaire on the way they calculate the period and replies have been received from all Member countries. Annex I summarises the replies and an analysis of them is provided below.

i) Methods used

11. The majority of Member countries (17 out of 24) use the "days of physical presence" method although, in the case of *Switzerland*, a mixed method is used, i.e. physical presence related to the activity. *France*, *Germany*, *Greece*, *Italy*, *Luxembourg*, the *Netherlands* and *Spain* use the "duration of the activity" method; *Belgium* also uses this method, but only in the case of conventions where Article 15 was explicitly drafted accordingly.

ii) Days included or excluded from the calculation

12. The following analysis of the replies covers both methods:

a) Part of day:

All Member countries except Austria and Ireland include part of day in the calculation. Some countries do it on an hourly basis so that a part of a day is included but does not equate to a full day but this usually applies only to certain frontier workers. In addition, the United States exclude the time spent in the United States, if less then 24 hours, while in transit between two points outside the United States.

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b) Day of arrival:

Austria and Italy are the only countries which exclude the day of arrival from the calculation (in the case of Italy, only if it is not related to the beginning of the activity).

c) Day of departure:

Austria, Ireland and Italy are the only countries which exclude the day of departure from the calculation (in the case of Italy, only if it is not related to the activity).

d) Saturdays and Sundays:

All Member countries include Saturdays and Sundays spent inside the State of activity.

e) National holidays:

All Member countries include national holidays spent inside the State of activity.

f) Holidays spent inside the State of activity:

In all the countries using the "days of physical presence" method, holidays spent inside the State of activity are, with three exceptions, always included in the calculation whether the holidays are taken before, during or after the exercising of the activities. The exceptions are Australia, Austria and Switzerland which exclude the holidays if they are taken either before or after exercising the activities.

As for countries using the "duration of the activity" method, the replies vary. France includes the holidays in all cases, provided they are related to the activities; the Netherlands always exclude them whenever the holidays are taken inside of the Netherlands; Luxembourg includes them if they are taken during the time the activities are exercised and has not yet decided on whether to include or exclude days of holidays taken in the country before and after exercising the activity; Italy and Greece exclude them if they are taken before or after exercising the activities and include them if taken during the activities; Germany includes holidays taken during or after exercising the activities but excludes them

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if taken before exercising the activities; finally, Spain includes them if they are taken before or while exercising the activities but excludes them if they are taken after the completion of the activities.

g) Holidays spent outside the State of activity:

All Member countries except Belgium, France, Germany, Greece, Luxembourg and Spain exclude such days. Italy includes them but there is room for flexibility.

h) Short breaks (2 or 3 days):

All seven countries using the "duration of the activity" method include such short breaks in the calculation when they are taken outside the State of activity; in the other group of countries only Belgium and Switzerland follow that approach. All the other countries exclude such days. As for short breaks inside the State of activity they are included in the calculation by all Member countries.

i) Days of sickness:

All of the replying countries with the exception of Italy and the United States include days of sickness in the calculation. Whilst the United States answer indicates that they exclude such days, their practical position is in line with that of most other countries. In an earlier submission on this question they explained that an individual is not treated as being present on any day when, because of a medical condition that arose whilst such individual was in the United States, the individual is physically unable to leave. They added that the rule is interpreted narrowly, so that it applies only to people who would have left the United States but for their medical emergency.

Denmark, Finland, Iceland, Norway and Sweden would exclude days of sickness if they are spent outside of their respective countries. Luxembourg would also exclude such days if the sickness exceeds fourteen days. France includes them but only if they are consecutive to the activity.

Finally, the Netherlands include them but only to the extent they are considered as a normal interruption of work, i.e. if the sickness lasts no

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longer than one or two weeks; if it does, then those days will be excluded.

j) Death or sickness in the family:

All Member countries except Italy include such days in the calculation (Luxembourg has not yet decided on its position). The observations made by Denmark, Finland, Iceland, Norway and Sweden and by the Netherlands under i) above are also applicable in this case.

k) Interruption because of strikes or lock-out or delays in supply:

All Member countries except Italy (for strikes or lock-out) include such days in the calculation (Luxembourg has not yet decided on its position). Italy includes days of interruption because of delays in supplies but they could exclude them in certain cases. In line with their observation on other questions Denmark, Finland, Iceland, Norway and Sweden exclude these days if they are spent outside of their respective countries. Ireland excludes them in some cases.

iii) Comments and suggestions on the calculation of the period

13. The answers show that there is a high degree of uniformity in several respects in the calculation of the 183 day period but that there are also important divergences, in particular with respect to holidays.

14. The "days of physical presence" method is an objective test the application of which is straightforward in most countries: the individual is either physically present in a country or he is not. It is considered that days of absence could easily be documented by the taxpayers when required. It is admitted that exception could be made in special circumstances (e.g. people in transit or people prevented from leaving because of illness as is the practice in the *United States*) but it is generally agreed that these should be limited. A few countries, however, go beyond this practice and exclude: *Austria*, part of a day, day of arrival, day of departure and holidays before and after the activities; *Ireland*, part of a day and day of departure; *Australia* and *Switzerland*, holidays before and after the activities.

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15. The "duration of the activity" method is a more difficult concept than the one underlying the physical presence method because it is not easy to decide when an assignment begins or ends and which days should be disregarded when calculating the 183 day period. Replies to the questionnaire confirm these difficulties. There is, however, unanimous agreement on the following points: part of a day (included), Saturdays and Sundays (included), national holidays (included), short breaks outside and inside the State of activity (included) and interruptions because of delays in supplies (included).

16. The Committee considers that only the "days of physical presence" method clearly falls within the wording of Article 15 and that the use of any other method, or the use of that method with exceptions, increase the difficulties of applying the provision. Most argued that the only way to apply the method was by way of a strict interpretation, i.e. that no exception whatsoever should be made when a person is present in the State of activity. However, a few felt that such a rigid application could have undesirable results, e.g. a person otherwise exempt in the State of activity became taxable because he felt sick while in transit in that State at some other time or because he happened to have spent some holidays in that State a long time before starting his activities. It is with these considerations in mind that the Committee has reviewed the way the 183 day period should be calculated.

17. The majority of Delegates felt that few exceptions should be made in the application of the method. A few felt, however, that a certain degree of reasonableness should be allowed. To ensure uniformity in the application of the 183 day rule and to avoid the problems referred to above, the Committee agreed that Member countries should use only the "days of physical presence" method and that it should be calculated in the following way:

INCLUDED:

- part of a day
- day of arrival
- day of departure
- Saturdays and Sundays spent inside the State of activity
- national holidays spent inside the State of activity
- holidays spent inside the State of activity
  - before exercising the activities

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- while exercising the activities
- after completion of the activities

— short breaks spent inside the State of activity

— days of sickness, unless they prevent the individual from leaving and he would have otherwise qualified for the exemption

— days spent inside the State of activity due to
  - death or sickness in the family
  - interruption because of strikes or lock-out
  - interruption because of delays in supplies

EXCLUDED:

— transit between two different points outside the State of activity if the individual is present in the State of activity for less than 24 hours

— holidays spent outside the State of activity

— short breaks (for whatever reason) spent outside the State of activity.

18. The adoption of this method to calculate the 183 day period requires that a number of Member countries change their practice, but these countries have all indicated a willingness to do so.

D. Work concentrated in only one State

19. The exemption in the State of activity concerns, according to the Commentary, employment of a short duration abroad. This statement does not reflect the wording of the Article nor the reality because each fiscal year is treated separately. The scope of application is therefore much wider than employment of short duration. The 183 day rule may in fact be applicable to a one year stay, e.g. if the employee stays in the State of activity from 2 July of one year through 1 July of the next year and the fiscal year of that State is the calendar year. All Member counties have confirmed that this is the case when the wording of the Model is used. The provision would even apply where an employment of more than one year does not result in a presence of more than 183 days in any year. This situation will occur especially in industries where working periods are concentrated, as is the case in the offshore oil and gas

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industry. It is therefore recommended that all references to "short duration" be deleted from the Commentary.

E. The proper fiscal year

20. It has been argued that the fiscal year concerned shall be understood as the fiscal year of the taxpayer. This can easily be determined if the taxpayer remains resident in the same State throughout the calendar or fiscal year but, if he changes his residence and becomes resident in the State of activity or in a third State, it may create difficulties. In practice, the fiscal year is generally understood to be the fiscal year of the State of activity. If the fiscal year of a State corresponds to the calendar year, the fiscal year concerned therefore cannot end earlier than 31 December even if the taxpayer changes his residence.

21. Paragraph 2 of Article 3 of the 1977 Model Convention reads as follows: "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 which it has under the law of that State concerning the taxes to which the Convention applies." Thus if two Contracting States have different fiscal years, the State in which the employment is exercised can interpret the term "fiscal year" as meaning *its* fiscal year (*Norway*/*United Kingdom* November l, 1972, Department Finance Letter Skatte Nytt No. 12, 1972/A72-310). The State of residence could, on the same ground, argue that the proper fiscal year is its own but the context — whether an exemption should be given in the State of activity — clearly requires that it is the fiscal year of the State of activity that is concerned. The Committee recommends that this opinion be expressed in the Commentary.

F. The residence of the employer

22. The second condition for application of the 183 day rule requires that the employer not be a resident of the State in which the temporary employment is exercised. Some treaties, however, provide that the remuneration for the activity carried on during the employee's temporary presence must be "paid by an employer resident in the first-mentioned State", e.g. an employer resident in the same Contracting State as the employee. Such a provision broadens the scope of the right to tax of the State of activity. It also increases the possibility

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of avoiding a double exemption as stated by *Norway* in footnote 9 to Annex I. The Committee agreed that these views, which could be expressed in the Commentary as an alternative wording of this provision for exemption countries, should be considered in the context of the revision of the Model Convention.

G. "Is not borne by a permanent establishment"

23. The third condition for the application of the 183 day rule is that the remuneration not be borne by a permanent establishment or a fixed base which the employer has in the State in which the employment is exercised.

24. The interpretation of the term "is not borne by" raises several questions which the Committee agreed should be the subject of a thorough review at a later time.

H. Double taxation and double exemption

25. Double taxation or double exemption may result from the inconsistent application of the 183 day rule. Double taxation could arise in a case where the State of residence of the taxpayer does not recognise the right of the State of activity to tax but the State of activity does tax. This can happen if the two countries use different methods for calculating the 183 day period or use the same method but with a different interpretation. It can also happen if they disagree on whether or not the remuneration is borne by a permanent establishment. In such a case, the State of residence may refuse to give a foreign tax credit on the grounds that taxation in the State of activity is not in conformity with the treaty and double taxation would remain unless other provisions in the domestic legislation (e.g. relief in case of hardship) are used. If the State of residence is an exemption country which exempts the foreign remuneration only if the taxpayer has been away for more than 183 days, a disagreement between the countries will also result in double taxation.

26. Double exemption can arise where the State of residence exempts the income and considers that the income should either be exempt or taxed in the State of activity and the latter considers that, in both cases, it should exempt the income. One possible way to deal with these problems would be to introduce a

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"subject to tax" rule in paragraph 2 of Article 15 whereby the State of activity would exempt the income only if the State of residence of the taxpayer taxes it. The Committee has not reached a conclusion on this question and intends to review the matter at a later date.

I. Conclusion

27. This note deals with some of the difficulties arising with the application of the 183 day rule and identifies a number of areas where further discussion is called for. The discussion resulted in an agreement to adopt a uniform way of calculating the period and, in order to reflect such agreement, the Committee recommends that the following changes be made to the Commentary to the Model Convention.

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III. PROPOSED CHANGES TO THE COMMENTARY ON ARTICLE 15

1. Paragraph 3 is deleted and replaced by the following:

"3. Paragraph 2 contains, however, a general exception to the rule in paragraph 1. *This provision covers all individuals rendering dependent personal services (sales representatives, construction workers, engineers, etc.), to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen.*

4. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. *The first condition is that* the exemption is limited to the 183 day period. It is further stipulated that this time period may not be exceeded "in the fiscal year concerned". The formulation used may create difficulties in case the fiscal years of the Contracting States do not coincide. In order to avoid these difficulties such Contracting States may prefer to use another phrasing, for instance "fiscal year of that other State" or "calendar year". *However, if paragraph 2 of Article 3 comes into play in the determination of the proper fiscal year, the context would clearly require that the fiscal year of the State of activity is the one that should prevail.*

5. Although various formulas have been used by Member countries to calculate the period there is only one way which is consistent with the wording of this paragraph: the "days of physical presence" method. The application of this method is straightforward as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays (see paragraph 6) before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the

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family. The following days are not taken into account: transit between two different points outside the State of activity, holidays spent outside the State of activity and short breaks (for whatever reason) spent outside the State of activity.

6. While holidays spent inside the State of activity are normally included in the calculation, some flexibility is acceptable if the taxpayer can demonstrate to the satisfaction of the tax authorities of both Contracting States that the holidays are clearly related or not related to the activity.

7. The second condition is that the employer paying the remuneration must not be a resident of the State in which the employment is exercised. *Thirdly,* should the employer have in *the* State *in which the employment is exercised* a permanent establishment (or a fixed base if he performs professional services or other activities of an independent character), the exemption is given only on condition that the remuneration is not borne by a permanent establishment or a fixed base which he has in that State. It should be noted that, *where remuneration is dealt with under a different Article of the Convention, such as Article 17, the provisions of that Article, and not of this Article, apply."*

2. Paragraphs 4 to 7 are renumbered paragraphs 8 to 11 respectively.

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ANNEX I
COUNTRIES USING THE "DAY OF PHYSICAL PRESENCE" METHOD

	AUS	AUT	BEL	CAN	DEN	FIN
1. Are the following days included or excluded from the calculation?	INC	EXC	INC	INC	INC	INC
1.1 Part of a day	INC	EXC	INC	INC	INC	INC
1.2 Day of arrival	INC	EXC	INC	INC	INC	INC
1.3 Day of departure	INC	INC	INC	INC	INC	INC
1.4 Saturdays and Sundays (spent inside the State of activity)	INC	INC	INC	INC	INC	INC
1.5 National holidays (spent inside the State of activity)	EXC	EXC	INC	INC	INC	INC
1.6 Holidays spent inside the State of activity						
1.6.1 before exercising the activities	INC	INC	INC	INC	INC	INC
1.6.2 while exercising the activities	EXC	EXC	INC	INC	INC	INC
1.6.3 after the completion of the activities	EXC	EXC	INC (22)	EXC	EXC	EXC
1.7 Holidays spent outside the State of activity						
1.8 Short breaks (2 or 3 days)	EXC	EXC	INC (22)	EXC	EXC	EXC
1.8.1 outside the State of activity e.g. for consultation, compensatory leave, etc.)	INC	INC	INC	INC	INC	INC
1.8.2 inside the State of activity	INC	INC	INC	INC	INC (4)	INC (4)
1.9 Days of sickness	INC	INC	INC	INC	INC (4)	INC (4)
1.10 Death or sickness in the family	INC	INC	INC	INC	INC (4)	INC
1.11 Interruption because of						
1.11.1 strikes or lock-out	INC	INC	INC	INC	INC (4)	INC
1.11.2 delays in supplies	YES	YES	YES (23)	YES (3)	YES (5)	YES
2. The exemption is given twice if the employee is present in the country for less than 183 days in two consecutive fiscal years	YES	YES	YES	YES	YES	YES
3. 3.1 The 183 day rule is applied in the case of an employment solely exercised in the State of activity when the work is concentrated to limited periods and does not exceed 183 days during the year	YES	YES (1)	YES	YES	YES	YES
3.2 This rule applies even if such an arrangement goes on year after year	YES	YES	YES (24)	YES	YES	YES
4. The wording of sub-paragraph 2 b) of Article 15 is used in your tax treaties. If not, please indicate how you depart and the reasons therefor.						

INC = Included EXC = Excluded

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ANNEX I (cont.)
COUNTRIES USING THE "DAY OF PHYSICAL PRESENCE" METHOD

	ICE	IRE	JAP	NZE	NOR	POR (10)
1. Are the following days included or excluded from the calculation?	INC	EXC	INC	INC	INC	INC
1.1 Part of a day	INC	INC	INC	INC	INC	INC
1.2 Day of arrival	INC	EXC	INC	INC	INC	INC
1.3 Day of departure	INC	INC	INC	INC	INC	INC
1.4 Saturdays and Sundays (spent inside the State of activity)	INC	INC	INC	INC	INC	INC
1.5 National holidays (spent inside the State of activity)	INC	INC	INC	INC	INC	INC
1.6 Holidays spent inside the State of activity	INC	INC	INC	INC	INC	INC
1.6.1 before exercising the activities	INC	INC	INC	INC	INC	INC
1.6.2 while exercising the activities	INC	INC	INC	INC	INC	INC
1.6.3 after the completion of the activities	EXC	EXC	EXC	EXC	EXC	EXC
1.7 Holidays spent outside the State of activity	EXC	EXC	EXC	EXC	EXC	EXC
1.8 Short breaks (2 or 3 days)	EXC	EXC	EXC	EXC	EXC	EXC
1.8.1 outside the State of activity e.g. for consultation, compensatory leave, etc.)	INC	INC	INC	INC	INC	INC
1.8.2 inside the State of activity	INC (4)	INC (2)	INC	INC	INC (4)	INC
1.9 Days of sickness	INC (4)	INC (2)	INC	INC	INC (4)	INC
1.10 Death or sickness in the family	INC (4)	INC (2)	INC	INC	INC (4)	INC
1.11 Interruption because of	INC (4)	INC (2)	INC	INC	INC (4)	INC
1.11.1 strikes or lock-out	YES (5)	YES	YES	YES	YES (5)	YES
1.11.2 delays in supplies	YES	YES	YES	YES	YES	YES
2. The exemption is given twice if the employee is present in the country for less than 183 days in two consecutive fiscal years	YES	YES	YES	YES	YES	YES
3. 3.1 The 183 day rule is applied in the case of an employment solely exercised in the State of activity when the work is concentrated to limited periods and does not exceed 183 days during the year	NO	YES	YES	YES	NO (9)	YES
3.2 This rule applies even if such an arrangement goes on year after year						
4. The wording of sub-paragraph 2 b) of Article 15 is used in your tax treaties. If not, please indicate how you depart and the reasons therefor.						

INC = Included EXC = Excluded

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ANNEX I (cont.)
COUNTRIES USING THE "DAY OF PHYSICAL PRESENCE" METHOD

	SWE	SWI (11)	TUR	UK	US
1. Are the following days included or excluded from the calculation?	INC	INC	INC	INC	INC (12)
1.1 Part of a day	INC	INC	INC	INC	INC
1.2 Day of arrival	INC	INC	INC	INC	INC
1.3 Day of departure	INC	INC	INC	INC	INC
1.4 Saturdays and Sundays (spent inside the State of activity)	INC	INC	INC	INC	INC
1.5 National holidays (spent inside the State of activity)	INC	EXC	INC	INC	INC
1.6 Holidays spent inside the State of activity	INC	INC	INC	INC	INC
1.6.1 before exercising the activities	INC	EXC	INC	INC	INC
1.6.2 while exercising the activities	EXC	EXC	EXC	EXC	EXC
1.6.3 after the completion of the activities	EXC	INC	EXC	EXC	EXC
1.7 Holidays spent outside the State of activity	INC	INC	INC	INC	INC
1.8 Short breaks (2 or 3 days)	INC (4)	INC	INC	INC	EXC
1.8.1 outside the State of activity e.g. for consultation, compensatory leave, etc.)	INC (4)	INC	INC	INC	INC
1.8.2 inside the State of activity	INC	INC	INC	INC	INC
1.9 Days of sickness	INC	INC	INC	INC	INC
1.10 Death or sickness in the family	INC	INC	INC	INC	INC
1.11 Interruption because of	INC	INC	INC	INC	INC
1.11.1 strikes or lock-out	INC	INC	INC	INC	INC
1.11.2 delays in supplies	YES (5)	YES	YES	YES	YES
2. The exemption is given twice if the employee is present in the country for less than 183 days in two consecutive fiscal years	YES	YES	YES	YES	YES
3. 3.1 The 183 day rule is applied in the case of an employment solely exercised in the State of activity when the work is concentrated to limited periods and does not exceed 183 days during the year	YES	YES	YES	YES	YES
3.2 This rule applies even if such an arrangement goes on year after year	YES	YES	YES	YES	YES
4. The wording of sub-paragraph 2 b) of Article 15 is used in your tax treaties. If not, please indicate how you depart and the reasons therefor.	YES	YES	YES	YES	YES

INC = Included EXC = Excluded

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ANNEX I (cont.)
COUNTRIES USING THE "DURATION OF ACTIVITY" METHOD

	FRA	GER	GRE	ITA (15)	LUX	NETH	SPA
1. Are the following days included or excluded from the calculation?							
1.1 Part of a day	INC	INC	INC	INC	INC	INC	INC
1.2 Day of arrival	INC	INC	INC	EXC (16)	INC	INC	INC
1.3 Day of departure	INC	INC	INC	EXC (16)	INC	INC	INC
1.4 Saturdays and Sundays (spent inside the State of activity)	INC	INC	INC	INC	INC	INC	INC
1.5 National holidays (spent inside the State of activity)	INC	INC	INC	INC	INC	INC	INC
1.6 Holidays spent inside the State of activity	INC (18)	EXC	EXC	EXC	(6)	EXC	INC
1.6.1 before exercising the activities	INC (18)	INC	INC	INC	INC	EXC	INC
1.6.2 while exercising the activities	INC (18)	INC	EXC	EXC	(6)	EXC	EXC
1.6.3 after the completion of the activities	INC	INC	INC	INC (17)	INC	EXC	INC
1.7 Holidays spent outside the State of activity	INC	INC	INC	INC	INC	INC	INC
1.8 Short breaks (2 or 3 days)							
1.8.1 outside the State of activity e.g. for consultation, compensatory leave, etc.)	INC	INC	INC	EXC	(6)	INC (13)	INC
1.8.2 inside the State of activity	INC	INC	INC	EXC	INC (7)	INC (13)	INC
1.9 Days of sickness	INC	INC	INC	EXC	(6)	INC (13)	INC
1.10 Death or sickness in the family	INC	INC	INC	EXC	(6)	INC	INC
1.11 Interruption because of							
1.11.1 strikes or lock-out	INC	INC	INC	INC (17)	(6)	INC	INC
1.11.2 delays in supplies	INC	INC	INC	INC (17)	(6)	INC	INC
2. The exemption is given twice if the employee is present in the country for less than 183 days in two consecutive fiscal years	YES (20)	YES	YES	YES	YES	YES (14)	YES (5)
3. 3.1 The 183 day rule is applied in the case of an employment solely exercised in the State of activity when the work is concentrated to limited periods and does not exceed 183 days during the year	NO (20)	YES	YES	YES	YES	YES	YES
3.2 This rule applies even if such an arrangement goes on year after year		YES	YES	YES	YES	YES	NO
4. The wording of sub-paragraph 2 b) of Article 15 is used in your tax treaties. If not, please indicate how you depart and the reasons therefor.	YES	YES	YES (21)	YES	YES (8)	YES	YES

INC = Included. EXC = Excluded.

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NOTES TO ANNEX I

1. But only if there is no interrelationship between the recurrent stays in the State of activity; otherwise, there is only one continuing period in which the days spent in the State of activity are counted, the days spent outside that State are ignored.

2. These days are excluded if it is clear before arrival in the State that there was no expectation that these circumstances would occur.

3. Treaties under negotiations and new model treaty do not, since they refer to a "period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the calendar year concerned".

4. If the employee spends the day in the State of activity the answer is yes and if it is outside the answer is no.

5. The answer is yes provided that the convention says that the relevant period to calculate the 183 days is the fiscal year. (If the relevant period to calculate the 183 days is any period of 12 months the answer might be no in some cases.)

6. *Luxembourg* has not yet determined its position.

7. If the sick leave does not exceed 14 days.

8. There is an exception in the treaty with *Belgium* which specifically includes "normal breaks in work" in the 183 days period.

9. Sub-paragraph 2 b) of Article 15 in the Norwegian Model Convention has this wording:

> "the remuneration is paid by, or on behalf of, an employer who is a resident of the State of which the recipient is a resident, and whose activity does not consist of the hiring out of labour; and"

According to sub-paragraph 2 b) of the OECD Model, it is sufficient for the remuneration not to be taxed in the State of activity when the employer is not a resident of that State. However, where the employee is not a resident of the same State as the employer, he will not be taxable there and there will be no obligation on the employer for the withholding of taxes. The State of residence of the employee may not even know where the employee has been working nor his salary, nor know the identity of the employer. It is doubtful whether the Article on exchange of information will work properly in these cases even if there exists a convention between all three States. Therefore, to avoid non-taxation, *Norway* finds that the best solution in these cases is to give the right to tax to the State of activity because that State is most likely to have the necessary information for a correct assessment of the salary. The reason for adding the second departing condition saying that the activity of the employer must not consist of the hiring-out of labour, is that in *Norway* a hired-out employee for tax purposes is deemed to be employed by the user of the labour.

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A clarification of this question is also recommended in the report concerning "Taxation issues relating to international hiring-out of labour."

10. Whilst there is an exception in the treaty with *Belgium* which uses the duration of the activity method, the period specifically includes normal breaks of work and the calendar year is used rather than the fiscal year. The calendar year is also used in the treaties with *Finland* and *Norway*.

11. *Switzerland* uses the method of "physical presence" related to the activities.

12. Although the U.S. generally considers a part of a day to be a "day" for purposes of satisfying the 183-day rule, an exception is made for certain commuters and for persons present in the *United States* less than 24 hours while in transit between two points outside the *United States.*

13. Provided that the duration of the sickness can be considered as a normal interruption of work which means that it lasts no longer than one or two weeks.

14. With the exception of a few treaties in which the 183 day rule is linked to a period of twelve months instead of the fiscal or calendar year.

15. This, or the other method, has no legal or administrative basis but is generally used as a guideline for tax offices. The replies may vary according to the circumstances.

16. If the day of arrival or the day of departure has no relation to the beginning or end of the activity.

17. These are generally included but there is room for flexibility.

18. Only if related to the activities.

19. Consecutive to the activities.

20. Except if otherwise provided in a tax treaty.

21. Except for three old treaties (*United States*, 1950; *United Kingdom*, 1953; and India, 1965) which provide that the employer must be a resident of the State of which the employee is a resident.

22. Included unless the worker can prove otherwise.

23. In recent treaties *Belgium* has insisted on a provision providing that the exemption will not be granted of the stay is of 183 days or more in any twelve month period.

24. A few treaties provide that the employer must be a resident of the same State as the employee or that the employer must either be a resident of the same State as the employee or be a permanent establishment situated in that State.

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ANNEX II

RECOMMENDATION OF THE OECD COUNCIL

concerning the Application and Interpretation of the 183 Day Rule set by the OECD Model Double Taxation Convention on Income and Capital

(adopted by the Council on 24 October 1991)

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14th December 1960;

Having regard to the Recommendations of the Council of 11th April 1977 concerning the Avoidance of Double Taxation and of 21st September 1977 concerning Tax Avoidance and Evasion [C(77)40(Final), C(77)149(Final];

Having regard to the Report of the Committee on Fiscal Affairs of 24 January 1991 on The 183 Day Rule: Some Problems of Application and Interpretation (DAFFE/CFA(91)6/REVI);

Considering that the 1977 OECD Model Double Taxation Convention on Income and Capital (hereinafter referred to as the "Model Convention") has helped Member countries to harmonise bilateral conventions on the basis of uniform principles, definitions, rules and methods, to agree on a common interpretation and to extend the existing network of such conventions;

I. RECOMMENDS that Governments of Member countries, when applying existing bilateral Double Taxation Conventions on Income and Capital, follow the recommendations of the above-mentioned Report concerning the interpretation of the 183 day rule set out in paragraph 2 of Article 15 of the Model Convention and, in particular, to adopt the "days of physical presence" uniform method set out in the Report.

II. INSTRUCTS the Committee on Fiscal Affairs to modify the Commentary on paragraph 2 of Article 15 of the Model Convention as recommended in paragraph 27 of the Report, when the Model Convention is next revised.

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THE TAX TREATMENT OF SOFTWARE

(adopted by the OECD Council on 23 July 1992)

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I. INTRODUCTION

1. In recent years computerisation has become increasingly common in business and industry and one of the main issues arising from this technological explosion relates to the development and transfer of "software" across national borders. This is a major concern of the OECD, principally because trade in software is a substantial part of the total work on "trade in services". A report entitled "Software: An Emerging Industry" was published by the OECD in 1985. The report was prepared for the Committee for Information, Computer and Communications Policy by an ad hoc group of experts from Member countries. The report discussed developments and trends in the field of software. A discussion of the cross-border taxation problems arising from this modern day phenomenon is of considerable importance. The tax issues are relatively unsettled, and for this reason the Committee felt it would be useful to analyse these questions with a view to reaching agreement on the appropriate tax treatment and in particular whether these questions can be resolved under existing provisions in double taxation conventions.

2. The major issues which this report considers are

- the commercial law and practice of Member countries in relation to software rights;
- the nature of payments for software;
- the taxation treatment of software payments by Member countries under their domestic law and double taxation treaties;
- the application of the Model Convention and the need for any clarification or amendment of its provisions.

II. CHARACTERISTICS OF SOFTWARE

3. Software can best be described as a programme or series of programmes containing instructions for a computer. In a technical sense, there are two kinds of software. System software is aimed at the operational process of the computer itself (i.e. operational software), while application software consists of programmes for using a computer to accomplish specific tasks. These purposes

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may be specified by a single client/user, a group of client/users, or may result from a marketing effort by the software developer.

4. In general, software is the result of ideas and concepts arising out of research and development efforts. The result is generally a programme which can be described, can be written on paper, or can be carried on a magnetic medium (tape or disc) or an optical medium (a laser disc). The transfer of software may happen through the transfer of the carrier itself or by cable or satellite.

5. Application software may consist of standard software with a wide range of applications or may be special software (tailor-made for single users or to be applied by the developer itself).

6. Both system software and application software can be an integral part of a tangible asset, i.e. the hardware. Examples are system software as a part of production equipment and application software for the specific use of equipment such as a word processor.

7. On the other hand, software can have an independent form — often referred to as "canned software" — which can be used by a variety of hardware (with some minor modifications for the different types of computers) and may be applied as information systems for management, consulting and administration.

III. DEVELOPMENT OF SOFTWARE

8. Software is generated by research and development with the result that R & D costs are a major part of the cost of software. The production of software can be generally described along the following lines. The first stage (R & D) constitutes planning, designing, coding and testing the concept for its adaptability into a programme. When the technical feasibility of the programme is established, a master programme is designed. In order to make the product available for release to a specific customer/user, to a specific group of users or to the market generally, the master will be customised to the extent necessary and depending on whether the programme is standard or specific, then made ready for copying and transfer.

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9. Software may be developed for internal use, for use by related (foreign) companies or for sale to third parties as part of equipment, as a master copy or as copied and canned software.

10. The results of research and development projects can vary widely from development of software products with a sizeable profit potential to development of software products which either produce losses or are abandoned without any commercial exploitation. Generally one profitable product will have to compensate for the economic failures on many unproductive research efforts. Thus the royalty rates on software (as a percentage of product sales) are often higher than other, more traditional royalty arrangements (e.g. patents). For example a royalty rate of 25% of sales is not unusual and may even be on the low side. It is also of relevance that technical obsolescence is very rapid.

IV. TRANSFER OF SOFTWARE

11. Transfer of software can take a variety of commercial forms. Software can be transferred as a separate identifiable product ("unbundled") or transferred as a component in a hardware/software package ("bundled"). It clearly contains elements of intellectual property, and the question thus arises as to whether in conveying software, the transferor is also conveying a licence both to use and to reproduce for sale the ideas contained in the software. Arm's length commercial contracts normally cover this point by spelling out the rights conveyed and the limitations on such rights. Such limitations can have implications for income tax as well as for customs duty and sales tax.

12. Commercial contracts often involve the use of intermediaries as distributors of a finished product, or as assemblers of the elements of a finished product, with software acquired separately from the hardware. Such intermediaries can be economically independent or related.

13. Transaction involving software often grant buyers the right to subsequent improvements in the software or the right to request installation, maintenance and performance review services. Payments for these services may be separately identified, included in a gross price or form part of instalment payments. Additionally, the consideration in contracts covering software can take the form of a front-end lump sum payment, a front-end lump sum plus subsequent periodic payments based on sales (or some other measure of use) or exclusively

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periodic payments with no front-end payments. The fundamental economic characteristics of the arrangements may represent a transaction in goods, in services, in intellectual property, or in a combination of all three.

14. Another aspect of the subject concerns so-called service centres which are operated by independent firms, on a contract basis, to provide full-line hardware and software services to their clientele, or run payrolls, maintain inventory records, prepare financial statements, prepare plans, draft engineering drawings, monitor operations etc. These centres can also perform independent telecommunications services. Service centres can be solely operational (i.e., perform services using software produced by a related or independent "software house") or they can have a considerable in-house capability for programming (i.e. developing their own software). They can be large or small. Large MNEs typically have their own computers and accordingly their own service centres serving a number of their constituent members. An enormous range of experiences and situations must be expected. Software driven communications and computer services are linked through service centres. They can for part of an MNE's centrally-shared services.

V. MULTINATIONAL ENTERPRISES AND SOFTWARE USE

15. MNE groups use software to control specified activities such as inventory, purchases, sales, manufacture orders, billing and payroll; to prepare financial accounts; to control day-to-day plant operations; to monitor repair and replacement of physical assets; to handle engineering and design functions; to prepare financial and market estimates etc. Many MNEs have their own computer operations including software development capability. Alternatively they can purchase software for use by their in-house computers. To produce software an MNE can buy a basic "package" and modify it with internal staff programmers to meet local conditions in each country in which the package will be used. More often, because an MNE's requirements are unique, it must develop internally the basic software package and provide adaptations of local conditions in various countries in which it operates and intends to use the software.

16. For MNEs providing a greater degree of local autonomy, local members satisfy their software needs out of local resources (internal and external) but are mindful of the need to ensure that results are compatible with the software of the other group members. Where autonomy within the MNE is less extensive, it is

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more common to develop and provide software from the central unit (i.e. the parent or service centre) of the group to the operating units in the field. The operating units may require a substantial amount of local programming to adapt software obtained from central units or from third parties.

17. Consequently, within an MNE group as a whole — and within the individual component entities — the following pattern of activities may be involved in the acquisition and exploitation of software:

1. Purchase or licence of software from a third party:
   a) resident;
   b) non-resident.
2. Creation *ab initio* or modification of acquired software by:
   a) internal staff;
   b) external service bureau or software house;
   c) individuals retained on contracts for short periods or per project.
3. Transfer of software within the group and across borders:
   a) as internal services involving
      — no charge,
      — a cost charge,
      — a specific transaction with a mark-up;
   b) as capital assets with specific territorial rights and subsequent service rights;
   c) by identifiable licence.
4. Maintenance and follow-up services to keep software current, which are provided:
   a) cost free;
   b) at cost;
   c) at market price.
5. Operational services which are provided:
   a) cost free;
   b) at cost;
   c) at market price.

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18. Since software used for internal purposes frequently requires substantial time and expense to adapt to local needs, and common basic programmes have substantial "group" value (as contrasted to "individual entity" value), access to group software resources is often at low (or no) cost rather than at a "fair" cost charge that can be difficult to calculate. Additional direct costs are of course borne by the user.

19. Where MNEs utilise software as an internal control of production feature and not as a product, the transfer of software to affiliates is perceived by the business community as a service rather than as a transfer of a right to use a piece of intangible property.

VI. PRACTICE OF MEMBER COUNTRIES

20. In order to establish the taxation practices of Member countries in dealing with software payments the Committee used a questionnaire which is reproduced as Appendix 1. It sought information on the legal classification of software under their domestic laws, their tax practices as the country of residence of the recipient of software payments, the status of software payments in relation to their double taxation treaties and their views on whether the Model Convention required clarification or amendment. The responses to the questionnaire are summarised in Appendix 2.

Legal classification

21. All OECD Member countries give legal protection under domestic legislation to the intellectual property in software. In all countries except *Switzerland*, the protection is given under copyright law. In some countries protection is regarded as implicit in copyright law but there is a notable trend for countries to make the protection statutorily explicit. There is significant variation in the extent of protection. Protection may be limited to authors producing significant or unique work. It may be extended to adaptations of existing work and sometime to adaptations by persons other than the original author.

22. For income tax purposes, Member countries see no legal distinction between system software and application software nor whether software is "bundled" or "unbundled". Such distinctions may be of significance in certain countries for the purposes of turnover tax, VAT or custom duties.

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Tax classification — source country

23. The purpose of this part of the questionnaire was to determine

— in which circumstances payments relating to software are classified under domestic law as a capital gains matter;

— when they are not classified as such, in which circumstances under domestic law they are treated as payments for goods or services, or royalties.

The analysis of the replies shows the following trends.

Capital payments

24. Most of the countries which replied on this point consider that it is a capital gains matter where there is an outright transfer of software implying the transfer of all rights which are attached to it. Some consider that it is also a capital gains matter where:

— hardware is acquired with built-in software;

— the payment is in the form of a lump sum and in consideration of the right to use software for a significant period (three years is most often referred to).

Royalties or payments for goods or services

25. All countries except *Switzerland*, *Norway* and the *Netherlands* have powers to impose tax at source on royalty payments. Six countries also tax payments for goods and services at source. Certain countries draw no distinction between whether a software payment is for goods or services or represents a royalty payment; some because they do not tax payments in either category, the others because they exercise rights to withholding tax in respect of both. If a distinction has to be made for example because a country has taxing rights in respect of royalties only, then the total consideration is broken down on a reasonable basis having regard to the terms of the contract which defines what is provided in return for the payments in question.

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Tax classification — country of residence

26. When a resident receives a payment as consideration for transfer or all or part of the rights attached to software, the tax treatment of the receipt reflects the underlying nature of the transaction in most countries. The receipt is treated as business revenue if the rights transferred are comparable to inventory. Receipts are generally treated as a capital gains matter where the rights transferred are in the nature of fixed assets. Some countries also regard as a capital gains matter lump sum receipts or receipts in return for the grant of an exclusive right of use or of a right of use for a specific number of years (for example three years).

27. For many countries the question of whether income relates to goods and services or represents a royalty is of no relevance to its tax treatment. For countries where a distinction is necessary the income is broken down on a reasonable basis having regard to the particular terms of the contract.

28. When the payments have been taxed in the source country, the country of residence applies its domestic laws which may or may not prevent double taxation. No country has special provisions for software.

Double taxation conventions

29. There are differences between Member countries regarding the classification of "capital" payments relating to software. Some are of the opinion that these payments come under Article 12, for example when they relate to the use of software; others think that Articles 7, 13 or 14 might apply depending on the facts of the particular case. In most countries, software payments that are not regarded as a capital gains matter may fall to be dealt with under Article 12 or Articles 7 or 14, depending on the facts.

30. Where payments comprise elements for both goods and services and for royalties, a majority are in favour of applying Article 12 of the Model Convention solely to the royalties element. *Greece* and *Australia* consider that Article 12 normally applies to the whole of the payment.

31. In their bilateral negotiations, few countries aim to adopt Article 12 of the Model Convention in its entirety. Variations mainly consist in introducing additional items in the definition of royalties or in providing for the application of

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withholding tax. Only *France* has specifically referred to software in recent conventions.

32. In cases where a party to a convention has exercised rights of taxation in respect of software payments, classifying them in a different way from the domestic law of the recipient's country, the latter country will generally grant double taxation relief or seek a mutual agreement with the source country in accordance with Article 25.

33. Three countries are of the opinion that the text of Article 12 of the Model Convention ought to be amended. *Italy* and *Luxembourg* propose that the term software should be specifically mentioned in the text. *France* suggests that software should be dealt with in the same way as cinematograph films, namely by referring to the "product" (the software) and not the rights attached to the "product", whether these rights are copyrights or rights of another kind. Other countries think either that no amendments should be made to the Model Convention or that it would be sufficient to include clarification in the Commentary on Article 12 (and if necessary on Articles 7, 13 and 14) regarding the tax treatment of software.

VII. THE APPLICATION OF THE MODEL CONVENTION

34. The Articles of the OECD Model Double Taxation Convention which may be relevant to the tax treatment of software are:

— Article 7 (Business Profits);

— Article 12 (Royalties);

— Article 13 (Capital Gains);

— Article 14 (Independent Personal Services).

35. The tax treatment applying to payments between residents of two countries poses no problems when those countries have concluded a double taxation convention which conforms in all respects to Article 12 of the Model Convention, which does not allow for withholding tax on royalties in the source State. Suppose that payments are made by an enterprise of State S (the State of source) in favour of an enterprise of State R (the State of residence). State S will only be able to exercise taxing rights in respect of the payments if the enterprise of

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State R has a permanent establishment in State S and if the software which gives rise to the payments is/was effectively connected with such a permanent establishment. Otherwise taxation is solely a matter for State R.

36. The definition of "royalties" in paragraph 2 of Article 12 includes among others payments of any kind made for:

a) the use of or the right to use any copyright of literary, artistic or scientific work;

b) the use or the right to use industrial, commercial or scientific equipment;

c) information concerning industrial, commercial or scientific experience.

37. The Commentary on Article 12 specifies in particular that

— as regards copyright, the definition applies whether or not that right has been or is required to be registered in a public register;

— as regards equipment, a distinction must be made between royalties paid for the use of equipment (which fall under Article 12) and payments constituting consideration for the sale of equipment (which depending on the case fall under Articles 7, 13, 14 or 21).

However, in the report entitled "The Taxation of Income Derived from the Leasing of Industrial, Commercial or Scientific Equipment" (published in 1985 under the title "Trends in International Taxation") the Committee recommended not including under the definition of "royalties" income derived from the leasing on industrial, commercial or scientific equipment where a convention provides for the taxation of royalties in the source State.

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VIII. PROBLEMS RELATING TO SOFTWARE PAYMENTS

Problems described

38. Many bilateral treaties between Member countries maintain a limited rate of tax at source on royalties generally or on particular types of royalties. Twelve countries have indeed entered a reservation against the zero rate provided in Article 12. As bilateral treaties which provide for tax at source on royalties usually adopt the full definition of royalties in paragraph 2 of Article 12, a number of countries exercise taxing rights at source on many types of software payments on the grounds that they represent royalties.

39. Source taxation of software payments raises questions of principles and of practical application. As regards the latter, it is necessary to determine

— which of the various types of payments relating to software represent royalties;

— how payments effected under mixed contracts are to be dealt with.

Analysis

40. The Committee examined whether it was in principle appropriate to regard software payments as within Article 12. It took into account the following:

a) Article 12 recommends a zero rate of tax on royalties with the intention of protecting royalties from taxation in the State of source except to the limited extent provided by paragraph 3 of Article 12.

b) Taxation of royalties at source may lead to taxation on a gross basis which disregards the expenses incurred by the payee in earning the royalties. In some cases this may result in unrelieved double taxation when the State of residence is unable to credit fully the tax withheld at source because it taxes the royalties on a net basis.

c) Taxation on a gross basis occurs only in the absence of a permanent establishment; if a royalty is effectively connected with a permanent establishment, the effect of Article 7 together with paragraph 3 of Article 12 is to ensure taxation on a net basis. Paradoxically the less

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the connection of the payee with the State of source, the greater his tax burden there.

The Committee noted that nevertheless within OECD there was near unanimity in affording protection to software rights under copyright law. It concluded from this that software payments made for the right to exploit intellectual property in software could not be separated from copyright royalties generally. It was not able to recommend that software payments should be regarded as entirely outside the scope of Article 12. There are, however, difficulties in applying the copyright provisions of Article 12 to software royalties since paragraph 2 of the Article requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt, but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 of Article 12 which either omits all references to the nature of copyrights or refers specifically to software.

41. The Committee also examined the question of the boundary between software payments in the nature of royalties and software payments of other kinds — a problem which gives rise to considerable difficulties.

First hypothesis: partial transfer of rights

42. The first hypothesis is that of payments made in circumstances where less than the full rights to software are transferred. Some countries argued that payments made in consideration of a partial transfer of intangible rights attached to software were within the broad scope of the definition in Article 12 even when the leasing of equipment is excluded. They considered that it was not appropriate to distinguish according to whether:

— a single payment or payments spread over a period of time are involved;

— the rights of use are transferred for a limited period or otherwise;

— the transferor of the rights is the author of the software or another person downstream in the commercial exploitation of the software.

They accordingly expressed the view that in all of the above circumstances the payments are taxable in the State of source (State S) if the convention between

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State S and the State of residence (State R) of the recipient provides for the taxation of royalties at source. The royalties received in State R are also taxable there in accordance with its laws. State R must eliminate double taxation in accordance with the convention for example by giving a tax credit.

43. The contrary view of other countries was that the intention of Article 12 was to eliminate source taxation and that the definition of royalties had to be interpreted more narrowly so as to limit its scope. They considered that an important distinction had to be drawn between:

— the acquisition of software for the personal or business use of the purchaser;

— the acquisition of software for commercial development or exploitation.

In the first situation, they considered that the purchaser had done no more than purchase a product and that the payment fell to be dealt with in accordance with Article 7 or Article 13 as appropriate. They did not consider it to be relevant that the product was protected by copyright and that there were restrictions on the use to which the purchaser could put it. In the second situation, they agreed that the payments were made for rights to exploit intellectual property and accordingly were likely to be royalties. Examples of such exploitation included the reproduction or adaptation of software for onward distribution. In such situations, payments to the owner of the copyright were likely to be royalties especially if they were related to the number of products distributed.

44. The solution to these crucial differences of view must lie in the definition of royalties in paragraph 2 of Article 12: "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 [...] any patent [...]". On the broad interpretation, the mere purchase of a product protected by copyright or a patent is likely to result in the payment of a royalty as consideration for use of the product. The narrower interpretation is that "use" as referred to in the Model Convention is limited to use by an acquirer who seeks to exploit commercially the intellectual property of another. A substantial majority of the Committee took the firm view that the narrower interpretation was correct. They felt that paragraph 1 of the Commentary on Article 12 which describes royalties in principle as "income to the recipient from a letting" made the position clear. As the outright acquisition of a product (e.g. a computer programme) for simple use by the purchaser could not represent any form of letting it clearly could not give rise to a royalty within the meaning of Article 12.

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Second hypothesis: transfer of all rights

45. In the second hypothesis, the payments are effected as consideration for the final transfer of all the rights attached to the software. In this case there was general agreement that the payments were in consideration for the acquisition of the software without involving questions on rights to use it. The provisions of Article 12 were not applicable.

46. A further question is whether it is appropriate to classify certain other transactions as a transfer of software such as:

— those whose purpose is to transfer the exclusive right to use software during a specific period or in a limited geographical area;

— those involving additional consideration related to the usage of the software;

— those which comprise substantial lump-sum payments.

47. Countries have differing practices in their treatment of such transactions and it is impossible to draw a clear borderline between payments which are properly to be treated as a capital gains matter and those that are royalties within Article 12 in every situation. Nevertheless there are clear principles to be followed in determining the nature of the transaction. Firstly, regard must be had to the precise terms of the contract under which the software rights were transferred. Secondly, where a transfer of ownership of rights has occurred, payments cannot be for the use of the rights. Finally, the form that the consideration takes, whether payment by instalments or, in the view of most countries, payment related to a contingency, is irrelevant in determining the character of a transaction.

Mixed contracts

48. The Committee finally considered payments under mixed contracts. Examples of such contracts include:

— sales of hardware with built-in software;

— concessions of the right to use software combined with the provision of services.

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49. The problem of mixed contracts also arises in other fields, for example in respect of patent royalties and know-how. The Commentary on Article 12 discusses the problem at paragraph 12. It recommends breaking down the total amount of the consideration which is payable under the contract on the basis of the information contained in the contract or by means of a reasonable apportionment and then applying to each apportioned part the appropriate tax treatment. When, however, some of the parts are of an ancillary character compared to the principal part, the treatment applicable to the latter part may be extended to the entire consideration. Mixed contracts relating to software do not therefore pose any problem of principle since the approach in the Commentary for other types of mixed contracts is appropriate.

Specific example

50. An enterprise purchases a computerised machine tool. If a single payment were made, some countries would regard it as paid solely for the acquisition of an asset. If, however, further payments were required to be made, related for example to the number of times the machine was used or the number of products manufactured on it, then they would recognise the additional payments as royalties within Article 12. Other countries would regard the payment as partially for the acquisition of the asset and partially for the right to use the operating software. They would accordingly apportion the payment and treat the latter part as representing a royalty. Unless the latter part were minor or ancillary, they would apply source taxation.

IX. CONCLUSIONS

51. The subject of software payments is of undoubted importance in view of the rapidity of technological developments in recent years. The subject does not, however, raise new issues of principle. Rather it highlights in a new form long-standing difficulties especially regarding source taxation and the scope of Article 12 of the Model Convention. The Committee considered nevertheless that it was a useful subject of study and that it would be helpful to set out how the Model Convention is to be interpreted specifically in relation to software payments.

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52. The conclusions of the Committee are that:

a) Payments made in connection with software represent royalties within the meaning of Article 12 only in circumstances where there is a limited grant of rights (not amounting to a change in ownership) for the commercial development or exploitation of the software. Payments for software, whether "bundled" or not, which is acquired for the personal or business use of the purchaser do not represent royalties.

b) Payments made for the alienation of all rights attached to software do not represent royalties. The characterisation of payments made for more limited alienation of rights (as described in paragraph 46) may depend on the precise terms of the relevant contract but in circumstances where there is alienation of ownership, the consideration paid does not represent a royalty in the view of most countries.

c) Where countries adopt in their bilateral conventions the zero rate of withholding tax recommended in Article 12, problems in connection with software payments cannot arise since the taxation of such payments is solely a matter for the State of residence of the recipient except to the extent that the payments are effectively connected with a permanent establishment in the State of source.

d) Where a double taxation convention provides for source taxation in respect of some but not all royalties, it is expected that software payments that properly have the characteristics of royalties will normally be classified as paid in respect of copyright.

e) It is the responsibility of the State of residence to relieve any resulting double taxation where the terms of a bilateral convention with a State of source permits the latter to exercise rights of taxation in respect of software payments. Any difficulties in the application of the convention should be resolved under the mutual agreement procedure of Article 25.

f) The terms on which technology is transferred across national borders within multinational enterprises should conform with the arm's length principle underlying Article 9.

g) No changes to the text of the Model Convention are required but it is recommended that clarification of the treatment of software should be included in the Commentary on Article 12 (with cross-references to Articles 7 and 14) in accordance with Appendix 3 to this Report.

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Appendix 1

QUESTIONNAIRE ON TAX TREATMENT OF SOFTWARE

1. Legal Classification
   - 1.1 Is protection provided under your domestic legislation for the intellectual property in software?
   - 1.2 If it is protected, is it under the copyright legislation, patent legislation or other form of legislation?
   - 1.3 If it is protected, does it apply only to the author or does it also cover those who may adapt or transform the software?
   - 1.4 Are the following distinctions of significance in your internal law?
     - 1.4.1 System or operational software and application software,
     - 1.4.2 Software as an integral part of hardware or canned software,
     - 1.4.3 Bundled or unbundled software product, and
     - 1.4.4 Other distinctions?
   - 1.5 Please add any remark which may facilitate understanding the legal classification of rights related to software.

2. Tax Classification as the country of source

   Assume that payments for the use of software are made by a resident of your State to a resident of another State with which you do not have a tax treaty.
   - 2.1 Under your tax legislation would you classify any payment from the use of software as a capital payment?
     - 2.1.1 Only if it was for the outright acquisition of all rights relating to the software.
     - 2.1.2 In other circumstances and, if so, what?
     - 2.1.3 No.
   - 2.2 Under your tax legislation, under what circumstances would you classify a payment, other than a capital payment, as either:
     - 2.2.1 A payment for goods and services?
     - 2.2.2 A royalty payment?
   - 2.3 Where payments are for a right to use and for services under a contract requiring advice and information to be provided without any separately stated consideration, would you, in any circumstances, break down the total consideration into the separate elements of payment for services and royalty payment respectively?
     - 2.3.1 If no, is this because there is no power in your legislation to enable this to be done?

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2.3.2 If yes, on what basis is the split calculated?

2.4 Does your country provide for taxation at source on the following payments:

2.4.1 A capital payment?

2.4.2 A payment for goods and services?

2.4.3 A royalty payment?

2.5 In each case referred to in 2.4 is this because they are:

2.5.1 Classified as royalties?

2.5.2 For some other reasons?

2.6 If they are classified as royalties subject to tax at source, does the definition of royalties in your tax legislation coincide with the definition in Article 12 of the Model Convention and, if not, how does it differ?

3. Tax classification as the country of residence

Assume that payments for the use of software are made by a resident of another country with which you do not have a tax treaty to a resident of your country.

3.1 Under your tax legislation would you classify any receipt for the use of software as a capital payment

3.1.1 Only if it was for the outright disposal of all rights relating to the software.

3.1.2 In other circumstances and, if so, what?

3.1.3 No.

3.2. Under your tax legislation, under what circumstances would you classify a receipt, other than a capital receipt, either as:

3.2.1 A receipt for goods and services?

3.2.2 A receipt for royalty?

3.3 Where payments are for a right to use and for services under a contract requiring advice and information to be provided without any separately stated consideration, would you, in any circumstances, break down the total consideration into the separate elements of receipt for services and receipt for royalty respectively?

3.3.1 If no, is this because there is no power in your legislation to enable this to be done?

3.3.2 If yes, on what basis is the split calculated?

3.4 Are there any provisions in your tax legislation that would prevent you from giving a credit for the tax due to the country of source (or from exempting the receipt) that do not apply to income received from residents of other countries generally?

4. Are the distinctions referred to in 1.4 above relevant for any of the answers in paragraphs 2 and 3 above and, if so, how and in what ways?

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5. Double taxation conventions

5.1 Do you consider that the payments and receipts referred to in 2.1 and 3.1 come under Article 12 of the Model Convention? If not, under which Article would you consider them to fall?

5.2 Do you consider that the payments and receipts referred to in 2.2.1, 2.2.2 and 3.2.1, 3.2.2 come under Article 12 of the Model Convention? If not, under which Article would you consider them to fall?

5.3 In the cases described in 2.3 and 3.3 would you apply Article 12 to none, part only or all of the payment/receipt?

5.4 Do you generally adopt Article 12 of the Model Convention in your tax treaties with other Member countries? If not, please describe the main deviations?

5.5 When a right to tax royalties at source is provided, do you take the definition of "royalties" found in Article 12 as is or do you modify it (and if the latter, please specify)?

5.6 If you consider that Articles other than Article 12 apply to software payments, do you make any special provision in your treaties for software?

5.7 Where you have a treaty with the country of source which has exerted taxing rights having classified the income differently from your internal law, would you give double taxation relief and if so how and upon what measure of income?

5.8 Do you consider that the Model Convention and its Commentary need to be revised to deal in a clearer way with software payments and, if so, what suggestions would you make?

5.9 Any other comments?

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Appendix 2

REPLIES TO QUESTIONNAIRE ON TAX TREATMENT OF SOFTWARE

1. Legal classification

	1.1 Does domestic legislation protect?	**1.2 Is this Copyright or other?**	**1.3 Does protection apply only to author, are adoptions covered?**	**1.4 Are certain distinctions significant? (See full Questionnaire)**	**1.5 Other Remarks**
Netherlands	Yes	Copyright by case law	Includes licencees who adopt or transform	No	Legislation pending to include software
Australia	Yes	Copyright	Adaptations by owners and others	No	Inquiry into aspects of copyright protection
Greece	Indirectly	Copyright by case law possible	Others may be protected depending on contract	No	-
Ireland	Yes	Copyright	Only author	No	Not specifically included in copyright yet
Sweden	Yes	Copyright	Some adaptations	No	Software considered as literary work
Switzerland	Only partial	No copyright but some other protections	Where protected can include adaptations	1 & 2 Yes 3 & 4 No	-
United States	Yes	Copyright and some others	Owner of copyright, adaptation not usually covered	No	Definition of computer program included in copyright act
Germany	Yes	Copyright and possible patent	Author, some rare additions	Protection may apply only to sophisticated programs	See 1.4 high standards needed to gain protection
Austria	Yes	Copyright	Includes adaptations	No	Single program may not qualify as literary work. No specific mention in legislation

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1. Legal classification (cont.)

	1.1 Does domestic legislation protect?	1.2 Is this Copyright or other?	1.3 Does protection apply only to author, are adoptions covered?	1.4 Are certain distinctions significant? (See full Questionnaire)	1.5 Other Remarks
Spain	Yes	Copyright	Includes subsequent versions	3 may be of significance	Computer software specifically included
Japan	Yes	Copyright	Some adaptations	No	Software included specifically in copyright law
United Kingdom	Yes	Copyright	Some adaptations	No	Specifically included as copyright
Norway	Yes	Copyright	Some adaptations and transformations	No	Regarded as literary work not specifically included in legislation
France	Yes	Copyright	Yes, adaptations and transformations	Bundling effects accountancy treatment	-
Luxembourg	Yes	Copyright	Extends to adaptations	-	-
Italy	Yes	Copyright	-	Copyright if software independent. If integral then follow treatment of hardware	-
Portugal	Yes	Copyright	-	-	No specific legislation
Denmark	Yes	Copyright plus others	Extends to adaptations	-	Computer programs usually copyright. User manuals literary works

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1. Legal classification (cont.)

	1.1 Does domestic legislation protect?	1.2 Is this Copyright or other?	1.3 Does protection apply only to author, are adoptions covered?	1.4 Are certain distinctions significant? (See full Questionnaire)	1.5 Other Remarks
Canada	Yes	Copyright	Extends to adaptations	No	-
New Zealand	Probably	Copyright	Some adaptations	Not for tax, but may affect patent law	Copyright protection is unsettled but believed to exist
Belgium	Not directly	Copyright by case law	-	Yes, if integral part of hardware then treat as hardware. Others may be intangible property	Probable that protection will be introduced

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2. Classification as country of source - I

	2.1 **Under what circumstances are payments for software capital?**	2.2 **Are non capital payments classified as goods and services or royalties?**	2.3 **If payment covers services and right to use is a breakdown necessary?**	2.4.1 **Is tax deducted at source from payments for capital?**
Netherlands	Capital for acquisitions with useful life of at least 1 year	No distinction	No, no tax at source on royalties	No
Australia	Generally revenue, capital if sold with hardware	For all practical purposes as royalty	No, both treated as royalty	No
Greece	No specific provision	As royalty	No	No
Ireland	On facts, outright acquisition: capital	Goods and services if stock, most others royalties	Yes, on a fair and reasonable basis	No
Sweden	Capital if custom made and life more than 3 years	Goods and services if stock, royalty if licence fees periodical	Yes, split according to value	No
Switzerland	No taxation of royalties at source, no distinction	No distinction for tax purposes	No, no tax distinction	No
United States	Acquisitions: capital, payments for use: revenue, look to substance	Question of fact	Yes, depends on facts	Generally no. Some exceptions
Germany	Acquisition or unlimited use: capital	Goods and services if dominant part. Royalties if payment for limited right to use	Yes, if material, on a just and reasonable basis	No, with exceptions

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2. Classification as country of source - I (cont.)

	2.1 **Under what circumstances are payments for software capital?**	2.2 **Are non capital payments classified as goods and services or royalties?**	2.3 **If payment covers services and right to use is a breakdown necessary?**	2.4.1 **Is tax deducted at source from payments for capital?**
Austria	Capital if valuable asset	Standard software goods or services, if technical experience, then royalty	Yes, if material, on just and reasonable basis	Yes, if for use of technology
Spain	Capital if acquisition or lump sum for several years usage	Royalty if ownership of property remains, so tax significance	Yes, reasonable basis according to contract	Yes
Japan	-	Case by case basis	Yes	Yes if for use
United Kingdom	Acquisitions capital. Lump sum can be capital	Royalty unless bought as stock or for distribution	Yes if material, based on contract	Yes if for use
Norway	Capital if considerable and durable over 3 years life	No distinction necessary	No	If recipient in business in Norway
France	Outright acquisitions	No distinction necessary	No, as tax treatment similar	Yes
Luxembourg	Outright acquisitions	Patent if right to use	Yes, on reasonable basis	No
Italy	Not capital	No distinction necessary	No, as similar tax treatment	Yes
Portugal	-	Generally taxed as copyright payments	-	-

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2. Classification as country of source - I (cont.)

	2.1 **Under what circumstances are payments for software capital?**	2.2 **Are non capital payments classified as goods and services or royalties?**	2.3 **If payment covers services and right to use is a breakdown necessary?**	2.4.1 **Is tax deducted at source from payments for capital?**
Belgium	Capital if outright acquisition	Royalties if paid for use without outright acquisition	Yes	No
Denmark	Capital if sizeable and 3 years life	Royalty unless stock	Yes on estimated value	No
Canada	If outright disposal but this is unusual	Royalty unless for distribution	No, usually treat as royalty	No
New Zealand	Outright acquisitions capital	Generally royalty but services if payment unconnected with royalty or know how	Yes, but unusual, normally royalty	No

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2. Classification as country of source - II

	2.4.2 **Is tax deducted at source from payments for goods and services?**	2.4.3 **Is tax deducted at source from payments for royalties?**	2.5 **In 2.4 is this because they are royalties?**	2.6 **If royalties, if your definition of royalties similar to Article 12?**
Netherlands	No	No	No tax on royalties	N/A See 2.5
Australia	No, unless source income	Yes	Yes as royalties	Wider definition of royalty in Australian law
Greece	No	Yes	Yes as royalties	As model with additions
Ireland	No	No	No tax at source on copyright royalties	N/A See 2.5
Sweden	No	Yes	Yes on business profits	No definition of royalty, treated as business profits
Switzerland	No	No	No tax at source	N/A
United States	No. Unless recipient trading in US	Yes	Depends on source of income	No internal definition of royalty
Germany	No	Yes	Yes, with some exceptions	Yes
Austria	Yes	Yes	Yes	Definition is not as wide as Article 12
Spain	Yes	Yes	No, could be taxed at source anyway	Similar but no tax distinction between royalty and goods or services
Japan	Yes	Yes	-	Broader definition than Article 12

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2. Classification as country of source - II (cont.)

	2.4.2 **Is tax deducted at source from payments for goods and services?**	2.4.3 **Is tax deducted at source from payments for royalties?**	2.5 **In 2.4 is this because they are royalties?**	2.6 **If royalties, if your definition of royalties similar to Article 12?**
United Kingdom	No	Yes	Yes	Taxation at source only on some types of royalties
Norway	As 2.4.1	As 2.4.1	No withholding tax	No definition of royalty
France	Yes	Yes	No, can be taxed at source in both cases	-
Luxembourg	No	Yes	Yes	Yes
Italy	Yes, unless employee services	Yes	No can be taxed at source anyway	As Article 12
Portugal	-	-	-	Tax deduction when beneficiary or payor resident of Portugal
Belgium	Yes	Yes	Could be taxed in any event	No, could be different sources. Capital gains from sale of rights etc.. usually business profits
Denmark	No	Yes	Yes	Definition does not cover many payments for use
Canada	Yes	Yes	Yes but also tax on services	Similar but exceptions for reproductions
New Zealand	No	Yes	Yes	Broader than model Article 12

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3. Tax Classification as country of residence

	3.1 **Under what circumstances are receipts classified as capital?**	3.2 **Are non capital receipts classified as goods and services or as royalties?**	3.3 **If receipts cover services and right to use is a breakdown necessary?**	3.4 **Any special treaty provisions restricting credit for software but not other income?**	4 **Are the distinctions (e.g. bundled etc...) referred to in 1.4 relevant for question 2 and 3?**
Netherlands	Capital if ownership sold and durable	Goods and services if trade, royalty if for design	Yes, pro-rata split	No	No
Australia	Capital if not business income	Royalty, can be goods if sold with hardware	No both within definition of royalty	No	Relevant to 2.2 and 3.2
Greece	No specific provision	As royalty but no specific provision	No	-	No
Ireland	Outright disposals except where stock	Goods and services if trade, otherwise royalty	If different elements specified split on fair and reasonable basis	No	No
Sweden	Capital for outright disposal unless stock	No distinction for tax purposes	No, no distinction in tax treatment	No	No
Switzerland	No distinction relevant	No distinction relevant	No, no distinction in tax treatment	No	-
United States	Capital if for exclusive use and durable unless stock	Royalty if services only auxillary, reflect substance	Yes based on relative value	No	No

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3. Tax Classification as country of residence (cont.)

	3.1 **Under what circumstances are receipts classified as capital?**	3.2 **Are non capital receipts classified as goods and services or as royalties?**	3.3 **If receipts cover services and right to use is a breakdown necessary?**	3.4 **Any special treaty provisions restricting credit for software but not other income?**	4 **Are the distinctions (e.g. bundled etc...) referred to in 1.4 relevant for question 2 and 3?**
Germany	Capital if for unlimited use or if payment is a lump sum	Depends on contract	Yes if amounts material, on a just and reasonable basis	No	No
Austria	If fixed asset then disposal follows	Standard software sales receipts, right to use royalty	Yes if material split on just and reasonable basis	Relief can be granted if necessary	Possibly
Spain	Capital unless trading in software	No significance of distinction	No, as no tax distinction	No	Yes, customs duty on a bundled package precludes income tax
Japan	Business income if incorporated. If individual can vary	No difference in treatment	No, as no tax distinction	-	No
United Kingdom	Outright disposal: capital and in certain other cases	Can be distinguished but no internal tax differences	No, as no tax distinction	No	Yes bundled software usually follows treatment of hardware
Norway	Capital if for use of software	No difference both business income	No	No	No
France	Capital if disposal of all rights	No difference in treatment except for sale of goods	No	No	Bundled software effects accountancy treatment

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3. Tax Classification as country of residence (cont.)

	3.1 **Under what circumstances are receipts classified as capital?**	3.2 **Are non capital receipts classified as goods and services or as royalties?**	3.3 **If receipts cover services and right to use is a breakdown necessary?**	3.4 **Any special treaty provisions restricting credit for software but not other income?**	4 **Are the distinctions (e.g. bundled etc...) referred to in 1.4 relevant for question 2 and 3?**
Luxembourg	Capital for outright disposal	No difference in treatment except for sale of goods	No	No	No
Italy	Not capital	No difference in treatment	No, treatment same as sales price	No	Yes whether software is part of hardware
Portugal	-	No difference in treatment	No	No	-
Denmark	Capital unless trading	No difference in treatment	No	No	No
Canada	If outright disposal of fixed asset	No difference in treatment	No	No	No
New Zealand	Outright disposals capital unless by way of trade	Normally royalties unless payments for services not connected	Yes but not usual	No	Generally no, bundled software follows treatment of hardware
Belgium	Capital for outright disposal	No difference unless received by individual and not a business activity	Only if individual	No	Yes distinguish between sale of equipment and other payment

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4. Double Taxation Conventions - I

	5.1 **Are payments in 2.1 and 3.1 within Article 12 if not which article?**	5.2 **Are payments in 2.2.1 and 3.2.1 within Article 12 if not which article?**	5.3 **If payment in 2.3 or 3.3. do you apply Article 12 to none, all or part?**	5.4 **Do you adopt Article 12 in your treaties?**
Netherlands	No, 7 and 14 and possibly 13	Yes but also 7 and 14	In part	Aim for Article 12 but half treaties include withholding
Australia	Yes, but may be 12, 13 or 7	Yes but also 7 and 14	Normally all	No, wider definition of royalty and tax at source
Greece	Yes	Yes	All	Approximately but allow for tax at source in most treaties
Ireland	Yes but if capital then 13, 7 or 14	Yes but also 7 and 14	In part	Yes only 4 exceptions
Sweden	Yes but also 7, 13 and 14	As for 5.1	To royalty part	Yes
Switzerland	Not if acquisition then 7 or 14	Yes	Part only	Yes, but only incorporated in half of treaties
United States	Could also be 7 or 13	No	Part only	Yes generally, some treaties allow for reduced withholding tax
Germany	Only if for use otherwise, 13, 7 or 14	Yes for use but also 13, 7 and 14	To royalties part	Yes generally, but half treaties have reduced withholding tax

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4. Double Taxation Conventions - I (cont.)

	5.1 **Are payments in 2.1 and 3.1 within Article 12 if not which article?**	5.2 **Are payments in 2.2.1 and 3.2.1 within Article 12 if not which article?**	5.3 **If payment in 2.3 or 3.3. do you apply Article 12 to none, all or part?**	5.4 **Do you adopt Article 12 in your treaties?**
Austria	Only if for use otherwise 7	Yes	To royalty part	With a 10% tax at source
Spain	Yes but also 13, 7 or 14	Yes	To royalty element	No, reserve right to deduct tax at source
Japan	If for use, also 7, 13 and 14	Also 7, 13 and 14	To royalty part	No levy tax at source
United Kingdom	If for use, also 7, 13 and 14	Yes	To royalty part	Yes but half treaties include tax at source
Norway	7, 13 or 14 as case may be	Also 7, 13, 14	To royalty part	Yes
France	Also 7, 13 or 14	Yes	To royalty part	Treaties often include withholding tax, sometimes only certain royalties
Luxembourg	7, 13 or 14	Goods and services 7 and 14	To royalty part	Some treaties allow withholding tax
Italy	Also 7, 13 or 14	Yes	Yes except for employee services	Yes
Portugal	-	-	-	-

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4. Double Taxation Conventions - I (cont.)

	5.1 **Are payments in 2.1 and 3.1 within Article 12 if not which article?**	**5.2** **Are payments in 2.2.1 and 3.2.1 within Article 12 if not which article?**	**5.3** **If payment in 2.3 or 3.3. do you apply Article 12 to none, all or part?**	**5.4** **Do you adopt Article 12 in your treaties?**
Denmark	Also 7, 13 or 14	Also 7, 13, 14	To royalty part	As far as possible
Canada	Yes but others possible	7	To royalty part	Yes but with some withholding rights
New Zealand	Also 7, 13 or 14	Yes	To royalty part	No, wider definition, tax at source
Belgium	Yes but also 7, 13 or 14	7 or 14	To royalty part	Yes with some exceptions

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4. Double Taxation Conventions - II

	5.5 **If royalties are taxed at source are they defined as in Article 12?**	5.6 **Is software mentioned in other articles?**	5.7 **Where a treaty country taxes the income differently, do you give relief and how?**	5.8 **Amend the Model or its commentary?**	5.9 **Other comments?**
Netherlands	Yes with some modification	No	Yes if in accordance with treaty	No	No
Australia	No	No	Yes if foreign source	N/A	No
Greece	Yes with addition	No	Yes	As for UK	Include discussion in commentary
Ireland	Separate definition	No	Yes	No, not 12, no problem if no withholding tax	No
Sweden	Modified as in "Trends in International Taxation"	No	Yes by mutual agreement	No	Include in commentary that 7, 12, 13 or 14 could apply
Switzerland	Yes but with addition	No	No, but mutual agreement tried	Amend commentary	No
United States	Modified	None yet, some under discussion	-	No, resolve bilaterally	No
Germany	Yes, one exception	No	Yes	Add to commentary on Article 12	No
Austria	Yes, normally	No	Yes	No	No

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4. Double Taxation Conventions - II (cont.)

	5.5 **If royalties are taxed at source are they defined as in Article 12?**	5.6 **Is software mentioned in other articles?**	5.7 **Where a treaty country taxes the income differently, do you give relief and how?**	5.8 **Amend the Model or its commentary?**	5.9 **Other com-ments?**
Spain	Yes with addition	No	-	Yes expand commentary	No
Japan	Yes with addition	No	Yes	-	No
United Kingdom	Yes with addition	No	In accordance with treaty	No deal with bilaterally and expand commentary	No
Norway	Yes with modification	No	Mutual agreement	Expand commentary to point out that 7, 12, 13 or 14 could apply	No
France	Yes similar	Yes, in recent treaties	By mutual agreement	Mention in Article 12 and expand commentary on mixed contracts and when to apportion	-
Luxembourg	Yes with additions	No	By mutual agreement	Mention in 12 and expand commentary on mixed contracts	No
Italy	Yes	No	Yes	Mention software in 12	No
Portugal	-	-	-	-	No

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4. Double Taxation Conventions - II (cont.)

	5.5 **If royalties are taxed at source are they defined as in Article 12?**	5.6 **Is software mentioned in other articles?**	5.7 **Where a treaty country taxes the income differently, do you give relief and how?**	5.8 **Amend the Model or its commentary?**	5.9 **Other comments?**
Denmark	Narrower definition	No	Yes	Expand commentary to say 7, 12, 13 or 14 could apply	No
Canada	Yes	No	Yes, under domestic rules	No	No
New Zealand	Yes, often wider	No	Yes	Expand commentary to provide greater clarity	No
Belgium	Yes, minor amendments	No	Mutual agreement	Define types of payment in commentary	No

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Appendix 3

PROPOSED AMENDMENTS TO THE COMMENTARY ON THE MODEL TAX CONVENTION

1. Add the following at the end of the penultimate sentence of paragraph 34 of the Commentary on Article 7:

> "(cf. paragraph 13 of the Commentary on Article 12 which discusses the principles governing whether in the particular case of computer software payments should be classified as commercial income within Articles 7 or 14 or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other.)"

2. Add the following paragraphs 13 to 18 immediately after paragraph 12 of the Commentary on Article 12:

> "13. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. Software may be described as a programme, or series of programmes, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media for example in writing, on a magnetic tape or disc, or on a laser disc. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware. The rights in computer software are a form of intellectual property. Research into the practices of OECD Member countries has established that all but one protect software rights either explicitly or implicitly under copyright law. Transfers of rights occur in many different ways ranging from the alienation of the entire rights to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may

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make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment.

14. Three situations are considered. The first is of payments made where less than the full rights in software are transferred. In a partial transfer of rights the consideration is likely to represent a royalty only in very limited circumstances. One such case is where the transferor is the author of the software (or has acquired from the author his rights of distribution and reproduction) and he has placed part of his rights at the disposal of a third party to enable the latter to develop or exploit the software itself commercially, for example by development and distribution of it. It should be noted that even where a software payment is properly to be regarded as a royalty there are difficulties in applying the copyright provisions of Article 12 to software royalties since paragraph 2 of the Article requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 of Article 12 which either omits all references to the nature of copyrights or refers specifically to software.

15. In other cases, the acquisition of the software will generally be for the personal or business use of the purchaser. The payment will then fall to be dealt with as commercial income in accordance with Articles 7 or 14. It is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it.

16. The second situation is where the payments are made as consideration for the alienation of rights attached to the software. It is clear that where consideration is paid for the transfer of the full ownership the payment cannot represent a royalty and the provisions of Article 12 are not applicable. Difficulties can arise where there are extensive but partial alienation of rights involving:

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

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

18. The third situation is where software payments are made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 12 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part."

[The following paragraphs of the Commentary on Article 12 are renumbered accordingly.]

3. Add the following at the end of paragraph 3 of the Commentary on Article 14:

"e.g. in determining whether computer software payments should be classified as commercial income within Articles 7 or 14 or as royalties within Article 12."

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TRIANGULAR CASES

(adopted by the OECD Council on 23 July 1992)

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I. INTRODUCTION

1. Double tax treaties are concluded on a bilateral basis. Specific problems may therefore arise in situations where more than two States are involved. Sometimes the solution is to apply the provisions of the treaties that are relevant. For instance, Article 4 of the Model Convention contains rules for the settlement of conflicts concerning residence when a person is a resident of several States and receives income from third States.

2. But the Model Convention does not provide any general and consistent solution to the problems raised by typical triangular cases, i.e. those in which :

- income from dividends, interest or royalties is derived from a source in State S;
- such income is received by a permanent establishment in State P;
- the permanent establishment depends on an enterprise resident in State R.

3. The purpose of this note is to analyse the difficulties to which triangular cases give rise in the three States concerned, to show countries' current practices and to discuss ways of dealing with the problem.

II. OUTLINE OF THE PROBLEM

A. Practical importance of the typical triangular case

4. The fact that many States have already encountered problems with this typical triangular case shows that the matter is of some practical importance. With growing international economic co-operation and, in particular, economic integration within the European Communities, it is to be expected that triangular cases will occur more frequently in the future. The banking and insurance sectors, for example, are directly concerned. Banks often have foreign branches that may receive interest from third countries on loans granted to residents of those countries. Also, branches of insurance companies located in countries other than that where their head office is established are sometimes required, under the law

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of the country where they are located, to have risk-cover capital. The income from this capital, which often consists of shares or bonds, may come from third States, in which case it is clearly attributable to the branch.

5. Also, industrial or commercial enterprises with permanent establishments in a number of countries may, for example, attach to one of them an industrial plant hired to a resident of a third State; if the attachment of the corresponding asset to the permanent establishment is normal, then the rent from the plant hire is clearly also attributable to it.

B. Tax problems arising in the typical triangular case

6. Problems will differ depending on whether State R taxes (subject to the deduction of a tax credit) or exempts from tax the profits of the permanent establishment located in State P, profits which include passive income from State S.

i) State R taxes the profits of the permanent establishment

7. If there is no tax treaty between the three States concerned, the enterprise has an unlimited tax liability in State R. The profits of the permanent establishment, including income from State S, are taxed in State P. State S can also levy withholding tax on income paid to the permanent establishment.

8. As to the question of whether, and how, double taxation is avoided on the permanent establishment's profits in general or on income from a third State, only the domestic law of each country is relevant.

9. The situation is different if double taxation treaties have been concluded between the States concerned. The purpose of these treaties is to avoid the double taxation of income by two States. They apply only to the residents of one Contracting State who receive income from the other State or who possess assets located in the other State. In addition, they lay down general rules concerning income from third countries.

10. The typical triangular case, however, involves three States. If each of them has concluded a treaty with the other two States in accordance with the

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Model Convention, the tax situation according to the Articles of the Model Convention and the Commentaries is as follows:

Situation for State S

11. For State S, dividends, interest or royalties are paid to a resident of State R; State S can therefore impose withholding tax as provided for in the R-S treaty. The fact that the payments are attributable to a permanent establishment in State P does not mean that the treaty between State R and State S is not applicable to State S. On the other hand, the treaty between State P and State S is not applicable, given that the permanent establishment is not a resident of State P.

12. The problems that arise in this context relate to procedure and endorsement: is it the enterprise or the permanent establishment that must claim withholding tax relief and by whom should such a claim be endorsed?

Situation for State R

13. For State R, both treaties (R-S and R-P) are in principle applicable: the treaty between State R and State S because the income comes from State S and goes to a resident of State R, and the treaty between State R and State P because the profits are those of a permanent establishment situated in State P. Let us suppose that State R taxes the profits of the permanent establishment, which include the income from State S, and grants a tax credit. Such a tax credit usually takes into consideration the taxes paid in State P. But under the R-S treaty, State R is also required to avoid double taxation. As a rule, when no triangular cases are involved, it does so by allowing the tax due in State S to be set against its own taxes on income from State S.

14. In a triangular case, State R must already grant a credit for the taxes paid in State P; the question then arises as to whether the taxes paid in State S and not credited in State P should also be taken into consideration. The problems of procedure and endorsement mentioned for State S also arise for State R.

Situation for State P

15. Under the treaty between State R and State P, State P can tax the profits that are attributable to a permanent establishment via which an enterprise of

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State R carries on an activity in State P. The dividends and interest from State S form part of these profits and are therefore taxable in State P. The question arises, however, as to whether State P should take into account a limited right of taxation of State S. Given that the treaty between State P and State S is not applicable, it does not seem that State P has any obligations arising from it, such as granting a tax credit in respect of the tax due in State S. Should State P, under the R-P treaty, grant such a credit on the basis, for example, of the provisions on non-discrimination contained therein?

ii) State R exempts the profits of the permanent establishment

16. This situation does not often arise when State R and State P are not bound by a tax treaty. It is more frequent when State R and State P have concluded a treaty. The Model Convention (Articles and Commentaries) provides no satisfactory solution to the problems of double taxation and tax avoidance that arise in this situation.

Problem of double taxation

17. State R does not tax passive income from State S either as such or as an item included in the profits of the permanent establishment located in State P. It therefore cannot grant a tax credit in respect of:

— tax levied in State S, if State P grants no credit in respect of that tax;

— or any possible difference between the amount of that tax and the amount of the credit granted in State P.

18. In other words, when the income is imposed both in State S and in State P (which is quite normal if neither State S nor State P is a tax haven), double taxation can be eliminated only by State P.

19. When State R and State P have signed a treaty according to the Model Convention, a literal interpretation[1] of paragraph 4 of Article 24 would mean that State P would have to grant a tax credit in the same way as it would to residents

1. Some Member countries (e.g. *Ireland*, *Switzerland* and the *United Kingdom*) do not agree with such an interpretation.

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receiving dividends, interest or royalties from State S. This would, in certain cases, only partly solve the problem of double taxation, since the credit granted in State P (by virtue of the treaty between State P and State S) might be smaller than the tax charged in State S (by virtue of the domestic law of State S or of the treaty between State R and State S). But in such a situation the commentaries on paragraph 4 of Article 24 do not provide for the granting of a tax credit, and no other provision of the Model Convention can settle the double taxation problem.

Problem of tax avoidance

20. Most delegations consider that Articles 10, 11 and 12 of the treaty between State S and State R (supposing that the treaty follows the Model Convention) justify exemption or relief from tax on income in State S, even when that income is not liable to tax in State R (by virtue of that State's domestic law or of the treaty between State R and State P), and whatever the location of the permanent establishment receiving that income.

21. Clearly this interpretation gives banks and other enterprises in State R an incentive to place assets generating passive income in one of their permanent establishments in a State or Territory offering favourable tax treatment. So, far from closing a loophole, the Model Convention makes one available.

22. The problem is briefly referred to in paragraph 6 of the Commentary on Article 21, and it is suggested:

— either that an addition be made to paragraph 2 of Article 21, waiving the application of its provisions when income-generating assets are attached to a permanent establishment essentially in order to take advantage of paragraph 2 of Article 21 in the treaty between State R and State P;

— or that State R should not apply paragraph 2 of Article 21 of the R-P treaty when State R considers that the attachment of the assets concerned to the permanent establishment situated in State P is fictitious.

23. In certain cases, however, the first method suggested is extremely difficult, not to say impossible, to apply — for instance, to banks carrying out large numbers of transactions in many countries. The second method disregards States whose domestic legislation exempts from tax the profits made by permanent

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establishments located outside their territory. So, in fact, satisfactory solutions to the tax avoidance problem considered here still have to be found.

III. DISCUSSION OF POSSIBLE SOLUTIONS

24. First, it is necessary to examine the solutions provided for by the Model Convention and the Commentary. Next, the way countries have responded needs to be studied in order to see what solutions have been found. And, lastly, the advantages and drawbacks of the various possibilities have to be discussed.

A. Discussion based on the Model Convention and Commentary

25. The Commentary on the Model Convention mentions the problems raised by triangular cases in relation to Article 21, "Other income" (paragraphs 5 and 6 of the Commentary), Article 23, "Methods for elimination of double taxation" (paragraph 10 of the Commentary) and Article 24, "Non-discrimination" (paragraphs 52 to 55 of the Commentary). These comments did not appear in the Commentary on the 1963 Draft Convention.

26. When the 1963 Draft Convention was being revised , the problems raised by triangular cases were examined, particularly in respect of the following questions:

- What is the scope of the Article on non-discrimination?
- Is the permanent establishment in State P entitled to a tax credit, or even an exemption, in respect of income from State S?
- How large should this tax credit be?
- What are the formal requirements for the granting of relief?
- How can abuses be prevented?

27. At the time, Member countries came to the conclusion that the problems involved in the typical triangular case were too complex to be dealt with in the actual wording of the Model Convention or Commentary. They therefore recommended that countries should prescribe ways of dealing with them in their bilateral treaties or settle them by mutual agreement.

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B. Practice in Member countries

28. Since the Model Convention provides no solution to triangular cases, it is useful to see how Member countries deal with them in practice. The replies to a questionnaire sent out to Member countries are summarised below.

i) General

29. A large number of countries have already had to contend with triangular cases. Some of them (usually those which eliminate double taxation of the permanent establishment by the credit method) seem not to have met too much difficulty dealing with them. Others, however, have and these countries consider that a standard procedure should be included in the Model Convention or Commentaries. With respect to the problem of avoiding double taxation, States may find themselves in one of the following positions:

State P

30. Most of the countries which, as State P, apply the credit method under their domestic law for their own enterprises, also usually grant tax credits to permanent establishments of non-resident enterprises. *Ireland* and the *United Kingdom* grant it only in limited cases (branches of foreign banks for example). The obligation under paragraph 4 of Article 24 is not recognised by all the countries that grant a tax credit under their domestic law.

31. Some countries pointed out that a literal interpretation of paragraph 4 of Article 24 obliges a State to grant a tax credit even if its domestic law does not provide for such a grant to non-residents, since the treaty prevails over domestic legislation. Other States do not agree that such an obligation exists.

32. The first group of countries base their interpretation notably on rulings handed down by their own courts that paragraph 4 of Article 24 is sufficiently clear to be followed to the letter. Such literal interpretation certainly conflicts with paragraph 55 of the Commentary on paragraph 4 of Article 24. But as the Commentary has no legal or statutory force, they cannot be opposed to the rulings handed down by the courts, which consider that they enlarge on the wording of Article 24 rather than being simply interpretative commentaries.

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33. Some countries consider on the basis of a decision of the Court of Justice of the European Communities that the principle of freedom of establishment enshrined in Article 52 of the Treaty of Rome requires that a branch be taxed in the same way as a subsidiary. This jurisprudence thus means, they argue, that a branch established in an EEC State and dependent on an enterprise with its headquarters in an EEC State, is entitled to the same tax credits as a subsidiary in the same circumstances.

34. Countries that do not come into one of the above-mentioned categories do not, as a rule, see any possibility of granting a tax credit to a permanent establishment because they consider that the treaty between State P and State S is not applicable. A situation thus arises in which double taxation is not eliminated by State P.

State R

35. States which, as State R, apply the credit method are usually willing to grant a tax credit in respect of tax levied in State P (based on the treaty between State R and State P) but also in respect of tax due in State S (based on the treaty between State R and State S) which has not been credited by State P. For these countries, therefore, the triangular case does not give rise to any particular problems concerning possible double taxation.

36. Countries which, as State R, apply the exemption method in respect of profits by a permanent establishment and grant credits for the taxes due on dividends, interest and royalties received directly from State S do not see any possibility of granting a tax credit based on a treaty between State R and State S because the income from State S is not taxed in State R. For the same reason, State R cannot take into consideration tax due that has not been credited by State P. In these cases, double taxation subsists unless it is eliminated by State P.

State S

37. As regards the situation of State S, virtually every country considers that the treaty between State R and State S is applicable and that tax relief must be granted on the basis thereof. If the claim has to be endorsed, residence as a rule has to be certified by the State R of which the enterprise is a resident.

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38. However, certain States say these solutions are not appropriate when State R exempts from tax the profits of the permanent establishment, pointing out, in particular:

— That systematic application of the treaty between State R and State S is bound to incite enterprises in State R — especially banks — to attach income-generating assets to permanent establishments located in the countries which tax such income lightly or not at all. In some cases, such income would thus be exempted from tax in State S, State P and State R.

— That the endorsement procedure is intended, notably, to inform the tax authorities of State R about the nature, amount and source of income received by the taxpayer who requests a certificate of residence. But such information is of no interest to State R when it exempts from tax the profits of a permanent establishment situated in State P, whereas it would be of interest to State P (unless it is a tax haven), so that State P should at least be concerned in the endorsement procedure.

ii) Position concerning the application of the treaty between State P and State S

39. Some countries consider that the treaty between State P and State S should be applied in triangular cases, either by an amendment to the Model Convention, or by the mutual agreement procedure. The majority of States are strongly opposed to such a solution, above all because such States fear it might encourage "treaty shopping", i.e. induce enterprises resident in States which exempt from tax the profits of permanent establishments located outside their territory to attach their income-generating assets to permanent establishments situated in those States that offer the most favourable tax treatment.

C. Assessment of possible solutions

i) Elimination of double taxation

The substantive problem

40. As we have seen, State R cannot eliminate double taxation when it exempts from tax the profits of a permanent establishment situated in State P.

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When it does tax those profits, the tax credit it can grant will usually be limited to the amount of the tax payable. If that amount does not exceed the amount of the tax levied in State P, State R cannot give a tax credit in respect of tax (or tax liability) in State S. Therefore, since State R often has little or no possibility of eliminating double taxation, a solution has to be sought in State P.

41. If State P grants tax credits under its domestic law to its own enterprises, it should also, according to some, grant them to permanent establishments of a resident of State R (see paragraph 51 of the Commentary on Article 24 of the Model Convention). When State P does not grant a tax credit under its domestic law, the question arises of whether it should do so under the treaty between State P and State S or the treaty between State R and State P.

Treaty between State P and State S

42. The Model Convention in principle concerns only residents in one or both States. As the permanent establishment situated in State P is resident in State R, the treaty between State P and State S, in the situation under consideration, could be applied only if it provided expressly for the treatment of triangular cases.

43. This solution would mean that permanent establishments situated in State P would be treated like residents of State P with respect to the taxation of passive income they received from State S. They could thus put in their own claim for tax relief in State S; State P would have to endorse their claims and grant the same tax credit as to its own enterprises.

44. This method, which would introduce a new element into the treaties, has some advantages but also some drawbacks:

— The problem of tax credit would be solved. Permanent establishments would be treated on an equal footing with enterprises of State P; State P would be able to certify residence and control the taxation of income from State S.

— State S would have to grant the advantages provided for under the treaty concluded with State P to permanent establishments of third States with which it might have no treaty. But the treaty between State P and State S would thus work on the principle of reciprocity that prevails in tax treaties, and the quality of permanent establishment recognised in respect

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of the taxation of industrial and commercial profits would also have to be recognised in respect of the taxation of passive income.

— Enterprises of a State R would, in the absence of a treaty between State R and State S, be able, after setting up permanent establishments in State P, to take advantage of the treaty between State P and State S; or they might well be tempted to maintain permanent establishments in State P in order to take advantage of a withholding tax rate under the treaty between State P and State S lower than the rate under the treaty between State R and State S.

The danger of "treaty shopping" arises when State R eliminates double taxation of the permanent establishment's profits by the exemption method.

45. States which chose to apply the treaty between State P and State S in their bilateral relations could, for instance, add a provision to this effect to paragraph 4 of Article 24. This was done in a new treaty between *France* and *Italy* that was signed recently. The provision reads as follows:

> "When a permanent establishment situated in one State receives dividends, interest or royalties from the other State corresponding to assets or rights effectively attached to its activities, that income shall be taxable in the State of source, in accordance with the provisions of Articles 10, 11 and 12 respectively. The State where the permanent establishment is situated shall eliminate double taxation by the method as provided for in Article ... (the granting of a tax credit). This provision shall apply whatever the location of the headquarters of the enterprise on which the permanent establishment depends."

46. A large majority of the Member countries are opposed to such a solution because it departs too much from the principles underlying the Model Convention and current practices.

Treaty between State R and State P

47. If the treaty between State R and State P is applied, the double taxation problem can only be resolved if State P is obliged to grant to permanent establishments of State R the same treatment that it grants to its own enterprises.

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48. For it to be clearly spelt out that permanent establishments in State P enjoy the same advantages as State P's own enterprises, it would have to be agreed that express reference to this treatment be made in the treaty between State R and State P. Possibly, for instance, it could be stipulated in the Article on non-discrimination that permanent establishments of enterprises of State R would be entitled, in the same way as residents of State P, to a tax credit in respect of income from third countries. The amount of the credit, however, would depend on the credit to which enterprises of State P would be entitled, i.e. it could not exceed the amount of the withholding tax under the treaty between State P and State S.

49. The following methods could be adopted when the rates of withholding tax under the treaty between State R and State S differ from those under the treaty between State P and State S:

— R-S rate lower than P-S rate:

  State P would have to grant a tax credit at the lower R-S rate in order to avoid granting credit in excess of the tax effectively levied in State S;

— R-S rate higher than P-S rate:

  State P would not grant a credit in respect of the whole amount of withholding tax levied in State S. Thus partial double taxation would subsist, except in those cases where it was eliminated by State R.

50. The method of granting in State P a tax credit for the tax (or some of the tax) levied in State S would involve, in particular, amending paragraph 55 of the Commentary on paragraph 4 of Article 24 of the Model Convention. However, to meet the needs of those countries which consider that the wording of this paragraph does not justify that method, paragraph 4 of Article 24 would also have to be amended by the addition of an express mention of the method(s) recommended in order to eliminate double taxation in triangular cases.

Procedure

51. As indicated above, the elimination of double taxation in application of the treaty between State P and State S would involve certification by the tax authorities of State P. Where the treaty between State R and State P was applied, certification would have to be endorsed by the tax authorities of State R. But for

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the reasons set out in paragraph 38 of this report, it is not satisfactory for State P to be left out of this procedure:

— first, because State R may issue a certificate that does not directly concern itself but may, on the contrary, provide a loophole for tax avoidance unless State R can be quite sure that the income concerned is taxed in the normal way in State P;

— second, because it is in State P's interest to be given an opportunity to endorse a certificate that informs it of the existence of income in respect of which an enterprise is requesting that the treaty between State R and State S be applied.

52. When the elimination of double taxation results from a combination of the provisions in the R-P and R-S treaties, a recommendation could be added to the Commentary on the Model Convention to the effect that State P, too, should take part in the endorsement procedure and that the information contained in the certificate should be ample enough to meet the requirements of State R and State P.

ii) Tax avoidance

53. The most difficult problem appears to arise in the situation where income arising in State S and paid to a permanent establishment in a tax haven would be taxed very little or not at all.

54. Countries which decided to include in their treaties arrangements to eliminate double taxation by applying the treaty between State P and State S would, of course, have to be careful not to do so if State P did not tax in the normal way income received from outside sources by permanent establishments located in State P.

55. Countries which follow the traditional approach and which apply the treaty between State R and State S may be confronted to the problem created by a permanent establishment situated in a tax haven. A recommendation could be added in the Commentary on the Model Convention, for instance that these countries:

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— Include in the treaty between State R and State S a provision stipulating that the advantages of the treaty shall be extended to permanent establishments in third countries only on condition that the said permanent establishments pay tax in the normal way on the income concerned. However, such a provision would provide a remedy only in the most flagrant cases of abuse, i.e. those situations where income from State S is not taxed at all or benefits from a specially favourable rate.

— Include in the treaty between State R and State S a provision whereby State S shall grant relief only on condition that it has also concluded with State P an agreement on the elimination of double taxation (or an agreement on administrative assistance). Relief could, if necessary, be restricted to the amount provided for in that agreement.

— Agree on a general provision enabling State S not to grant tax relief and State R not to certify residence in cases where improper use was being made of the treaty.

56. When an enterprise of State R sets up or transfers funds or activities to a permanent establishment in State P in order to take advantage of more favourable tax treatment there, State R may argue, on the basis of Article 7 of the Model Convention, that the income therefrom is not in fact attributable to that permanent establishment. State R may then tax the income from State S and refuse to endorse the permanent establishment's claims for tax relief.

57. Although this kind of action may not always be successful when the enterprise takes certain precautions in order to hide the fact that it is seeking to avoid tax, it could nevertheless be mentioned in the Commentary on the Model Convention.

IV. CONCLUSION

58. Most Member countries would be interested in finding a solution to the problems that can arise in the typical triangular case. First, it is necessary to eliminate a certain amount of discrimination that exists in respect of permanent establishments, resulting from the fact that in some cases a credit is not granted in respect of tax due in State S. Second, typical triangular cases ought to be treated as consistently and uniformly as is compatible with the tax systems in force in the

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countries concerned. Experience shows that recourse to the mutual agreement procedure is not often practicable when three countries are involved.

59. This report suggests some methods which might make it possible to eliminate double taxation in most cases and to limit the risks of tax avoidance. These methods should be presented in the Commentary on the Model Convention.

V. RECOMMENDATION

60. Since the majority of Member countries prefer, on the basis of the basic principle that the treaty applies only to residents of one or the other of the Contracting States, the solution referred to in paragraphs 47 to 50 and reject that referred to in paragraphs 42 to 46, the Committee recommends that the Commentary on the Model Convention be revised as follows:

PROPOSED CHANGES TO THE COMMENTARY[2]

1. Paragraph 19 of the Commentary on Article 10 is replaced by the following:

> "19. The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a refund. *Specific questions arise with triangular cases (see paragraph 55 of the Commentary on Article 24).*"

2. Paragraph 9 of the Commentary on Article 11 is replaced by the following:

> "9. The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. *Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law. Specific questions arise with triangular cases (see paragraph 55 of the Commentary on Article 24)."*

2. Parts in italics indicate proposed additions.

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3. Paragraph 5 of the Commentary on Article 12 is replaced by the following:

"5. The Article deals only with royalties arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to royalties arising in a third State as well as to royalties arising in a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases, cf. paragraphs 4 to 6 of the Commentary on Article 21). *Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law. Specific questions arise with triangular cases (see paragraph 55 of the Commentary on Article 24)."*

4. The fourth and following sentences of paragraph 10 of the Commentary on Article 23 are deleted.

5. Paragraphs 52 to 55 of the Commentary on Article 24 are replaced by the following paragraphs 52 to 56:

"52. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States. This question is examined below, the particular case of dividends, interest and royalties being dealt with in paragraph 53 below.

F. Extension to permanent establishments of the benefit of double taxation conventions concluded with third States

53. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends, interest or royalties from a third State, then the question arises as to whether and to what extent the Contracting State in which the permanent establishment is situated should credit the tax that cannot be recovered from the third State.

54. There is agreement that double taxation arises in these situations and that some method of relief should be found. The majority of Member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 4 of Article 24. States that under their present legislation cannot give credit in such a way or that wish to clarify the situation may wish

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to supplement the provision in their convention with the Contracting State in which the enterprise is resident by wording that allows the State in which the permanent establishment is situated to credit the tax liability in the State in which the income originates to an amount that does not exceed the amount that resident enterprises in the Contracting State in which the permanent establishment is situated can claim on the basis of the Contracting State's convention with the third State. If the tax that cannot be recovered under the convention between the third State and the State of residence of the enterprise which has a permanent establishment in the other Contracting State is lower than that under the convention between the third State and the Contracting State in which the permanent establishment is situated, then only the lower tax collected in the third State shall be credited. The following addition to Article 24, paragraph 4 after the first sentence, is therefore proposed:

> *"When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends, interest or royalties from a third State and the right or the asset in respect of which the dividends, interest or royalties are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends, interest or royalties, as the case may be, but the amount of such credit shall not exceed the amount calculated by applying the appropriate rate provided for under the convention with respect to taxes on income and on capital between the Contracting State of which the enterprise is a resident and the third State."*

55. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure as this procedure would provide useful information for audit purposes. Another

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question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.

56. 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 to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21). States can settle these matters in bilateral negotiations."

6. Paragraphs 56 and following of the Commentary on Article 24 are renumbered accordingly.

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THE TAX TREATMENT OF EMPLOYEE'S CONTRIBUTIONS TO FOREIGN PENSION SCHEMES

(adopted by the OECD Council on 23 July 1992)

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I. INTRODUCTION

1. At its meeting on 24-25 January 1989, the Committee on Fiscal Affairs agreed to a request from Working Party No. 6 that Working Party No. 1 should draft a provision, for inclusion in the Model Convention, dealing with the tax treatment of pension contributions made by persons who render dependent personal services to multinational enterprises whilst they are seconded abroad.

2. This reports considers the form that such a provision might take, and puts forward a suggested provision for inclusion in the Commentary on Article 18.

II. BACKGROUND

3. It is common for staff of multinational enterprises (and particularly for the more senior staff) to be expected from time to time to work outside their home country. Whilst abroad they may continue to be employed by the company to which they rendered dependent personal services in their home country, or they may be employed by an associated company in the host country.

4. Employees who were members of a pension scheme in their home country will often wish to go on contributing to the scheme during their absence abroad. This is both because switching schemes can lead to a loss of rights and benefits, and because many practical difficulties (including exposure to exchange losses) can arise from having pension arrangements in many countries.

5. Before taking up an overseas assignment, employees commonly qualify for tax relief on pension contributions paid in the home country. When assigned abroad, employees in some cases continue to qualify for relief; for instance, where a person remains resident and fully taxable in the home country, he will generally continue to qualify for relief there. But frequently contributions paid in the home country by someone assigned abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become costly, if not impossible, to maintain membership of a pension scheme in the home country during a foreign assignment.

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6. The Model Convention offers no assistance. It defines how pensions should be taxed, but it says nothing about how pension contributions should be treated. In the circumstances, the Committee on Fiscal Affairs decided that a provision dealing with pension contributions of employees assigned abroad should be drafted.

7. However, some delegates considered that there were other, more convenient ways of dealing with the problem than by means of a new treaty provision. *Norway* and *Japan* felt, respectively, that adaptation of the pension scheme to secure deductibility in the host State, or a compensatory amendment to the overall terms of employment, provided a simpler and more expeditious solution to the problem. In addition, domestic legislation in some countries might limit the application of a wide provision; for example in *Belgium*, where only contributions to schemes run by companies established therein are deductible, or in *Ireland*, where deductions are only available for contributions made by Irish residents.

8. Taking these difficulties into account, the Committee concluded that agreement could not be reached on a draft provision and commentary to be added to the Model. The approach favoured by most delegates was to draft explanatory paragraphs and a suggested provision to be included in the Commentary to an existing Article of the Model Convention. Member countries could then include the provision in bilateral treaties if they wished, and were able, to do so. Whilst there were a number of existing commentaries to which the paragraphs on pension contributions could be added, for example those on Articles 7, 15 or 18, the Commentary on Article 18 was considered most appropriate as it also dealt with matters concerning pensions arising out of past employments.

9. When drafting the suggested provision, the Committee decided that contributions to social security schemes should be disregarded. The Committee felt that the right or obligation to join a social security scheme was primarily a matter of social legislation rather than tax law. This note does not therefore deal with contributions to such schemes, but it should be noted that many Member countries have entered into bilateral social security totalisation agreements.

10. The Committee also concluded that the tax deductibility from profits of pension contributions made by employers in respect of employees working abroad created no real practical difficulties. It also noted that problems could arise with the treatment by the host State of income accruals in home State pension schemes.

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However, the Committee decided that, at least for the time being, efforts should be concentrated on drafting a provision in respect of employee contributions only.

11. The majority of delegates were in favour of extending the suggested provision to cover the tax deductibility of pension contributions made by individuals rendering independent personal services abroad. However, this was felt to be beyond the initial objective, although it was agreed that the Commentary should recognise the possibility of extending the suggested provision to cover such contributions in bilateral negotiations.

III. EXISTING TREATIES

12. Although the Model Convention does not contain a provision dealing with pension contributions, seven member countries (*Canada*, *Denmark*, *France*, the *Netherlands*, *Switzerland*, the *United Kingdom* and the *United States*) have negotiated bilateral treaties containing such provisions. All (six) of these provisions provide for the host country in certain circumstances to give tax relief for contributions an employee makes to a pension scheme in his home country. Some of them go further and also deal with contributions paid by individuals performing independent personal services, and with the taxation of employers' contributions as benefits in kind to employees.

13. These provisions are reproduced in Annex A; and a summary of them (employing the headings used in Section VI of this report) is included in Annex B.

IV. AIM OF A PROVISION FOR INCLUSION IN THE COMMENTARY

14. The aim of a suggested provision would be to ensure that, so far as possible, an employee was neither discouraged nor encouraged from taking up an overseas assignment within the meaning of Article 15 of the Model by the tax treatment of contributions made to a home country pension scheme by an employee working abroad. It follows, therefore, that the provision should seek, first, to determine the general equivalence of pension plans in the two countries, and then to establish limits to the deductibility of employee contributions that may be based on the limits in the laws of both countries.

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V. FORM OF A PROVISION FOR INCLUSION IN THE COMMENTARY

15. In principle, a provision could take one of two basic forms. It could look for relief for contributions to a home country pension scheme to be given by either:

— the home country; or

— the host country.

16. At an economic level, the argument for looking to the host country is that this is where the economic activities giving rise to the contributions are carried out. Against that, the argument is that the home country should give relief as this is where the scheme is situated and where the source of the future pension will be.

17. At a practical level, where (as is generally the case) countries give relief by way of a deduction in computing taxable income, looking to the home country might not be effective, since the employee may not have any taxable income in the home country against which relief could be given. This might be because the length of the assignment was such that the employee ceased to be resident in the home country, or because although remaining resident in the home country the employee was not taxable there because it was an exemption country.

18. The practical considerations are more complicated where an employee remains resident in the home country and it is a credit country. If relief were given in the home country rather than the host country there might be an excess of foreign tax that could not be relieved in the home country. This would be because the tax base was wider in the host country than in the home country, meaning that (depending on the tax rates in the two countries) more tax may be payable in the host country than in the home country.

19. However, if relief were only given in the host country, the benefit of the relief would be dissipated by the home country taxing the remuneration in full (i.e. including that part relieved in the host country). However, this would not generally be a problem in practice, as credit countries sometimes exempt under their domestic law the foreign earnings of residents, and where this is not the case, relief for pension contributions would normally be due in the home country under its domestic laws.

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20. Practical considerations therefore suggest that it would be sensible for the provision to concentrate on looking to the host country to give relief. This is the position adopted in the six provisions negotiated to date.

VI. CONDITIONS OF A PROVISION FOR INCLUSION IN THE COMMENTARY

21. If it is agreed that the suggested provision should concentrate on providing relief in the host country for employee contributions to a home country pension scheme, it would then be for consideration what precise conditions would need to be included in the provision for relief to be due.

22. Possible qualifying conditions can be divided into three categories. These concern the characteristics of:

a) the employee;

b) the contributions; and

c) the relief.

Characteristics of the employee

Residence test

23. There are two aspects to this:

— the first concerns the employee's residence status before working in the host country; and

— the second concerns his residence status while working there.

24. First, consideration needs to be given to the employee's residence status before working in the host country. In order to limit the provision to secondees, it would be necessary to ensure that the employee was not resident in the host country prior to working there. This would cover employees transferred from a third country.

25. Since it is not unusual for an employee to be seconded to a number of different countries in succession, Member countries may feel that it would be

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appropriate for the suggested provision to be limited simply to employees who were not resident in the host country before taking up employment there within the meaning of Article 15 of the Model Convention. Of the six present provisions, five cover employees coming from a third country as well as employees coming from the treaty partner (the remaining one has no restriction about prior residence).

26. Second is the question of the employee's residence status while working in the host country. The consideration here would be whether all employees working abroad in the host country should be covered by the provision or just those who become resident there. Of the six present provisions, only two apply to employees whose temporary presence does not amount to residence.

27. In many cases employees working abroad who remain resident in their home country will continue to qualify for relief in the home country. But this will not be so in all cases. For instance, where the home country is an exemption country, a resident may not qualify for relief there if he is taxable in the host country on earnings from working in that country. There would therefore seem to be a case for the provision to apply to non-residents working in the host country as well as to residents. However, domestic legislation in some Member countries would not allow a deduction for payments to a pension scheme by non-residents so these countries would, presumably, seek to restrict the suggested provision to individuals who became resident in the host country.

28. In addition, where relief was due in the home country, there could be foreign tax credit problems if the home country was a credit country and the host country did not give relief (see paragraph 18 above).

29. Some Member countries tax non-residents at a special low rate and may not, therefore, wish to give relief to non-residents. The suggested provision, as drafted, applies to non-residents but the addition to the Commentary can make it clear that countries with a special regime for non-residents, or which are limited by domestic legislation, might, in bilateral negotiations, wish to restrict such a provision to residents.

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Nationality/citizenship test

30. A further consideration would be whether the provision should be restricted to employees who are not nationals of the host country. Three of the six present provisions are restricted in this way.

31. If an individual is a national of the country in which he is working, it may be questionable whether that country is a host country rather than his home country. Including host country nationals in the provision might allow employees who were not genuine secondees, to circumvent the host country's domestic rules on relief for pension contributions.

32. Suppose for instance that the rules regarding maximum pension contributions and benefits were tighter for schemes in the host country than in the home country. To circumvent the host country rules, a company situated therein might set up a company in the home country. The host country company might then transfer its employees to the home country company, which would then second them back to the host country company. In this way the employees would be able to join a pension scheme in the home country and benefit from its more relaxed rules compared with those of host country schemes, but nevertheless qualify for relief in the host country.

33. Assuming the suggested provision was restricted to employees who were not resident in the host country before exercising the employment there (as is proposed in the suggested provision attached to this note), it could be argued that the possibility of artificial arrangements of the kind described above would be limited. But the possibility would remain of individuals dropping out of residence in the host country for only a short period, in order to come within the provision.

34. The requirement considered in paragraphs 43 to 46 below — that for contributions to a home country scheme to qualify for relief in the host country, the scheme would have to generally correspond to schemes recognised for tax purposes in the host country — would reduce the scope for abuse. But the thought behind the requirement is that a scheme should be broadly similar, rather than identical, to host country schemes.

35. Any limit on the length of time an employee could qualify for relief in the host country would also reduce the scope for abuse. This possibility is considered in paragraphs 38 and 39 below.

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36. The argument against including a nationality test is that it could work against the free movement of genuine secondees. For instance, the best qualified individual from within the head office of a multinational group to be seconded to another country is frequently one who originally came from that country, since he will have the necessary background and linguistic qualifications. It would arguably be wrong to rule out relief for such a person on the grounds that his home was really in the country to which he was seconded, particularly if he had left that country some years before.

37. The Committee, with one exception, did not support the inclusion of a nationality test. The suggested provision, as drafted, does not include a nationality test but it is recognised that countries may wish in bilateral negotiations to supplement the provision with one.

Time limit

38. There is a case for arguing that the provision should cease to apply if the employee continues to work in the host country for more than a specified length of time. This would be on the basis that a point comes when an employee may have worked so long in the host country that in effect it becomes his home country. Indeed, *Ireland* already restricts relief for contributions to foreign employer/employee schemes to cases where the seconded employee is present in *Ireland* on a temporary basis.

39. Only two of the present provisions contain such a limitation (the time limit in them being 60 months). If a nationality test was included (as discussed in paragraphs 30 to 37 above) Member countries may feel that a time limit was unnecessary. It may, however, be felt appropriate to include a time limit if it was decided that host country nationals should be able to qualify for relief under the provision. The inclusion of a time limit has been left as an option.

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Characteristics of the contributions

Scheme recognised in the home country

40. The aim of the provision is, so far as possible, to ensure that contributions are neither more nor less favourably treated for tax purposes than they would be if the employee was resident in his home country.

41. One way of doing this might be to limit the provision to contributions made to schemes that the home country recognises for tax purposes as pension schemes.

42. Five of the present provisions are restricted to contributions to schemes recognised for tax purposes in the home country. In the suggested provision, a pension scheme is "recognised for tax purposes" in the home State if the contributions to the scheme would qualify for tax relief in that State. The diversity of treatment accorded to pensions schemes by individual Member countries is such that any further refinement may be best left to bilateral negotiations, where specific references to domestic legislation, or references to "occupational" or "employer/employee" schemes could be used.

Corresponding schemes

43. Five of the present provisions contain a further restriction limiting relief to contributions made to home country schemes which correspond to schemes recognised for tax purposes in the host country. This is on the premise that only contributions to recognised schemes qualify for tax relief.

44. A limitation of this kind would not of course necessarily secure equivalent tax treatment of contributions paid when an employee was working abroad and contributions paid when he was working in the home country. If the host country's rules for recognising pension schemes were narrower than those of the home country, the employee could find that his contributions to his home country pension scheme were less favourably treated when he was working in the host country than when working in the home country. Much would depend on how restrictively the requirement for a scheme to correspond was interpreted.

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45. However, Member countries felt that it would be going too far to have to give relief for contributions to schemes which did not — at least broadly — correspond with domestically recognised schemes. To do so would mean that the amount of relief due in the host country would become dependent on the legislature in the home country. In addition, it could be hard to defend treating employees working side by side differently depending on whether their pension scheme was at home or abroad (and if abroad, whether it was in one country rather than another). The following example illustrates this difficulty. The home country allows relief for pension contributions subject to a limit of 18 % of income. The host country allows relief subject to a limit of 20 % of income. The suggested provision would require the host country to allow relief up to its domestic limit of 20%. Countries wishing to adopt the limit in the home country would need to amend the wording of the provision appropriately.

46. The present provisions, which are limited to corresponding schemes, provide that it is for the competent authority of the host country to determine whether the scheme in the home country corresponds to recognised schemes in the host country. This seems a sensible arrangement if a corresponding scheme limitation is thought desirable. The Committee noted that there could be wide divergences between the tax treatment of pension schemes in individual countries but felt that, nevertheless, it should be possible to identify schemes which broadly, or generally, corresponded with host country schemes.

Existing membership

47. It could be argued that the provision should apply to contributions to new pension schemes which an employee joins while abroad as well as to contributions to schemes of which he was a member before taking up his foreign assignment. This would be in line with seeking to ensure that the employee was not prejudiced by working abroad rather than by continuing to work at home (where — subject to the domestic law of the home country — he would be able to join new schemes and qualify for relief on contributions to them).

48. However, Member countries felt that covering new as well as existing schemes would be going too far. The principal difficulty with the present position concerns contributions to existing schemes, and it was felt that any suggested provision should be limited to such schemes. Of the six present provisions, five

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are limited to contributions to schemes to which the employee was contributing before he was assigned abroad.

49. In some Member countries, when a company is taken over by another company, it is common for the existing pension scheme to be ended and a new one opened. In such cases, Member countries may wish, in bilateral negotiations, to supplement the suggested provision to cover such substitute schemes.

Characteristics of relief

50. The question here is, assuming that the employee and the contributions fall within the provision, what relief should the host country give? This would include matters such as:

— whether contributions should qualify for relief in full, or only in part; and

— whether relief should be given as a deduction in computing taxable income (and if so, which income — e.g. just employment income or all income) or as a tax credit.

51. The considerations here are similar to those discussed in paragraphs 43 to 46 about whether a home country scheme would need to correspond to a host country scheme in order for contributions to be allowable. For similar reasons, Member countries felt that relief should be given in a corresponding way to the manner in which relief would be given if the contributions were to a scheme in the host country. All six of the present provisions are drawn in this way.

VII. OTHER CONSIDERATIONS

52. There are two further issues which require consideration.

53. First, being assigned to work abroad may not just mean that an employee ceases to qualify for tax relief on contributions to a pension scheme in the home country, it may also mean that contributions to the pension scheme by the employer are regarded as the employee's income for tax purposes. Three of the six present provisions therefore specify that, where the various conditions of the provisions are met, employers' contributions shall not be regarded as being taxable benefits for the employees.

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54. In some countries, however, employees are taxed on employers' contributions to domestic schemes. The suggested provision does not, therefore, cover the treatment of employers' contributions to foreign schemes in the context of the employees' tax liability, although negotiators may wish to extend the provision in individual treaties to provide the same treatment as is given to contributions to domestic schemes.

55. Second, some home countries do not permit employees to remain in home country pension schemes while they are working abroad. In such circumstances a provision of the kind considered in this note would have no value. The question of what relief to give in respect of contributions would not arise, since there would be no contributions.

56. It would therefore be for consideration whether a provision should also specify circumstances in which an employee working abroad should be able to remain a member of a home country pension scheme. However, none of the existing provisions cover this point and Member countries felt that this was an area best left to domestic law.

VIII. SUGGESTED PROVISION

57. Drawing on these considerations, a suggested provision and paragraphs for addition to the Commentary on Article 18 have been drafted (cf. Annex C).

58. In the suggested provision, relief is restricted to contributions to home country pension schemes which:

- the employee was contributing to before beginning to exercise, in the host country, an employment within the meaning of Article 15 of the Model Convention;
- are recognised for tax purposes in the home country; and
- generally correspond to schemes recognised for tax purposes in the host country.

59. The provision is restricted to employees who were not resident in the host country before beginning to exercise the employment there, but it leaves open the

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question of whether it should be restricted to employees who are not nationals of the host country.

60. Relief for employee contributions which fell within the provision would be given by the host country as if the contributions were paid to a scheme recognised by the host country.

61. The draft provision does not:

— confine itself to residents working in the host country;

— place a time limit on how long an employee could qualify for relief (but it might be felt that it would be appropriate to do so if it was decided not to include a nationality test); or

— require home countries to allow employees working abroad to be able to remain members of home country schemes.

IX. CONCLUSION

62. This report considers the format of a provision and related commentaries that would be included in the Commentary on Article 18 of the Model Convention, and that would deal with the tax treatment of employees' contributions to foreign pension schemes. As a result of the discussion on the suggested provision, the Committee recommends that the attached paragraphs (Annex C) be inserted in the Model Convention, in the existing Commentary on Article 18.

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ANNEX A

PROVISIONS IN BILATERAL TAX CONVENTIONS

1. DENMARK-SWITZERLAND (1973)

Article 28 (Miscellaneous Rules)

"3. Payments by Swiss nationals resident in Denmark to the Swiss State old age, dependents' and disablement insurance scheme may be deducted in Denmark from taxable income.

4. Payments which an individual resident in one of the Contracting States, who is not a national of that State, makes to a personnel fund recognised as such for tax purposes in the other Contracting State, to which he already belonged before he came resident in the first-mentioned Contracting State, may be deducted from taxable income in the first-mentioned Contracting State in the same way as payments to a personnel fund recognised as such for tax purposes in that State: payments by the employer shall not be deemed in this case to be taxable income of the employee."

2. DENMARK-UNITED KINGDOM (1980)

Article 28 (Miscellaneous Rules)

"3. Payments made by an individual who is resident in a Contracting State, but is not a national of that State, to a pension scheme established in and recognised for tax purposes in the other Contracting State may be relieved from tax in the first-mentioned State provided that:

a) The individual was contributing to the pension scheme before he became a resident of the first-mentioned State; and

b) The pension scheme is accepted by the competent authority of that State as corresponding to a pension scheme recognises as such for tax purposes by that State.

In such a case relief from tax shall be given in the same way as if the pension scheme was recognised as such by State and payments to the pension scheme by the enterprise paying his remuneration shall not be deemed to be taxable income of the individual."

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3. FRANCE-UNITED STATES (1984)

Article 19 (Private pensions and annuities)

"5. a) Contributions paid by, or on behalf of an individual resident of a Contracting State, who is not a citizen of that State, to pension, profit-sharing, and other retirement plans that are recognised for tax purposes in the other Contracting State will be treated in the same way for tax purposes in the first-mentioned State as contributions paid to pension, profit-sharing and other retirement plans that are recognised for tax purposes in the first-mentioned State, provided that the competent authority of the first-mentioned State agrees that the plans correspond to pension, profit-sharing or other retirement plans recognised for tax purposes by that State."

4. FRANCE-CANADA (1987)[1]

Article 29 (Miscellaneous Rules)

"5. Contributions in a year in respect of services rendered in that year paid by, or on behalf of, an individual who is a resident of one of the Contracting States or who is temporarily present in that State, to a pension plan that is recognised for tax purposes in the other Contracting State shall, during a period not exceeding in the aggregate 60 months, be treated in the same way for tax purposes in the first-mentioned State as a contribution paid to a pension plan (that is, in the case of Canada, not an employee benefit plan) that is recognised for tax purposes in that first-mentioned State, provided that:

a) Such individual was contributing to the pension plan before he became a resident of or temporarily present in the first-mentioned State; and
b) The competent authority of the first-mentioned State agrees that the pension plan corresponds to a pension plan recognised for tax purposes by that State.

For the purposes of this paragraph, "pension plan" includes a pension plan created under a public social security system".

1. The same provision is found in paragraph 4 of Article 24 of the Canada-Netherlands tax convention (1986).

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5. FRANCE-UNITED KINGDOM (1987)

Article 25

"8. Payments made by an individual who is a resident of a Contracting State to a pension schemes established in the other Contracting State provided that:

a) the individual was contributing to the pension scheme before he became a resident of the first-mentioned State; and

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

In such case relief from tax shall be given in the same way as if the pension scheme was recognised as such by that State and payments to the pension scheme by the enterprise paying his remuneration shall not be deemed to be taxable income of the individual."

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ANNEX B
SUMMARY OF THE SIX PROVISIONS ALLOWING RELIEF FOR PENSION

	Characteristics of employee			Characteristics of contribution			Characteristics of relief		
	Nationality citizenship test	Residence test		Time limit	Scheme recognised in home country	Scheme corresponds to recognised scheme in home country	Existing membership only	Relief as if host country	Employers' contributions not treated as taxable income of the employee
		A Prior to working in host country	B While working in host country						
Canada Netherlands		X	X (1)	X	X	X	X	X	(2)
Denmark Switzerland	X	X	X		X		X	X	X
Denmark United Kingdom	X	X	X		X	X	X	X	X
France Canada		X	X (1)	X	X	X	X	X	(2)
France United States	X		X		X	X		X	
France United Kingdom		X	X			X	X	X	X

1. Also applies to non-residents who are temporarily present.
2. Where Canada is the host country the employer's contribution is exempt from tax in the hands of the employee.

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ANNEX C

SUGGESTED ADDITIONS TO THE COMMENTARY ON ARTICLE 18 CONCERNING THE TAX TREATMENT OF CONTRIBUTIONS TO FOREIGN PENSION SCHEMES

Add the following after paragraph 3 of the existing Commentary on Article 18 of the Model Convention:

"**The tax treatment of contributions to foreign pension schemes**

A. General comments

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

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

6. The tax treatment accorded to pension contributions of employees who are assigned to work outside their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment, employees commonly qualify for tax relief on pension contributions paid in the home country. When assigned abroad, employees in some cases continue to qualify for relief. Where an individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue to qualify for relief there. But frequently, contributions paid in the home country by an individual assigned to work abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the

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case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the home country during a foreign assignment. Paragraph 11 below suggests a provision which Member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions of employees assigned to work outside their home country.

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

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

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

B. Aim of the provision

10. The aim of the provision is to ensure that, as far as possible, an employee is not discouraged from taking up an overseas assignment by the tax treatment of

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contributions made to a home country pension scheme by an employee working abroad. The provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the deductibility of employee contributions based on the limits in the laws of both countries.

C. Suggested provision

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

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

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

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

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

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

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

12. Sub-paragraph *a*) of the suggested provision lays down the characteristics of both the employee and the contributions to which the provision applies. It also provides the principle that contributions borne by an individual rendering dependent personal services within the meaning of Article 15 in one Contracting

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State (the host State) to a defined pension scheme in the other Contracting State (the home State) are to be relieved from tax in the host State, subject to the same conditions and limitations as relief for contributions to domestic pension schemes of the host State.

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

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

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

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

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

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

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

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

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

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

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rules for recognising pension schemes were narrower than those of the home State, the employee could find that contributions to his home country pension scheme were less favourably treated when he was working in the host country than when working in the home country.

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

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

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

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

27. Sub-paragraph *a*) also sets out the relief to be given by the host State if the characteristics of the employee and the contributions fall within the terms of the

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provision. In brief, the relief is to be given in a way which corresponds to the manner in which relief would be given if the contributions were to a scheme established in the host State.

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

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

30. Being assigned to work abroad may not only mean that an employee's contributions to a pension scheme in his home country cease to qualify for tax relief. It may also mean that contributions to the pension scheme by the employer are regarded as the employee's income for tax purposes. In some Member countries employees are taxed on employer's contributions to domestic schemes whilst working in the home country whereas in others these contributions remain exempt. The provision, therefore, is silent on the treatment of such contributions, although Member countries may wish to extend the suggested provision in bilateral treaties, to ensure that employers contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.

31. Subdivision *b*)(*i*) defines a pension scheme for the purposes of sub-paragraph *a*). It makes it clear that, for these purposes, a pension scheme is an arrangement in which the individual who makes the payments participates in order

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to secure retirement benefits. These benefits must be payable in respect of the exercise of the employment in the host State.

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

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

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

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

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

37. This method of attempting to achieve parity of treatment assumes that in all Member countries only contributions to recognised pension schemes qualify

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

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ATTRIBUTION OF INCOME TO PERMANENT ESTABLISHMENTS

(adopted by the OECD Council on 26 November 1993)

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I. INTRODUCTION

1. Article 7 of the OECD Model Tax Convention provides that the business profits of an enterprise of one State may be taxed in another State, but only to the extent that such profits are attributable to a permanent establishment situated therein. The determination of the income attributable to a permanent establishment can give rise, however, to an element of uncertainty. This is why the Committee on Fiscal Affairs decided to examine the rules concerning the determination of the income of permanent establishments in order to clarify their application. The work of the Committee has benefited from the work done by the International Fiscal Association (IFA) at its 1986 Congress in New York, the first topic of which was "The transfer of assets into and out of a taxing jurisdiction". Discussions on this topic focused on the tax consequences of transfers of goods within a single legal entity, i.e. between a firm's head office and its permanent establishments located outside its country of residence, or between different permanent establishments of the same enterprise; the IFA general report and recommendation show that this particular aspect of the determination of the income of a permanent establishment is especially troublesome.

2. Discussions within the Committee and in IFA identified the following concerns:

a) The transfer of goods and services between tax jurisdictions may give rise to taxation which is not necessarily based on actual profits.

b) Uncertainty about the taxation of permanent establishments is heightened by the fact that the Commentary on Article 7 of the OECD Model Tax Convention suggests a duality of approach whereby tax authorities may in some instances treat a permanent establishment very much as if it were an independent entity legally separate from the enterprise of which it is part and in other instances treat it simply as a sub-division of one and the same enterprise. In the first instance, internal transfers will be evaluated according to the arm's length principle by attributing to the transferring part of the entity the profit which it might have been expected to make had it been dealing with a wholly independent enterprise. In the second instance it may be considered appropriate to evaluate the transfer by reference only to its historic cost. In principle it may be argued that this duality is

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justifiable both because of the legal limits of any agreement between a permanent establishment and the rest of the enterprise of which it forms part and by reference to the nature of the particular transaction under consideration. Nevertheless, the fact remains that this duality of approach leads to uncertainty which may in itself lead to results incompatible with the underlying principles of double taxation agreements (the avoidance of economic double taxation and a fair allocation of taxation rights between countries) where the outward transfer country taxes a given transfer of goods or services on the basis of a price which includes a profit while the inward transferring country takes into account only the residual accounting value or historic cost price (similar problems may arise where the situation is reversed).

The problem is more acute where the country of residence of the enterprise gives relief for the tax levied by the host country of the permanent establishment by exempting those profits from tax. In this situation, the computation of the exempted profits and the computation of the profits as taxed by the host country may be inconsistent, which may lead to either economic double taxation or to under taxation. Where the country of residence of the enterprise gives relief by the credit method, a significant problem will only arise if it takes the view that the host country is levying tax on the enterprise in a manner which is inconsistent with the terms of the relevant bilateral treaty. In such a case, the country of residence may be reluctant to give full credit for the tax levied by the host country and economic double taxation may arise. There is however usually no danger of economic non-taxation since, if the host country levies tax on a more limited basis than the country of residence would consider appropriate, this only results in the reduction of the amount of tax credit which the country of residence has to grant against its own taxes.

c) This uncertainty is accentuated where a permanent establishment (for example, a construction site) has quite a short life so that it cannot therefore be argued that over a period of years the potential distortions favourable or unfavourable to the taxpayer might be offset.

d) The existence of two different methods for eliminating double taxation, the right of each country to define profits earned abroad according to its domestic law, as well as the different approaches to the determination of the timing of the realisation of a gain or loss and to

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foreign currency translation can potentially result in overtaxation and undertaxation.

e) Lastly, the differences that exist in most countries between the taxation of resident companies and of permanent establishments of foreign enterprises raise the issue of whether the non-discrimination principle is being observed and whether these differences of treatment are in fact due to the special nature of the permanent establishment.

This Report discusses these problems and puts forward proposed modifications to the Commentary on Article 7 of the OECD Model Tax Convention on Income and on Capital. These modifications will be incorporated into the next update of the Model which will be issued early in 1994. The structure of the Report is as follows: Section II discusses the issues that were identified in replies to a questionnaire sent out to Member countries and analyses these replies, Section III sets out the conclusions of this analysis and annexes provide separately the questionnaire, the Resolution adopted by IFA at its 1986 Congress and the proposed changes to the Commentary on Article 7.

II. ISSUES RAISED BY THE TAX TREATMENT OF PERMANENT ESTABLISHMENTS

3. The Committee on Fiscal Affairs has addressed the question of the international apportionment of income between head offices and their permanent establishments several times between 1984 and 1986.

4. Following preparatory work carried out for the 1986 IFA Congress and the recommendations adopted at that Congress (see Annex I), the Committee instructed an ad hoc group to draw up a questionnaire on the subject. The questionnaire was sent out in February 1989 to all delegates. Seventeen countries replied to the questionnaire and their replies are analysed below.

Analysis of the replies received and comments on them

5. Of the seventeen replying countries, eleven (*Australia, Canada, Finland, Greece, Italy, New Zealand, Portugal, Spain, Sweden, the United Kingdom* and the *United States*) use the credit method of eliminating international

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economic double taxation and six (*Austria, Belgium, France, Germany, Netherlands* and *Switzerland*) use the exemption method.

A. The recognition of profits or losses

6. Part A of the questionnaire attempted to ascertain whether the head office of a multinational enterprise and its permanent establishments are, in a given commercial year, taxed on actual income accruing to the enterprise as a whole or whether notional profits are taxed. To simplify the analysis, only internal transfers of goods were considered since these might be sold to third parties only in subsequent commercial years.

From the replies received, three situations generally arise:

a) When the outward transfer country (a/1)[1] is that of the head office, both the tax authorities of credit and exemption countries are usually in a satisfactory position. The former take no account of the internal transfer and wait until a profit actually accrues through the permanent establishment. This does not mean, however, that these tax authorities do not take into consideration the book value of the goods as disclosed in the accounts of the permanent establishment, since the profit declared by the permanent establishment will affect the tax credits they will eventually grant.

The exemption countries can defer taxing an internal transfer until a profit actually accrues, unless this is excluded by domestic legislation which does not allow for a provision corresponding to the gain to be made. It appears that *Austria* and *France* are not able to allow their resident enterprises to make such provision.

b) As to determining the taxable profit of a permanent establishment belonging to a non-resident enterprise (a/2; b/4), credit countries and exemption countries have identical views. In both cases, the accounting and tax treatment is the same as that of legally independent entities. Neither outward nor inward transfer countries make any distinction between an internal transfer and a sale to a third party (or delivery from a third party).

1. These numbers refer to the cases analysed in the questionnaire: see Annex II.

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In case (a/2) — outward transfer country — the question is whether there is not a certain discrimination against non-resident enterprises. Admittedly this may not be so when the internal transaction concerned is actually completed in the course of the same year or, the subsequent commercial year. This would generally be the case when the transferred goods form part of the current assets of the enterprise. But doubts remain when the transfer concerns fixed assets, especially when a permanent establishment is wound up, since profits may be taxed some years before the appreciation that existed at the time of the transfer can be actually realised.

c) When the inward transfer country is that where the enterprise's head office is located or when the internal transfer is between permanent establishments forming part of that enterprise (b/3; c/5), problems can arise in credit countries. The countries in which the permanent establishments operate will levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year (a/2). Consequently, there will inevitably be a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. This means that if the country of residence does not allow tax credits to be carried forward (or offset tax in some other manner), the profit in question may be overtaxed. From this it can be deduced that the country of residence, too, cannot ignore outward prices as taken into consideration by the permanent establishment country.

By contrast, an exemption country has no particular problem, since it can either accept the notional sum taxed by the permanent establishment country or, in accordance with the principle of economic reality, wait until a profit is actually made. In either case, the profit attributable to the permanent establishment will be exempt.

7. The question then is: what are the practical consequences of the problem that arises when an outward transfer country taxes a profit realised on an internal transfer of goods simply because the goods are leaving its fiscal jurisdiction?

In the opinion of the Committee, the notion of realisation depends mainly on each country's domestic law. It follows that outward transfer countries taxing permanent establishments of foreign countries cannot be expected to defer levying

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tax on transfers of goods until a profit has actually been made, since in their capacity as hosts to foreign enterprises' permanent establishments they obviously cannot follow what happens to a good once it has been transferred and is no longer in their jurisdiction. Head office countries, however, can trace a transaction from beginning to end by referring to the enterprise's general accounts. Therefore, it is logical in such a case that most countries using an exemption method allow deferral of the taxation of the profit on the internal transfer until it is actually realised; as for credit countries, they cannot do otherwise.

Inasmuch as goods transferred by the permanent establishment form part of the enterprise's current assets and are generally used for the manufacture of other products to be sold or sold as they are, the length of time between taxation on the transfer and actual realisation of the profit on it will be quite short. Thus no serious inconvenience will be experienced by the taxpaying enterprise, since it usually keeps its accounts fairly flexibly and if necessary, will be able to move the dates of the two events closer together so that the transfer of goods and the realisation of the profit accruing are disclosed in the same commercial year.

8. A more serious problem relates to the time lag between the transfer of goods and realisation of profit when a permanent establishment transfers fixed assets or— in the event that it is wound up — its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases — which are fairly unusual — several years may pass between the transfer and the realisation of the profit accruing from it. Nonetheless, for the reasons referred to above, it would be unrealistic to expect that the outward country would unilaterally defer levying tax until realisation occurred. For that reason, the Committee believes it is up to the head office country to seek a bilateral solution with the outward country where there is serious risk of double taxation.

Another significant problem concerning the transfer of assets arises in relation to international banking. A number of banks have made loans to customers from countries (including the countries themselves) which are experiencing economic difficulties such as to cast doubt on the value of the debt concerned. Such loans may have been made by the head office of the bank concerned or by one of its branches. Such debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Uncertainty arises as to the taxation significance of such transfers. The first question is whether the transfer should be recognised at all for taxation purposes. In the view of the Committee such a transfer should not be recognised where it cannot reasonably be considered that it takes place for valid commercial reasons

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or that it would have taken place between independent enterprises, for instance where it is undertaken solely for tax purposes with the aim of maximising the tax relief available to the bank. In such cases, a transfer would not have taken place between wholly independent enterprises and therefore would not have affected the amount of profits which a separate enterprise might have been expected to make in dealing independently with the enterprise that has the permanent establishment (paragraph 2 of Article 7).

However, there may be instances in which recognition has to be extended to such a transfer. The arguments for doing so are that there does exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might have been expected to have taken place between independent banks, for example where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans which had been in former years granted by the head office or other branches to residents of the country where the bank has recently opened that branch.

In the opinion of the Committee, any such transfer should be treated (to the extent that it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. The question however arises as to whether relief should be allowed for the difference between the face value of the debt and its open market value in computing the profits of the transferring part of the bank. In the opinion of the Committee, some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values. However, the domestic laws of countries differ as to the point at which relief should be given in respect of the loss suffered in relation to a loan the market value of which has fallen below the face value. Some countries pay regard, for tax purposes, to the market value on a year by year basis, others pay more regard to the loss suffered on final disposal of the loan. It should be borne in mind that, at the time when the bank transfers a loan from one branch to another, no actual loss is occasioned to the bank as a whole and the actual loss to the bank will only be capable of precise measurement at the point when the loan is disposed of or repaid. Nevertheless, it will not always be reasonable to keep the liability of the transferring branch undetermined up to the point when the

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transferred loan is finally disposed of by the bank. In cases where the transferee disposes of the loan after a very short time, the country of the transferor should be entitled to limit the overall relief granted to the bank to the difference between the historic value (generally the face value) of the loan and the amount actually realised on disposal. In such cases, the total loss to the bank as a whole would be relieved in the country in which the transferring branch was situated and there would be no grounds for giving further relief in the country to which the loan was transferred where that country is a country of exemption.

In order that adequate relief for such a loss be granted, the two jurisdictions concerned should reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of the internal transfer, was the result of mistaken judgement as to debtor's solvency or whether the value at that date did reflect an appropriate judgement of the debtor's position at that time. In the former case, it might be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country.

B. Contractual freedom or limited recognition of arrangements concluded between permanent establishments and the rest of the enterprise of which they form part

9. Part B of the questionnaire dealt with this complex question. At the outset, it may be useful to note that while it is true that the term "contract" can rarely apply to arrangements within a single legal entity, nevertheless, tax

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authorities frequently require (or allow) accounting records to be presented as if an arm's length transaction had taken place.

The principle of arm's length accounting (or computation) seems to be universally accepted when the goods or services transferred are essentially the same as those supplied to third parties by the enterprise as part of its principal activity. In all other cases, a general principle of limited recognition applies to arrangements concluded by permanent establishments with other parts of the enterprise of which they form part. This leads to widely differing approaches, depending on the concept that prevails in each particular case (economic reality, equivalent treatment or purely fiscal technique):

— setting of an arm's length price, notably when the functions performed are comparable in nature and in importance to those being traded between companies forming part of the same group;

— exact attribution of the costs relating to the permanent establishment's functions;

— and apportionment of total profit based on the importance of the parties' respective functions.

It seems that limited recognition of arrangements concluded by permanent establishments within the enterprise is often prompted by fear that the application of the arm's length principle and arm's length prices will result in the creation of artificial profits. *Australia's* reply to the questionnaire, for instance, puts this very clearly:

> "The recognition of internal contracts can, however, result in the creation of artificial profits or losses and income or deductions, even to the extent that the taxable income of the enterprise as a whole would differ from that that would be calculated if the enterprise was conducting its business from one point. It is considered that this would be contrary to the principles behind the establishment of taxation treaties.
>
> However, as has been mentioned earlier, the strict application of the arm's length principle to transactions between the permanent establishment and its head office could lead to the creation of deductions which have not been incurred or income which has not been earned by the enterprise, and in this regard we would not necessarily treat the resident and the permanent establishment in the same manner."

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In the opinion of the Committee, such fears are unjustified if one is aware of the role that application of the arm's length price principle within a single legal entity is intended to play. In fact, the purpose of applying that principle should be to determine the tax share of each country in respect of the enterprise's actual profits. The fear expressed by *Australia* is, however, certainly not unfounded if one considers the cases where an enterprise allows itself to be taxed sometimes according to the direct or separate enterprise method and sometimes according to an indirect or apportionment method.

10. The present situation is unsatisfactory both for the corporate taxpayers and the tax authorities involved. Admittedly, enterprises ought to frame their internal agreements more in the light of the functions really performed by the different parties and disclose them in a consistent manner in the head office and permanent establishment accounts, rather than resort to legal artifices that tend to suppose a contractual relationship which in no way reflects economic reality. For instance, an internal agreement could allot to a permanent sales establishment the role of principal (accepting all the risks and entitled to all the profits from the activity) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and receiving a limited share of the resulting income). The opposite situation, too, is conceivable.

It will still, however, be illusory to believe that real functions are being taken into consideration unless this is reflected symmetrically in the accounts of the different parts of the enterprise. It is thus essential that the outgoing valuation in the accounts of the exporting permanent establishment and the incoming valuation in the books of the importing permanent establishment should always correspond exactly — at least in terms of the national currency or the functional currency in which the enterprise records its transactions.

11. The present situation could be improved if all Member countries could agree as to when the direct method and when the indirect method should be applied. Once the appropriate method is agreed upon, it should be used by all the countries where the enterprise performs its activities. Such a symmetrical arrangement would be easier to achieve if all countries could base their computations on the national or functional currency used by the enterprise.

Lastly, the Committee confirmed that even if the head office and permanent establishments kept regular and symmetrical accounts, corporate taxpayers would still have to show that those accounts were a true reflection of economic reality.

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C. Principle of a distinct and separate enterprise: arm's length price or allocation of expenses

12. The purpose of Part C of the questionnaire was to check whether the duality of approach revealed by the Commentary on Article 7 of the Model Tax Convention is in fact reflected in tax authorities' practice.

In general this seems to be so, but there are nevertheless some important exceptions which need to be examined.

C.1 Goods, technology and trademarks, services, financial transactions

13. It would seem that the arm's length price principle is accepted for final transfers of goods when those goods still have a firm market value subsequent to the commercial year during which they are transferred, depreciation allowances being subsequently allowed on the basis of this transfer value. This applies not only to tangible assets in general (raw materials, semi-finished or finished products and industrial equipment) but also to certain intangible assets (know-how, patents and trademarks) — although, of course, final transfer of a patent or of know-how is quite exceptional.

In all other cases, notably as regards central administrative services, the right to use intangible assets, temporary assignment of industrial equipment, transfers of equity holdings and national currency or foreign currency assets (receivables and liquidities), the general rule is allocation of actual (historic) cost. For instance, temporary assignment of equipment will carry a transfer price that generally corresponds to the accounting depreciation of the goods concerned. Most countries therefore exclude royalties or lease payments and even exchange losses or gains on transfers of foreign currency assets.

What, then, are the exceptions to this general trend?

— As regards final transfer of patents, know-how or trademarks, *Australia* allows only the allocation of actual costs;

— *Finland, France, Greece, Italy, Netherlands and Switzerland* allow central administrative services to be invoiced at arm's length prices. However, when the services rendered benefit, to varying degrees, the whole of the enterprise (i.e. the head office and all its permanent establishments) and the direct method is administratively

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impracticable, *France* and *Finland* apportion the actual cost of the services without including a profit margin;

— *France, Greece, Italy and Switzerland* allow rights of use of intangible assets to produce a return at arm's length prices. As regards research and development, *Belgium* allows arm's length remuneration only for services actually rendered, but not for simple accession to rights to use intangible assets;

— *France, Germany, Italy and Switzerland* recognise that industrial equipment may be temporarily assigned at arm's length value;

— *Belgium, Finland, France, Italy, Netherlands, Portugal and Switzerland* recognise that equity holdings and assets expressed in national currency or foreign currency may be transferred at their real value.

However, regardless of the nature of the good transferred or the service rendered, all the outward transfer countries require permanent establishments of foreign enterprises to apply the arm's length price principle (see A/a/2). This is, however, subject to the limitation of this principle in regard to the provision of services which — from the standpoint of the permanent establishment's outward transfer country — are ancillary. The Committee took the view that, in such a case, it is more appropriate to require an allocation of actual costs in accordance with the views expressed in paras. 18-19 of the existing Commentary on Article 7.

14. Given the diversity of replies received, it is not possible to point to a universally accepted method of computing profits and charges applicable both to inward and outward transfer of goods. This is unfortunate, even if satisfactory methods can be arranged to eliminate any resulting double taxation or non-taxation. In the view of the Committee it would be desirable to supplement the existing Commentary on Article 7 by material which makes it easier for Member countries to reach agreement on the appropriate methods to use in particular circumstances.

To some extent the problem derives from the need to reconcile paragraphs 2 and 3 of Article 7 of the Model Tax Convention. It has sometimes been suggested that this reconciliation can create practical difficulties as paragraph 2 requires that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent

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enterprise whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element.

In the view of the Committee, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate entity principle of paragraph 2. In general, independent enterprises will seek to realise a profit and when transferring property or providing services to each other will charge such prices as the open market will bear. Nevertheless, there are circumstances where a particular property or service would not have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate entity principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether such an internal transfer, whether of a temporary or final nature, is similar to one for which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, i.e. by normally including in the sale price an appropriate profit. It is convenient to consider this question separately in respect of each of the headings of paragraph 13 above:

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a) Goods

Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods then it will normally be appropriate for the provisions of paragraph 2 of Article 7 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. As indicated in paragraph 13 above, there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material, i.e. in the case of a plant, the depreciation costs suffered while the plant is in use in particular parts of the trade.

It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment so that no question of attribution of profit arises in such circumstances.

b) Technology and trademarks

As between associated members of a group, there are normally two methods of dealing with intangible costs and rights. The members of the group may agree on some cost sharing mechanism whereby the historic costs of creating the intangible rights are shared between the members of the group. Alternatively, the costs may be borne by one member of the group in which case it is appropriate that other members of the group be expected to pay to the owning member an appropriate royalty etc. having regard to the value of the rights being used. Between non-associated enterprises, a royalty payment is the norm although cost sharing arrangements are used in certain areas.

Similar conditions should, in principle, apply in allocating the profits of a single entity. However, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be

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appropriate to allocate the historic costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. It may be objected that intangible rights may have been created and paid for before parts of the enterprise, e.g. an overseas branch, came into existence but equally it may be that costs of the creation of intangible rights are attributed to a permanent establishment which goes out of existence before the fruition of the rights which it has helped to create. In general therefore it seems that the best solution will usually be an allocation of actual historic costs as they incur. In doing so, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (e.g. the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise. An alternative which was discussed by the Committee is to consider only the divisions that actually created the intangibles as the respective owners and, therefore, also as the exclusive bearers of the said risks. These divisions would consequently be entitled to a risk compensation. But, it is of a greater importance that whatever solution is reached is agreed between the competent authorities of the country of residence and the host country.

c) Services

The area of services is one in which it is often difficult to determine whether in a particular case a service should be charged between the various parts of a single enterprise at its actual historic cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. At one extreme, it may be that it is the trade of the enterprise as a whole to provide services to third parties and that, while in the form a service is provided to another part of the enterprise, in practice it is being provided to an outside customer. In such a case it may be wrong to consider that the service has been provided to another part of the entity.

In more normal circumstances, part of the trade may consist of the provision of such services and there may be a standard charge for their provision. An example might be the financial services provided by banks which may be provided to other parts of the enterprise on exactly the same basis as they are provided to an outside customer. In such a case it will usually be appropriate to charge a service at the same price as is charged to the outside customer.

However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of

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the enterprise benefit from it. In such a case, it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on a historic cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise. This border line may be difficult to determine precisely. In the view of the Committee, it is more important that the taxation authority of the country of the provider of the services and that of the recipient reach an agreement to deal with such services on a mutually consistent basis than it is to decide on which side of the line between the arm's length basis and the historic cost basis the service should properly fall.

d) Financial assets

As to exchange gains or losses on the occasion of an internal transfer of financial assets, the Committee considered that this raises specific questions mainly concerning banks and financial institutions which should not be considered in great detail in this report because the problems are both complex and of a very specialised nature. Some problems relating to the transfer of financial assets are considered in the report on multinational banking enterprises included in a previous publication entitled "Transfer Pricing and Multinational Enterprises — Three Taxation Studies", and nothing in this report is intended to deviate from the views expressed on these various questions in that report. One special problem which is not discussed therein relates to the transfer of debts from one part of the bank to another and is discussed in paragraph 8 above of the present report.

The other main problems dealt with in that previous report were the recognition or non-recognition of charges made in connection with the transfer of funds between various parts of a banking enterprise and the attribution of capital to the permanent establishment of a bank in situations where either actual assets were transferred to such a branch and in situations where they were not. Difficulties in practice continue to arise from the differing views of members on these questions and this report would merely emphasise the desirability of agreement on mutually consistent methods of dealing with these problems.

15. In summary, the Committee judged that the main necessity was for a fiscally neutral approach which avoided both economic double and non-taxation by reason of differences between the approach to these questions adopted by the Member countries. The Committee considered whether fiscal neutrality could be

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achieved by advocating universal application of an arm's length price including normally but not invariably a profit element but for the reasons given above, did not consider that such a universal application, displacing the allocation of costs basis indicated by paragraph 3 of Article 7, was always appropriate. In general terms, the arm's length principle by which a charge for goods, services etc. is based on the price which would have been charged to a third party is generally applicable but there are a large number of cases where the application of such a test leads to the conclusion that as between unrelated parties acting at arm's length, the agreement which would have been reached between them would have been to allocate a particular expense on the basis of historic cost without regard to which of the two unrelated parties actually incurred the cost initially.

C.2 Attribution of a capital endowment, capital raised from external sources (borrowing) or own funds in the form of interest-bearing loans

16. Part C.2 of the questionnaire discusses the question of remuneration for internal borrowing. The rule indicated in the Commentary on the Model Tax Convention is followed by most countries, so that remuneration of internal borrowing is usually not allowed. As a result, interest payments on loans purely for the benefit of a permanent establishment can be deducted for tax purposes only from the income declared by that permanent establishment. In all other cases interest payments are broken down between the head office and all its permanent establishments (the *United States* employs only this indirect method).

Countries seldom have any precise rules on the capital endowment of permanent establishments, so capital varies from one instance to the next and may be quite modest or even non-existent (except for *Australia*). However, in other countries (e.g. *Netherlands* and *Switzerland*), capital will, in fact, not depart from what is usual for comparable enterprises operating in the same line of business. *Finland*, *Italy* and *Switzerland* normally allow internal loans to yield a return. *France*, on the other hand, does so only if the internal financing concerned stems from a commercial relationship. Special problems in this area related to banks are discussed in paragraphs 8 and 14 above.

17. As regards countries which levy a tax on net wealth, it seems that deduction of liabilities is always allowed, insofar as those liabilities result from a transfer for which the tax authorities require, or tolerate, an arm's length price; this means that a corresponding value must appear among the permanent

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establishment's assets. These liabilities are consequently treated in the same way as accounts payable to suppliers.

18. In the context of this survey, the main point is not so much whether debtor/creditor relationships are admissible within the same legal entity as whether arm's length interest rates can be charged. This question arises essentially for two reasons:

— from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is a formal act incompatible with the true legal nature of a permanent establishment;

— from the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity-funded it ought not be allowed to deduct interest charges that it has manifestly not had to pay. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.

In business, an enterprise's head office and its permanent establishments may have recourse to borrowing. If debts were used solely to finance the borrower's activity, the problem would be reduced to one of thin capitalisation. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain extent, the rest of the money borrowed providing basic capital for its permanent establishments.

19. The approach suggested in the Commentary on Article 7, namely the direct and indirect apportionment of actual debt charges, is open to criticism because it can often cause difficulties.

It is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties, since accurate computation is possible only if the average annual status of assets and liabilities in every part of the enterprise can be ascertained. Furthermore, a computation of this nature presupposes that the whole enterprise is engaged in the same activity. What material value could a proportional allocation of interest charge payments have if no distinction were made among the different activities of a highly decentralised firm? Distortions of the taxable results will most likely follow. It is also well known that the direct apportionment of total interest expense may not accurately reflect the cost of

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financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality.

20. After long discussions, the majority of the Member countries considered that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organisation and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks discussed in paragraph 14 d) above. If a permanent establishment were undercapitalised, it would be up to the head office country to avoid any risk of double taxation by allowing a deduction for the part of the interest payments that the permanent establishment had not been able to deduct from its taxable income. If a permanent establishment were overcapitalised, it should be entitled to deduct a fair amount for deemed interest and such remuneration of the financing function would be for the head office a compensation for not investing the amount in long-term loans. The answer to the question as to whether a permanent establishment is under- or over-capitalised will, in principle, depend on the rules and practice of the host country, unless there is a divergent mutual agreement under Article 25 of the Model Tax Convention.

D. Taxation of actual profits; consolidation

21. The principal purpose of Part D of the questionnaire was to see whether there was any possibility, when taxing a permanent establishment, of taking due account of the worldwide profits of the enterprise of which that permanent establishment was a part. This problem obviously arises when one or the other permanent establishment realises a loss or, a fortiori, when the whole company realises an overall loss.

Replies make it very clear that countries hosting permanent establishments of overseas enterprises tax only profits arising by or through those permanent establishments. Consequently, it is for the country of residence of an enterprise, and for that country alone, to take into consideration the enterprise's worldwide profits or losses. On this point there is hardly any difference of opinion between credit countries and exemption countries, although:

— *Belgium*, when it is the country of residence, takes into consideration the losses suffered by certain permanent establishments overseas only

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if those losses exceed gains by other overseas permanent establishments belonging to the resident enterprise concerned;

— *France* applies the territoriality principle to both losses and gains overseas; however, companies resident in France may opt to be taxed under the worldwide profit or consolidated profit system.

22. The above considerations once more raise the difficulties that can occur when permanent establishments are taxed on internal transfers before the profits on those transfers have actually been realised. In some cases, serious risks of overtaxation can be avoided by adopting bilateral arrangements (see paragraphs 7 and 8 above). Nonetheless, the Committee firmly upholds the principle whereby the permanent establishment country has an absolute right to levy tax on profits realised on its territory or, more broadly speaking, on profits attributable to that permanent establishment. There is thus no question of a permanent establishment being allowed a deduction, even provisionally, in respect of any loss suffered by the rest of the enterprise of which it forms part, or of that permanent establishment's being exempted from tax if the company to whom it belongs makes an overall loss. Consequently, if an exemption country takes no account of losses suffered by overseas permanent establishments of a resident enterprise, it is not in any way violating the territoriality principle. However, since most exemption countries do take into account losses suffered by overseas permanent establishments, there is a potential risk of double deduction of such losses, unless the country of residence has the legal possibility to make the necessary retroactive adjustments (e.g. *Netherlands* during 8 years and *Switzerland* during 7 years).

E. Special cases

23. Part E of the questionnaire dealt with special cases and while it is impossible to summarise the solutions suggested under this heading, it is worth noting that all the replying countries recognised that special cases ought to be treated in the light of the arm's length price criterion.

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F. Attribution of profits and principle of non-discrimination

24. Part F of the questionnaire dealt with this question. It is hard to tell whether the permanent establishments of overseas companies are treated, overall, as favourably as resident companies, for where one difference of treatment may be seen as discriminatory, others may, in taxpayers' eyes, be seen as favouring permanent establishments. Furthermore, some differences derive from the real nature of permanent establishments. The principal question is whether this real nature is taken into consideration in a neutral and consistent manner, or whether the patchwork of concepts that exists at present does not require a review of the Commentary on Article 24 (Non-discrimination) as regards permanent establishments.

25. The Committee intends to examine this issue in the context of future work, in particular with respect to provisions that prevent permanent establishments from claiming deductions or exemptions in respect of returns on shareholdings and tax-free allocations to different funds.

G. Methods for the elimination of double taxation

26. Part G of the questionnaire examined the ways in which credit and exemption countries eliminate double taxation. Descriptions by the credit countries of the methods they use to eliminate double taxation may be summarised as follows:

— *Australia*: Worldwide basis, but divided into three income classes. Excess foreign tax credits are transferable within wholly-owned company groups for set-off against Australian tax payable on other similar class of foreign income derived by another group company in the same year;

— *Canada*: Country by country; any unused foreign tax can be carried back three years and forward seven years;

— *Finland*: Country by country with no carry forward or carry-back of excess credits;

— *France*: In case of an optional derogation from the territoriality principle (cf. paragraph 21), overall credit with carry forward for five subsequent years;

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— *Greece*: Country by country with no carry forward or carry-back of excess credits;

— *Italy*: Per country limitation with no carry forward or carry-back of excess credits;

— *New Zealand*: Country by country with no carry forward or carry-back of excess credits;

— *Portugal*: Country by country with no carry forward or carry-back of excess credits;

— *Spain*: The foreign tax credit basis is referred to the income derived from each single operation and coming from the same country with no carry forward or carry-back of excess credits;

— *Sweden*: Overall credit with carry forward for three subsequent years;

— *United Kingdom*: Item by item with no carry forward or carry-back of excess credits;

— *United States*: Worldwide basis, but separately for different types of income (baskets); excess foreign tax credits can be carried back two years and forward five years.

From these answers, it is impossible to tell with any certainty whether a credit system can always prevent double taxation. Even supposing that the tax base on which a credit is granted is materially the same in both the countries concerned, there will still be a difference due to exchange losses or gains. Obviously, if all taxes paid in the permanent establishments countries were to be credited in the head office country and the system entitled the taxpayer to a long enough carry back or forward, complete elimination of double taxation could be guaranteed. But a country-by-country credit system, especially one that comprised no carry back or carry forward entitlement, cannot offer such a guarantee.

27. As regards the exemption countries, it may be said that the tax base in the permanent establishment country and the exemption base computed by the head office country are sure to correspond as long as exchange rate fluctuations are taken into account in calculating the sum eligible for exemption. The two bases also correspond if all exchange rate gains and losses which appear in the overall result of the enterprise expressed in the national or functional currency are systematically taxed or borne by the country of residence (in the case of *the Netherlands*, for example). Furthermore, experience has shown that a per country

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exemption produces accurate results whereas an overall exemption sometimes leads to distortions. When the territoriality principle is strictly applied, the enterprise concerned — even in the long term — will not always escape being overtaxed. Some countries, e.g. *Belgium*, mitigate the consequences of the territoriality principle by the way losses abroad are taken into account (cf. paragraph 21 above).

28. Taxes finally levied by the source countries are not usually offset by credits on the tax due by permanent establishments. Even when there is no doubt at all that the income concerned is attributable to those permanent establishments, this practice apparently remains unchanged. There are, however, some notable exceptions: *Belgium*, *Germany* and *the United States* as a general rule, *the United Kingdom* for the permanent establishments of banks only and *France*, depending on the provisions of its treaty with the source country.

29. However, as this question has already been dealt with in the context of the report of the Committee on "Triangular Cases" (published in 1992 under the title "Model Tax Convention: Four Related Studies"), there is no need for the Committee to make additional recommendations in that respect.

III. CONCLUSIONS AND SUGGESTIONS

30. It is the Committee's opinion that the criteria governing the taxation of permanent establishments could be made clearer and more consistent if the Commentary on Article 7 of the Model Tax Convention were modified in the light of the considerations put forward in this report concerning:

a) the recognition of taxable profit and losses giving rise to deductions for tax purposes (paragraphs 7 and 8 above);

b) the account to be taken of real functions and symmetrical accounting in respect of them, as well as the application of one and the same method by all the countries concerned (paragraphs 9 to 11 above);

c) the interaction of the separate and independent enterprise principles put forward in paragraph 2 of Article 7 of the Model Tax Convention with the cost allocation method found in paragraph 3 of the same Article (paragraphs 14 and 15 above).

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The Committee therefore recommends that the Commentary on Article 7 be amended along the lines of the detailed proposals contained in Appendix III.

31. With respect to the above point 30(c), the Committee is of the opinion that the following question is relevant in order to reconcile the arm's length and the cost allocation principles:

> Is the internal transfer of goods or services (whether temporary or final) one of the same type which the enterprise might in the ordinary course of its activity be likely to have offered to or be requested to supply by an independent third party?

The answer to this question will be in the affirmative if the expense was initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. The answer will be negative if, on the basis of the facts and circumstances of a specific case, it appears that the expense was initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.

Consequently, in applying this test, Member countries should take into account the distinctions suggested in paragraphs 13 to 20 above and should bear in mind that in the absence of a clear dividing line, it is more important that an agreement be reached in particular cases on a method of dealing with problems on a mutually consistent basis than it is to reach unilaterally decisions of principle which are to be universally adhered to despite differences of opinion with other jurisdictions. The mutual agreement procedure provided by Article 25 of the Model Tax Convention should be used where possible to arrive at satisfactory solutions in cases where countries hold differing views whether based on domestic law or on unilateral interpretations of relevant double taxation agreements.

32. As regards international consolidation of profits and losses (paragraphs 21 and 22), special cases (paragraph 23), neutral tax treatment of branches and permanent establishments (paragraphs 24 and 25) and the degree of success achieved by methods for the elimination of double taxation (paragraphs 26-29), the Committee, for the reasons already stated, makes no suggestions.

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Annex I

XL IFA CONGRESS, NEW YORK 1986

Subject I: Transfer of assets into and out of a taxing jurisdiction

RESOLUTION (original version: French)

The XL Congress of IFA meeting in New York, as a result of its discussions, arrived at the following Findings:

1. The physical and non-physical transfer of assets, current or fixed, between tax jurisdictions, whether or not they are the result of a legal transfer of property, may give rise, sometimes even in a third country, to taxation in the absence of real profits. This is mainly the case where, as a result of the transfer, accrued appreciation is recognised although no realisation has occurred. Such taxation jeopardises tax neutrality, having an undesirable impact on business decisions, and hampers free physical and legal circulation of goods even among countries in the process of integration. The reason for this lies in the concern of the countries that taxable substance which they consider as attributable to them would be removed from their control and would ultimately escape taxation.

2. These problems are aggravated when the outgoing and incoming valuations, which are, respectively, the measure of the accrued appreciation for the departure country and which supply, for the country of entry, the basis for the ultimate taxation of capital gain and for amortisation, are not the same. During the debates, it appeared that, whereas the departure country generally applies, for its valuation, the arm's-length criterion, the country of entry uses other methods, such as historical cost reduced by amortisation. This prevents an equitable sharing of taxable substance between the two countries and may lead to double taxation.

3. The examples which have been dealt with in the discussions have shown that these distortions may be particularly disturbing in the case of short-term establishments, such as construction plants and maritime oil rigs.

4. It appeared, first from the report, then in the discussions, that these problems are of little interest to those countries which both in their internal law

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and in their treaties, apply worldwide taxation with a credit relief system ("credit countries"). For those countries, as a rule, there is taxation only when the transfer occurs between legal entities. Then these countries tax the entire capital gain, even that part of it which is attributable to the period during which the asset remained in the departure country. Thus, when the transfer occurs between two credit countries, the first one makes no claim to levy tax on the gain, whereas, if the transfer occurs from a country with a territorial or exemption system ("exemption country") to a credit country, the available credit cannot always prevent the double taxation which may result from aggregating partial taxation in the departure country and total taxation in the country of entry.

In this respect, it was also noted that, by virtue of the consistent application of their own tax rules throughout, the credit countries benefit from the tax sacrifice which may have been made by the departure country for the development of its economy, unless special rules provide otherwise.

5. The discussions highlighted the particular situation where the business of a permanent establishment of a foreign company is contributed in return for shares in a subsidiary in the country of the permanent establishment. Irrespective of whether the taxation method in either country is the credit or the exemption system, the taxation of the accrued appreciation should be deferred in such a way that the right to taxation is safeguarded, until the appreciation is effectively realised.

On the basis of these findings the XL Congress of IFA in the present stage of the study of these problems,

Recommends that:

I. To the extent that the right of the departure country to tax appreciation which has accrued under its jurisdiction in recognised:

a) taxation should be deferred until realisation; this can be achieved for example by providing for a reserve equal to the accrued appreciation, such reserve to be dissolved upon disposal of the goods, or, as to amortizable goods, as amortisation progresses;

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b) the outgoing and incoming valuations should, to the extent possible, be fixed by applying the same criterion, which should be the arm's-length principle.

II. These objectives may sometimes be achieved internally, by administrative and judicial interpretation on the basis of general principles of tax law, and, internationally, by mutual agreement procedures. Time lags between taxation in the two countries may, as recalled by the resolutions of the 1981 XXXVth Congress in Berlin, require waiver of the statute of limitations. In cases that cannot be so ruled upon, legislation should be amended to satisfy the above objectives, either by harmonised unilateral measures, particularly among countries in the process of integration, by means of directives or model provisions, or by supplementing, preferably on the basis of additional provisions in the model conventions, the double taxation avoidance treaties.

III. In all these respects, it is desirable that this research subject be further pursued in future IFA works. Particularly mergers and other similar cross border reorganisations would be a worthwhile subject for IFA.

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Annex II

QUESTIONNAIRE ON THE ISSUES RAISED BY THE TAX TREATMENT OF PERMANENT ESTABLISHMENTS

A. The recognition of profits or losses

General remarks

— It is assumed that the goods and services will be sold or made available to third parties in subsequent commercial years;

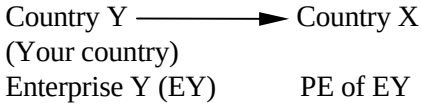
— It is also assumed that the transactions are made in the normal course of business of the enterprise and at arm's length (Section C deals with the actual practices);

— Please answer each question on the assumption that you represent country Y.

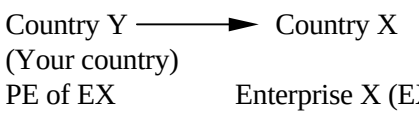
What are the accounting and tax law implications for your country when it is:

a) The outward transfer country

1. In the case of the transfer of economic goods and services from the head office in country Y (a country Y enterprise) to the permanent establishment maintained by the same enterprise in country X.



2. In the case of the transfer of economic goods and services from the permanent establishment maintained by enterprise X (a country X enterprise) in country Y to the head office located in country X.



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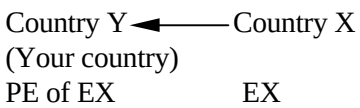
b) The inward transfer country

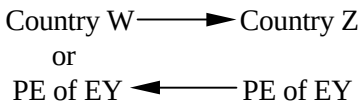
3. In the case of the transfer of economic goods and services from the permanent establishment maintained by enterprise Y (a country Y enterprise) in country X to the head office located in country Y.

4. In the case of the transfer of economic goods and services from the head office in country X (a country X enterprise) to the permanent establishment maintained by the same enterprise in country Y.



c) The country of residence of the head office (enterprise of country Y) which is not directly involved in the business transactions

5. In the case of the transfer of economic goods and services between the permanent establishments maintained by enterprise Y (a country Y enterprise) in countries W and Z.



B. Contractual freedom or limited recognition of arrangements concluded between permanent establishments and the rest of the enterprise of which they form part

What importance do you attach to internal arrangements between the head office and the permanent establishment? In your view, can contractual freedom be applied to business transactions between the parent company and its permanent establishments, or between permanent establishments within a single company?

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Or does your country apply a general principle of limited recognition (i.e., taking account of the economic reality of the transaction) with regard to arrangements concluded between permanent establishments and the rest of the enterprise of which they form part?

C. Principle of a distinct and separate enterprise (Article 7, OECD Model Tax Convention); arm's length principle for intra-company transfers of economic goods and services or allocation of expenses to permanent establishments and head office or also splitting of turnover (or profit) derived from outside transactions (in the case of split business i.e., where both the head office and the permanent establishment take part in a specific economic activity.)

1. Assuming that the imported economic goods or services received should clearly be attributed from an economic and functional standpoint to either the permanent establishment or the parent company, what are the criteria you use to appraise the final transfer or temporary assignment of the following economic goods and services?

Goods

— Transfers of raw materials and semi-finished products;

— Transfers of finished products;

— The transfer of assignment of industrial equipment (this also raises the question of accounting depreciation);

— The transfer of assignment of other economic goods.

Transfer of Technology and Trademarks

— The transfer or assignment of patents;

— Assignment of know-how;

— Common research centre services.

Certain intra-group Services

— Central administrative services.

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Loans and other financial transactions

— Transfers of equity holdings;

— Transfers of national currency or foreign currency assets.

2. The attribution of a capital endowment, capital raised from external sources (borrowing) or also own funds in the form of interest-bearing loans raises various questions:

— Domestic law requirements (deemed capital);

— The treatment of interest directly or indirectly paid to independent lenders;

— The treatment of liabilities emerging from transactions between permanent establishments and head office (deduction in computing the taxable net wealth);

— Other specific questions.

Describe the practice in your country — or if experience is insufficient — the approach you would advocate in the matter.

D. Taxation of actual profits; consolidation

1. As the country of residence of a company (head office), are you required by law or in practice to take account of the company's worldwide profits or losses?

2. As the country of residence of the permanent establishment, are you required by law or in practice to take account of the company's worldwide profits of losses?

E. Special cases (excluding those mentioned in Article 5, paragraph 4 of the OECD Model Tax Convention)

Attribution of profits in the following circumstances:

— Permanent establishments primarily performing a support function relative to the head office (repair and maintenance workshops, permanent assembly plants, coordination services in the case of a "turn-key" contract where the head contractor is a non-resident,

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permanent establishments performing administrative functions for the account of the head office);

— Construction sites (during the construction years and/or at the liquidation);

— Permanent establishment having the sole function of manufacturing the products which are sold by the head office and the other permanent establishments of the company; permanent establishment having the sole function of selling the products manufactured by the other permanent establishments and the head office of the company;

— Persons having authority to conclude contracts in the name of the enterprise (Article 5, paragraph 5, OECD Model Tax Convention), e.g., the agent of an insurance company;

— Other special cases.

F. Attribution of profits and principle of non-discrimination

Does your country treat the permanent establishments of foreign companies invariably as favourably as resident companies (e.g., with respect to the carrying forward of losses, with respect to tax rates, foreign tax credit)?

G. Methods for the elimination of double taxation

— Please describe briefly the method (credit, exemption) you use to avoid double taxation and provide one or two numerical examples.

— On what basis is the credit or exemption granted?

— The treatment of third country withholding tax on income which is effectively connected with a permanent establishment.

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Annex III

PROPOSED MODIFICATIONS TO THE COMMENTARY ON ARTICLE 7 OF THE MODEL TAX CONVENTION[2]

It is proposed to:

1. Delete the last two sentences of paragraph 2 and replace them by the following :

> ***"However, since such problems may result in unrelieved double taxation or non-taxation of certain profits, it is more important for tax authorities to agree on mutually acceptable methods for dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25, than to adopt unilateral interpretations of basic principles to be adhered to despite differences of opinion with other States. In this respect, the methods for solving some of the problems most often encountered are discussed below."***

2. Replace paragraph 11 by the following new paragraph 11:

> "11. This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. ***This corresponds to the "arm's length principle" discussed in the Commentary on Article 9.*** Normally, ***the profits so determined*** would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. ***The arm's length principle*** also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise; but Contracting States which

2. Changes to the existing Commentary appear in bold italics.

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consider that the existing paragraph does not in fact cover these more general transactions may in their bilateral negotiations, agree upon more detailed provisions ***or amend paragraph 2 to read as follows***:

> ***"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 independent enterprise engaged in the same or similar activities under the same or similar conditions."***

3. Replace paragraph 12 by the following new paragraphs 12, 12.1 and 12.2:

> "12. In the great majority of cases, trading accounts of the permanent establishment — which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches — will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 24 to 28 below). But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasised that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.
>
> ***12.1 This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and***

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that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal.

12.2 ***In this respect, i***t should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment (cf. paragraphs ***17.1*** below and following)."

4. Replace paragraph 13 by the following new paragraph 13:

"13. Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with ***the arm's length principle (cf. paragraph 2 above)***. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent

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with this ***principle***, and profits have thus been diverted from the permanent establishment to the head office, or vice versa."

5. Replace paragraph 15 by the following new paragraphs 15 to 15.4:

"15. ***Many*** States consider that there is a realisation of a taxable profit when an asset, ***whether or not*** trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated ***below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law.***

15.1 Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or — in the event that it is wound up — its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of overtaxation.

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

15.3 However, there may exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might have been expected to have taken place between independent banks. An instance of such a transfer might be a case where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans previously granted to residents of that country by the head office or other branches. Any such transfer should be treated (to the extent that it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. Some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values (this question is further discussed in the Report of the Committee entitled "Attribution of Income to Permanent Establishments", which will be published in 1994).

15.4 Where loans which have gone bad are transferred, in order that full, but not excessive, relief for such a loss be granted, it is important

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that the two jurisdictions concerned reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of the internal transfer, was the result of mistaken judgement as to debtor's solvency or whether the value at that date did reflect an appropriate judgement of the debtor's position at that time. In the former case, it might be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country."

6. Replace paragraph 17 by the following paragraphs 17 to 17.7:

"17. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3

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indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions, whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

17.1 In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to realise a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, i.e. by normally including in the sale price an appropriate profit.

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17.2 On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.[3]

17.3 Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph (2) to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material, e.g. in the case of machinery, the depreciation costs that relate to its use by each of these parts. It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (sub-paragraph 4 d) of Article 5) so that no question of attribution of profit arises in such circumstances.

17.4 In the case of intangible rights, the rules governing the relations between enterprises of the same group (e.g. payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate "ownership" of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the

3. Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have already been dealt with in a separate study entitled *The Taxation of Multinational Banking Enterprises* (published in 1984 under the title *Transfer Pricing and Multinational Enterprises — Three Taxation Issues*) and which are the subject of paragraphs 19 and 20 below.

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enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate the actual costs of the creation of such intangible rights between the various parts of the enterprise without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences of any research and development activity (e.g. the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge.

17.5 The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer.

17.6 Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case.

17.7 However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing

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the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise."

7. Replace paragraph 18 by the following new paragraphs 18 to 18.3:

"18. Special considerations apply to payments which, under the name of interest, are made to a head office by its permanent establishment with respect to loans made by the former to the latter. In that case, the main issue is not so much whether a debtor/creditor relationship should be recognised within the same legal entity as whether an arm's length interest rate should be charged. This is because:

- ***from the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is a formal act incompatible with the true legal nature of a permanent establishment;***
- ***from the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity-funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. While, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.***

18.1 If debts incurred by the head office of an enterprise were used solely to finance its activity or clearly and exclusively the activity of a particular permanent establishment, the problem would be reduced to one of thin capitalisation of the actual user of such loans. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain extent, the rest of the money borrowed providing basic capital for its permanent establishments.

18.2 The approach previously suggested in this Commentary, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect

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apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustments may need to be made to reflect economic reality.

18.3 Consequently, the majority of Member countries considered that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organisation and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below (this question is further discussed in the Report of the Committee entitled "Attribution of Income to Permanent Establishments", which will be published in 1994; cf. also the report on Thin Capitalisation published in 1987 in the series "Issues in International Taxation" [no 2])."

8. Replace paragraphs 19 and 20 by the following new paragraphs 19 and 20:

"***19. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises. This problem, as well as other problems relating to the transfer of financial assets, are considered in the report on multinational banking enterprises included in the OECD 1984 publication entitled "Transfer Pricing and Multinational Enterprises — Three Taxation Studies". This Commentary does not depart from the positions expressed in the report on this topic. One issue not discussed in the report relates to the transfer of debts by bankers from one part of the bank to another; this is discussed in paragraph 15.2 to 15.4 above.***

20. The above-mentioned report also addresses the issue of the attribution of capital to the permanent establishment of a bank in situations where either actual assets were transferred to such a branch

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***and in situations where they were not. Difficulties in practice continue to arise from the differing views of Member countries on these questions and the present Commentary can only emphasise the desirability of agreement on mutually consistent methods of dealing with these problems.*"**

9. At the beginning of paragraph 21, replace the words "The third case" by "***Another case***".

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TAX SPARING
A Reconsideration

(adopted by the OECD Council on 23 October 1997)

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FOREWORD

The changes in the international setting have lead both OECD Member and non-Member countries to reconsider their attitude towards including tax sparing provisions in their tax treaties. This re-consideration has in particular been provoked by the realisation that tax sparing provisions in treaties offer wide opportunities for tax planning and tax avoidance.

This report explains why Member countries have become more reluctant to grant tax sparing in treaties. It also provides a set of suggestions ("best practices") on the design of tax sparing provisions to minimise abuse.

In approving the Report by the Committee on Fiscal Affairs on "Tax Sparing: A Reconsideration, on the 23rd October 1997, the OECD Council adopted a Recommendation to the Governments of Member countries and instructed the Committee to pursue its work on issues pertinent to tax sparing and to develop a dialogue with non-Member countries that request tax sparing, with the aim of developing a more coherent position on the granting and design of tax sparing provisions (see Annex VIII).

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I. INTRODUCTION

a) The changing global economic framework

The removal of capital controls and the continuing liberalisation of the financial markets have increased the flows of cross-border investment and accelerated the pace of integration of national economies. Improved global communication technologies have enabled large corporations and financial institutions to develop global strategies. Whilst these developments have lead to a rapid expansion of cross border activities, which in turn has increased the wealth of nations, they have also increased the geographical mobility of national tax bases and the scope for tax avoidance and evasion.

Globalisation has also contributed to the integration of non-OECD economies into the world economy. Many Asian and Latin American countries are today major players in the world economy and account for an important part of global trade and investment. They are amongst the largest trading partners and recipients of inward investment from OECD Member countries. This rapid economic growth in the Asian and Latin American regions has created a more balanced distribution of trade and investment flows between OECD Member and non-Member countries.

The move from planned to market economies by the former Soviet bloc countries has brought new actors into the international economic arena and already some of these economies, particularly Russia, are playing an increasingly important role in international trade.

These developments have blurred a number of traditional distinctions which underlie existing international tax arrangements. Outside of the OECD area there are an increasing number of countries which have a high per capita income and a developed and diversified industrial base. Many of these countries are rapidly developing their service and high technology sectors. A number of them (*e.g.* Argentina, Chile, Singapore, Chinese Taipei) have a higher per capital income than some of the less developed Member countries.

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Similarly, the assumption that all OECD Member countries are major exporters of capital and all non-Member countries are major importers of capital is increasingly being questioned. Australia, the Czech Republic, Canada, Hungary, Mexico and Poland, for example, are major importers of capital, whilst non-member countries such as Chile, Chinese Taipei, Singapore are now major sources of foreign direct investment.

Many OECD Member countries share the tax policy concerns of non-Member countries which rely on the extraction and processing of natural resources. Australia, Canada, Norway, the UK and the US are all major natural resource producers.

Today's world is far too complex and diversified to allow traditional and potentially misleading distinctions to influence approaches to negotiating tax treaties. A reassessment is required recognising that whilst there are many countries outside of the OECD area which remain developing countries (most African countries for example), a growing number of non-Member countries are now rapidly catching up with Member countries in terms of their level of economic development.

This increasing commonality of interest between OECD Member and certain non-Member countries needs, however, to be put in perspective. Whilst investment flows between OECD Member and non-Member countries are now becoming more balanced, most developing countries continue to rely heavily on capital imports for their development and this is unlikely to change in the immediate future.

Many countries provide incentives to encourage domestic and foreign investment. These can take the form of cash grants, in-kind advantages (*e.g.* free land), favourable access to government contracts and tax incentives. This note is concerned with the issues that arise when subsidies are delivered by means of the tax system.

Whilst recognising the right of source countries to structure their tax systems in accordance with their own objectives, the purpose of this report is to promote a collective reconsideration of tax sparing provisions and to assist in the development of a more coherent approach by both OECD Member and non-Member countries to tax sparing.

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At the outset, it may be useful to provide a brief description of what is "tax sparing". To encourage foreign investment, many countries grant different kinds of tax concessions to foreign investors. When such a country concludes a convention with a country that applies the exemption method (see Article 23A of the Model Tax Convention), no restriction of the relief given to the taxpayer arises, because the other country must give exemption regardless of the amount of tax, if any, imposed in the country of source. The exemption method usually applies to direct investments (*e.g.* investments made through subsidiaries or permanent establishments). But where the other country applies the credit method (see Article 23B of the Model Tax Convention), the concession may be nullified to the extent that such other country will allow a deduction only of the tax actually paid in the country of source. This may be seen as frustrating the other country's tax incentive legislation.

Box I

EXAMPLE

Company A that is a resident of country X establishes subsidiary S in country Y. S derives 100 in net income during its first year of operation. The income tax rate in country Y is 30 per cent. Because of applicable tax incentive legislation in country Y, S pays no income tax during the first five years of operation. Accordingly, the taxes spared in year 1 by S in country Y amount to 30.

In year 2, S pays 50 of its net income in dividends to A in country X. The corporate income tax rate in country X is 40 per cent. There is no tax at source on outward dividends in country Y. Country X taxes foreign dividends at the full corporate income tax rate, but allows a credit for foreign taxes paid, including corporate income tax paid by foreign subsidiaries on income out of which the dividends are paid (the "underlying tax" on the income distributed). Since no tax has been levied in country Y on the distributed income, A will pay 20 in corporate income tax on the dividends in country X (40 per cent out of 50).

To avoid that result, some countries have agreed to include "tax sparing" provisions in treaties with developing countries. In the case of a credit country, tax sparing provisions basically enable the investor to obtain a foreign

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tax credit for the taxes that have been "spared" (*i.e.* not actually paid) under the incentive regime of the source country. Similarly, to the extent an exemption country applies the credit method, *e.g.* in respect of portfolio dividends or interest (see Article 23A of the Model Tax Convention), a tax sparing provision will enable a crediting of the tax that has been spared in the source country.

Box II

EXAMPLE

Following the example above, the tax sparing provision in the tax treaty between country X and country Y would require country X to grant A a credit for the taxes that would have been paid by S on the distributed income in the absence of the incentive legislation in country Y. The tax due on the dividends in country X amounts to 20 (40 per cent out of 50). However, A is now granted a credit of 15 (30 per cent out of 50), constituting the tax that would have been paid in country Y had S not benefited from the incentive legislation. Because of the tax sparing provision in the treaty, A will pay only 5 in income tax in country X on the dividends.

b) Tax sparing - a time for reconsideration?

The new global environment has encouraged, and in some cases even compelled, countries to re-examine established tax structures and the policies upon which taxation arrangements are based. Tax sparing arrangements have not escaped this scrutiny. Tax sparing provisions have more than four decades of history in bilateral tax treaties, including treaties between OECD Member countries, but the world of today is quite different from that when the positions of Member and non-Member countries towards tax sparing were developed.

The large majority of the OECD Member countries are of the view that the provision of tax sparing in treaties is not an effective way to promote foreign investment and to promote national economic goals. These views have been reinforced by the overall disappointing experience of most Member countries and many economies in transition with the use of tax incentives: a

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trend well documented in a recent OECD publication entitled "Taxation of Foreign Direct Investment" (1995). Furthermore, recent experience shows that tax sparing provisions offer ample opportunities for tax planning and tax avoidance which undermines the tax bases of both the residence and source country.

There are also many misconceptions of the views of foreign investors to tax sparing. Investment decisions taken by international investors resident in credit countries are rarely dependent on or even influenced by the existence or absence of tax sparing provisions in treaties. This is supported by the experience of the international business community which encourages countries to conclude treaties regardless of whether tax sparing can be obtained.

At the same time, some non-Member countries are becoming concerned about the concessions that they have to make to obtain tax sparing when negotiating tax treaties. These concessions may take the form of lower withholding tax rates or stricter permanent establishment rules. These countries are questioning whether the price of obtaining tax sparing is too high given the limited benefits of such provisions.

This report presents a brief overview of the historical background of tax sparing provisions (section II) and of the traditional country views on tax sparing (section III). A review is provided of the reasons behind the changing Member country attitudes to tax sparing (section IV). It further provides an analysis of recent trends and current Member country practices (section V), and some best practices in regard to the design of tax sparing provisions (section VI). Finally, some recommendations are made in section VII. Annex I reproduces in alphabetical order the Member country tax sparing provisions referred to in this report and Annexes II and III provide charts of existing tax sparing provisions in treaties between OECD Member countries and between OECD Member countries and selected non-Member countries. Annexes IV and IV contain examples of tax avoidance schemes detected in Member countries. Annex VI reproduces examples of Member country model tax sparing anti-abuse provisions and Annex VII reproduces the section on tax sparing in the OECD Model Tax Convention. The recommendation of the OECD Council on the granting and design of tax sparing in tax conventions is reproduced in Annex VIII.

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For the purposes of this report, the term “resident country” refers to the country that grants tax sparing in a tax treaty. The terms “host country” and “source country” refer to the country to which tax sparing is granted.

c) The growing importance of the Model Tax Convention outside the OECD area

The changing global economic framework and increasing economic strength of many non-Member countries in both Asia and Latin America have led to a reconsideration of non-Member countries attitudes to tax treaties.

Many advanced non-Member countries are today in the process of expanding and up-dating their tax treaty network. Some, particularly in the Latin American Region (following the lead of Mexico and taking into account the development of regional trading blocs), are re-assessing their policy of not negotiating tax treaties. Since several of these countries are both capital exporters and capital importers, they have begun to look to their policy interests as both source and residence countries rather than as one or the other. This has led to an emerging recognition among many advanced non-Members that tax treaties which follow the OECD Model Convention provide a favourable tax climate to promote cross-border flows of investment and trade, although they will not always wish to follow all of the provisions of the Model.

Most of the 1500 or so bilateral tax treaties currently in force world-wide are based on the Model Tax Convention. The Model is widely used not only in treaty negotiations between Member and non-Member countries, but also in negotiations between non-Member countries. The importance of the OECD Model is further evidenced by the fact that about 90 per cent of the text of the UN Model Tax Convention is based upon the OECD Model. The growing interest among non-Members to become more closely associated with the work of the Committee on Fiscal Affairs in this area also supports this view.

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II. THE HISTORICAL DEVELOPMENT OF TAX SPARING PROVISIONS

One early reference to tax sparing can be found in the 1953 report of the British Royal Commission (referred to by Prof. Surrey at the US Senate hearings on 9 August 1957). The Commission examined the question of aiding British investment abroad through tax policy and recommended adoption of the concept of tax sparing. The Parliament debated the issue in 1953 and a second time in 1956. The Commission proposal was finally rejected by the Chancellor of the Exchequer in 1957. However, the debate on the issue continued in the following years and, in 1961, legislation was enacted enabling the UK to give relief to developing countries for taxes spared under foreign incentive programmes tailored to promote industrial, commercial, scientific, educational or other development.

Tax sparing appeared in a treaty context for the first time in 1957 in a treaty negotiated between the United States and Pakistan. The tax sparing provision of the US-Pakistan treaty is reproduced in box III below:

Box III

Pakistan-US (1957) - Article XV

For the purposes of this credit there shall be deemed to have been paid by a United States domestic corporation the amount by which such Pakistan taxes (other than the business profits tax) have been reduced under the provisions of section 15B of the Income Tax Act, 1922 (XI of 1922) as in effect on the date of the signature of the present Convention: Provided, that any extension made by law of the period within which an industrial undertaking may be set up or commenced in order to obtain the reduction provided in section 15B shall be deemed to be in effect on the date of the signature of the present Convention. [...]

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As regards the scope of benefits covered, the Pakistan-US treaty (1957) provided for temporary tax sparing on business (permanent establishment) income, derived by specified enterprises established during 1958 which were partially or fully exempt from tax by a certain Pakistani statute. As regards limitations, tax sparing was applied only to tax reductions or exemptions granted under the specified law that was in force at the date of the signature of the treaty. The tax sparing credit was available only for investment that earned no greater than a 5 per cent return.

The US Senate, however, firmly rejected the tax sparing provision in the proposed US-Pakistan treaty and refused to ratify the treaty in its original form because of the inclusion of the tax sparing provision. The United States has ever since steadfastly opposed the inclusion of tax sparing provisions in their treaties.

Notwithstanding the consistent US opposition to tax sparing, the inclusion of tax sparing provisions in treaties by other countries increased world-wide throughout the 1960s and 1970s. Furthermore, the tax sparing provision of the non-ratified US-Pakistan treaty (as well as other tax sparing provisions in US treaties that were negotiated in the late 1950s but that never entered into force) came to influence the design of tax sparing provisions in other treaties, notably with respect to the scope of benefits covered and to limitations.

In some cases, the provisions were broader than the original proposals in the US treaties. For example, formulations that would allow continuation of tax sparing after amendment to the incentive provisions were added in a number of treaties (a) clarifying the continued application in the case of minor modification of the specified measures [*e.g.* Pakistan-UK 1961], (b) allowing the possibility to agree bilaterally to extend tax sparing to subsequent substantially similar measures [*e.g.* Pakistan-UK (1961)] or (c) allowing broad possibilities for expansion [*e.g.* Italy-Zambia (1972)].

The benefits of tax sparing were also expanded to include reduction of tax in a source country by agreed treaty rates applicable to the payments of dividends, interests and royalties [*e.g.* France-Israel (1963), Japan-Korea (1970)].

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Another development was that the amount of withholding tax "deemed paid" on the payment of dividend, interest and royalties was fixed in a number of tax treaties [*e.g.* Germany-Indonesia (1977), Brazil-Japan Protocol (1976].

Time limitations were also introduced, generally in one of the following two types: *a)* limiting the application of tax sparing benefits to a specified number of years in respect of a particular source [*e.g.* UK-Indonesia (1974)] or *b)* limiting the effect of the tax sparing provisions ("sunset" clause) by providing for the expiration of the provision [*e.g.* Sweden-Philippines (1966)] or by applying mandatory review [*e.g.* the Australia-Singapore treaty signed in 1969 would have expired in 1974 had there been no agreement by the governments in the form of an Exchange of Notes]. The issue of introducing "Sunset" clauses was raised relatively early, but their use did not seem to spread until the mid-1980s.

A discussion of the tax sparing issue was inserted in the Commentary on Article 23 of the 1963 Draft Double Taxation Convention. This discussion was expanded in the 1977 Model Tax Convention. The Commentary refers to various formulations by a brief description of their nature. (paragraphs 72-78 of the Commentary on Article 23 of the Model are reproduced in Annex VII).

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III. TRADITIONAL COUNTRY POSITIONS ON THE ISSUE OF TAX SPARING

Many OECD Member countries that have been critical to or opposed the inclusion of tax sparing provisions in treaties apply the credit method to avoid double taxation. These countries generally take the view that the overall tax system of a particular country should be neutral so that the tax consequences of investment decisions ought to be the same regardless of whether the investment is made at home or abroad. Tax considerations should not influence investors' decisions to invest domestically or abroad.

To satisfy this objective, many such countries apply the foreign tax credit method in taxing foreign source income. Tax sparing provisions are incompatible with the policy behind the credit method in that they preserve the effectiveness of foreign tax incentives, making it more favourable, with respect to taxation, to invest abroad than at home.

With the exception of the United States, developed countries have nevertheless granted tax sparing to developing countries in treaties. The reasons are several.

Most Member countries have traditionally viewed tax sparing as part of the foreign aid policy and granted it with a view to promoting industrial, commercial, scientific, or other development in developing countries. Some Member countries have granted tax sparing as a matter of tax policy. This policy has partly been prompted by a fear that a consistent application of the credit method would put their resident investors at a competitive disadvantage compared to local or other foreign investors able to fully benefit from tax incentives in the host country.

Tax sparing is also frequently used as a bargaining chip in treaty negotiations. Some Member countries are prepared to offer tax sparing in exchange for other benefits; for example, lower withholding taxes on dividends, interest, and royalties. Furthermore, some developing countries simply refuse to conclude treaties unless tax sparing is granted. Many OECD Member countries

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have therefore accepted the necessity of granting tax sparing in order to have treaties with certain developing countries (however, see Section II, paragraph 5 for the position of the United States).

Tax sparing is also an issue for countries that are usually categorised as "exemption countries" to the extent that these countries still apply the foreign tax credit method to certain categories of foreign income, typically passive, portfolio income, and/or operate a general exemption system which provides for the possibility to switch-over to the credit method in particular situations (anti-avoidance rules may provide that foreign direct investment dividends or business income are exempt only if the income has been subject to a certain minimum taxation in the foreign country).

The exemption-oriented countries usually attach more importance to creating a tax environment where their MNEs can operate on equal terms with local investors in foreign markets than creating a tax neutral environment in relation to other resident investors. This is particularly so for smaller countries that have small domestic markets, but relatively large numbers of companies operating globally. In these countries, foreign investment tends to supplement rather than constitute a substitute for domestic investment, as the domestic markets provide few investment opportunities for their resident MNEs.

These countries have often been more willing to grant tax sparing to developing countries. In part, they have been influenced by the considerations mentioned in paragraphs 4 and 5 of this section. In part, it has simply been considered consistent with their overall tax policy objectives to grant tax sparing.

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IV. TAX SPARING: AN EMERGING CONSENSUS ON THE NEED FOR A RE-EVALUATION

A re-evaluation of the benefits of tax sparing is underway in many countries, both within and outside of the OECD area. This re-evaluation has been prompted by the trends referred to in Section I of this paper, by a greater awareness of the potential for abuse of tax sparing provisions and a greater awareness on the ineffectiveness of tax incentives to promote economic development.

a) The new global economic framework

The increasing economic strength of non-Member countries

Over the years, the primary policy rationale for granting tax sparing has been the necessity to promote economic development in developing countries. Some countries which were developing countries in the 1960s and 1970s, are now economically much more sophisticated. Certain non-Members have today reached an economic level which is equivalent or even superior to that of some Member countries. These developments have made many OECD Member countries more reluctant to grant tax sparing provisions in new or renegotiated treaties.

The repercussions on the resident countries of granting tax sparing

The tax sparing device was developed at a time when the size of global trade and investment was relatively modest, national markets were heavily regulated and where there were extensive controls on inward and outward investment. As globalisation has radically increased the amount of cross-border trade and investment and lowered or eliminated traditional barriers on such activities, the potentially adverse effects on the resident country economy of granting tax sparing have become more evident in recent years. Because of the difficulty of limiting tax sparing to typically domestic activities, parts of the industry of the resident country may inadvertently end up

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competing with enterprises falling under incentive legislation in the host country (indirectly) benefiting from tax sparing (as regards economic distortions and abuse, see below).

b) Tax sparing as an instrument of foreign aid

As can be seen from the criteria used by countries to grant tax sparing, foreign aid considerations are taken into account.

Direct foreign aid is a relatively transparent means of providing assistance to developing countries. The recipient(s), the amount, and the anticipated use of the foreign aid can generally be established in relatively precise terms. Many of the control mechanisms associated with foreign aid are missing from tax sparing. The resident country is not usually involved in the identification, assessment, design, implementation, monitoring and evaluation of tax spared projects. Tax sparing viewed as aid is also subject to the traditional criticism attached to any form of tied aid; the assistance is linked to companies resident in the country providing the tax sparing. Generally speaking there are no limits on the amount of tax sparing provided. The only limit is the amount of income generated by investors in the host country. Often, it is impossible for the home country to assess accurately the tax revenue cost of its tax sparing arrangements. Furthermore, tax treaty negotiators mostly grant tax sparing without considering the nature and extent of other direct aid flowing to that developing country. The value of the tax sparing to the investors fluctuates with the rates of tax in the host and home country. Some commentators have agreed, however, that tax sparing has the advantage of being an automatic transfer of resources and one which promotes directly private sector development (for a more general discussion on the advantages and disadvantages of assistance provided directly or by means of the tax system, see Section IB of the 1984 OECD report, “Tax Expenditures. A Review of the issues and Current Practices”).

c) Tax Sparing may encourage an excessive repatriation of profits

The purpose of tax incentives for which tax sparing is typically required is to attract foreign direct investment. Tax sparing provisions may have a counterproductive effect in this regard in that they provide an encouragement for foreign investors to repatriate an excessive percentage of their profits rather

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than to re-invest these profits in the source country to consolidate or to expand the original investment, and thereby further promoting that country's economic development. Indeed, in the case of foreign investment through a local subsidiary, which is by far the most common form of foreign direct investment, tax credit countries typically defer tax on subsidiary profits until those profits are distributed. When those distributed profits bring with them a tax sparing credit, the effects of tax sparing are perverse since it encourages the return of profits to the residence country rather than the re-investment of these profits in the country of operation. Consequently, source countries, particularly those wishing to encourage re-investment, need to give careful consideration to achieving a proper balance between the need to attract new investment and the need to encourage re-investment of profits made by existing foreign investors. Tax sparing risks upsetting this balance.

Box IV

In renegotiating expired tax sparing provisions, OECD Member countries are often presented with figures of the actual flows of dividends and other income out of the host country to illustrate the amounts that would be immediately taxed in the residence country in the absence of the tax sparing provision. However, these figures are often necessarily inflated, because they are premised on the existence of a clear incentive (the provision of tax sparing relief) to repatriate profits early. Regardless of the existence of any tax sparing provision, it is recognised that companies operating in countries with high rates of inflation tend to have their profits from those operations repatriated as quickly as possible.

d) The basic assumption underlying tax sparing is invalid

The preceding comments also point to a deficiency in the basic assumption underlying tax sparing, *i.e.* that without tax sparing, the tax foregone through the granting of a tax incentive will accrue to the treasury of the country of residence of the investor. This assumption requires that the income that has benefited from the tax incentive be taxed also in the country of residence of the investor. However, companies tend to maximise the tax benefits derived from incentives even in the absence of tax sparing. Taxation in

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the country of residence may either never occur or may occur only after a number of years.

First, as already noted, in the case of foreign investment through a local subsidiary, which is by far the most common form of foreign direct investment, tax credit countries will not tax the subsidiary's profits until those profits are distributed as dividends.[1] Yet a large part of profits of companies are never distributed as dividends, but re-invested in the country of origin or abroad.

Also, since dividends may be paid only many years after the underlying profits are earned, if one wanted to determine to what extent the tax imposed in the country of residence offsets the tax foregone in the source country through the tax incentive, one would need to discount the amount of residence tax to reflect its present value at the time the income is earned.

Finally, one should also take account of the particular features of foreign tax credit systems. When tax sparing is not granted and the foreign profits which have not borne local tax because of a tax incentive provision are repatriated (or included in the tax base currently in the case of branch operations), it is not the case, as if often assumed, that the residence country will automatically increase its share of tax revenues from the local investment. Almost all credit-based residence countries allow a broad "averaging" of income and income tax rates for active business income. Thus the repatriation or accrual of low-taxed or untaxed foreign income will often simply allow the investor to utilise credits for "excess" taxes already paid with respect to other higher-taxed investments. As a result of the general lowering of tax rates in OECD Member countries in recent years, the large majority of corporate investors appear to be in "excess" credit positions and can thus effectively utilise tax-free foreign income. As a result, in most cases, the investor and not the residence country in effect benefits from the local tax incentive.

The foregoing point may be illustrated by the experience of the United Kingdom. The UK allows credit for foreign tax paid on an item of income only against the UK tax otherwise payable on the same item of income. Foreign tax that cannot be credited in this way cannot be relieved in another year. Many UK groups seek to circumvent these restrictions by using so-called "mixer companies". The mixer company will be the immediate subsidiary of a UK company and it will in turn hold investments in a number of other companies.

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Some of these will be in high tax jurisdictions and others in low tax jurisdictions. The mixer company may, for example, receive from one subsidiary gross dividends of 100 in respect of which no foreign tax is paid and gross dividends of 100 from another subsidiary in respect of which foreign tax (underlying or indirect tax as well as withholding tax) of 66 is paid. Out of those two separate streams of income the mixer company will pay a single gross dividend of 134 to the UK. If the mixer company is resident in another EC Member State, no withholding tax will be deducted from the dividend paid to the UK company. The latter will be regarded for UK tax purposes as having received a gross dividend of 200 in respect of which credit relief of 66 is available. This is exactly the amount required to cancel UK tax liability on the dividend at 33 per cent. In the Finance Act 1997, the UK Parliament enacted legislation to counter avoidance schemes that took the abusive use of mixer companies beyond acceptable limits, for example by buying-in highly-taxed foreign income from a previously unconnected group.

Box V

The US business community, established in foreign countries that have been unwilling to conclude tax treaties with the US without tax sparing, has in recent years encouraged those countries to enter into treaty negotiations with the US, notwithstanding the consistent US opposition to granting tax sparing. Many US companies have acknowledged that they do not need tax sparing to invest in a developing country. These companies recognise that it is rather the absence of a tax treaty, not the absence of tax sparing, that deters further investment.

e) Effectiveness of tax incentives

As discussed below, another reason for the growing opposition to the use of tax sparing is the overall disappointing experience of OECD Member countries and other countries with the use of tax incentives. Tax incentives are viewed by a growing number of countries as distortive and as an inappropriate tool for economic development (see the 1995 OECD report, “Taxation and Foreign Direct Investment. The Experience of the Economics in Transition”). During the past decade, the policy of most OECD Member countries has

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therefore been to move away from the use of tax incentives and instead broaden the income tax base and reduce the tax rates. While developing countries are of course free to set their own policies regarding tax incentive devices, Member countries are also free to question the effect that such devices can have on their own tax base through tax sparing.

Whilst all OECD Member countries continue to use some form of tax incentives, these incentives are increasingly focused on specific areas, particularly where there are significant externalities. Thus many countries provide specific tax incentives for Research and Development and for environmental purposes. Nevertheless the general trend has been to move away from general tax incentives to promote economic development. The following paragraphs summarise the experience of OECD countries and of the former Socialist countries with the use of tax incentives. These experiences may also apply to other countries. A full description of these experiences can be found in the 1995 OECD report referred to in the previous paragraph.

Costs and gains

The direct cost of a tax incentive is the resulting foregone tax revenues. The expectation is that a small contribution of public funds will induce a substantial increase in private sector funds for investment. However, most empirical evidence suggests that the foregone tax revenue exceeds the increase in the desired investment (*e.g.* the Canadian experience suggests that a dollar of revenue foregone yields only 80 cents of new investment that would not have been undertaken in the absence of the incentive). The reason is that it is very difficult to target exclusively incremental investment. Therefore, a substantial amount of the incentives generates investment that would have occurred in any event.

Targeting

It is difficult to ensure that the companies which are intended to use the incentives are able to do so with any degree of confidence. But it is even more difficult, as most developing countries have found, to ensure that taxpayers who are intended to be excluded are effectively precluded from taking advantage of the incentives. Taxpayers naturally arrange their affairs to qualify for the incentives. For example, where tax concessions are available only to

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foreign investors, domestic investors may, to become eligible for the tax concessions, establish a foreign subsidiary and then route purely domestic investments through that foreign company. The negative impact of tax planning alone may neutralise the public benefits otherwise flowing from the incentives. Anti-avoidance rules are therefore often required. These rules are inevitably complicated and frequently work against the certainty that is required if there is to be any positive effect from the measure.

Furthermore, because foreign investors have difficulty in knowing how long tax incentives will be maintained, the incentives tend to attract companies engaged in sectors such as the retail trade and the service sector. These categories of activities are, however, highly mobile ("footloose" companies). Therefore, when the incentives expire, the activities often move to other jurisdictions offering the same type of incentives. The mobility of the activity that makes the company responsive to the incentive also acts to limit the benefit to the host country. This uncertainty sometimes also induces companies established in the host country to extract profits from the country rather than re-invest them there.

Complexity

Another problem with incentives is the complexity they introduce into the tax system. Incentives require definitions of the eligible activities. This in itself complicates the tax legislation. This is particularly so where the incentives attempt to attract special classes of activities, such as high technology or R&D activities. The legislation must be sufficiently precise to allow taxpayers to predict accurately whether or not they qualify for the provision. If it is not, taxpayers cannot plan their affairs on the assumption that they will receive the incentive. In this case its receipt is simply a windfall to them, with no positive impact on their behaviour.

Tax competition

The use of tax incentives has also the potential of triggering competition, particularly among countries in the same region or among countries having similar industry structures. For example, a country may be tempted to use tax incentives to attract so called footloose manufacturing

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companies or to offer substantial tax cuts to global companies willing to establish a regional base (including Headquarters companies) in its country for manufacturing and supply. The response of the country that views itself as being in competition with the country offering incentives is to introduce some form of off-setting incentive. In the end, the tax incentives offered by the countries do nothing to alter the relative incentive to invest between the two countries. The only result of the competition is that both countries receive lower tax revenues.

Non-tax factors versus tax factors

When planning and making investment decisions, enterprises base their decisions on a wide range of different factors, such as political stability, size and location of markets, profitability, security of tenure, availability and cost of skilled labour and of raw materials, exchange control regulations, availability of roads, railways, harbours and other transport facilities, a trained and efficient civil service and the tax consequences of the investment. Thus, taxation is only one of many factors affecting the investment behaviour of enterprises. To the extent that companies do take tax factors into account, they generally attach greater importance to the overall structure and administration of the tax system than to the existence of tax incentives.

Lobbying

Another general problem with incentives is that their adoption into a tax system leads to pressure from other deserving sectors for special treatment. Whenever incentives are provided to one type of activity there will be other activities which are closely related to the preferred activity that do not qualify for the incentive. They will be able to argue that they are disadvantaged in competing with the companies receiving the incentives. A similar argument is often raised where incentives target only foreign investors. The question is then asked why the government should disadvantage domestic companies relative to foreign-owned companies? This kind of lobbying is very difficult to withstand once some targeted incentives have been given. The general experience is that incentives over time spread to other activities and that it is politically difficult to remove them, notwithstanding the reason for their introduction may be gone long ago. While any one targeted incentive may not involve a significant revenue cost, the total for all the resulting incentives can sharply erode government revenues from the business sector.

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f) Abuse of tax sparing provisions

A growing criticism raised against tax sparing is based on the realisation that tax sparing provisions in treaties in themselves offer wide opportunities for tax planning and tax avoidance. Not only may residents inappropriately exploit tax sparing provisions, but the residence country may also be used as a conduit by third country residents (treaty shopping). The cost of such tax avoidance schemes to the residence country may be huge - particularly where the country is being used as a conduit. The source country may also find that its revenue base is eroded in unintended ways.

The most common tax avoidance schemes involving tax sparing provisions may be divided into four different groups:

Transfer pricing abuse

Tax sparing provisions provide an inherent incentive to affiliated companies in the residence country (or third countries) to inflate the profits in the host country through transfer pricing abuse. This leads to a loss of tax in the residence country and requires valuable resources to be devoted to identifying and investigating such cases. Although the OECD Transfer Pricing Guidelines (OECD 1995) are intended to limit the scope for such abuse, the effectiveness of counteracting measures very much depend on the efficiency of the administration. Furthermore, although transfer pricing and expense allocation rules are tailored to deal with such avoidance schemes, they are unlikely to act as an effective counter in all cases.

Conduit situations

In a typical conduit situation, a third country investor attempts to exploit the existence of tax sparing in the treaty between the resident country and the source country. The third country investor, wishing to invest in the source country, establishes a company (or several companies) in the resident country with a view to channelling the investment to the source country through the resident company. The conduit company thereby becomes eligible for the tax sparing benefits granted in the treaty (for an example of conduit scheme, see annex IV).

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Routing

Routing is particularly common in situations where the resident country has agreed under a tax treaty to spare withholding tax on interest or royalties. For example, a resident bank making a loan to a foreign investor may be tempted to route the transaction through a financial institution in a developing country to benefit from tax sparing granted in respect of withholding tax on interest in the treaty between the resident country and the developing country (for an example of a routing scheme, see annex V).

Potential government abuse of tax sparing

Tax sparing provisions also create an incentive for host countries to maintain artificially high rates of tax. In some cases “special” tax rates appear to have been designed primarily to secure greater tax sparing credit benefits for foreign investors of credit countries .

g) Administrative difficulties

Many OECD Member countries have encountered administrative difficulties in applying tax sparing provisions. For example, where the tax sparing provision refers to particular sections of the law of the host country under which that country’s tax is waived or reduced for the purpose of promoting economic development, it is often difficult, if not impossible, to establish whether the taxpayer has really benefited from the incentives identified in those sections. Often, the taxpayer is unable to verify it, and the competent authority of the host country is unwilling or unable to provide assistance.

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V. RECENT TRENDS IN TAX SPARING PROVISIONS

Over the past 15 years, the number and variety of tax sparing provisions have increased considerably. In an attempt to deal with some of the problems described above, the provisions have generally become more targeted.

Some of the new features found in tax sparing provisions in recent years relate to the categories of taxpayers, countries or income eligible, the limits on the deemed paid tax, the period of availability, and the need to combat abuse.

a) Categories of taxpayers

Where the scope of taxpayers is not limited and the tax sparing includes interest and dividends, purely private loans and investment would also be covered, *e.g.* income received by individuals [*e.g.* Canada-Thailand (1984)]. A number of recent treaties therefore limit the application of tax sparing to companies and/or to investments made by taxpayers with substantial holdings [*e.g.*, Canada-Argentina (1993)].

b) Categories of income

The categories of income covered by tax sparing provisions vary between different treaties. References are often made to the relevant provisions of the law of the source country. Typically, the scope of the tax sparing provision is limited to income derived from tax incentives designed to promote economic development in the host country. Many countries now add additional conditions, for example, to prevent investment income (*i.e.* interest and capital gain) from being included in the business income [*e.g.* Denmark-Poland Protocol (1994)].

Income from corporate activities do not generally require a tax sparing provision to avoid taxation in the residence country insofar as the corporate earnings are re-invested in the host country. When tax sparing is given also on

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corporate income, dividends paid by foreign subsidiaries out of eligible income are exempt from residence taxation to preserve the effect of the host country exemption from or reduction of tax.

Tax sparing on interest income has posed a number of problems, perhaps because funds are highly mobile and the amount of "deemed withholding tax paid" is calculated on the gross amount of interest, not all of which is necessarily attributable to the host country. A number of different approaches have been adopted to reduce or eliminate such problems. Apart from not extending tax sparing to interest income [*e.g.* the provisions in Japan-Bulgaria (1991) and Japan-Vietnam (1995) provide for tax sparing on dividends and royalties, but not on interest income], many countries limit tax sparing to interest income that seem unlikely to attract abuse [*e.g.* scope of lenders and borrowers limited to non-financial enterprises, *i.e.* manufacturers, *e.g.* Argentina-Canada (1993)].

c) Limitation of the "deemed paid tax"

The overall benefit of tax sparing obtainable by taxpayers resident in countries applying the credit method in their tax treaties is determined by the combination of the scope of the provision and the amount of "spared" tax. Whilst the former is generally specified in the treaty, the latter could be increased by unilateral changes of the general tax rate in the host country. A number of safeguards have been inserted in recent treaties to restrict the ability of the host country from unilaterally changing the rate of deemed paid tax.

Such safeguards may, for example, limit the benefits under the tax sparing provision to the tax incentives available on the date of signature of the treaty. This might, however, be difficult to administer in practice.

Another way is to fix in the treaty the percentage amount of deemed paid tax. For example, the treaty may specify the applicable percentage rates [*e.g.* Canada-China (1986)]. The rate may be fixed at (a) the ceiling rate provided for in the treaty [*e.g.* Germany-Indonesia (1977) and this is also the effect of the tax sparing provisions in UK treaties], (b) above the treaty rates [*e.g.* Brazil-Japan Protocol (1976] or (c) below the treaty rates [*e.g.* Japan-Bangladesh (1991)].

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Other safeguard provisions of this kind ensure that the amount of "deemed paid tax" fixed in the treaty does not exceed the amount of tax under the general tax regime by incorporating rules that limit the amount of deemed paid tax to the level of taxation under the general taxation law of the source country [*e.g.* France-Turkey (1987) and Bangladesh-Netherlands (1993)].

d) Duration of tax sparing

Many treaties limit the availability of the tax sparing relief for each source [in UK treaties]. As mentioned previously, a time limitation may also be applied to the tax sparing provision itself. It has become more common in recent years to insert "sunset" clauses in the tax sparing provisions [*e.g.* Bulgaria-Japan (1991), Australia- China (1988), Denmark-Poland (1994), and Mongolia-UK (1996)].

e) Types of countries

Many OECD countries that agreed to insert tax sparing provisions in treaties concluded in the 1960's and 1970's with non-Member countries, which have now reached a certain level of economic development, wish to remove or renegotiate the tax sparing provisions considering that the economic justification for such provisions has ceased. In certain cases, these countries have repealed the tax sparing provisions by agreeing to treaty changes. In other cases a "sunset" clause has been added. Some countries have begun to use objective criteria to define countries eligible for tax sparing. Only countries the economic level of which is below a certain benchmark is considered for tax sparing. For example, Japan uses the graduation standard of the World Bank as a reference to define eligible countries.

f) General anti-abuse provisions

Some recent treaties also contain a specific anti-abuse provision to reduce the potential of abuse [*e.g.* New Zealand-Singapore (1993)]. Section IV and Annex VI provide more details.

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VI. BEST PRACTICES IN DESIGNING TAX SPARING PROVISIONS

The following paragraphs describe a number of additional features that have been used in the design of tax sparing provisions and which may help the countries that decide to use tax sparing to achieve a better targeting of the provision and reducing the potential for abuse in both the residence and source country.

a) Definition of tax incentives

Many countries have determined that the tax incentives covered by the tax sparing provision should be defined precisely - typically through a specification of eligible incentives - to ensure that tax sparing is granted only for agreed concessions. These countries have concluded that general references to *"special incentive laws designed to promote economic development"* provide the host country with too much discretionary authority to determine the kind and size of the tax sparing aid to be provided by the residence country. This is commonly done through a direct reference to domestic legislation. The reference is typically "static" (*i.e.* a reference is made to domestic legislation as drafted on the date of signature) to avoid the host country from subsequently extending the scope of the tax sparing provision. To avoid the risk, however, that such limitation would prevent minor amendments being made to the tax incentive provisions, some treaties permit minor modifications of the incentive legislation to be made provided that its general character is not affected. Many of those treaties also include a clause that accepts new incentives of a substantially similar character [*e.g.* Article 25(4) of Spain-India Convention (1993)]. The competent authorities of the Contracting States must sometimes agree that the new incentives are substantially of the same character [*e.g.* Article 23(5) of the Australia-Vietnam Convention (1992)].

Yet another possibility would be to ensure that tax sparing not be given to general and widely applicable incentive features such as broadly based tax holidays.

As noted in Section V(b) above, tax sparing provisions often do not apply to passive income such as interest and royalties and relatively few

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provisions give a "matching credit" (*i.e.* providing that a foreign tax credit will be granted at a fixed rate specified in the treaty regardless of the actual rate of withholding tax levied in the source country). This seems to reflect concerns about tax incentives directed at passive investment as well as concerns about the potential for abuse (see section IV (f) above) involved with these forms of tax sparing.

b) Definition of activities

Where particular tax incentive legislation is defined in broad terms or where the incentive legislation might conceivably apply to inappropriate activities, it has sometimes been found necessary to limit the applicability of the tax sparing provision to certain specified activities, *e.g.* enumerated *active* business activities, excluding financial intermediation activities such as banking and insurance, or activities that assist in the development of the host country's capital base, such as public infrastructure, plant, equipment, skills, and knowledge [*e.g.* Article 24(2) of the Norway-Mexico Convention (1995)]. Furthermore, to avoid that export-oriented businesses in developing countries compete on "no tax" terms with businesses in other countries which have to pay tax at full rates, tax sparing relief has been given only to typically domestic-oriented activities [*e.g.* Article 23(3)(b) of the United Kingdom-Papua New Guinea Convention (1991) and Article 22(2) of the Sweden-Malta Convention (1995)].

c) Tax rates

Where tax sparing credits are based on the host country's *domestic tax rate*, it has in some cases been agreed to limit the maximum domestic rate that could apply for tax sparing credits in order to prevent increases of tax with limited application aimed at increasing the value of the tax spared credits [*e.g.* Article 23(4) of the Australia-Vietnam Convention (1992)].

Similarly, in some cases where the Contracting countries have agreed on a maximum tax rate or a deemed paid tax rate that the host country may impose on particular types of income, it has been found inappropriate to allow these rates, for the purposes of calculating tax sparing credits, to be higher than those set under domestic law. In some cases, it has been clarified in the treaty

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that the domestic rate applies where this rate is lower than the specified treaty rate [*e.g.* Article 23(1) of the German-Turkey Convention (1985)].

Tax sparing credits may also be based on maximum treaty rates. For example, where the Convention limits the withholding tax on dividends to 5 per cent, and the host country gives up its withholding tax on dividends entirely under incentive legislation recognised under the Convention, the rate of tax for which the residence country will give tax sparing credit is then limited to 5 per cent.

d) Income exempt under domestic law or treaty

Some OECD Member countries apply the credit method to only particular types of income. For example, while the credit method may be used on income derived by resident companies through foreign permanent establishments; dividends paid by foreign subsidiaries may be exempt under domestic law or under the treaty. Tax sparing should never be considered in regard to the latter type of income. The most a country can do is to exempt foreign income from taxation. No additional tax sparing credit should be granted in such a case.

e) Anti-abuse clause

Recent experience has shown that tax sparing provisions are very vulnerable to abuse (see Annexes IV and V). A number of treaties now include a tax sparing anti-abuse clause [*e.g.* Article 23(1) of the Spain-Argentina Convention (1992), Article 23(7) of the Australia-Vietnam Convention (1992), see also Annex VI]. Alternatively, where the resident country has an existing anti-abuse rule within its domestic tax law, the Contracting countries may expressly agree to make the tax sparing provision in the treaty subject to that domestic anti-abuse rule.

f) Time limitation

Investor level

Tax incentives are generally intended to encourage the start-up of new operations. It has therefore been found appropriate in some treaties to place a

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time limit on the availability of the tax sparing relief for each taxpayer, thereby preventing tax sparing from becoming a permanent concession [*e.g.* Article 21(3) of UK-Indonesia Convention (1993)]. Furthermore, to prevent taxpayers from abusing this rule by simply transferring the activity to a different legal entity before each time limit expires, it may be appropriate to provide that the duration should be measured having regard also to associated entities undertaking the same or similar activities. As previously noted, many tax sparing provisions today also contain traditional sunset clauses applicable to all taxpayers [see *e.g.* Article 25(5) of Mongolia-UK Convention (1996), see also Section V(d) above].

Country's economic development level

Tax sparing is primarily an instrument to encourage economic development in developing countries. Where the developing country has reached a certain degree of development, countries have sometimes agreed to have the tax sparing provision removed from the treaty at a certain date [see Article 22(5) of Japan-Vietnam Convention (1991)] . Many countries have found it more effective, however, to grant tax sparing only for limited periods ("sunset" clause), for example, for 5 or 10 years [*e.g.* Article 25(5) of the Spain-India Convention (1993), see also Section V(d) above] which may facilitate the removal of the clause once its original purpose has been fulfilled.

However, provision of tax sparing for defined periods may raise additional practical problems. When tax sparing commences there is the possibility that contracts could be rewritten to bring the income within the tax sparing period. Furthermore, when tax sparing is expiring, contracts (particularly loan agreements) could be drafted so that income is derived before the date of expiry by, for example, by use of prepayments or cancellation fees. An interpretative provision could be included in tax treaties to ensure that the tax sparing period relates only to income accrued during the period, or the domestic law of the residence country could possibly contain rules for allocation of income to the tax sparing period.

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g) Controlled foreign company legislation

Controlled foreign company (CFC) legislation has been enacted by fifteen OECD countries in response to regulatory reform and the growing use of tax havens and preferential tax regimes to defer or avoid taxation.[2] While foreign investment that is targeted by CFC legislation generally is excluded from the scope of applicable tax sparing provisions, CFC and tax sparing rules may in certain instances apply concurrently. The rules of the CFC legislation may then conflict with those of the tax sparing provisions. To remove any doubt, an interpretative provision could be included in the treaty providing that CFC legislation will prevail in these situations.

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VII. RECOMMENDATIONS

This report has identified a number of concerns that put into question the usefulness of the granting of tax sparing relief by OECD Member countries. These concerns relate in particular to:

- the potential for abuse offered by tax sparing;
- the effectiveness of tax sparing as an instrument of foreign aid; and
- general concerns with the way in which tax sparing may encourage countries to use tax incentives.

The Report has shown that tax sparing is very vulnerable to taxpayer abuse, which can be very costly in terms of lost revenue to both the residence and source country. Experience has shown that this kind of abuse is difficult to detect. In addition, even where it is detected, it is difficult for residence countries to react quickly against such abuse. The process of persuading treaty partners of the necessity to remove or modify existing tax sparing provisions to prevent such abuses may be slow and cumbersome.

The emerging change in attitude among countries towards tax sparing has to be seen also in the context of the increasing problem with harmful tax competition. The continued, and in recent years accelerating, integration of national economies has made many segments of the national tax bases increasingly geographically mobile. These developments have induced some countries to adopt tax regimes that have as their primary purpose the erosion of the tax bases of other countries. These types of tax incentives are specifically tailored to target highly mobile financial and other services that are particularly sensitive to tax differentials. The potentially harmful effects of such regimes may be aggravated by the existence of ill-designed tax sparing provisions in treaties. This is particularly so where a country adopts a tax regime subsequent to the conclusion of treaties and tailors this regime so as to ensure that it is covered by the scope of the existing tax sparing provision.

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This report has also shown that tax sparing is not necessarily an adequate tool to promote economic development. Countries that have traditionally sought to obtain tax sparing benefits in treaties may have good reasons to reconsider their position on the issue. The report not only challenges the assumption generally underlying tax sparing, but it also suggests that tax sparing, by promoting the repatriation of profits, provides an inherent incentive to the foreign investor to engage in short-term investment projects and a disincentive to operate in the source country on a long-term basis.

The argument that tax sparing is needed to prevent that the granting of a tax incentive by a host country merely results in a transfer of tax revenues to the country of residence of the investor ignores the fact that this revenue transfer will occur only to the extent that profits are repatriated. No nullification will occur if there is no repatriation. But, even if profits are repatriated, the features of foreign tax credit systems, which all allow some form of pooling of foreign income, may be structured in such a way that tax may not necessarily be levied in the country of residence notwithstanding that no or low tax is imposed in the country of source.

The analysis of this report does not suggest that OECD and other countries which have traditionally granted tax sparing should necessarily cease to do so. In bilateral negotiations between Member and non-Member countries, some countries will, for what they see as legitimate reasons, continue to press for such provisions. But the strength of their case will need to be assessed in the course of their negotiation or renegotiation of bilateral treaties. In addition, it may now be an appropriate time to consider how OECD Member countries working together with non-Member countries can develop a more coherent position towards the granting of tax sparing. This may enable Member countries to reassess the need to give tax sparing, particularly to countries that have reached a certain level of economic development. In judging whether there is a case for continuing to provide tax sparing, countries will need to balance the considerations discussed in the preceding sections, particularly the scope for abuse and the role which tax sparing has played in encouraging tax competition. This would also assist countries that chose to grant tax sparing to achieve a better targeting of the provisions and to reduce the potential for abuse. Non-Member countries that have traditionally requested tax sparing should reconsider whether this is an appropriate instrument to promote economic development and whether tax sparing serves their long-term economic interests.

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The Committee on Fiscal Affairs recommends that if a Member country chooses to give tax sparing credits, tax sparing should be considered only in regard to countries the economic level of which is considerably below that of OECD Member countries. Member countries should employ objective economic criteria to define countries eligible for tax sparing. Where countries agree to insert a tax sparing provision, they are encouraged to follow the guidance set out in Section VI of this report. The use of these "best practices" will minimise the potential for abuse of such provisions by ensuring that they apply exclusively to genuine investments aimed at developing the domestic infrastructure of the source country (see Section VI (b) above). A narrow provision applying to real investment would also discourage harmful tax competition for geographically mobile activities.

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Annex I

MEMBER COUNTRY TAX SPARING PROVISIONS REFERRED TO IN THE REPORT

Below is reproduced in alphabetical order the Member country tax sparing provisions referred to in the report.

Australia - China (1988) Article 23

4. For the purpose of paragraphs 2 and 3, Chinese tax paid shall include an amount equivalent to the amount of any Chinese tax forgone.

5. In paragraph 4, the term "Chinese tax foregone" means, subject to paragraph 6, an amount which, under the law of China relating to Chinese tax and in accordance with this Agreement, would have been payable as Chinese tax on income but for an exemption from, or reduction of, Chinese tax on that income in accordance with:

a) Articles 5 and 6 of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment and Article 3 of the Detailed *Rules* and Regulations for the Implementation of the Income Tax Law of the People's Republic of China concerning Joint Ventures with Chinese and Foreign Investment;

b) Articles 4 and 5 of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises;

c) Articles I, II, III, IV and X of Part I, Articles I, II, III and IV of Part II and Articles I, II and III of Part III of the interim provisions of the State Council of the People's Republic of China on reduction in or exemption from enterprise income tax and the consolidated

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industrial and commercial tax for special economic zones and fourteen coastal cities;

d) Articles 12 and 19 of the State Council Regulations for the Encouragement of Investment in the Development of Hainan Island;

e) Articles 8, 9 and 10 of the State Council Regulations concerning the Encouragement of Foreign Investment; and

f) Articles 1, 2 and 3 of the interim provisions of the Ministry of Finance of the People's Republic of China regarding (reduction in or exemption from) enterprise income tax and industrial and commercial consolidated tax for encouraging foreign investment in the coastal open economic areas; insofar as they were in force on, and have not been modified since, the date of signature of this Agreement, or have been modified only in minor respects so as not to affect their general character and any other provision which may subsequently be made granting an exemption from or reduction of tax which the Treasurer of Australia and the Commissioner of the State Taxation Administration of China agree from time to time in letters exchanged for this purpose to be of a substantially similar character, if that provision has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.

6. In the application of paragraph 5 in relation to dividend, interest and royalty income to which Articles 10, 11 and 12 respectively apply, the amount of Chinese tax shall be deemed to be the amount equal to:

a) in the case of dividends, 15 per cent of the gross amount of those dividends;

b) in the case of interest, 10 per cent of the gross amount of that interest; and

c) in the case of royalties, 15 per cent of the gross amount of those royalties, but only where the rate of tax levied under the law of China, other than a provision specified in paragraph 5, is not less than 15 per cent.

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7. Paragraphs 4, 5 and 6 shall apply only in relation to income derived in any of the first ten years of income in relation to which this Agreement has effect by virtue of sub-paragraph (a)(ii) of Article 27 and in any later year of income that may be agreed by the Treasurer of Australia and the Commissioner of the State Taxation Administration of China in letters exchanged for this purpose.

Australia - Vietnam (1996) Exchange of Notes

The Exchange of Notes refers to Article 23 of the Convention (1992).

4. paragraphs 5 and 6, the total amount which, under the law of Vietnam relating to Vietnamese tax and in accordance with this Agreement, would have been payable as Vietnamese tax on income but for an exemption from, or reduction of, Vietnamese tax on that income (which total amount shall be deemed to be no greater than 20 per cent of the Vietnamese taxable income that relates to the income the subject of the exemption or reduction), less the actual amount of Vietnamese tax payable on that income.

5. Paragraph 4 shall apply only in respect of exemptions or reductions resulting from the operation of:

a) i) Articles 26, 27, 28 or 32 of the Law on Foreign Investment in Vietnam 1987; or

ii) Articles 66, 67, 68, 69 or 72 of Decree N° 18-CP on implementing regulations of the Law on Foreign Investment in Vietnam dated 16 April 1993; or

iii) Circular N° 48-TC-TCT on Profits Tax Rates and Exemption from and Reduction of Profits Tax dated 30 June 1993; or

iv) Part A of Part II of Circular N° 51-TC-TCT on Taxation of Foreign Investment in Vietnam dated 3 July 1993; or

v) Decree N° 87-CP on Build-Operate-Transfer (BOT) Contracts dated 23 November 1993 and the regulations issued with that Decree,

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to the extent those provisions were in force on, and have not been modified since, the date of this Note, or have been modified only in minor respects so as not to affect their general character; or

b) any other provision which may subsequently be made granting an exemption from, or reduction of, Vietnamese tax which the Treasurer of Australia and the Minister of Finance of Vietnam determine from time to time in letters exchanged for this purpose to be provisions to which this paragraph applies. Subject to its terms, such a determination of applicable provisions shall be valid for as long as those provisions are not modified after the date of that determination or have been modified only in minor respects so as not to affect their general character.

6. Paragraph 4 shall apply only to the extent that the exemption or reduction is granted in respect of Vietnamese tax on income from the following activities:

a) construction of infrastructure facilities including communications, power production and supply, construction of infrastructure facilities for the export processing and industry intensive zones and information and telecommunication facilities in mountainous areas in which natural and socio economically difficult conditions exist; or

b) plantation of new forests for commercial exploitation; or

c) extremely important activities listed in the investment portfolio announced by the Vietnamese State Committee for Co-operation and Investment for each period; or

d) exploitation of natural resources except oil, gas or rare and precious natural resources; or

e) heavy industry projects including metallurgy, mechanical engineering production, base chemical production, cement production, electrical and electronic materials manufacturing, fertiliser manufacturing and anti epidemic medicines for use in animal production or forestry; or

f) plantation of long term industrial crops; or

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g) activities in mountainous areas in which naturally and socio economically difficult conditions exist including hotel undertaking projects; or

h) any project satisfying at least 2 of the following criteria:

i) employing at least 500 Vietnamese; or

ii) applying advanced technology which satisfies the requirements listed in Article 4 of the Ordinance on the Transfer of Foreign Technology dated 5 December 1988, subject to the approval of the Ministry of Science and Technology and Environment; or

iii) exporting at least 8 per cent of the products manufactured by the project itself; or

iv) the prescribed capital or contributed capital for the implementation of the business co-operation contract is at least US $ 10 million dollars; or

i) projects carrying out infrastructure activities within a definite time period in which the foreign partner transfers the infrastructure to the Vietnamese Government without any compensation.

7. Notwithstanding the operation of paragraph 4, Vietnamese tax forgone shall not be deemed to have been paid in respect of income derived from:

a) banking, insurance, consulting, accounting, auditing and commercial services of any kind; or

b) the operation of ships or aircraft, other than ships or aircraft operated principally from places in Vietnam and used solely in carrying on a business in Vietnam; or

c) any scheme entered into by an Australian resident with the purpose of using Vietnam as a conduit for income or as a location of property in order to evade or avoid Australian tax through the exploitation of the Australian foreign tax credit provisions or to confer a benefit on a person who is neither a resident of Australia, nor of Vietnam.

8. Paragraphs 4, 5, 6 and 7 shall not apply in relation to income derived in any year of income after the year of income that ends on:

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a) 30 June 2003; or

b) any later date that may be agreed by the Treasurer of Australia and the Minister of Finance of Vietnam in letters exchanged for this purpose.

whichever is the later in time occurring".

Canada - Argentina (1993) Article 23

2. For the purpose of sub-paragraph (a) of paragraph 1, tax payable in Argentina by a company engaged primarily in the manufacturing or natural resources sector which is a resident of Canada in respect of:

a) interest, other than interest which is exempted in Argentina in accordance with paragraph 3 of Article 11, or

b) industrial royalties referred to in paragraph 3 of Article 12 paid by a company engaged primarily in the same sector which is a resident of Argentina shall be deemed to have been paid at the rate of 12.5 per cent in the case of interest and at the rate of 15 per cent in the case of royalties. The provisions of this paragraph shall apply for the first five years for which the Convention is effective, but the competent authorities of the Contracting States may consult with each other to determine whether this period shall be extended.

Canada - China (1986) Article 21

2. For the purposes of paragraph 1(a), tax payable in the People's Republic of China by a company which is a resident of Canada shall be deemed to include any amount which would have been payable as Chinese tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under any of the following provisions of Chinese law:

a) Articles 5 and 6 of the Income Tax Law of the People's Republic of China concerning Joint Venture with Chinese and Foreign Investment and Article 3 of the Detailed Rules and Regulations for the Implementation of the Income Tax Law of the People's

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Republic of China concerning Joint Ventures with Chinese and Foreign Investment;

b) Articles 4 and 5 of the Income Tax Law of the People's Republic of China concerning Foreign Enterprises;

c) Articles I, II, III, IV and X of Part 1, Articles I, II, III and IV of Part II and Articles I, II and III of Part III of the interim provisions of the State Council of the People's Republic of China concerning reduction or exemption from enterprise income tax in special economic zones and coastal cities; so far as they were in force on, and have not been modified since, the date of signature of this Agreement, or have been modified only in minor respects so as not to affect their general character; or

d) any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character;

Canada - Thailand (1984) Article 22

3. For the purposes of paragraph 1(a), the term "tax payable in Thailand" shall be deemed to include any amount which would have been payable as Thai tax for any year but for an exemption or reduction of tax granted with a view to promoting industrial, commercial, scientific, educational or other development in Thailand, for that year or any part thereof under:

a) the provisions of the Special Incentive Laws designed to promote economic development in Thailand so far as they were in force on, and have not been modified since, the date of signature of this Convention, or have been modified only in minor respects so as not to affect their general character; or

b) any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not affect its general

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character. Provided that relief from Canadian tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than ten years after the exemption from or reduction of Thai tax was first granted in respects of that source. Provided further that any deduction from Canadian tax granted in accordance with the provision of this paragraph in respect of dividends or interest paid to an individual shall not exceed 15 per cent of the gross amount thereof; and in respect of dividends paid to a company, other than a company referred to in paragraph 3 of Article 10, or in respect of interest paid to a company shall not exceed 20 per cent of the gross amount thereof.

Denmark - Poland (1994) Protocol

Article III

After Article 23, paragraph 2, subparagraph (c), the following subparagraphs shall be inserted:

"*d)* where in accordance with the laws of a Contracting State a reduction of tax on the profits of an enterprise is granted for the purpose of encouraging economic development in that State, the references in paragraph 1 and paragraph 2, subparagraphs (a) and (b) of this Article, to "taxes paid" or "income tax paid" shall be deemed to include any amount which would have been payable as tax in accordance with this Agreement for any year but for a reduction of tax granted for that year, provided that such an enterprise (being a permanent establishment) is engaged in the manufacture or sale of goods or merchandise or services (other than services in the financial sector) and that no more than 25 per cent of the enterprise's income arises from interest and gains from the alienation of shares and bonds;

e) where dividends are paid by a company which is a resident of Poland to a person (being a company) which is a resident of Denmark, and which owns directly or indirectly not less than 25 per cent of the share capital of the first-mentioned company

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then such dividends shall be exempt from Danish tax, provided that the company paying the dividends is engaged in the manufacture or sale of goods or merchandise or services (other than services in the financial sector) and that no more than 25 per cent of the company's income arises from interest and alienation of shares and bonds;

f) the provisions in subparagraphs (d) and (e) shall apply for the first five years for which the Protocol amending the original Agreement between Poland and Denmark is effective. The competent authorities shall consult each other in order to determine whether this period shall be extended. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures."

Germany - Indonesia (1977) Article 22(1)

c) If in the cases (aa), (bb) and (cc) of subparagraph (b) above, Indonesian tax on dividends on interest, or on royalties is wholly relieved or reduced below the rates of tax provided for in Article 9 paragraph 2, Article 10 paragraph 2, or Article 11 paragraph 2, by special incentive measures under Indonesian Law designed to promote economic development in Indonesia, there shall be allowed as a credit against German income tax and corporation tax, including the surcharge thereon, on such dividends, interest or royalties, an amount corresponding to the rate of tax provided for in the foregoing mentioned provisions of this Agreement. The credit allowed under the foregoing sentence, shall, however, not exceed the amount of Indonesian tax which would have been payable but for such reduction.

Germany - Turkey (1985) Article 23(1)

(d) Where dividends, interest and royalties mentioned in subparagraph (b) are taxed under special measures introduced in Turkish law for the purpose of promoting the economic development of the Republic of Turkey, at rates of tax which are reduced below 10 per cent, there shall under the conditions provided

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in subparagraph (b) be allowed as a deduction from the tax paid in the Federal Republic of Germany on such income an amount equal to at least 10 per cent of the gross amount of such income. However, the deduction shall not exceed the tax paid in the Republic of Turkey in the absence of such measures.

Japan - Bangladesh (1991) Article 23

3. For the purposes of the credit referred to in subparagraph (a) of paragraph 1 above, where an amount of tax paid in Bangladesh on dividends or royalties to which the provisions of paragraph 2 of Article 10 or paragraph 2 of Article 12, as the case may be, apply, is less than 10 per cent of the gross amount thereof, Bangladesh tax shall be deemed to have been paid at the rate of 10 per cent of the gross amount of such dividends or royalties.

4. For the purposes of the credit referred to in subparagraph (a) of paragraph 1 above, where an amount of tax paid in Bangladesh on interest to which the provisions of paragraph 2 of Article 11 apply is less than 5 per cent of the gross amount thereof, Bangladesh tax shall be deemed to have been paid at the rate of 5 per cent of the gross amount of such interest, if such interest is subject to:

(a) the provisions of paragraphs (a), (b), (c), (d), (e), (f) and (g) of Notification number S.R.O. 417A-L/76 dated 29 November 1976; or

(b) any provision referred to in (a) above as modified after the date of signature of this Convention or any other special incentive measure designed to promote economic development in Bangladesh which may be introduced in future in the Bangladesh tax laws in modification of, or in addition to, the existing measures referred to in (a) above, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said provision so modified or the said measure. The provisions of this paragraph shall not apply to interest to which the provisions of paragraph 3 of Article 11 apply.

5. For the purposes of the credit referred to in paragraph 1 above, the term "Bangladesh tax payable" shall be deemed to include the amount of the Bangladesh tax which would have been paid under the laws of Bangladesh if the Bangladesh tax had not been reduced or exempted in accordance with:

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(a) the provisions of Notification number S.R.O. 289-L/89 dated 17 August 1989 (relating to exemption from tax for industry set-up in any Export Processing Zone); or

(b) any provision referred to in (a) above as modified after the date of signature of this Convention or any other special incentive measure designed to promote economic development in Bangladesh which may be introduced in future in the Bangladesh tax laws in modification of, or in addition to, the existing measures referred to in (a) above, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said provision so modified or the said measure.

Japan - Brazil (1976) Protocol

Sub-paragraphs (a), (b) and (e) of paragraph (2) of article 22 shall be deleted and replaced by the following:

(a) (i) Where a resident of Japan derives income from Brazil which may be taxed in Brazil in accordance with the provisions of this Convention, the amount of the Brazilian tax payable in respect of that income shall be allowed as a credit against the Japanese tax imposed on that resident. The amount of credit, however, shall not exceed that part of the Japanese tax which is appropriate to that income.

(ii) Where the income derived from Brazil is a dividend paid by a company which is a resident of Brazil to a company which is a resident of Japan and which owns at least 10 per cent either of the voting shares of the company paying such dividend, or of the total shares issued by that company, the credit referred to in (i) above shall take into account the Brazilian tax payable by the company paying the dividend in respect of its income.

(b) (i) For the purposes of the credit referred to in sub-paragraph (a) (i) above, Brazilian tax shall always be considered as having been paid:

(A) At the rate of 25 per cent in the case of dividends to which the provisions of paragraphs (2) and (5) of article 9 apply, and of royalties to which the provisions of sub-paragraphs (b) and (c) of paragraph (2) of article 11 apply;

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(B) At the rate of 20 per cent in the case of interest to which the provisions of paragraph (2) of article 10 apply.

(b) (ii) For the purposes of the credit referred to in sub-paragraph (a) above, Brazilian tax shall be deemed to include the amount of Brazilian tax which would have been paid if the Brazilian tax had not been exempted or reduced in accordance with the special incentive measures designed to promote economic development in Brazil, which are effective on March 23, 1976, or which may be introduced thereafter in the Brazilian tax laws in modification of, or in addition to, the existing measures, provided that the scope of the benefit accorded to the taxpayer by those measures shall be agreed to by the Governments of both Contracting States.

(c) In the application of the provisions of sub-paragraph (b)(ii) above, there shall not, in any event, be deemed to have been paid an amount of tax higher than that which, but for the exemption or reduction of tax due to the special incentive measures, would result from the application of the Brazilian tax laws effective on 23 March 1976."

Japan - Bulgaria (1991) Article 23

3. For the purposes of the credit referred to in subparagraph (a) of paragraph 2 above, where an amount of tax paid in Bulgaria on dividends or royalties to which the provisions of paragraph 2 of Article 10 or paragraph 2 of Article 12, as the case may be, apply is less than 10 per cent of the gross amount thereof. Bulgarian tax shall be deemed to have been paid at the rate of 10 per cent of the gross amount of such dividends or royalties.

4. For the purposes of the credit referred to in paragraph 2 above, the term "Bulgarian tax payable" shall be deemed to include the amount of the Bulgarian tax which would have been paid under the laws of Bulgaria if the Bulgarian tax had not been reduced or exempted in accordance with the special incentive measures designed to promote economic development in Bulgaria, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said measures.

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5. The provisions of paragraphs 3 and 4 shall not apply in respect of income derived by a resident of Japan in any taxable year beginning on or after the first day of January of 2002.

Japan - Vietnam (1995) Article 22

3. For the purposes of the credit referred to in paragraph 2, taking into account the stage of economic development of Vietnam, there shall be deemed to have been paid by the taxpayer the amount which would have been paid as Vietnamese tax under the laws of Vietnam and in accordance with this Agreement if the Vietnamese tax had not been reduced or relieved in accordance with the special incentive measures designed to promote economic development in Vietnam, effective on the date of signature of this Agreement or which may be introduced in the future in the Vietnamese tax laws in modification of or in addition to the existing measures, provided that an agreement is made between the two Governments in respect of the scope of the benefit accorded to the taxpayer by the said measures.

4. For the purposes of the credit referred to in sub-paragraph (a) of paragraph 2, the Vietnamese tax shall always be considered as having been paid at the rate of 10 per cent of the gross amount in the case of dividends to which the provisions of paragraph 2 of Article 10 apply and of royalties or proceeds to which the provisions of paragraph 2 or 5 of Article 12 apply.

5. The provisions of paragraphs 3 and 4 of this Article shall not apply in respect of income derived by a resident of Japan in any taxable year beginning after 31 December of the fifteenth calendar year next following the calendar year in which this Agreement enters into force.

The Netherlands - Bangladesh (1993) Article 23

4. Where, by reason of special relief given under the provisions of Bangladesh law for the purpose of encouraging investment in Bangladesh the Bangladesh tax actually levied on interest and royalties arising in Bangladesh is lower than the tax Bangladesh may levy according to paragraph 2 of Article 11 and paragraph 2 of Article 12, then the amount of the tax paid in Bangladesh on such interest and royalties shall be deemed to have been paid at the rates of tax

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mentioned in the said provisions. However, if the general tax rates under Bangladesh law applicable to the afore-mentioned interest and royalties are reduced below those mentioned in the foregoing sentence these lower rates shall apply for the purposes of that sentence.

The provisions of the two foregoing sentences shall only apply for a period of 10 years after the date on which the Convention became effective. This period may be extended by mutual agreement between the competent authorities.

New Zealand - Singapore (1993) Protocol

Article I

Notwithstanding paragraph 3 of Article 19 of the Agreement, a New Zealand resident deriving income from Singapore, being income referred to in that paragraph, shall not be deemed to have paid Singapore tax in respect of such income where the competent authority of New Zealand considers, after consultation with the competent authority of Singapore, that it is inappropriate to do so having regard to:

a) whether any arrangements have been entered into by any person for the purpose of taking advantage of paragraph 3 of Article 19 for the benefit of that person or any other person;

b) whether any benefit accrues or may accrue to a person who is neither a New Zealand resident nor a Singapore resident;

c) the prevention of fraud or the avoidance of the taxes to which the Agreement applies;

d) any other matter which the competent authorities consider relevant in the particular circumstances of the case including any submissions from the New Zealand resident concerned.

Article II

Article I of this Second Protocol shall apply to income derived on or after 1 July 1993.

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Spain - India (1993) Article 25

4. For the purposes of deduction referred to in paragraph 3, the term "income-tax paid in India" shall be deemed to include any amount which would have been payable as Indian tax under the laws of India and in accordance with this Convention for any year but for an exemption from, or reduction of, tax granted for that year under:

i) Sections 10(4), 10(15)(iv), 10A, 10B, 32A, 32AB, 80HH, 80HHC and 80I of the Income-tax Act, 1961 (43 of 1961) so far as they were in force on, and have not been modified since, the date of the signature of this Convention, or have been modified only in minor respects so as not to affect their general character; or

ii) any other provision which may be enacted hereafter granting a deduction in computing the taxable income or an exemption or reduction from tax which the competent authorities of the Contracting States agree to be of a substantially similar character if it has not been modified only in minor respects so as not to affect its general character.

5. The provision of paragraph 4 shall apply for the first 10 years for which this Convention is effective but the competent authorities of the Contracting States may consult each other to determine whether this period shall be extended.

Sweden - Malta (1995) Article 22(2)

d) For the purposes of sub-paragraph (a) of this paragraph the term "Malta tax paid" shall be deemed to include the Malta tax which would have been paid but for any time-limited exemption or reduction of tax granted under incentive provisions contained in the Malta law designed to promote economic development to the extent that such exemption or reduction is granted for profits from industrial or manufacturing activities or from agriculture, fishing or tourism (including restaurants and hotels) provided that the activities have been carried out within Malta. For the purposes of sub-paragraph (c) of this paragraph a tax of 15 per cent calculated on a Swedish tax base shall be considered to have been paid for

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such activities under those conditions mentioned in the previous sentence. The competent authorities may agree to extend the application of this provision also to other activities.

e) The provisions of sub-paragraph (d) of this paragraph shall apply for the first ten years during which this Convention is effective. This period may be extended by a mutual agreement between the competent authorities.

United Kingdom - Indonesia (1993) Article 21

3. For the purposes of paragraph (1) of this Article, the term "Indonesian tax payable" shall be deemed to include any amount which would have been payable as Indonesian tax for any year but for an exemption or reduction of tax granted for the year or any part thereof under Article 15(5) and Article 16(1) and (2) of Law No 1 of 1967 of Indonesia to the extent that these provisions continue in force by virtue of Article 33(2)(a) of Act No 7 of 1983 of Indonesia. Provided that relief from United Kingdom tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than 10 years after the exemption from, or reduction of, Indonesian tax was first granted in respect of that source.

United Kingdom - Mongolia (1996) Article 24

4. For the purposes of paragraph 1 of this Article, the term "Mongolian tax payable" shall be deemed to include any amount which would have been payable as Mongolian tax for any year but for a reduction of tax granted for that year or any part thereof as a result of the application of the following provisions of Mongolian law:

a) sub-paragraph (i) of paragraph 1 of Article 20 of the Foreign Investment Law of Mongolia so far as it was in force on, and has not been modified since, the date of signature of this Convention, or has been modified only in minor respects so as not to affect its general character; or

b) any other provision which may subsequently be made granting a reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it

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has not been modified thereafter or has been modified only in minor respects so as not to affect its general character.

5. Relief from United Kingdom tax by virtue of paragraph 4 of this Article shall not be given where the profits, income or chargeable gains in respect of which tax would have been payable but for the exemption or reduction of tax granted under the provisions referred to in that paragraph arise or accrue more than ten years after the date on which this Convention enters into force.

6. The period referred to in paragraph 5 of this Article may be extended by agreement between the Contracting States.

United Kingdom - Papua New Guinea (1991) Article 23

3. For the purposes of paragraph 1 of this Article, the term "Papua New Guinea tax payable" shall be deemed to include any amount which would have been payable as Papua New Guinea tax for any year but for an exemption or reduction of tax granted for that year on any part thereof under any of the following provisions of Papua New Guinea law:

a) Sections 45L, 73(9), 97 or 97A of the Papua New Guinea Income Tax Act 1959 as amended, so far as they were in force on, and have not been modified since, the date of signature of this Convention, or have been modified only in minor respects so as not to affect their general character; or

b) Sections 72A(3), 73(3) or 73(7) of the Papua New Guinea Income Tax Act 1959 as amended, so far as they were in force on, and have not been modified since, the date of signature of this Convention, or have been modified only in minor respects so as not to affect their general character: and provided always that the competent authority of Papua New Guinea has certified that any such exemption or relief from Papua New Guinea tax given under these Sections has been granted in order to promote industrial, commercial, scientific, educational or other development in Papua New Guinea and the competent authority of the United Kingdom has accepted that such exemption or relief has been granted for such purpose; or

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c) any other provision which may subsequently be made granting an exemption or reduction of tax which is agreed by the competent authorities of the Contracting States to be of a substantially similar character, if it has not been modified thereafter or has been modified only in minor respects so as not to affect its general character. Provided that relief from United Kingdom tax shall not be given by virtue of this paragraph in respect of income from any source if the income arises in a period starting more than 10 years after the exemption from, or reduction of, Papua New Guinea tax was first granted in respect of that source.

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Annex II

TAX SPARING PROVISIONS BETWEEN OECD MEMBER COUNTRIES

	Aus	Aus	Bel	Can	Cze	Den	Fin	Fra	Ger	Gre	Hun	Ice	Ire	Ita	Jap
Australia															
Austria															
Belgium										X					
Canada													X		
Czech R															
Denmark														R	
Finland													X	R	
France															
Germany										X					
Greece			X						X						
Hungary															
Iceland															
Ireland				X			X								X
Italy						R	R								
Japan													X		
Korea		X		X	R		X	X	R	R			R	R	X
Luxemburg										X					
Mexico								X	X					1	X
Nederlands										X					
New Zealand															
Norway													X		
Poland					R										
Portugal		X	X				X	X	X					2	
Spain			X	X		X			X						X
Sweden										X				X	
Switzerland															
Turkey		X	X			X	X	X	X					R	X
U.K.															
U.S.A.															

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Kor	Lux	Mex	Ned	N.Z.	Nor	Pol	Por	Spa	Swe	Swi	Tur	UK	US	
														Australia
X							X				X			Austria
							X	X			X			Belgium
X								X						Canada
R						R								Czech R
								X			X			Denmark
X							X				X			Finland
X		X					X				X			France
R		X					X	X			X			Germany
R	X		X							X				Greece
														Hungary
														Iceland
R					X									Ireland
R		1					2		X		R			Italy
X		X						X			X			Japan
	X	3	X	X						X	R	X		Korea
X								X						Luxemburg
3			X		X			4	X	X		X		Mexico
X		X												Nederlands
X														New Zealand
		X					X	X			X			Norway
														Poland
					X					X		X		Portugal
	X	4			X				X	X		X		Spain
		X						X			X			Sweden
X		X					X	X						Switzerland
R					X				X			X		Turkey
X		X					X	X			X			U.K.
														U.S.A.

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Notes on the Table

Source: The International Bureau of Fiscal Documentation

Some of the OECD Member countries listed in the table have not concluded tax treaties with each other.

Unless otherwise noted in the table, the following countries are always the recipients of tax sparing:

Greece	Ireland	Italy	Korea
Mexico	Portugal	Spain	Turkey

Keys in table

1 = Italy grants tax sparing to Mexico
2 = Italy grants tax sparing to Portugal
3 = Korea grants tax sparing to Mexico
4 = Spain grants tax sparing to Mexico
R = Tax sparing granted on a reciprocal basis

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Annex III

TAX SPARING PROVISIONS IN TREATIES BETWEEN OECD MEMBER AND CERTAIN NON- MEMBER COUNTRIES

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TAX SPARING PROVISIONS IN TREATIES BETWEEN OECD MEMBER AND CERTAIN NON-MEMBER COUNTRIES

Country	Argentina	Brazil	China	India	Indonesia
Australia			X	X	
Austria		X	X		X
Belgium		X	X	X	X
Canada	X	X	X	X	X
Czech Rep.		X	X (R)	X (R)	
Denmark	X	X	X	X	
Finland	X	X	X	X	
France	X	X	X	X	X
Germany	X	X	X	X	X
Greece					
Hungary		X	X		
Iceland					
Ireland					
Italy	X	X	X	X	
Japan		X	X	X	X
Korea		X (R)	X (R)	X (R)	X (R)
Luxembourg		X	X		
Mexico					
Netherlands		X	X	X	X
New Zealand			X	X	
Norway		X	X	X	
Poland			X	X (R)	
Portugal					
Spain	X	X (R)	X	X	
Sweden		X		X	X
Switzerland			X	X	
Turkey					
U.K.	X		X	X	X
U.S.A.					

Source: The International Bureau of Fiscal Documentation.
Note: Some of the OECD Member and non-Member countries listed in the table have not concluded tax treaties with each other.

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TAX SPARING PROVISIONS IN TREATIES BETWEEN OECD MEMBER AND CERTAIN NON-MEMBER COUNTRIES (CONTINUED)

Country	Malaysia	Philippines	Singapore	Thailand	Venezuela
Australia		X		X	
Austria	X	X		X	
Belgium	X	X	X		
Canada	X	X	X	X	
Czech Rep.	X (R)			X (R)	
Denmark	X	X (R)	X		
Finland	X	X			
France	X	X	X		X
Germany	X	X	X		X
Greece					
Hungary	X			X	
Iceland					
Ireland					
Italy	X	X	X		X
Japan	X	X		X	
Korea	X (R)	X	X (R)		
Luxembourg			X		
Mexico			X *		
Netherlands	X	X	X		X
New Zeal.	X	X	X		
Norway	X	X	X		
Poland					
Portugal					
Spain		X			
Sweden		X	X	X	X
Switzerland	X				
Turkey					
U.K.	X		X	X	X
U.S.A					

® = Tax sparing granted on a reciprocal basis
* = Tax sparing granted only to the OECD country

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Annex IV

TAX AVOIDANCE SCHEME I

The conduit-scheme example described below has been reproduced from the New Zealand note SG/EMEF/CFA(96)18 to the EMEF meeting in Paris on 26-27 September 1996.

The following scheme is designed effectively to offset tax sparing credits against tax liabilities that do not relate to the foreign investment which gave rise to the tax sparing credit. The scheme has particular application in situations where the taxpayer has excess tax sparing credits. The scheme came to New Zealand's attention three years ago and precipitated renegotiation of the tax sparing provision in six of New Zealand's treaties to include an anti-avoidance rule to stop the scheme. Two of the schemes discovered involved loans of hundreds of millions of US dollars. More recently, during an audit of an international financial institution, we discovered correspondence confirming that the scheme is being used in Asia.

Tax sparing provisions in tax treaties are intended to prevent the home country clawing back a tax incentive by the host country. Where there is no tax liability in the home country in respect of the income that is spared by the host country, the tax sparing credits should not, in principle, be available to offset the tax liability on other unrelated income. New Zealand's tax law does not allow foreign tax credits (including tax sparing credits) to offset liabilities on other non-related income. However, as the examples below will show, this effect may be achieved by allocating the income and expenditure through different legal entities. As a result, this scheme exposes countries that give tax sparing to being used as conduits for loans destined for developing countries. The scheme can erode their existing tax bases by an amount equal to the value of the tax spared by the host country.

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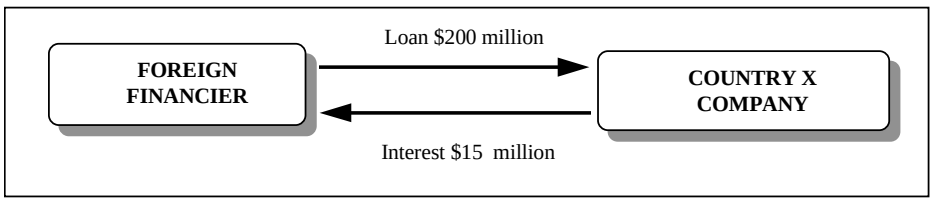
The scheme is illustrated using three scenarios. They assume a company resident in a developing country (Country X) requires a loan of $200 million to fund a development project that is approved under that country's various economic expansion incentives. An international financier ("Foreign Financier") agrees to lend the money at a rate of 7.5 per cent per annum.

Scenario one - direct loan from Foreign Financier to Country X Company

This scenario illustrates the substance of the transactions that are outlined in the examples that follow: $200 million is loaned by Foreign Financier to "Country X Company", a company resident in Country X which offers a number of tax concessions, including a tax exemption for interest paid to non-residents.

Under this scenario $15 million interest is paid by Country X Company to Foreign Financier. No tax is imposed in Country X since the interest is exempt under one of Country X's economic expansion incentives. Foreign Financier may or may not be taxed on the $15 million interest income, depending on the tax system in the country in which it is resident.



Scenario two - loan from Foreign Financier to Country X Company, but loan is channelled through a New Zealand company

This is similar to scenario one, except the loan is channelled through New Zealand. The New Zealand part of the transaction is essentially a back-to-back loan arrangement. "New Zealand Company" earns $15 million interest

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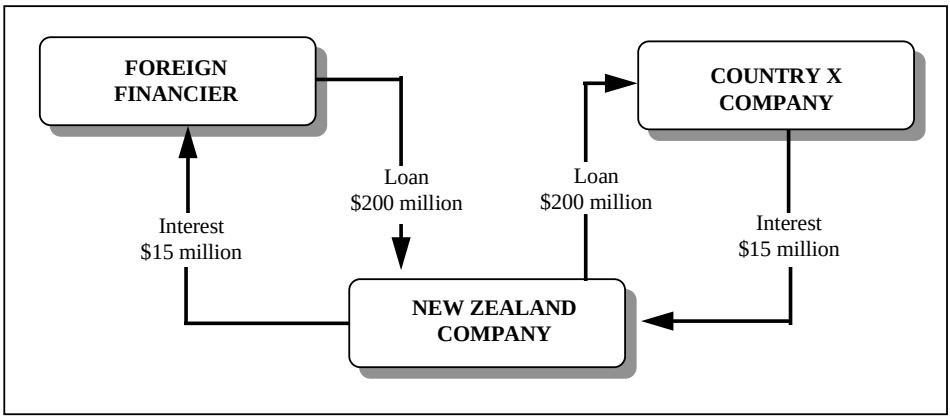
income but is entitled to a tax deduction of the $15 million interest expense that relates to the income. We assume that New Zealand has granted tax sparing to Country X on this interest income at a rate of 10 per cent, being the maximum tax on gross interest typically set under our tax treaties.



The tax consequences are as follows:

- Country X: No Country X tax is imposed because the tax is spared under one of Country X's economic expansion incentives.
- New Zealand: New Zealand Company pays no New Zealand tax since its net profit is nil (interest income equals its interest expenses). Tax credits for tax spared under the New Zealand/Country X tax treaty are not used, therefore, as there is no New Zealand tax liability.
- The interest income paid from New Zealand to Foreign Financier may be subject to either interest withholding tax of 10 per cent to 15 per cent, or a 2 per cent levy.[3]
- Foreign Country: Foreign Financier may or may not be subject to tax, depending on the tax system in the country in which it is resident.

In summary, nothing is gained by using New Zealand as a conduit for a simple back-to-back financing arrangement.

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Scenario three - similar to scenario two, except two New Zealand companies are used - one to soak up the tax sparing credits and the other to accumulate tax losses

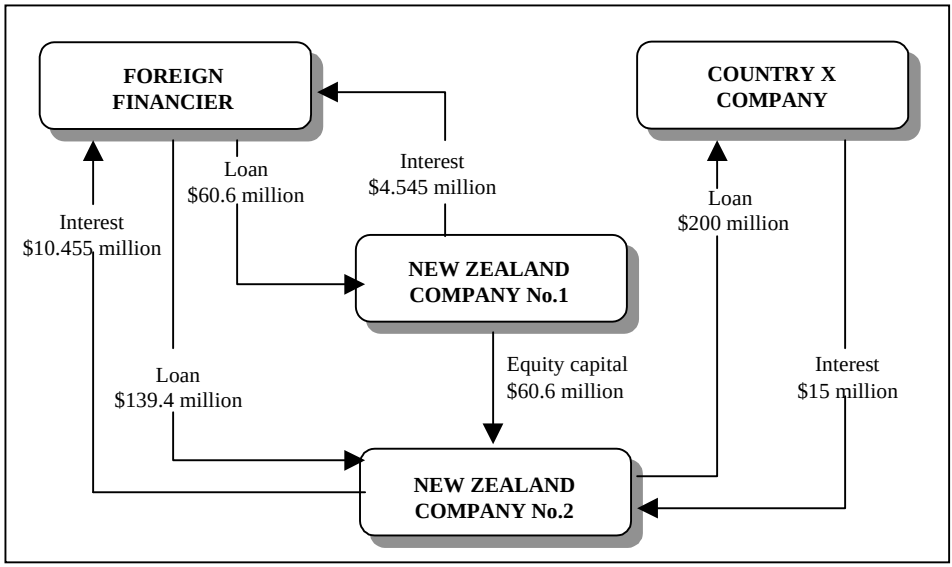
A tax-effective structure ensures that the tax spared credits are soaked up by the recipient company. This is done by splitting the interest expenditure (and loans) between two companies to create a profit in the credit soak-up company. The interest expenses (not required by the tax credit soak-up company) are passed (typically sold) to a profitable New Zealand company that can offset them against other income or accumulate them as tax losses for future use.

As illustrated below, the $200 million loan from Foreign Financier is split between the two New Zealand companies in the following proportions:

– "New Zealand Company No. 1" (NZ Co 1) - $60.6 million; and

– "New Zealand Company No. 2" (NZ Co 2) - $139.4 million.

NZ Co 1 passes the funds that it borrowed ($60.6 million) on to NZ Co 2 by way of an equity capital injection (for example, a purchase of shares in NZ Co 2). NZ Co 2 then lends the full $200 million to Country X Company. We assume again that New Zealand has granted tax sparing to Country X on this interest income at a rate of 10 per cent.



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Country X Company pays $15 million interest to NZ Co 2. NZ Co 2 is taxed in New Zealand as follows:

Interest income	15 000 000
Interest expenses	10 454 545
Net profit	4 545 455
Tax on net profit (33 per cent)	1 500 000
Tax sparing credits (10 per cent x $15 million)	(1 500 000)
Tax to pay	Nil

NZ Co 1 has incurred an interest expense of $4,545,455. This translates to a net loss of the same amount on this transaction because it receives no current taxable income from its equity investment in NZ Co 2. This loss can be offset against other income of NZ Co 1 or offset against the income of another company in the same group of companies.

The tax consequences are as follows:

- Country X: No Country X tax is imposed since the tax is spared under one of Country X's economic expansion incentives.
- New Zealand: NZ Co 2 pays no New Zealand tax because its $1 500 000 tax liability is eliminated by a tax sparing credit.

NZ Co 1 is left with a tax loss of $4 545 455 which may be offset against other New Zealand income. The tax benefit of this loss - which is borne by the New Zealand tax base - is $1 500 000 ($4 545 455 x 33 per cent). This is equivalent to the amount of the tax sparing credit.

The interest income paid from New Zealand to Foreign Financier may be subject to either interest withholding tax of 10 per cent to 15 per cent, or a 2 per cent levy

- Foreign Country: Foreign Financier may or may not be subject to tax, depending on the tax system in the country in which it is resident.

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By channelling debt investments through a country that grants tax sparing credits, and ensuring that an appropriately tax-planned structure is used to soak up the spared foreign tax credits, a tax benefit equal to the value of the tax spared credits can be obtained. This is contrary to the purpose of tax sparing, which is intended to prevent the home country clawing back the tax incentive of the developing country. It is not there to give a cash subsidy equal to the value of the tax spared by the developing country.

The example has been presented in a simplified form so that the concept can be understood. In the actual schemes that we have encountered, the tax benefit was shared between the foreign financier, a New Zealand company and the company in the developing country (which was to receive a discounted rate of interest). The schemes did not proceed because New Zealand and the treaty partners concerned quickly inserted an anti-avoidance rule in the treaties which permit the New Zealand competent authority to deny tax sparing credit claims if the provision is being abused. This anti-avoidance rule is discussed in more detail later in this paper. We also considered amending New Zealand's domestic law to counter the scheme, but we could not find a suitable remedy. The tax treaty solution appears to have deterred international financiers from using the treaties concerned, although some financiers have advised that they will instead run the scheme through other countries with tax sparing provisions.

We also became aware of schemes that were to use a structure similar to the one outlined above, except the debt funding was to flow from the developing country to New Zealand and then back to the developing country. The sole purpose of this circular flow of funds would be to exploit the tax sparing provision in the tax treaty. We suspect that the lender and borrower in the developing country were either the same entity or associated entities.

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Annex V

TAX AVOIDANCE SCHEME II

The routing-scheme example described below has been reproduced from the Australian note SG/EMEF/CFA(96)17 to the EMEF meeting in Paris on 26-27 September 1996.

The largest scheme so far encountered in Australia involves a circular flow of funds. A series of loans were to be purportedly made by an Australian financial institution to a major foreign bank via an intermediary finance company resident in a developing country with which Australia had agreed under a tax treaty to tax spare interest withholding tax forgone by that country under a particular development incentive tax concession. The foreign bank then effectively was to pay the loan moneys back to the Australian financial institution. Interest on such loans were normally subject to 10 per cent interest withholding tax by the developing country. However, the Finance Minister of that country agreed to reduce the interest withholding tax rate on these loans to 1.5 per cent under the relevant development incentive.

Judged against a test of commercial reality, the proposed scheme was artificial and contrived, with the transactions being intended to take place in the space of 30 minutes. Although ostensibly the proposed transactions involved funds of several billion Australian dollars, the transactions were to use only approximately $A 200m, which was to be made available to the intermediary finance company and most of that amount would have been returned immediately to the Australian financial institution in the form of prepaid interest. The scheme would have enabled that financial institution to incur a notional loss which was approximately sufficient in amount to offset the interest income it had earned. The "tax spared" foreign tax credit in respect of the interest withholding tax was to be offset against the tax payable on other foreign income of the financial institution. Over the duration of the scheme the cost to

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Australian revenue would have been in the order of $A 100m. It was only by means of strong representations to its treaty partner that Australia was able to prevent the scheme from being implemented.

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Annex VI

ANTI-ABUSE PROVISIONS

Country model tax sparing anti-abuse provisions

New Zealand: Notwithstanding paragraph (...) of Article ... [tax sparing provision in the Elimination of Double Taxation Article] of the Agreement, a New Zealand resident deriving income from [other country], being income referred to in that paragraph, shall not be deemed to have paid [other country] tax in respect of such income where the competent authority of New Zealand considers, after consultation with the competent authority of [other country], that it is inappropriate to do so having regard to:

a) whether any arrangements have been entered into by any person for the purpose of taking advantage of paragraph (...) of Article ... for the benefit of that person or any other person;

b) whether any benefit accrues or may accrue to a person who is neither a New Zealand resident nor a resident of [other country];

c) the prevention of fraud, evasion, or avoidance of the taxes to which the Agreement applies;

d) any other matter which the competent authorities consider relevant in the particular circumstances of the case including any submissions from the New Zealand resident concerned.

Australia: (Host country) tax forgone shall not be deemed to have been paid in respect of income derived from any scheme entered into by an Australian resident with the purpose of using [host country] as a conduit for income or as a location of property in order to evade or avoid Australian tax through the exploitation of the Australian foreign tax credit provisions, or to confer a benefit on a person who is neither a resident of Australia, nor of (the host country).

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Annex VII

ARTICLE 23B OF THE COMMENTARY TO THE OECD MODEL TAX CONVENTION

C. The relation in special cases between the taxation in the State of source and the ordinary credit method

72. In certain cases a State, especially a developing country, may for particular reasons give concessions to taxpayers, *e.g.* tax incentive reliefs to encourage industrial output. In a similar way, a State may exempt from tax certain kinds of income, *e.g.* pensions to war wounded soldiers.

73. When such a State concludes a convention with a State which applies the exemption method, no restriction of the relief given to the taxpayers arises, because that other State must give exemption regardless of the amount of tax, if any, imposed in the State of source (see Section III, paragraph 3). But when the other State applies the credit method, the concession may be nullified to the extent that such other State will allow a deduction only of the tax paid in the State of source. By reason of the concessions, that other State secures what may be called an uncovenanted gain for its own Exchequer.

74. Should the two States agree that the benefit of the concessions given to the taxpayers in the State of source are not to be nullified, a derogation from paragraph 2 of Article 23 A, or from Article 23 B will be necessary.

75. Various formulae can be used to this effect, as for example:

a) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (*e.g.* limitations of rates provided for dividends and interest in

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Articles 10 and 11) even if the State of source, as a developing country, has waived all or part of that tax under special provisions for the promotion of its economic development;

b) as a counterpart for the tax sacrifice which the developing country makes by reducing in a general way its tax at the source, the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;

c) the State of residence exempts the income which has benefited from tax incentives in the developing country.

Contracting States are free to devise other formulae in the course of bilateral negotiations.

76. If a Contracting State agrees to stimulate especially investments in the other State being a developing country, the above provisions will generally be accompanied by guarantees for the investors, that is to say, the Convention will limit the rate of tax which can be imposed in the State of source on dividends, interest and royalties.

77. Moreover, time restrictions or time limits can be provided for the application of the advantages referred to in formula *a*), and possibly *c*), above: the extended credit (or the exemption) may be granted only in respect of incentives applied temporarily in developing countries, or only for investments made or contracts concluded in the future (for instance, from the date of entry into force of the Convention) or for a determined period of time.

78. Thus, there exists a considerable number of solutions to this problem. In fact, the concrete effects of the provisions concerned can also vary as a result of other factors such as the amount to be included in the taxable income in the State of residence (formulae *a*) and *b*) above); it may be the net income derived (after deduction of the tax effectively paid in the State of source), or the net income grossed-up by an amount equal to the tax effectively paid in the State of source, or to the tax which could have been levied in accordance with the Convention (rates provided for in Articles 10 and 11) or to the tax which the State of residence agrees to allow as a deduction.

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Annex VIII

RECOMMENDATION OF THE COUNCIL ON THE GRANTING AND DESIGN OF TAX SPARING IN TAX CONVENTIONS

THE COUNCIL,

Having regard to Article 5 b) of the Convention on the Organisation for Economic Co-operation and Development of 14 December 1960;

Having regard to the Recommendation of the Council of 23 October 1997 concerning the Model Tax Convention on Income and on Capital C(97)195;

Having regard to the Report on tax sparing: "Tax Sparing: A Reconsideration" [DAFFE/CFA(97)3/REV2], hereafter referred to as the Report;

Considering that the granting of tax sparing in tax conventions may offer wide opportunities for tax planning and tax avoidance;

Considering that the granting of tax sparing in tax conventions may have the effect of provoking harmful tax competition between countries;

Having regard to the need to develop a more coherent approach among Member countries and non-member countries towards the granting and design of tax sparing in tax conventions;

I. RECOMMENDS to the Governments of Member countries that, in negotiating and concluding tax treaties, they follow the recommendations set out in the Report on the use and design of tax sparing provisions, as it may be amended from time to time; and

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II. INVITES the Governments of Member countries to inform, as appropriate, the Committee on Fiscal Affairs of any modification in their policy on the use and design of tax sparing provisions;

III. INSTRUCTS the Committee on Fiscal Affairs:

1. to pursue its work on issues pertinent to tax sparing; and

2. to develop a dialogue with non-Member countries that request tax sparing, with the aim of developing a more coherent position on the granting and design of tax sparing.

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NOTES

1. The current report is focused primarily on foreign investment activities carried on through a subsidiary. Since foreign branches of companies are generally taxed on a current basis in the residence country, some of the arguments raised in this and other sub-sections would not be directly relevant to branch-situations. This fact does not necessarily affect the conclusions of this report. First, the bulk of foreign operations of multinationals are carried out through subsidiaries. Second, the decision to establish foreign activities through a branch is often taken in cases where the resident company anticipates that the foreign operations initially will generate substantial losses. The use of a branch enables the resident company to offset those losses against other income derived by the company. When the branch operations later begin to generate income, the residence company often reorganises the branch into a subsidiary to benefit from deferral.

2. For a general overview of the CFC regimes in the OECD Member countries, see the OECD report, Controlled Foreign Company Legislation, Studies in Taxation of Foreign Source Income (1996).

3. The rate may be set by a tax treaty or domestic law and some instruments are exempt from income tax but subject to a levy.

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THE APPLICATION OF THE OECD MODEL TAX CONVENTION TO PARTNERSHIPS

(adopted by the OECD Committee on Fiscal Affairs on 20 January 1999)

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FOREWORD

This publication, the sixth in the series "Issues in International Taxation", includes the report entitled "The Application of the OECD Model Tax Convention to Partnerships" which the Committee on Fiscal Affairs adopted, and decided to make available to the public, on 20 January 1999.

The report deals with the application of the provisions of the OECD Model Tax Convention, and indirectly of bilateral tax conventions based on that Model, to partnerships. It puts forward a number of changes to the Model Tax Convention which will be included in the next update to the Model.

At the time of adopting the report, the delegations for France, Germany, the Netherlands, Portugal and Switzerland have expressed reservations on various aspects of it. These reservations are reproduced in Annex II.

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THE APPLICATION OF THE OECD MODEL TAX CONVENTION TO PARTNERSHIPS

I. INTRODUCTION

I.1 Background

1. In 1993, the Committee formed a Working Group to study the application of the Model Tax Convention to partnerships, trusts, and other non-corporate entities. This first report by the Working Group, which the Committee adopted on 20 January 1999, focuses exclusively on partnerships. The Committee recognises, however, that many of the principles discussed in its report may also apply with respect to other non-corporate entities and therefore intends to now examine the application of the Model Tax Convention to these other entities in light of this report.

2. In this respect, it should also be noted that the references to "partnerships" in this report cover entities that qualify as such under civil or commercial law as opposed to tax law. Thus the term "partnership", as used in this report, does not imply anything about the tax treatment of the relevant entity and should not be confused with a reference to entities, whether partnerships or not, which are treated as transparent for tax purposes.

3. At the beginning of the work on this topic, it was decided that this work should generally focus on practical cases and an approach based on the discussion of factual examples was therefore adopted. It was quickly found that many of the problems that were brought to the attention of the Committee arose from so-called "conflicts of qualification" — cases where the treaty partners interpret or apply the treaty in different ways. The Committee agreed that while this broader issue extended beyond the treatment of partnerships under tax conventions, it should nevertheless be dealt with in the context of this work on partnerships.

I.2 Organisation of the report

4. As previously indicated, this report focuses on specific factual examples. For each example, the facts and, where applicable, relevant aspects of domestic tax laws are described. The Committee's analysis of how the OECD Model Tax

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Convention applies in the example is then presented and, where appropriate, changes to the Model Tax Convention are put forward.

5. Section II discusses various aspects of the application of tax conventions by the State of source where partnerships are involved. It includes a discussion of the entitlement to treaty benefits of partners and partnerships in various circumstances.

6. Section III addresses issues arising from the application of tax conventions by the State of residence. Subsection III.1 discusses problems related to conflicts of qualification while subsection III.2 discusses problems related to conflicts of income allocation.

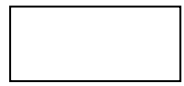
7. Annex I includes changes to the Model Tax Convention which are either specifically included in the report or reflect its contents. Annex II includes general observations by France, Germany, the Netherlands, Portugal and Switzerland. Annex III includes a list of entities found in the countries that have co-operated to the preparation of this report.

8. The following abbreviations are used in this report:

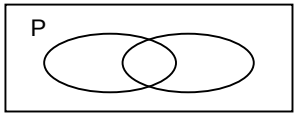
P	=	The partnership
A and B	=	Partners in P
State P	=	The State in which P is located
State R	=	The State of residence of one or all the partners
State S	=	The State of source, i.e. the State in which income arises, where three States are involved

9. Similarly, the following symbols are used in the various diagrams used in this report:

Indicates a partner of partnership P

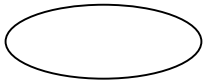


Indicates a company

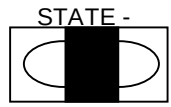


Indicates the partnership

Indicates that the State treats partnerships as transparent entities



Indicates a fixed base or permanent establishment



Indicates that the State treats partnerships as taxable entities

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II. APPLICATION OF TAX CONVENTIONS BY THE STATE OF SOURCE

II.1 Preliminary remarks on the tax treatment of foreign entities

10. In addressing the issue of how tax conventions apply to partnerships, a useful starting point is to examine how foreign entities are treated for purposes of the taxation, by the State of source, of income derived from its territory.

11. In most Member countries, as a matter of principle, tax laws apply on the basis of the legal relationship deriving from other branches of the law. Thus the tax laws of these countries, when referring to partnerships, will, absent special tax definitions, refer to those entities that constitute partnerships according to domestic civil or commercial law.

12. Difficulties often arise, however, where income is derived by an entity organised under the laws of another jurisdiction. In that case, the entity will have to be classified for purposes of the application of the tax laws of the country where the income is derived, regardless of whether or not that classification is compatible with the civil or commercial law system of the jurisdiction from which the entity derives its legal status.

13. For example, if the tax system of a country recognises only individuals, companies and partnerships (but not trusts) as taxpayers and provides for a different tax treatment for these three types of taxpayers, that country will have to "force" foreign entities in one or the other of these categories (with more or less difficulty depending on the similarity of the civil and commercial law of the countries concerned) for purposes of applying its tax system to domestic income derived by these foreign entities.

14. In doing so, the practice of most countries is to adopt the same approach as the one they apply in a purely domestic context. They will therefore apply their domestic tax classification to foreign entities on the basis of the foreign law's legal characteristics of the entity. In the previous example, the country, for the purposes of taxing the domestic income of a trust established under the law of a foreign jurisdiction, will typically examine the legal characteristics of the trust as they derive from the trust law of the foreign jurisdiction in order to determine whom it should tax and whether that person should be taxed as an

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individual, company or partnership, which are the only categories recognised under its tax law.

15. In a system of international taxation where income taxes are levied on the basis of both residence and source, this means that, in addition to the well-known problem of the same item of income being taxed in the State of residence and the State of source, there will be risks of double-taxation or non-taxation associated with:

- the different classification of a given entity in the State of residence and the State of source,

- the different tax treatment, in these States, of a given entity despite common classification.

These risks, which are further analysed in the next two subsections, are compounded when the participants in the entity (e.g. the partners of a partnership) reside in a different State from that in which the entity has been established. Subsection II.2 discusses how these differences are particularly important for partnerships.

II.2 Differences that affect the tax treatment of partnerships

a) Different classification

16. While most, if not all, Member countries recognise the concepts of company and of partnership for tax purposes, their definitions of these two concepts may vary.

17. In most cases, the similarities between the legal systems of the Member countries will be sufficient to ensure that what is a company or a partnership in the country where it has been established is recognised as such, for tax purposes, in other countries. Entities, however, that are not widespread in the civil or commercial laws of the Member countries will create difficulties if they cannot easily be classified in one of these categories but need to be so classified for tax purposes. In that case, it is possible that one country will treat the entity as a partnership while the other will treat it as a company, with completely different tax results.

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b) Different treatment

18. Problems will also arise, however, where two countries classify a given entity in the same way but treat that entity in different ways.

19. These problems are particularly important for partnerships and most of the examples in this report are based on these problems. A well-known difficulty is that while some countries treat partnerships as transparent entities, imposing no tax on the partnership itself but taxing each partners on its share of the partnership's income, others treat the partnership as a taxable entity, usually taxing the partnership on its income as if it were a company.

20. There are, however, many other possible differences which may result in double taxation or non-taxation, some of which are discussed in this report. For instance, while some countries accept that a partner may also be a creditor of the partnership and may therefore derive interest income from the partnership, others consider that no interest may be paid to a partner, any payment of what purports to be interest being treated as a distribution of the income of the partnership.

21. Other differences relate to how countries apply the transparency approach. The mere fact that the income of the partnership is taxed at the partners' level does not, in itself, address all issues related to the computation of the tax to be paid on that income. Tax rules often differ depending on the nature of the taxpayer or on the relationship between the taxpayer and another party to a transaction. Countries may have different views as to what extent the partnership should be ignored in applying rules based on the nature of the taxpayer or on its relationship with another person (the question of the extent to which a transparent partnership should be ignored for the purposes of the application of the provisions of tax conventions is discussed in subsection II.6 below).

22. To assist countries in identifying cases where these differences may create problems, the Committee has decided to develop a list that describes the tax treatment of entities established under the laws of each country and commonly used for commercial and investment purposes. That list is included in Annex III.

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c) The effect on tax conventions

23. The differences described above create a number of difficulties with respect to the application of the provisions of tax conventions.

24. The Commentary on Article 1 of the Model Tax Convention already refers to the problem described in paragraph 19 above in the following words:

> "The domestic laws of the various OECD Member countries differ in the treatment of partnerships. The main issue of such differences is founded on the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries disregard the partnership and tax only the individual partners on their share of the partnership income."

25. The difficulties that this and other differences create in the context of the application of the provisions of tax conventions are discussed throughout this report. This section focuses on the problems that the differences described above create for the application of the Convention by the State of source, including the determination of who is entitled to the benefits of a tax convention in relation to income derived by a partnership (subsections II.3 to II.5) and the application of the provisions of the Convention that are dependent upon certain characteristics or attributes of the taxpayer (subsection II.6). Section III deals with the problems related to the application of the Convention by the State of residence, focusing on conflicts of qualification (subsection III.1) and conflicts of income allocation (subsection III.2).

26. The Committee believes that many of these difficulties may be solved through a better co-ordination in the application and interpretation of some of the provisions of tax conventions. This report puts forwards a number of suggestions in that respect.

II.3 When is a partnership entitled to the benefits of a tax convention?

27. Where income is derived from a particular State, the determination of the tax consequences in that State will first require the application of the domestic tax laws of that State. It is the provisions of these laws that will determine who may be subjected to tax on that income in that State. The provisions of tax conventions, however, may then intervene to restrict or eliminate the taxing

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rights originating from domestic law where a person, usually but not necessarily the taxpayer identified under domestic law, is eligible for the benefits of the tax convention in relation to that income.

28. The clear rule of Article 1 of the Model Tax Convention is that only persons who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. Where income is earned by a partnership, the issue of whether the partnership itself is entitled to the benefits of the Convention will depend on whether the partnership qualifies as a person who is a resident of a Contracting State under the definitions of Article 3 and of paragraph 1 of Article 4.

a) Is a partnership a "person"?

29. For a partnership, entitlement to treaty benefits will therefore first depend on whether it qualifies as a "person". Subparagraph 1 *a*) of Article 3 of the Model defines a "person" for purposes of the Convention as "an individual, a company and any other body of persons". Paragraph 2 of the Commentary on Article 3 provides:

> "The definition of the term "person" given in subparagraph *a*) is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense (cf. especially Articles 1 and 4). The definition explicitly mentions individuals, companies and other bodies of persons. From the meaning assigned to the term "company" by the definition contained in subparagraph *b*) it follows that, in addition, the term "person" includes any entity which, although itself not a body of persons, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation, Stiftung*) may fall within the meaning of the term "person". Special considerations for the application of the Convention to partnerships are found in paragraphs 2 to 6 of the Commentary on Article 1."

30. The Commentary on Article 1, however, does not discuss the issue of whether a partnership is a "person" within the meaning of Article 3. While the practices of Member countries are not entirely uniform in this respect, the Committee has determined that partnerships should be considered to be "persons" within the meaning of the definition found in Article 3. In most countries, partnerships (as well as the individual partners) will be considered to be "persons" within the meaning of Article 3 either because the partnerships fall

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within the definition of company or because they are bodies of persons. The Committee has therefore decided to delete the last sentence of paragraph 2 of the Commentary on Article 3 and to replace it with the following sentence:

> "Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons."

31. The Committee has noted, however, that the definition of the term "national" in subdivision 1 *f*) (*ii*) of Article 3 may give rise to an implication that partnerships are not "persons" for purposes of the Convention. That definition provides that the term "national" includes "any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State". As a matter of grammar and logic, a specific term that is included within a broader general term is not ordinarily given separate mention in a list that contains the general term.[1]

32. In order to avoid any confusion that may result from that definition, the Committee has agreed to add the following paragraph to the Commentary on Article 3:

> "The separate mention of partnerships in sub-paragraph 1 *f*) is not inconsistent with the status of a partnership as a person under sub-paragraph 1 *a*). Under the domestic laws of some countries, it is possible for an entity to be a "person" but not a "legal person" for tax purposes. The explicit statement is necessary to avoid confusion."

1. Since partnerships qualify as "persons", they should be entitled, under paragraph 1 of Article 25, to have recourse to the mutual agreement procedure. Where, however, a partnership does not qualify as a "resident of a Contracting State" (see below), paragraph 1 of Article 25 does not indicate to which competent authority it should present its case. The Committee believes that this procedural hurdle should not prevent the partnership from presenting its case to the competent authority of the State of residence of its partners since the same result could be obtained, albeit in a more cumbersome way, if each of the partners presented the case himself.

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b) Is a partnership a "resident of a Contracting State"?

33. Paragraph 3 of the Commentary on Article 1 deals specifically with the problem of whether a partnership qualifies as a "resident" for treaty purposes. The Commentary states:

> "First, the question arises whether a partnership as such may invoke the provisions of the Convention. Where a partnership is treated as a company or taxed in the same way, it may reasonably be argued that the partnership is a resident of the Contracting State taxing the partnership on the grounds mentioned in paragraph 1 of Article 4 and therefore, falling under the scope of the Convention, is entitled to the benefits of the Convention. In the other instances mentioned in paragraph 2 above, the application of the Convention to the partnership as such might be refused, at least if no special rule is provided for in the Convention covering partnerships."

34. The Committee discussed this paragraph and concluded that its analysis is correct. If the State in which a partnership has been organised treats that partnership as fiscally transparent, then the partnership is not "liable to tax" in that State within the meaning of Article 4, and so cannot be a resident for purposes of the Convention. Although inconvenient at times (e.g. paragraph 89 below), there appears to be little scope for a contrary argument under the current wording of Article 4.

35. To clarify this point, the Committee has agreed to delete the last sentence of paragraph 3 of the Commentary on Article 1 and to replace it with the following sentences:

> "Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners are entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of

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taxation in their State of residence (cf. paragraph 8.2 of the Commentary on Article 4)."

36. The Committee recognised that the determination of whether a partnership is "liable to tax" in a given State may present practical difficulties having regard to the different systems that countries use to impose tax on partnerships' income. It believes that the list referred to in paragraph 22 above, which is included in Annex III, would assist countries in dealing with these difficulties.

37. The Committee discussed in detail how the concept of "liable to tax" should be understood in the context of different systems for taxing partnerships' income. The Committee first discussed cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes. While this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report.

38. The Committee then examined two common approaches to taxation of partnerships. In many countries, the tax laws provide that income derived by a partnership from a particular source must be computed at the partnership level as if the partnership were a distinct taxpayer. Each partner is then allocated his share of that income which retains its character and is added to his income for purposes of determining his taxable income. His taxable income, including his share of the partnership's income is then reduced by the personal allowances and deductions to which he is entitled and tax is then determined, assessed and paid at the partner's level. In such cases, it is clear that the partnership is not itself liable to tax.

39. In other countries, the income and the tax payable is computed in a similar way, but the tax payable by the partners is then aggregated at the level of the partnership which is then assessed for the total amount of the tax. In these cases, the assessment of the tax in the hands of the partnership is a collection technique that does not change the fact that the tax payable on the income of the partnership is determined at each partner's level taking into account the other income of that partner, the personal allowances to which he is entitled and the

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tax rate applicable to him (which may vary depending on his total income or his nature). In such cases, the partnership is also not liable to tax.

40. The Committee agreed that for purposes of determining whether a partnership is liable to tax, the real question is whether the amount of tax payable on the partnership income is determined in relation to the personal characteristics of the partners (whether the partners are taxable or not, what other income they have, what are the personal allowances to which they are entitled and what is the tax rate applicable to them). If the answer to that question is yes, then the partnership should not itself be considered to be liable to tax. The fact that the income is computed at the level of the partnership before being allocated to the partners, that the tax is technically paid by the partnership or that it is assessed on the partnership as described in the preceding paragraph will not change that result.

41. The fact that a partnership may be said to be liable to tax in a State will not, however, be sufficient for it to be considered a resident of that State for purposes of tax conventions. Paragraph 1 of Article 4 also requires that the liability to tax in that State be caused by one of the criteria listed therein (e.g. residence, domicile etc.). Thus, for a partnership to be a resident of a Contracting State, it has to be liable to tax in that State by reason of one of these criteria.

42. The provisions of tax conventions will apply differently depending on whether or not a partnership qualifies as a resident. Where a partnership does not so qualify because it is the partners who are liable to tax on the partnership's income, the income derived by the partnership should be considered to keep the nature and source that it had in the hands of the partnership for purposes of the provisions of a tax convention. This corresponds to the situation that is generally provided for under the domestic laws of the countries that do not treat partnerships as taxable entities. Thus, where a partnership is treated as transparent for purposes of tax conventions because it is the partners rather than the partnerships who are liable to tax on the partnership's income, that income will, when applying the relevant Convention, keep the nature and source that it had in the hands of the partnership for purposes of taxation in the hands of the partners.[1]

1. See the diverging opinion by France in Annex II.

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43. While the Convention generally does not apply to partnerships that are treated as fiscally transparent since they do not meet the criteria of paragraph 1 of Article 4, some countries have included partnerships within the coverage of their Conventions in certain circumstances. In specially negotiated provisions, the partnership is treated as a resident to the extent that its income is subject to tax in the hands of the partners. This can come about because the partners are resident in the State in which the partnership is organised or because, in the case of non-resident partners, the partnership maintains a permanent establishment in the State of organisation and the income is attributable to the permanent establishment. If all of the income of the partnership is attributed to either resident partners or to a permanent establishment when non-resident partners are present, the partnership would be treated in the same way as a resident company which was subject to worldwide tax liability. The following text from the Protocol to the Convention between Germany and Italy illustrates the use of such specially negotiated provisions:

> "A partnership is deemed to be a resident of a Contracting State in the sense of paragraph 1 of Article 4 if it has been established in accordance with the law of that State or if the main object of its activities is in that State. However, the limitations to the right to tax of the other Contracting State as provided in Articles 6 to 23 apply only insofar as the income derived from that State or the capital situated therein is subject to tax in the first-mentioned State.

44. One justification for such special provisions treating the partnership itself as resident is that they are viewed by some countries as avoiding the administrative problems involved in requiring that all partners establish that they are entitled to treaty benefits. In addition, in some cases, the provisions originated where one of the Contracting States treated partnerships as taxable entities and the other State, though applying a fiscal transparency approach, insisted on reciprocal treatment. Finally, since the income will necessarily be subject to tax in the State of organisation, providing treaty benefits will not result in double non-taxation or in the reduction of source State taxation where there is no tax in the State where the partnership has been formed.

45. On the other hand, there are some substantial problems and issues which such an approach raises. In the first place, it may be difficult to determine when the source State income is in fact attributable to a permanent establishment in the State of organisation. If the income was attributable to a third State's

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permanent establishment, for example, in a tax haven, the source State relief would not necessarily be matched with taxation in the State of organisation. Secondly, where the source State relief takes the form of a reduction in withholding tax, it is not clear how the reduction should be calculated where only a "part" of the partnership is treated as a treaty resident. The reduction might inure indirectly to the benefit of a partner not otherwise entitled to benefits. In addition, the existence of the partnership allows income which is attributed to a permanent establishment in the State of organisation to qualify for treaty benefits for a third State partner where the existence of a direct permanent establishment would not give rise to similar benefits.[1]

46. Given these difficulties, the Committee did not feel that the approach was promising enough to attempt to develop an alternative provision.

II.4 The partners' entitlement to treaty benefits when the partnership is not a resident

47. Where the partnership as such does not qualify as a resident under the principles developed in the preceding section, the Committee agrees that the partners should be entitled to the benefits provided by the Conventions entered into by the countries of which they are residents to the extent that they are liable to tax on their share of the partnership income in those countries. The following introductory examples illustrate the results which the Committee believes are appropriate in some commonly recurring situations. It is important to note that the solutions developed in this report do not exclude the possibility that Member countries may in their bilateral relations develop different solutions to the problems of double taxation which may arise in connection with partnerships.

1. See the diverging opinion by Germany in Annex II.

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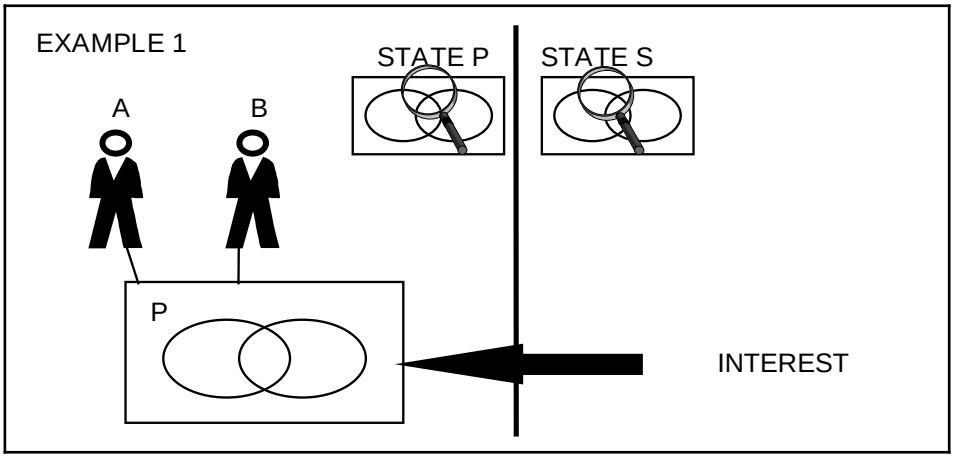
Example 1: *P is a partnership established in State P. A and B are P's partners who reside in State P. Both States P and S treat P as a transparent entity. P derives interest income from State S that is not attributable to a permanent establishment in State S.*



48. In this example, State S would likely determine that, under its domestic law, the relevant taxpayers are A and B. After applying its domestic law, it would then consider the application of the S-P tax Convention and, in particular, Article 11. Under paragraph 1 of Article 11, the Article applies to interest that is "paid to a resident of another state." In these circumstances, the income is appropriately viewed as "paid" to A and B since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in State P. They thus have derived the income in the sense which is relevant for the application of the treaty. In effect, the source State should view the income as having "flowed through" the transparent partnership to the partners who are liable to tax on that income in the state of their residence.

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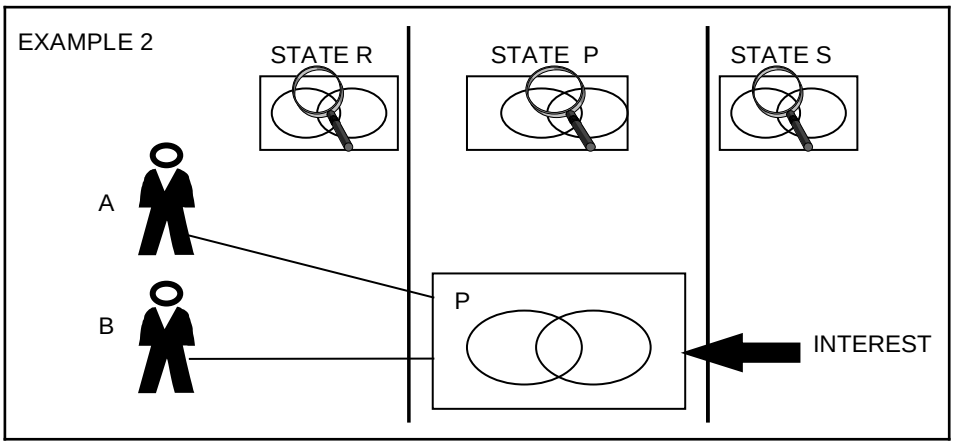
Example 2: *P is an entity established in State P. A and B are P's partners who reside in State R. States R, P and S all treat P as a transparent entity. P derives interest income from State S that is not attributable to a permanent establishment in State S.*



49. This example extends the basic principle illustrated in example 1 to a more complex situation involving three countries and two Conventions. As regards State S, again it will begin the analysis by determining that under its domestic law, the relevant taxpayers are A and B. In applying the S-R treaty, it would likewise determine that A and B have been allocated the income by State R and thus are liable to tax on that income for purposes of determining their entitlement to benefits under the Convention. By contrast, P may not claim benefits under the S-P Convention since it is not a resident of State P (it is not liable to tax in that State).

50. Such cases, in which the partners are not residents in the State where the partnership has been organised, raise additional difficulties for tax authorities wishing to verify a taxpayer's entitlement to treaty benefits. Clearly, states should not be expected to grant the benefits of tax conventions in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, the application of the provisions of the S-R Convention will be conditional on State S being able to obtain all the necessary information.

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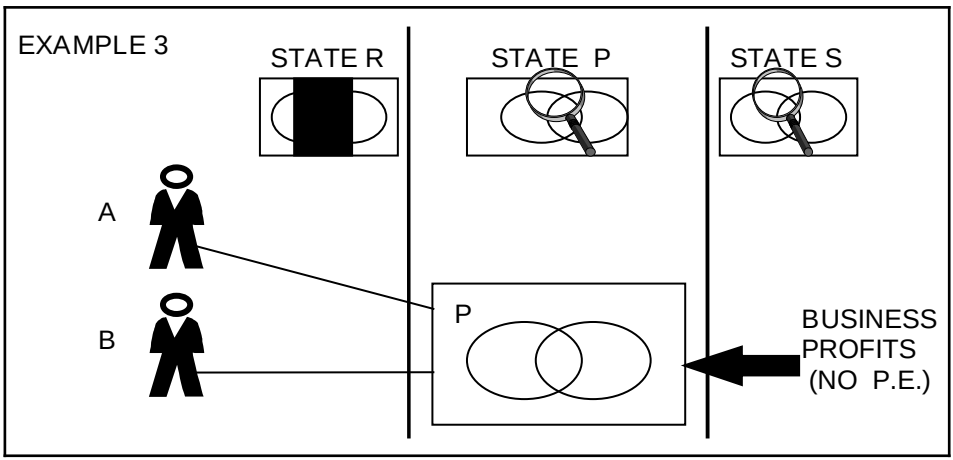
Example 3: *P is an entity established in State P. A and B are P's partners who reside in State R. States P and S both treat P as a transparent entity but State R treats it as taxable entity. P derives business profits from State S that is not attributable to a permanent establishment in State S.*



51. Here, unlike the first two examples, there is a difference in the allocation of the income involved among the countries. State S under its domestic law treats A and B as the relevant taxpayers. However, when it comes to apply the S-R treaty, it is crucial that State R, while it generally treats A and B as residents, does not allocate to them the income arising in State S since, under the domestic law of State R, that income is allocated to P, an entity which is not resident, i.e. not liable to tax in State R. Thus in these circumstances, State S would not be required to extend the benefits of the Convention to the income which State R allocates to P for purposes of determining the liability to State R's tax on that income, a conclusion which may be reached by a number of different routes as explained below. Correspondingly, for purposes of applying the S-R Convention, the treatment of P in State P is not relevant, though of course it would be important in the application of the S-P Convention as will be discussed in subsequent examples.

52. The Committee views the outcome in the above examples as resulting from an application of the Convention that takes account of the basic purposes of the Convention: to eliminate double taxation and to prevent double non-

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taxation. As discussed in the introductory section of this report, it recognises that the existing Convention and its Commentary do not deal explicitly with many of the issues which arise in the treatment of partnerships under the Convention. Under a literal application of the provisions of the Convention, a partnership that is not itself liable to tax would not be entitled to the benefits of the Convention and to the extent that the income derived by or paid to the partnership would not be considered to be derived by or paid to the partners themselves, the partners would also be precluded from claiming the benefits of the Convention with respect to the partnership's income. To avoid the result that the provisions of tax conventions do not apply to the income of a transparent partnership, it is therefore necessary to determine whether and how it would be possible to obtain the desired results under the structure of the existing Convention.

53. One broadly based approach would be to recognise as implicit in the structure of the Convention the principle that the source State, in applying the Convention where partnerships are involved, should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident. If that State "flows through" the income to the partner, then the partner should be considered liable to tax and entitled to the benefits of the Convention of the State of which he is a resident. It may be observed, in that respect, that a partner is still to be considered liable to tax on the income which "flows through" to him where, in the State of residence, tax is not imposed on that income by virtue of, e.g. a participation exemption in the case of dividends or the application of the exemption method for the relief of double taxation in the case of income attributable to a permanent establishment. On the other hand, if the income, though allocated to the taxpayer under the laws of the source State, is not similarly allocated for purposes of determining the liability to tax on that item of income in the State of residence of the taxpayer claiming the benefits of the Convention, then the source State should not grant benefits under the Convention. In these latter circumstances, the underlying factual premise on which the allocation of taxing rights is based, that is, that the source State is only obliged to reduce its domestic law tax claim where the income in question is potentially liable to tax in the hands of a resident of the treaty partner, is simply not present. This interpretation, which looks at how the partnership's income is taxed by the State of residence, avoids denying the benefits of tax conventions to a partnership's income on the basis that neither the partnership,

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because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them, can claim the benefits of the Convention with respect to that income.

54. Another approach would involve consideration of the terms of the distributive rules in the relevant Articles of the Convention. Under that analysis, in the case of dividends, interest and royalties, the inquiry would be whether or not the recipient of the item of income was the beneficial owner of the income under the laws of the State of residence of the taxpayer claiming treaty benefits and thus the taxpayer in relation to the income. In the case of a partnership treated as transparent under the laws of the source State but as a taxable entity under the laws of the residence State, the entity itself and not the partners would be treated as the beneficial owner. Because of the treatment of the income in the State of residence, the partners would not be the beneficial owners of the income for purposes of the treaty. Thus the partners would not be entitled to treaty benefits in those circumstances and whether the entity was so entitled would depend on whether it independently qualified as a resident. Similarly, where business profits are involved, the determination of whether the profits were attributable to an enterprise "of" the residence State of the taxpayer claiming the benefits would be determined by the source State on the basis of the treatment of the situation in the residence State. Again, if the partnership was treated as an entity by that latter State, it, and not the partners, would be the relevant party which would be required to establish a claim from treaty benefits.

55. Finally, some countries would feel constrained to follow the allocation of the income under their principles of domestic law, even when that results in the income being subject to taxation in the State of source and taxation in the hands of the partners under the law of their state of residence. Even those countries, however, recognise the desirability of some mechanism to relieve the resulting double taxation and either provide for the situation in special provisions in their Conventions or at least show a willingness to relieve the double taxation through the mechanism of the mutual agreement procedure, particularly where a distribution of partnership income is made in the year in which the income is realised.

56. In the light of the preceding analysis, the Committee has therefore agreed to add the following paragraph to the Commentary to Article 4:

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> "8.2 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the Conventions concluded by the States of which they are residents. This latter result will obtain even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States."

57. The following examples examine some of the implications of this general approach, as outlined in paragraphs 52 and 53, and the results that it would generate in a variety of situations.

II.5 Entitlement to treaty benefits when one State treats the partnership as a taxable entity

58. The first set of situations involve cases where one of the States treats the partnership as a taxable entity and another State views it as fiscally transparent. This question is considered first in a bilateral setting then where triangular relations are present.

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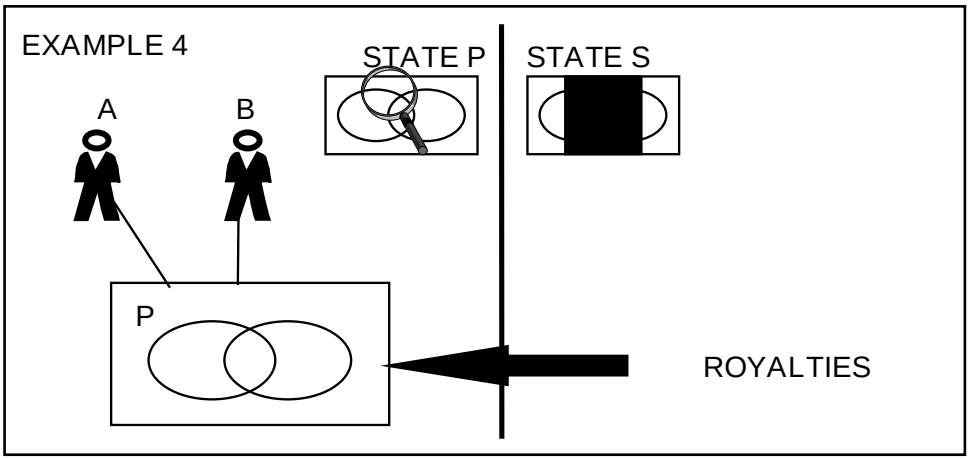
a) Bilateral cases

Example 4: *P is a partnership established in State P. A and B are P's partners who reside in State P. State P treats P as a transparent entity while State S treats it as a taxable entity. P derives royalty income from State S that is not attributable to a permanent establishment in State S.*



59. This example involves the fundamental difference in the tax treatment of partnerships that has already been referred to in paragraph 19 onwards above. The question is how the State S should apply the provisions of the Convention in such a case.

60. Under State S domestic law, the taxpayer will be partnership P. State S could then argue that since partnership P is not entitled to the benefits of the treaty, it can tax the income derived by P regardless of the provisions of the S-P Convention. This, however, would mean that the income on which A and B are liable to tax in State P would be subjected to tax in State S regardless of the Convention, a result that seems in direct conflict with the object and purpose of the Convention.

61. The Committee compared that approach, under which State S applies the provisions of the Convention by reference to the treatment of the partnership under its domestic law, with another approach, under which State S considers the entitlement to treaty benefits of A and B, both residents of State P, under the principles put forward above. Under the latter approach, State S would

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determine that the provisions of the Convention should be applied to prevent it from taxing the royalties since, under these principles, the income must be considered to be paid to A and B, two residents of State P, who should also be considered to be the beneficial owners of such income as these are the persons liable to tax on such income in State P. The Committee concluded that this approach was the correct one as it is more likely to ensure that the benefits of the Convention accrue to the persons who are liable to tax on the income.

62. The Committee did not consider this approach to be inconsistent with the provisions of paragraph 2 of Article 3, under which terms not defined in the Convention have, unless the context provides otherwise, the meaning which they have under the domestic law of the Contracting State that applies the Convention. In the example, the tax treatment of the partnership in State P is part of the facts on the basis of which the terms of the Convention are to be applied. Thus, by referring to that tax treatment, State S does not adopt a particular interpretation of the terms of the Convention put forward by State P; it merely takes into account of facts required for the application of these terms. The Committee concluded that, in any event, if an interpretation based on domestic law would lead to cases where the income taxed in the hands of residents of one State would not get the benefits of the Convention, a result that would be contrary to the object and purpose of the Convention, the context of the Convention would require a different interpretation.

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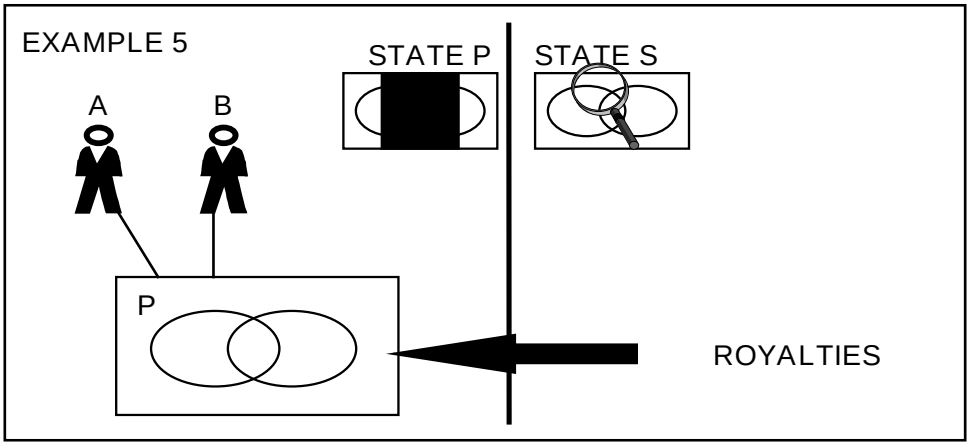
Example 5: *The facts are the same as in example 4 but the tax treatment of the partnership in State P and S is reversed. P is a partnership established in State P. A and B are P's partners who reside in State P. State P treats P as a taxable entity while State S treats it as a transparent entity. P derives royalty income from State S that is not attributable to a permanent establishment in State S.*



63. In this situation, in following its domestic law rules for allocating the income of the partnership, State S would treat A and B as the relevant taxpayers. However, in applying the treaty, the principles developed in subsection II.4 would require that it takes into consideration that State P had allocated the income of the partnership to P. Thus, for purposes of the Convention, P would be the taxpayer entitled to claim the benefits of the Convention since it is liable to tax in State P on the income of the partnership. While, in the particular circumstances of this example, it does not make a difference whether State S considers the treaty entitlements of the partners or of the partnership, this would matter, as shown in subsequent examples, if the partners, or one of them, were not residents of State P.

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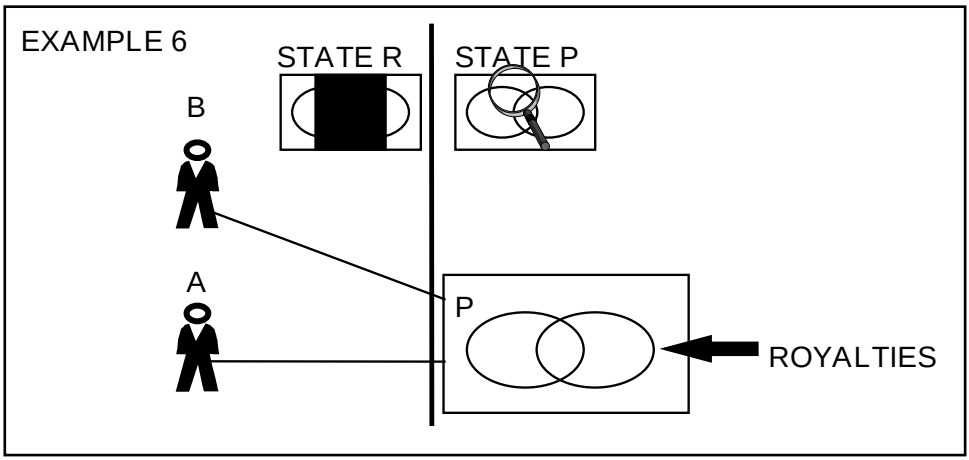
Example 6: *P is a partnership established in State P. A and B are P's partners who reside in State R. State P treats P as a transparent entity while State R treats it as a taxable entity. P derives royalty income from State P that is not attributable to a permanent establishment in that state*.



64. While the Committee agrees that in this situation State P should not be required to give the benefits of the Convention with respect to the royalty income, several different approaches are used to support this result. Using one approach, partners A and B, though residents as such of State R are not liable to tax on the partnership income under the allocation rules applied by State R, consequently they are not entitled to benefits under the Convention in respect of that income. P is not a resident of State R for purposes of the Convention since, from the perspective of State R, it is not a domestic taxpayer in any sense. Thus again, State P's right to tax the partnership income would not be restricted under the Convention.

65. Alternatively, as discussed in paragraph 54 above, the partners would not be entitled to benefits under the Convention because they would not be considered as beneficial owners of the income for purposes of the Convention. Adopting a more literal approach, State P might simply focus on the fact that, under its allocation rules, the income has been paid to P and P would not qualify as a resident either of State R or State P. Here the treatment of A and B would not be relevant.

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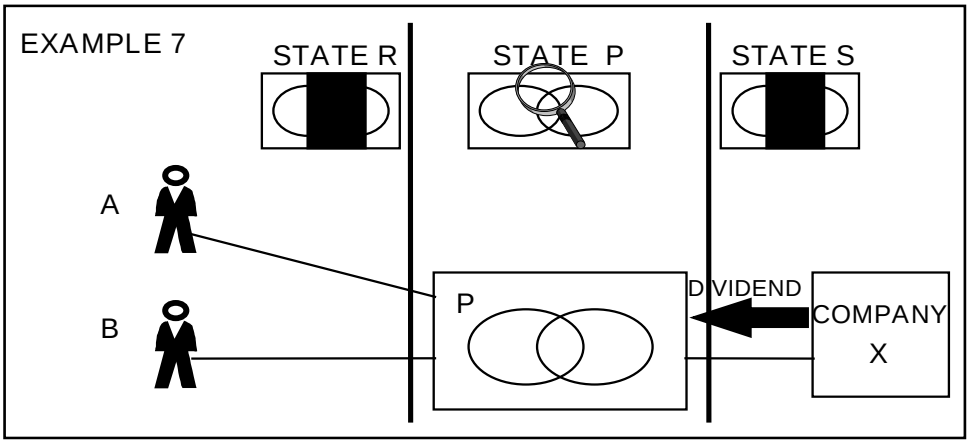
66. Finally, some countries would deny treaty benefits to A and B based on concepts of bad faith or abuse of treaty rights. The distributive rules of the Convention are based on the underlying assumption that A and B would be attributed the income on which treaty relief would be granted and where that is not the case, these general concepts would allow State P to resist any claims by A or B for benefits.

67. Example 18 below deals with the tax treatment of the subsequent distribution by P of the partnership profits to A and B.

b) Triangular cases

68. Triangular cases pose difficult problems with respect to the determination of the entitlement to treaty benefits. The Committee believes, however, that these problems may be solved through the application of the same principles put forward in paragraphs 52 and 53 above. The following examples discuss how these principles should be applied in different situations involving three states.

Example 7: *P is a partnership established in State P. A and B are P's partners who reside in State R. P owns shares in X, a company that is a resident of State S. X pays a dividend to P. States R and S treat P as a taxable entity while State P treats it as fiscally transparent.*



69. In this situation, the partnership is not liable to tax in State P and is therefore not a resident of that state for purposes of the P-S Convention.

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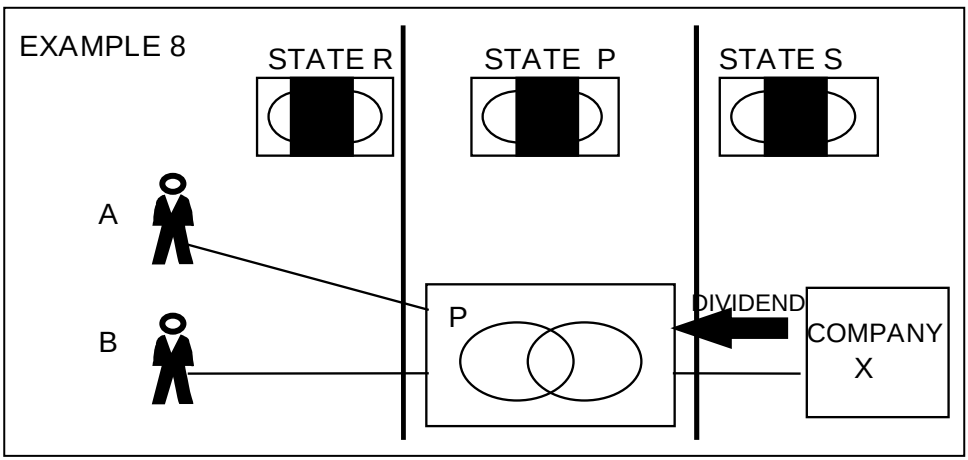
Similarly, though P is treated as the taxpayer for purposes of the domestic law of State S and the income is allocated to P under the domestic laws of R, P is not liable to tax in State R because it is not treated as a resident. Finally, though A and B are potentially liable to tax as residents in State R, under R's allocation rules, the income is not allocated to them but to P. Thus P is not a resident of State R and A and B are not entitled to benefit from the R-S Convention with respect to the partnership's income. State S would thus be entitled to tax the income without restriction.

70. It should be noted that, in this example (as in the following examples), the tax treatment of partnerships in State S does not have any impact on the entitlement to treaty benefits. Thus, the S-R and S-P Conventions would still not be applicable with respect to the dividends if State S treated partnerships as transparent rather than taxable entities.

Example 8: *The facts are the same as in example 7 except that the tax treatment of the partnership in State P is reversed. P is a partnership established in State P. A and B are P's partners who reside in State R. P owns shares in X, a company that is a resident of State S. X pays a dividend to P. All States treat P as a taxable entity*.



71. In this example, partnership P is a resident of State P as it is liable to tax therein. Partners A and B should not be considered to be entitled to the benefits of the S-R Convention with respect to the partnership income as they are not

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liable to tax on that income. Conversely, P should be considered by State S to be entitled to the benefits of the S-P Convention in relation with the dividends it derives from that State as it is liable to tax on those dividends and should therefore be considered to be the recipient and beneficial owner of that income. Thus the S-P Convention will restrict State S right to tax the dividends, even if State S taxes the dividends in the hands of partners A and B under its domestic rules applicable to the taxation of partnerships. It should be noted, however, that since P is a partnership, it will not get the benefits of the reduced rate of tax provided for in subparagraph 2*a)* of Article 10 of the Model Tax Convention (the subparagraph expressly excludes partnerships from its application) unless the two Contracting States agree to modify subparagraph 2a) to give the benefits of the reduced rate to a partnership treated as a body corporate (cf. paragraph 11 of the Commentary on Article 10).

72. As already mentioned, the tax treatment of partnerships in State S does not have any impact on the entitlement to treaty benefits in this case. Thus, the S-P Convention would still be the only relevant one if State S treated partnerships as transparent rather than taxable entities.

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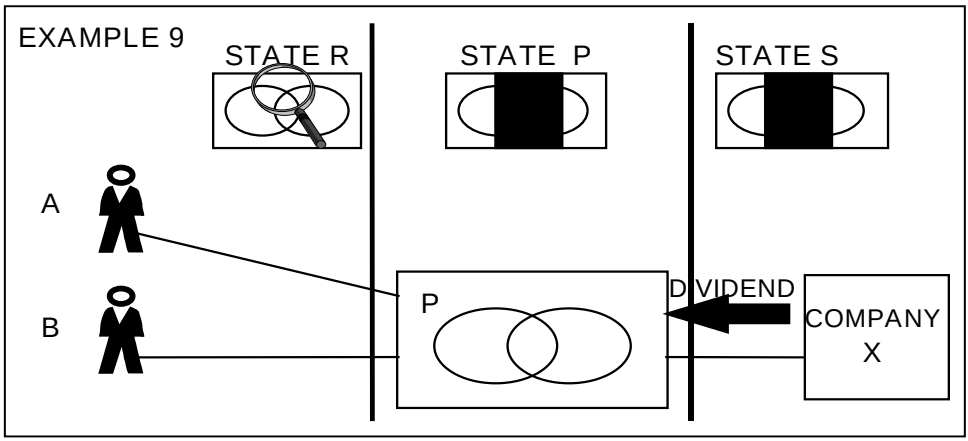
Example 9: *The facts are the same as in example 8 except that the tax treatment of the partnership in State R is reversed. P is a partnership established in State P. A and B are P's partners who reside in State R. P owns shares in X, a company that is a resident of State S. X pays a dividend to P. State P and State S treat P as a taxable entity while State R treats it as fiscally transparent.*



73. This example presents a case where there will be a double entitlement to treaty benefits with respect to the same income. As in the previous example, partnership P is a resident of State P as it is liable to tax therein. P should again be considered by State S to be entitled to the benefits of the S-P Convention in relation with the dividends it derives from that State as it is liable to tax on those dividends and should therefore be considered to be the recipient and beneficial owner of that income. In contrast to the previous example, however, partners A and B should also be considered to be entitled to the benefits of the S-R Convention with respect to the partnership income as they are also liable to tax on that income. Thus both the S-P and S-R Conventions will restrict State S right to tax the dividends, regardless of whether State S taxes these dividends in the hands of the partnership or of partners A and B (under its domestic rules applicable to the taxation of partnerships, it will likely tax them in the hands of the partnership). Again, the tax treatment of partnerships in State S will not have any impact on this result so that both conventions would still be applicable if State S treated partnerships as transparent rather than taxable entities.

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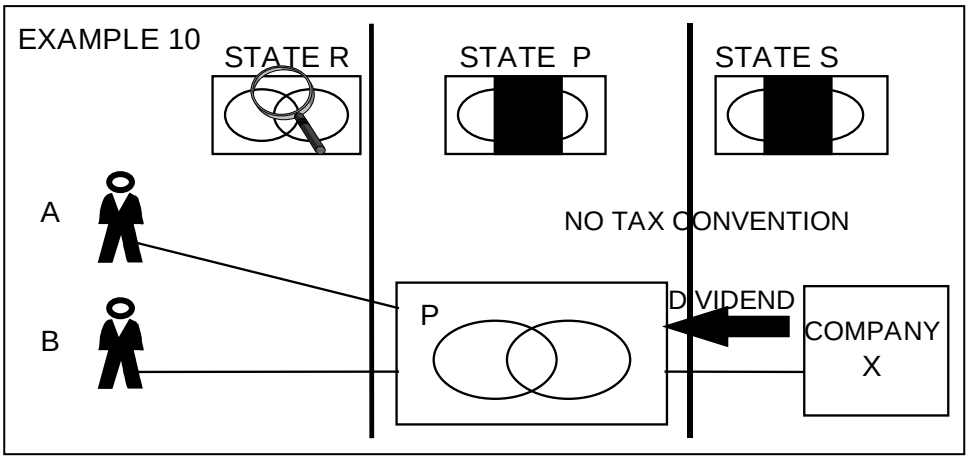
74. The Committee agreed that this double entitlement to treaty benefits will be satisfied by State S imposing the lowest amount of tax allowed under the two treaties. Thus, if the S-R Convention restricts to 15% of the gross amount of the dividends the tax that can be levied by State S while the S-P treaty restricts the tax to 10% of that amount, the obligations imposed on State S under both conventions will be satisfied if the tax imposed by State S does not exceed 10% of the dividends.

75. While the Committee agreed on that approach, it recognized the administrative difficulties that its implementation would generate in the case of a partnership that would have a large number of partners who would be residents of different States.

Example 10: *The facts are the same as in example 9 except that there is no tax convention between States S and P.*



76. The Committee also discussed how the principles and conclusions formulated in its analysis of the previous examples would apply if the partnership were a resident of a state with which the State of source did not have a tax convention, including the case where the partnership was a resident of a tax haven. It concluded that same conclusions should apply as concerns the application of the Convention between the State of source and the State of residence of the partners.

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77. Thus, in this example, partners A and B should be considered to be entitled to the benefits of the S-R Convention in respect of the dividends as they are both taxable in State R on these dividends.

78. As already noted, States should not, however, be expected to grant the benefits of a tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus if State P is a tax haven from which State S cannot obtain tax information, the application of the provisions of the S-R Convention will be conditional on State S being able to obtain all the necessary information from the partners or from State R. In such cases, State S might well decide to use the refund mechanism for the purposes of applying the limitation of tax provided for in Article 10 even though it normally applies this limitation at the time of the payment.

II.6 Application of the Convention where the benefits are dependent upon certain characteristics or attributes of the taxpayer

79. As indicated in paragraph 21 above, differences in how States apply the transparency approach may create difficulties for the application of tax conventions. Where a State considers that a partnership does not qualify as a resident because it is not liable to tax and the partners are liable to tax in their State of residence on their share of the partnership's income, it is expected that that State will apply the provisions of the Convention as if the partners had earned the income directly so that the classification of the income for purposes of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows-through the partnership.

80. Difficulties may arise, however, in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and another party to a transaction. States may have different views as to what extent the partnership should be ignored in applying such rules. The following subsections describe how the Committee believes that some of the provisions of the Convention should be applied in that respect.

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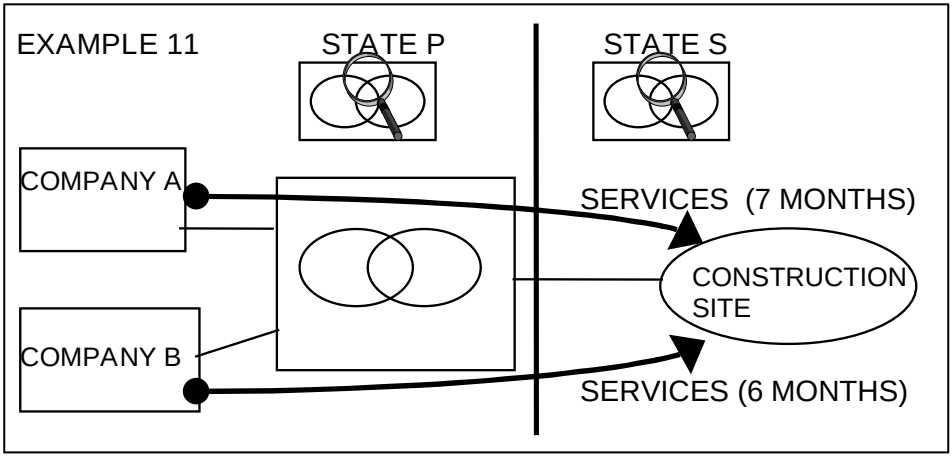
a) Construction activities

Example 11: *Company A carries on a business of engineering and company B carries on a business of electrical installation. Both companies are residents of State P. They have established a partnership P in State P for the purpose of a contract to design and install the electrical equipment in a nuclear reactor being built in State S. As part of the obligations of P under the contract, employees of Company A will be present on the construction site from 1 January to June 10 and employees of Company B will be there from 10 June to 1 February. When performing their duties, these employees will act as employees of the respective companies, each company acting as agent for the partnership.*



81. In this example, the Committee concluded that the period of time spent by the two partners should be aggregated at the partnership level with the result that the 12 month limit of paragraph 3 of Article 5 is exceeded. The enterprise carried on by the partnership will therefore be considered to have a permanent establishment in State S so that each partner will be considered to have a permanent establishment in State S for purposes of the taxation of their share of the business profits derived by the partnership from State S. This conclusion would not hold good if the relationship between A and B constituted merely a joint venture or consortium rather than a partnership.

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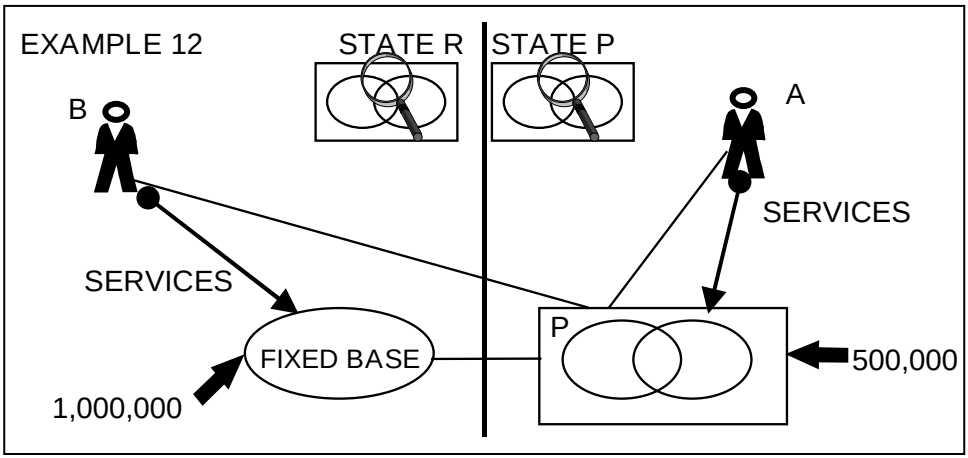
b) Income attributable to the fixed base of a partnership

Example 12: *Partnership P, which has been established in State P, has a fixed base in State R. Partner A is a resident of State P and partner B is a resident of State R. They have agreed to divide the profits of the partnership equally. P earns 1,500,000 during the taxable period. 1,000,000 of that amount is attributable to the services performed by B from the State R fixed base. The remaining 500,000 is attributable to services performed by A in State P. Both States treat partnerships as transparent entities.*



82. This example raises the question of the extent to which a transparent partnership should be ignored for purposes of the application of Articles 7 and 14. The Committee agreed that under Article 14, P's fixed base in State R should be considered to be a fixed base of both A and B and that the same is true for a permanent establishment under Article 7.

83. The Committee then considered to what extent the activities of the partnership could be similarly allocated to each of the partners for the purposes of applying paragraph 1 of Article 14, which require that the fixed base be regularly available to a person "for the purpose of performing his activities".

84. Two views were expressed. Under the first view, the reference to "his activities" in paragraph 1 of Article 14 refer to the personal activities of each partner and the partnership's activities cannot be flowed-through to the partners.

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According to that view, Article 14 would not allow State R to tax partner A on his share of the income attributable to the fixed base (500,000) since the fixed base was not regularly available to A for the purposes of his own personal activities.

85. The majority, however, agreed with the different view that the activities of the partnership should be allocated to the partners to the same extent that the fixed base of the partnership is attributed to each of them. Applying this approach to the above example, State R would be allowed, as a source State, to tax partners A and partner B on their respective share of the income attributable to the fixed base located therein. State R will also be allowed, as the residence State, to tax partner B's share of any other partnership income. Similarly, State P will be allowed, as a source State, to tax all the partnership's income attributable to the fixed base of the partnership that is located in that State.

86. The Committee realised, however, that cases in the real world are rarely as simple as this example. The partnership agreement may specifically allocate the income from various States to particular partners. Entities that may be considered as partnerships for some purposes may not be partnerships for tax purposes; many international partnerships grant considerable autonomy, both managerial and financial, to their in-country subsidiary organisations. Both taxpayers and tax authorities strive to avoid administratively unmanageable results.

87. The Committee decided that these issues would more appropriately be dealt with in the context of its work on issues related to Article 14. It noted, however, that there should not be differences in result whether Article 7 or 14 applied and that a different conclusion would give rise to difficulties.

c) Determination of "employer" for purposes of Article 15

88. During its discussion of whether partnerships qualify as residents for purposes of tax conventions, the Committee also examined a related issue arising from the reference to the concept of resident in subparagraph 2*b*) of Article 15. Paragraph 2 of Article 15 exempts employment income earned by a resident of a Contracting State in the other State from tax by that other State if a number of conditions apply. One such condition is that the employer must not be a resident of the state in which the employment income is earned. The application of this rule may be problematic when the employer is a partnership.

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89. As discussed above, a partnership that is treated as a transparent entity by a Contracting State does not qualify as a resident of that State under Article 4. While it is clear that a partnership that is treated as a transparent entity could qualify as an "employer" (especially under the domestic law definitions of the term in some countries, e.g. where an employer is defined as a person liable for a wage tax), the application of the condition imposed by subparagraph 2*b*) of Article 15 at the level of the partnership regardless of the situation of the partners would render the condition totally meaningless because the partnership cannot possibly qualify as a resident by virtue of its transparent status.

90. The Committee examined this result in the context of Article 15 and in light of the object and purpose of subparagraphs 2*b)* and *c)* of that Article. In its view, the conditions imposed by these subparagraphs aim at avoiding the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State since he is not resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to be constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State.[1]

91. On that basis, the Committee concluded that in order to achieve a meaningful interpretation that would accord with the context and the object of paragraph 2 of Article 15, subparagraph 2b) should, in the case of partnerships treated as transparent entities, be considered to refer to the partners of such a partnership. Thus, the Committee favours an interpretation where the concepts of "employer" and "resident", as found in subparagraph 2*b*), are applied at the level of the partners rather than at the level of the partnership. This approach is fully consistent with that put forward in paragraphs 81 and 85 above, under which certain provisions of tax conventions must be applied at the partners' level rather than at that of the partnership in order to avoid absurd or unreasonable results.

92. The Committee realised that this interpretation would create difficulties where the partners resided in different States. Such difficulties, however, could be addressed through the mutual agreement procedure by reference, for

1. See the diverging opinion by Germany in Annex II.

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example, to the State in which the partners who own the majority of the interests in the partnership reside (i.e. the State in which the greatest part of the deduction will be claimed).

III. APPLICATION OF TAX CONVENTIONS BY THE STATE OF RESIDENCE

93. Where partnerships are involved, the application of tax conventions by the State of residence also raise difficulties, primarily with respect to the application of Article 23 on Elimination of Double Taxation. This Chapter examines some of these difficulties. Section III.1 focuses on the particular problem of conflicts of qualification while section III.2 focuses on other problems that conflicts of income allocation may create for the State of residence.

III.1 Conflicts of qualification

a) Description of the problem

94. The Committee has found that a number of difficulties relating to the application of tax conventions to partnerships fall in the broader category of so-called "conflicts of qualification", where the residence and source States apply different articles of the Convention on the basis of differences in their domestic law. Example 13 below illustrates such a conflict.

95. Subsection b) presents the conclusions reached by the Committee. Subsection c) discusses various cases of conflicts of qualification involving partnerships on the basis of these conclusions, presenting the answer to example 13 in paragraph 119.

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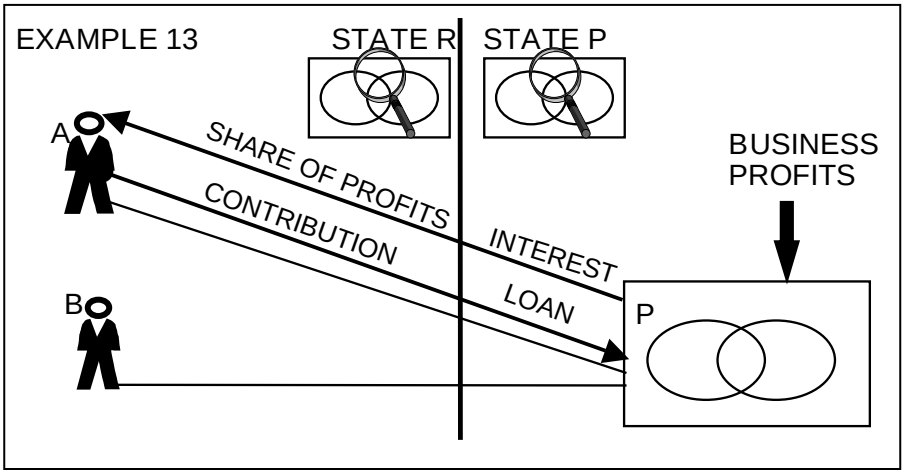
***Example 13**: Partner A makes a loan to partnership P, which has been established in State P where it carries on a business through a permanent establishment. P pays interest to A. State P recognizes loans between partners and partnerships; under its domestic legislation State P allows P a tax deduction for the interest. State R does not recognize loans between partners and partnerships under its domestic law. Both States treat partnerships as transparent entities and apply Article 7 to the income of P, but State P applies Article 11 to the interest payment and State R does not.*



96. In this example, while partner A is clearly entitled to the benefits of the R-P Convention, there is disagreement between States P and R as to which provisions of the Convention are applicable. State P, being the State of source of the income, applies its domestic laws for the purposes of taxing the income of and from the partnership. It accordingly determines that partner A receives interest from the partnership and that Article 11 of the Convention applies to restrict to 10% the tax that it can impose on the interest. Under the domestic law of State R, there has been no loan and consequently A has no interest income. State R, however, will consider that the payment from P to A is a distribution of A's share of the business profits of the partnership which has been taxed upon realisation under Article 7.

97. The position of State P is in accordance with the provisions of the Convention. Pursuant to paragraph 2 of Article 3, State P has interpreted the word "debt-claims of every kind", which are found in paragraph 3 of Article 11,

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in accordance with its domestic law and has therefore concluded that a loan by a partner qualifies as a debt-claim on which interest may be paid. It has applied Article 11 of the Convention accordingly.

98. The consequences of the position taken by State P must, however, be examined in relation to the taxation of partner A in State R. One must distinguish, in that respect, the case where State R eliminates double taxation through the exemption method from that where it applies the credit method.

(i) State R uses the exemption method

99. Under the domestic law of State R, there is no debt-claim between partner A and the partnership and A therefore does not derive interest from State P. If State R follows that position when considering its obligation to eliminate double taxation under Article 23A, that could lead it to consider that the payment made to partner A is a distribution of the partnership's business profits which is attributable to a permanent establishment situated in State P which constitutes income that must be exempted under paragraph 1 of Article 23A. To the extent that State P would have interpreted the Convention as obliging it to limit its tax to 10% of the gross amount of the payment, the result would be partial non-taxation (it would be total non-taxation if Article 11 of the R-P Convention did not provide for any source taxation of interest).

100. It must be noted that, regardless of the Convention, State R may still be obliged to exempt the income under its domestic tax rules related to the elimination of double taxation as these rules may require an other approach to be followed. This, however, would be a problem that could only be solved through an amendment to State R's domestic tax laws.

(ii) State R uses the credit method

101. Under the domestic law of State R, there is no debt-claim between partner A and the partnership and A therefore does not derive interest from State P. Even if State R follows that position when considering its obligation to eliminate double taxation under Article 23B, it should still tax any share of the partnership's income attributed to A so that non-taxation will be avoided.

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b) Analysis of the application of tax conventions in cases of conflicts of qualification

102. The Committee agreed that, in addressing conflicts of qualification problems faced by the State of residence, a useful starting point is the recognition of the principle that the domestic law of the State applying its tax governs all matters regarding how and in the hands of whom an item of income is taxed. The effect of tax conventions can only be to limit or eliminate the taxing rights of the Contracting States. In the case of the source State, the right to tax items of income is limited by provisions based on Articles 6 through 21 of the Model Tax Convention. In the case of the residence State, while provisions based on Articles such as 8 and 19 might be relevant, the primary restriction would arise from the provisions of the Article on Elimination of Double Taxation (Article 23 in the Model Tax Convention), by which the residence State agrees to either exempt income that the source State may tax under the Convention or to give a credit for the tax levied by the source State on that item of income.

103. When taxing an item of income, the source State therefore applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions. The way that the State of residence qualifies an item of income for treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income. The reverse, however, is not true. The way the State of residence eliminates double taxation will depend, to some extent, on how the Convention has been applied by the State of source.

104. The wording of Article 23 of the OECD Model Tax Convention is crucial in that respect. That article requires that relief be granted, either through the exemption or credit system, where an item of income may be taxed "in accordance with the provisions of the Convention". Thus, the State of residence has a treaty obligation to apply the exemption or credit method vis-à-vis any item of income where the tax convention authorizes taxation of that item of income by the State of source.

105. The meaning of the phrase "in accordance with the provisions of this Convention, may be taxed" needs to be clarified in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income, provisions of the Convention that are different from those that the State of

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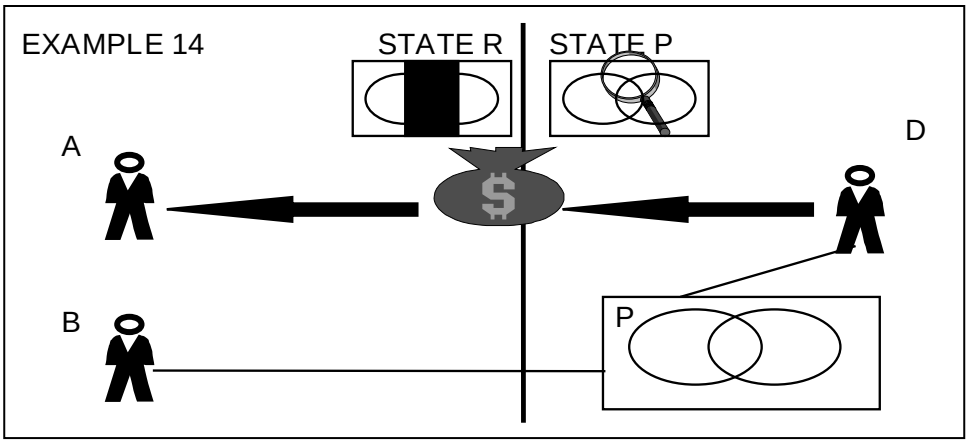
residence would have applied to the same item of income, the income is still being taxed in accordance with the provisions of the Convention, in this case as interpreted by the State of source. In such a case, therefore, Article 23 requires that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

106. It may be useful to consider the following example to examine the results of that approach.

Example 14: *Partner A, a resident of State R, sells his interest in P to D, a resident of State P, for an amount that exceeds A's adjusted basis in the interest. Under State R's domestic law, State R treats P as a company and would regard the gain as a capital gain of a* resident of State R. *Under State P's domestic law, State P treats P as fiscally transparent and would regard the gain as attributable to a State P permanent establishment.*



107. In this example, State P therefore considers that the alienation of the interest in the partnership is, for the purposes of its Convention with State R, an alienation by the partner of the underlying assets of the business carried on by the partnership, which may be taxed by State P according to paragraph 1 or 2 of Article 13. State R, as it treats the partnership as a corporate entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which could not be taxed by State P by reason of paragraph

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4 of Article 13. In such a case, the conflict of qualification results exclusively from the different treatment of partnerships in the domestic laws of the two States and State P must be considered by State R to have taxed the gain from the alienation "in accordance with the provisions of the Convention" for purposes of the application of Article 23. State R must therefore grant an exemption or give a credit pursuant to Article 23 of the Model Tax Convention irrespective of the fact that, under its own domestic law, it treats the alienation gain as income from the disposition of shares in a corporate entity and that, if State's P qualification of the income were consistent with that of State R, State R would not have to give relief under Article 23. No double taxation will therefore arise in such a case.

108. This does not mean that the wording of Article 23 requires the State of residence to eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable. For instance, in the example above, if, for purposes of applying paragraph 2 of Article 13, State P considers that the partnership carried on business through a fixed place of business but State R argues that paragraph 4 applies because the partnership did not have a fixed place of business in State P, there is a legitimate dispute as to whether State P has taxed the income in accordance with the provisions of the Convention. The same may be said if State P, when applying paragraph 2 of Article 13, has interpreted the phrase "forming part of the business property" so as to include certain assets which would not fall within the meaning of that phrase according to the interpretation given to it by State R. Such conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification described in the above paragraph where the divergence is based not on different interpretations of the provisions of the Convention, but on different provisions of domestic law. In the former case, the State of residence can argue that the State of source has not imposed its tax in accordance with the provisions of the Convention if it has applied its tax based on what the State of residence considers to be a wrong interpretation of the facts or a wrong interpretation of the Convention. States should use the provisions of Article 25 (Mutual Agreement Procedure), and in particular paragraph 3 thereof, in order to resolve this type of conflict when the difference in approaches would otherwise result in unrelieved double taxation.

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109. In other situations, however, the phrase "in accordance with the provisions of this Convention, may be taxed" needs to be interpreted in relation to possible cases of double non-taxation involving residence States that follow the exemption method. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income which it would otherwise have taxed, the State of residence should, for purposes of applying paragraph 1 of Article 23A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to tax that income if it had been the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

110. This situation may be illustrated by reference to the facts of the above example. A business is carried on through a fixed place of business in State P by a partnership established in that State and a partner, resident in State R, alienates his interest in that partnership. Changing the facts of the example, however, it is now assumed that State P treats the partnership as a taxable entity whereas State R treats it as fiscally transparent; it is further assumed that State R is an exemption State. State P, as it treats the partnership as a corporate entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which it cannot tax by reason of paragraph 4 of Article 13. State R, on the other hand, considers that the alienation of the interest in the partnership should have been taxable by State P as an alienation by the partner of the underlying assets of the business carried on by the partnership to which paragraph 1 or 2 of Article 13 would have been applicable. In determining whether it has the obligation to exempt the income under paragraph 1 of Article 23A, State R should nonetheless consider that, given the way that the provisions of the Convention apply in relation to the domestic law of State P, that State may not tax the income in accordance with the provisions of the Convention; State R is thus under no obligation to exempt the income.

111. Such cases should not be confused with cases where the provisions of a Convention grant to the source State the right to tax an item of income but that item of income is not taxed under the domestic law of the State of source. In such cases, the State of residence must still exempt that item of income under

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the provisions of paragraph 1 of Article 23A (cf. paragraph 34 of the Commentary on Article 23).

112. Other cases that need to be distinguished are those where the double non-taxation results from disagreements between the State of residence and the State of source on the interpretation of the provisions of the Convention. In such cases, the State of residence does not agree that, in relation to the domestic law of the State of source, that State is precluded from taxing the item of income. The State of residence is therefore arguing that, to the extent that its interpretation of the Convention is correct, it has to grant exemption. Conversely, the source State is arguing that, if its interpretation of the Convention is the correct one, it cannot tax the income and the residence State should therefore not grant exemption. A similar problem could arise in the case of different interpretations of facts.

113. The Committee decided that the best way of addressing such cases of double non-taxation would be through a provision, to be added to Article 23A, that would provide that the residence State does not have to grant exemption in these cases. Such a provision would deal with cases of double non-taxation resulting from different interpretations of the provisions of the Convention or of the facts. The Committee therefore decided that the following paragraph 4 be added to Article 23A of the Model Tax Convention:

> "4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income."

114. This proposed provision would only apply to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10 or 11 to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of the income

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that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10 or 11.

115. The preceding comments concern the position of the residence State where the wording of the provisions on elimination of double taxation in the relevant bilateral Convention is similar to that of Article 23 of the Model Tax Convention. Where, however, the wording is different from that used in the Model Tax Convention, the result might also be different.

116. One variation that is often found in bilateral Convention is to begin the Article on elimination of double taxation by the words "[d]ouble taxation shall be avoided as follows: [...]". Where such wording is used, the conclusions presented in the preceding paragraphs would be reinforced since these words make it clear that the Article is intended to apply only where there is double taxation and the obligation imposed on the Contracting States to avoid double taxation will best be satisfied by adopting the approach described in this section.

117. In some Conventions, the Article on elimination of double taxation includes an explicit reference to internal law, e.g. requiring a credit for foreign taxes to be granted subject to the provisions of the domestic law regarding the crediting against domestic tax of tax payable in the other State but without affecting the general principle provided in the article. While the effect of these provisions has to be determined on the basis of their precise wording, such wording, which provides that the reference to domestic law should not affect the principle of the treaty article, will generally allow the application of the conclusions of the preceding paragraphs. In some Conventions, however, the reference to domestic law is not so limited, provided that any inconsistency between the domestic law and the treaty rules existed at the time of signature of the Convention. To avoid confusion, Contracting States may wish to make clear the extent to which domestic law will control in situations existing at the time of entry into force of the Convention where the application of the domestic provision could be said to be inconsistent with the "general principle" of achieving double tax relief.

c) Cases of conflicts of qualification involving partnerships

118. The following examines how the general principles developed in the preceding subsection apply in some cases of conflicts of qualification involving partnerships.

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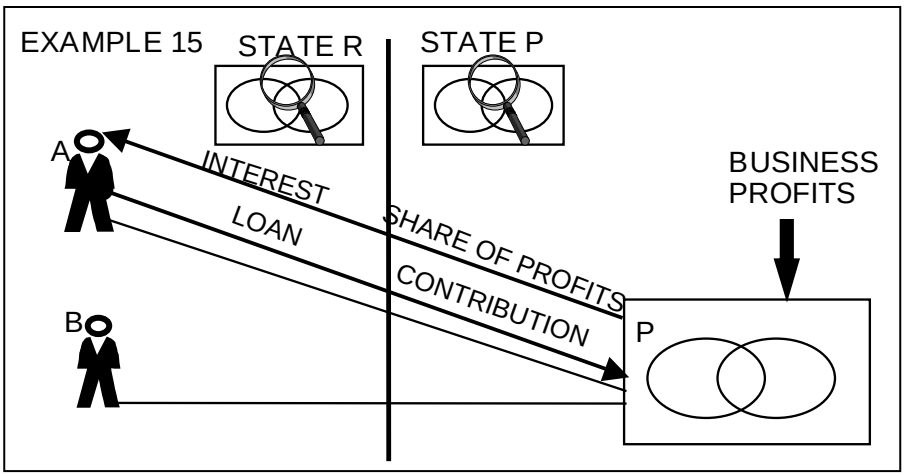
119. Starting with example 13 (the facts of that example appear in subsection a)), it should be concluded that in that example, the partial non-taxation referred to in paragraph 99 above will be avoided since State R will not be required to exempt what State P considers as interest since it may be said that State P may, under its domestic law, tax that part of the income of the partnership under paragraph 2 of Article 11. State R will therefore apply the credit method in that case, either under paragraph 2 of Article 23 A (exemption method) or under paragraph 1 of Article 23 B (credit method).

Example 15: *The facts are the same as in example 13 except that the treatment of the loan in States P and R is reversed. Partner A makes a loan to partnership P, which has been established in State P where it carries on a business through a permanent establishment. P pays interest to A. State R recognizes loans between partners and partnerships but State P does not. Both States treat partnerships as transparent entities and apply Article 7 to the income of P, but State R considers that Article 11 should apply to the payment made to partner A.*



120. This example is a mirror image of the conflict of qualification presented in example 13. State P, as the State of source of the income, determines that the payment is a distribution of partner A's share of the partnership business profits and that Article 7 of the Convention applies to allow it to tax that share without restriction. State R, however, considers that the payment from P to A is a payment of interest subject to the rules of Article 11.

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121. Again, the position of State P is in accordance with the provisions of the Convention. Pursuant to paragraph 2 of Article 3, State P has interpreted the words "debt-claims of every kind", which are found in paragraph 3 of Article 11, in accordance with its domestic law and has concluded that the financial contribution made by partner A did not qualify as a debt-claim for purposes of determining whether the payment was interest.

122. As Articles 23 A and 23 B both provide for the credit method to be applied in relation to interest, it may be argued that the consequences of that position for State R will be the same whether that State eliminates double taxation predominantly through the exemption method or through the credit method. Under the domestic law of State R, there is a debt-claim and partner A derives interest from State P. If State R follows that position when considering its obligation to eliminate double taxation under Articles 23 A or 23 B, that could lead it to consider that the payment made to partner A is interest that it may tax, subject to giving a credit for any State P tax levied in accordance with paragraph 2 of Article 11. If the Convention does not allow for source taxation of interest, the result of that approach will be double taxation. If the Convention follows Article 11 of the Model Tax Convention, the application of paragraph 2 of Articles 23 A or of paragraph 1 of Article 23 B under that approach will likely result in some double taxation to the extent that State R may only give credit for the part of the State P tax that it considers to have been imposed in accordance with Article 11, i.e. 10% of the payment of the interest.

123. On the basis of the principles developed in subsection b), however, that result will be avoided since State R will be obliged either to exempt what it considers to be interest (if it applies the exemption method) or to give a credit for the full amount of tax levied by State P on that item of income (if it applies the credit method). This is because the tax which State P has levied under Article 7 has been levied in accordance with the provisions of Article 7 of the Convention, taking into account the qualification of the income in light of State P's domestic tax law.

III.2 Problems arising from conflicts of income allocation

124. As discussed in section II, conflicts of income allocation may result from the fact that two Contracting States classify the same entity differently so that one treats it as a partnership and the other does not or from the fact that one

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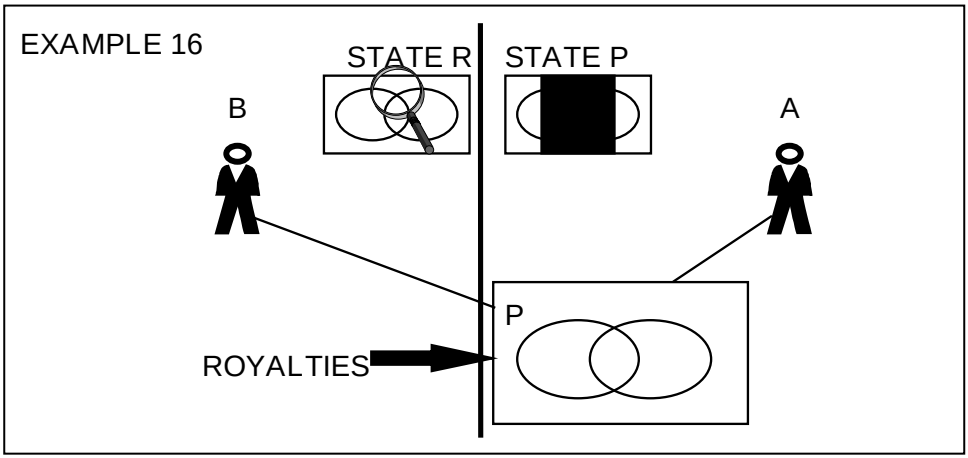
State taxes partnerships as taxable entities while the other treats them as transparent entities for tax purposes. Such conflicts, where the income is taxed by the two States in the hands of different taxpayers, create particular problems for the State of residence. These problems are discussed under the following examples.

Example 16: *P is a partnership established in State P. Partner B is a resident of State R while partner A is a resident of State P. State P treats the partnership as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State R that is not attributable to a permanent establishment in State R. P has an office in State P and may therefore be considered to have a permanent establishment in State P.*



125. In that example, P qualifies as a resident of State P as it is a person "liable to tax" therein according to the laws of State P. Under Article 12 of the P-R treaty, it is clear that State R cannot tax the partnership on the royalty. State R, however, would like to tax partner B, a resident, on his share of the income of the partnership.

126. Some delegates took the position that the R-P Convention prevents State R from taxing in that situation. On the basis of paragraph 1 of Article 12, which provides that royalties arising in State R and paid to a resident of State P are taxable only in State P if the resident is the beneficial owner thereof, they argued that because the partnership qualifies as a resident of State P and is the

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beneficial owner of the royalties, the conditions of the paragraph are met and the royalties may only be taxed in State P. The delegates who adopted that interpretation therefore concluded that unless the case fell under the application of CFC rules or the Convention included a special provision allowing State R to tax its residents in such circumstances (e.g. a specific provision applicable to partnerships or a so-called "saving clause" such as is found in Conventions concluded by the United States), the Convention would prevent State R from taxing partner B on his share of the royalties.

127. The majority, however, disagreed with that position. When taxing partner B, State R is taxing its own resident on income arising in its territory. Article 12 of the Convention does not affect taxation that is based on residence but only taxation that is based on source. When applying the Convention, State R may indeed consider, based on the principles developed in previous examples, that partner B may be considered to have received payment of his share of the royalties for the purposes of taxation in that State so that the limitation of Article 12 does not apply since that Article is only applicable where royalties arising in one State have been paid to a resident of the other State.

128. The Committee therefore decided that the Commentary on Article 1 be amended by adding the following paragraph thereto:

> "Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State."

129. Since State R's right to tax partner B on his share of the income of the partnership derives from the partner's residence in that State, it follows that State R must also give the benefits of Article 23 to partner B. The fact that the partnership has a permanent establishment in State P is not relevant in that respect since, as discussed in subsection b), the tax levied by State P will still have been levied in accordance with the provisions of the Convention since State P is allowed to tax partnership P as its resident. The application of Article 23 by State R may, however, raise some difficulties because State P will levy its

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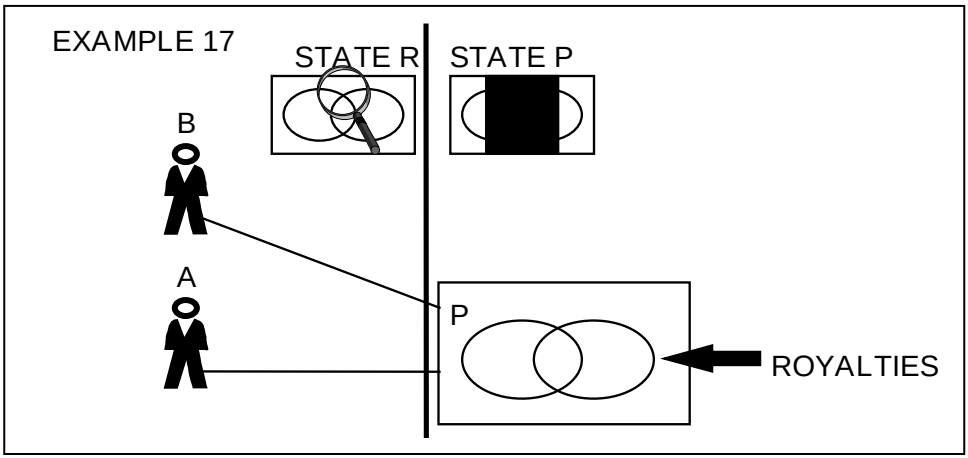
tax on the partnership rather than on the partners and because that tax may be levied both when the income is realized and when it is distributed (i.e. through a withholding tax on the distribution which State P may treat as a dividend). These difficulties are examined below in relation to example 18.

Example 17: *P is a partnership established in State P. A and B are P's partners who reside in State R. State P treats P as a taxable entity while State R treats it as a transparent entity. P derives royalty income from State P that is not attributable to a permanent establishment in that state.*



130. This example addresses a factual situation similar to that described in the preceding example but from the perspective of the State of residence of the partnership, i.e. State P. In this example, State P would, under its domestic law, impose tax on the royalties in the hands of the partnership. From its perspective, P is a resident taxpayer and as such liable to tax on its income arising in State P. Thus, Article 12 of the Convention would not apply since the royalties arise in State P and are paid to a resident of State P. However, because State R allocates the income to partners A and B, they are also liable to tax on the royalties in State R as residents. There would thus be double taxation on the same item of income because of the differing allocation rules in this situation.

131. The majority was of the view that, despite the general principles discussed in Section II.5 which would require the source State to take into consideration the treatment of the income in the State of the residence of the

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partners, in this situation State P would not be limited in its taxing rights by the P-R Convention. In its view, the situation involves a purely domestic matter from the perspective of State P; it is simply taxing the domestic source income of a resident taxpayer and nothing in the Convention can limit that right. The fact that double taxation results because of the differing income allocations of States R and P is not a reason to limit its right to tax its residents.

132. Some delegates, however, would continue to follow the principle that State P, in applying the Convention, should take into account the fact that, under the allocation of income rules in State R, the income would be liable to tax in the hands of A and B. Their position would be that State P is obliged to relieve the potential resulting double taxation by applying Article 12 to exempt the income in the hands of the partners, thus leaving the exclusive taxing right with State R.

133. Where P continues to tax the income in the hands of P, the possible application of Article 23 is discussed in section III.1.

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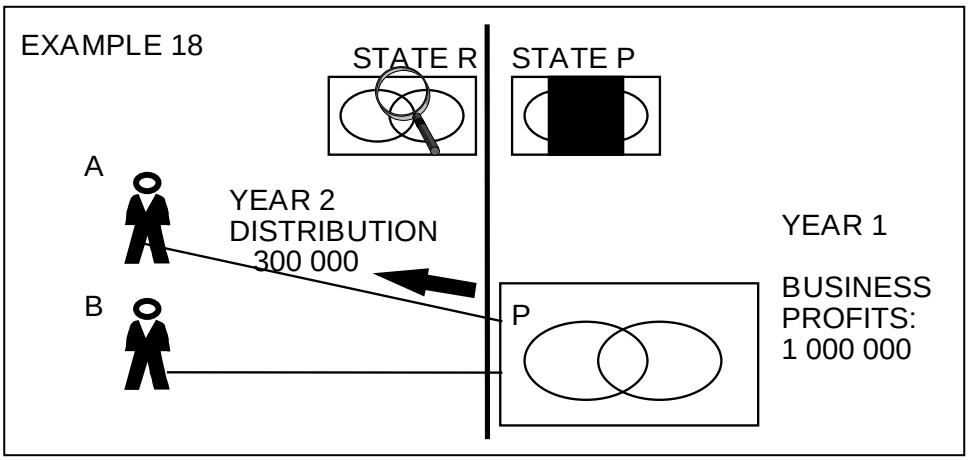
Example 18: *In Year 1, P, which is established and has a permanent establishment in State P, earns profits of 1 million. In Year 2, P distributes to A, a resident of State R, his share in the profits earned in Year 1 (300,000). Under State P's domestic law, P is a company, and the profits would be taxed in Year 1 at 40% (400,000). In year 2, a further withholding tax (30,000) on the distribution to A would be imposed (by treating it as a dividend). Under State R's domestic law, P is fiscally transparent, and State R would tax A in Year 1 on A's share in P's profits (500,000). State R would treat the distribution in year 2 as having no tax effect.*



134. In this example, the conflict in income allocation that results from the different treatment of partnerships in States P and R raises the following various difficulties with respect to the elimination of double taxation by State R:

- the fact that State P taxes two different events (the earning of the profits and their distribution) while State R only taxes one event (the earning of the profits);
- the timing mismatch that results from the fact that State P taxes the distribution in year 2 but State R imposes its tax in year 1;
- the fact that the State P tax which is levied when the profits are earned is paid by the partnership while the State R tax is levied on the partners.

135. The first difficulty relates to whether State R should provide credit for the tax levied by State P upon the distribution. This is an issue that concerns

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equally States applying the exemption method and States applying the credit method. If State R applies the exemption method, it must refrain from taxing the partnership's business profits derived from State P in year 1 (it is, of course, entitled to take the excluded income into account in determining the rate of tax on A's remaining income pursuant to paragraph 3 of Article 23 A); if it is a credit State, it must give credit for State P's tax levied on these profits in year 1. In both cases, however, the Convention theoretically requires that it should provide a credit for State P's tax levied on the distribution against its tax on such a distribution (paragraph 2 of Article 23 A and paragraph 1 of Article 23 B).

136. Since, however, State R does not tax the distribution, there is no tax levied by State R against which to credit State P's tax levied upon the distribution. While the Convention would allow State R to tax the profit distribution made in year 2, such taxation would be inconsistent with State R's treatment of partnership and is therefore not allowed by its domestic law. Under that law, the income may be taxed (subject to any relief from double taxation) only in the year it was earned, i.e. year 1. The manner in which taxation rights allowed by a treaty are exercised is, of course, a matter of domestic law.

137. A clear distinction must be made between the generation of profits and the distribution of those profits. State R, if it is an exemption State, has to exempt from tax the generation of profits in year 1 and therefore is not permitted under the Convention to tax the profits when earned on the basis that Article 10 would allow them to be taxed when distributed. Similarly, however, State R (if it is a credit State) should not be expected to credit the tax levied by State P upon distribution against its own tax levied upon generation.

138. Once it is agreed that State R does not levy tax on the distribution, the second difficulty, i.e. the timing mismatch, is no longer relevant. While timing mismatches frequently create problems for foreign tax credit purposes, which leads States to adopt rules allowing for the carry-back or carry-forward of foreign tax credits, the issue does not arise in this example since there is no double taxation of the distribution.

139. The third difficulty concerns only States that apply the credit method and relates to the fact that both States impose tax upon the same income, but on different taxpayers. The issue is therefore whether State R, which taxes partner

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A on his share in the partnership profits, is obliged, under the Convention, to give credit for the source tax that is levied in State P on partnership P, which State P treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that State R flows-through the income of the partnership to the partners for the purpose of taxing them, it should be consistent and flow-through the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partners. In other words, if the corporate status given to the partnership by State P is ignored for purposes of taxing the share in the profits, it should likewise be ignored for purposes of giving access to the foreign tax credit.

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ANNEX I: PROPOSED CHANGES TO THE OECD MODEL TAX CONVENTION

The following are the changes to the Model Tax Convention resulting from the report (changes to the existing text of the Commentary are indicated by ***bold italics*** and ~~strikethrough~~):

Articles of the Model

1. Add the following paragraph 4 to Article 23A of the Model Tax Convention:

> ***"4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income."***

Commentary

2. Delete paragraphs 2 to 6 of the Commentary on Article 1 and replace them by the following:

> ***"2. Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships. These difficulties are analysed in the report by the Committee on Fiscal Affairs entitled "The application of the OECD Model Tax Convention to Partnerships", the conclusions of which have been incorporated below and in the Commentary on various other provisions of the Model Tax Convention.***
>
> 3. [FROM PARA. 2] ***As discussed in that report, a main source of difficulties is*** the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries ***adopt what may be***

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referred to as the fiscally transparent approach, under which the partnership is ignored for tax purposes and the individual partners ***are taxed*** on their respective share of the partnership's income.

4. ***A first difficulty is the extent to which a partnership is entitled as such to the benefits of the provisions of the Convention. Under Article 1, only persons who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. While paragraph 2 of the Commentary on Article 3 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4.***

5. [FROM PARA. 3] Where a partnership is treated as a company or taxed in the same way, it ~~may reasonably be argued that the partnership~~ is a resident of the Contracting State ~~taxing~~ ***that taxes*** the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, ~~falling under the scope of the Convention,~~ ***it*** is entitled to the benefits of the Convention. ~~In the other instances mentioned in paragraph 2 above, the application of the Convention to the partnership as such might be refused, at least if no special rule covering partnerships is provided for in the Convention~~. ***Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not "liable to tax" in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners should be entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership's income is allocated to them for the purposes of taxation in their State of residence (cf. paragraph 8.2 of the Commentary on Article 4).***

6. The relationship between the partnership's entitlement to the benefits of a tax Convention and that of the partners raises other questions.

6.1 One issue is the effect that the application of the provisions of the Convention to a partnership can have on the taxation of the partners.

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Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State's right to tax the partnership on its income do not apply to restrict that other State's right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State's right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State.

6.2 Another issue is that of the effect of the provisions of the Convention on a Contracting State's right to tax income arising on its territory where the entitlement to the benefits of one, or more than one, Conventions is different for the partners and the partnership. Where, for instance, the State of source treats a domestic partnership as fiscally transparent and therefore taxes the partners on their share of the income of the partnership, a partner that is resident of a State that taxes partnerships as companies would not be able to claim the benefits of the Convention between the two States with respect to the share of the partnership's income that the State of source taxes in his hands since that income, though allocated to the person claiming the benefits of the Convention under the laws of the State of source, is not similarly allocated for purposes of determining the liability to tax on that item of income in the State of residence of that person.

6.3 The results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of source. This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

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6.4 Where, as described in paragraphs 6.2, income has "flowed through" a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as "paid" to the partners since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in their State of residence. Hence the partners, in these circumstances, satisfy the condition, imposed in several Articles, that the income concerned is "paid to a resident of the other Contracting State". Similarly the requirement, imposed by some other Articles, that income or gains are "derived by a resident of the other Contracting State" is met in the circumstances described above. This interpretation avoids denying the benefits of tax Conventions to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them, can claim the benefits of the Convention with respect to that income. Following from the principle discussed in paragraph 6.3, the conditions that the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of s ource, the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.

6.5 Partnership cases involving three States pose difficult problems with respect to the determination of entitlement to benefits under Conventions. However, many problems may be solved through the application of the principles described in paragraphs 6.2 to 6.4. Where a partner is a resident of one State, the partnership is established in another State and the partner shares in partnership income arising in a third State then the partner may claim the benefits of the Convention between his State of residence and the State of source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his State of residence. If, in addition, the partnership is taxed as a resident of the State in which it is established then the partnership may itself claim the benefits of the Convention between the State in which it is established and the State of source. In such a case of "double benefits", the State of source may not impose taxation which is inconsistent with the terms of either applicable Convention therefore, where different rates are provided for in the two Conventions, the lower will be applied. However, Contracting States may

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wish to consider special provisions to deal with the administration of benefits under Conventions in situations such as these, so that the partnership may claim benefits but partners could not present concurrent claims. Such provisions could ensure appropriate and simplified administration of the giving of benefits. No benefits will be available under the Convention between the State in which the partnership is established and the State of source if the partnership is regarded as transparent for tax purposes by the State in which it is established. Similarly no benefits will be available under the Convention between the State of residence of the partner and the State of source if the income of the partnership is not allocated to the partner under the taxation law of the State of residence. If the partnership is regarded as transparent for tax purposes by the State in which it is established and the income of the partnership is not allocated to the partner under the taxation law of the State of residence of the partner, the State of source may tax partnership income allocable to the partner without restriction.

6.6 Differences in how countries apply the fiscally transparent approach may create other difficulties for the application of tax Conventions. Where a State considers that a partnership does not qualify as a resident of a Contracting State because it is not liable to tax and the partners are liable to tax in their State of residence on their share of the partnership's income, it is expected that that State will apply the provisions of the Convention as if the partners had earned the income directly so that the classification of the income for purposes of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows-through the partnership. Difficulties may arise, however, in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and another party to a transaction. Some of these difficulties are discussed in paragraphs 19.1 of the Commentary on Article 5 and paragraphs 6.1 and 6.2 of the Commentary on Article 15.

6.7 Finally a number of other difficulties arise where different rules of the Convention are applied by the Contracting States to income derived by a partnership or its partners, depending on the domestic laws of these States or their interpretation of the provisions of the Convention or of the relevant facts. These difficulties relate to the broader issue of conflicts

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of qualification, which is dealt with in paragraphs 32.1 ff. and 56.1 ff. of the Commentary on Article 23."

3. Delete the last sentence of paragraph 2 of the Commentary on Article 3 and replace it by the following:

"Partnerships will also be considered to be "persons" either because they fall within the definition of "company" or, where this is not the case, because they constitute other bodies of persons."

4. Add the following paragraph 10.1 to the Commentary on Article 3:

"10.1 The separate mention of partnerships in sub-paragraph 1 f) is not inconsistent with the status of a partnership as a person under sub-paragraph 1 a). Under the domestic laws of some countries, it is possible for an entity to be a "person" but not a "legal person" for tax purposes. The explicit statement is necessary to avoid confusion."

5. Add the following paragraph 8.2 to the Commentary on Article 4:

"8.2 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the Conventions concluded by the States of which they are residents. This latter result will obtain even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States."

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6. Add the following paragraph 19.1 to the Commentary on Article 5:

"19.1 In the case of fiscally transparent partnerships, the twelve month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve month, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site."

7. Renumber paragraph 7 of the Commentary on Article 15 as paragraph 6 and add the following paragraphs 6.1 and 6.2:

"***6.1 The application of the second condition in the case of fiscally transparent partnerships present difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (cf. paragraph 8.2 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an "employer" (especially under the domestic law definitions of the term in some countries, e.g. where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.***

6.2 The object and purpose of subparagraphs 2b) and c) of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to be constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of subparagraph 2b) that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of "employer" and

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"resident", as found in subparagraph 2b), are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax Conventions must be applied at the partners' rather than at the partnership's level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (i.e. the State in which the greatest part of the deduction will be claimed)."

8. Add the following heading and paragraphs immediately after paragraph 32 of the Commentary on Article 23:

"E. Conflicts of qualification[1]

32.1 Both Articles 23 A and 23 B require that relief be granted, through the exemption or credit method, as the case may be, where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention. Thus, the State of residence has the obligation to apply the exemption or credit method in relation to an item of income or capital where the Convention authorizes taxation of that item by the State of source.

32.2 The interpretation of the phrase "in accordance with the provisions of this Convention, may be taxed", which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.

32.3 Different situations need to be considered in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance

1. See the diverging opinion by Switzerland in Annex II.

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with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

32.4 This point may be illustrated by the following example. A business is carried on through a permanent establishment in State E by a partnership established in that State. A partner, resident in State R, alienates his interest in that partnership. State E treats the partnership as fiscally transparent whereas State R treats it as taxable entity. State E therefore considers that the alienation of the interest in the partnership is, for the purposes of its Convention with State R, an alienation by the partner of the underlying assets of the business carried on by the partnership, which may be taxed by that State in accordance with paragraph 1 or 2 of Article 13. State R, as it treats the partnership as a taxable entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which could not be taxed by State E by reason of paragraph 4 of Article 13. In such a case, the conflict of qualification results exclusively from the different treatment of partnerships in the domestic laws of the two States and State E must be considered by State R to have taxed the gain from the alienation "in accordance with the provisions of the Convention" for purposes of the application of Article 23 A or Article 23 B. State R must therefore grant an exemption pursuant to Article 23 A or give a credit pursuant to Article 23 B irrespective of the fact that, under its own domestic law, it treats the alienation gain as income from the disposition of shares in a corporate entity and that, if State E's qualification of the income were consistent with that of State R, State R would not have to give relief under Article 23 A or Article 23 B. No double taxation will therefore arise in such a case.

32.5 Article 23 A and Article 23 B, however, do not require that the State of residence eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable. For instance, in the example above, if, for purposes of applying paragraph 2 of Article 13, State E considers that the partnership carried on business through a fixed place of

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business but State R considers that paragraph 4 applies because the partnership did not have a fixed place of business in State E, there is actually a dispute as to whether State E has taxed the income in accordance with the provisions of the Convention. The same may be said if State E, when applying paragraph 2 of Article 13, interprets the phrase "forming part of the business property" so as to include certain assets which would not fall within the meaning of that phrase according to the interpretation given to it by State R. Such conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification described in the above paragraph where the divergence is based not on different interpretations of the provisions of the Convention but on different provisions of domestic law. In the former case, State R can argue that State E has not imposed its tax in accordance with the provisions of the Convention if it has applied its tax based on what State R considers to be a wrong interpretation of the facts or a wrong interpretation of the Convention. States should use the provisions of Article 25 (Mutual Agreement Procedure), and in particular paragraph 3 thereof, in order to resolve this type of conflict in cases that would otherwise result in unrelieved double taxation.

32.6 The phrase "in accordance with the provisions of this Convention, may be taxed" must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have taxed, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

32.7 This situation may be illustrated by reference to a variation of the example described above. A business is carried on through a fixed place of business in State E by a partnership established in that State and

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a partner, resident in State R, alienates his interest in that partnership. Changing the facts of the example, however, it is now assumed that State E treats the partnership as a taxable entity whereas State R treats it as fiscally transparent; it is further assumed that State R is a State that applies the exemption method. State E, as it treats the partnership as a corporate entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which it cannot tax by reason of paragraph 4 of Article 13. State R, on the other hand, considers that the alienation of the interest in the partnership should have been taxable by State E as an alienation by the partner of the underlying assets of the business carried on by the partnership to which paragraphs 1 or 2 of Article 13 would have been applicable. In determining whether it has the obligation to exempt the income under paragraph 1 of Article 23 A, State R should nonetheless consider that, given the way that the provisions of the Convention apply in conjunction with the domestic law of State E, that State may not tax the income in accordance with the provisions of the Convention. State R is thus under no obligation to exempt the income."

9. Replace paragraphs 34 to 36 of the Commentary on Article 23 by the following:

"34. The State of residence must accordingly ***exempt income and capital which may be taxed by the other State in*** accordance ***with the Convention*** whether or not the right to tax is in effect exercised by ***that*** other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State.

34.1 The obligation imposed on the State of residence to exempt a particular item of income or capital depends on whether this item may be taxed by the State of source in accordance with the Convention. Paragraphs 32.1 to 32.7 above discuss how this condition should be interpreted. Where the condition is met, however, the obligation may be considered as absolute, subject to the exceptions of paragraphs 2 and 4 of Article 23 A. Paragraph 2 addresses the case, already mentioned in paragraph 31 above, of items of income which may only be subjected to a limited tax in the State of source. For such items of income, the paragraph provides for the credit method (cf. paragraph 47 below).

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Paragraph 4 addresses the case of certain conflicts of qualification which would result in double non-taxation as a consequence of the application of the Convention if the State of residence were obliged to give exemption (cf. paragraphs 56.1 to 56.3 below).

35. Occasionally, negotiating States may find it reasonable in certain circumstances***, in order to avoid double non-taxation***, to make an exception to the absolute obligation on the State of residence to give ***exemption in cases where neither paragraph 3 nor 4 would apply***. Such may be the case ***where no tax on specific items of income or capital is provided under the domestic laws of the State of source, or*** tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid ***such*** double non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself (cf. paragraph 9 of the Commentary on Article 15 and paragraph 12 of the Commentary on Article 17; for the converse case where relief in the State of source is subject to actual taxation in the State of residence, cf. paragraph 20 of the Commentary on Article 10, paragraph 10 of the Commentary on Article 11, paragraph 6 of the Commentary on Article 12, paragraph 21 of the Commentary on Article 13 and paragraph 3 of the Commentary on Article 21). One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption (cf. paragraph 31 above).

~~36. As already mentioned in paragraph 31 above, the exemption method does not apply to such items of income which according to the Convention may be taxed in the State of residence but may also be subjected to a limited tax in the other Contracting State. For such items of income, paragraph 2 of Article 23 A provides for the credit method (cf. paragraph 47 below).”~~

10. Add the following heading and paragraphs immediately after paragraph 56 of the Commentary on Article 23:

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"Paragraph 4

56.1 The purpose of this paragraph is to avoid double non taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or on the interpretation of the provisions of the Convention. The paragraph applies where, on the one hand, the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that eliminates its right to tax that item or limits the tax that it can impose while, on the other hand, the State of residence adopts a different interpretation of the facts or of the provisions of the Convention and thus considers that the item may be taxed in the State of source in accordance with the Convention, which, absent this paragraph, would lead to an obligation for the State of residence to give exemption under the provisions of paragraph 1.

56.2 The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10 or 11 to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source (cf. paragraph 34 above). Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of the income that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10 or 11.

56.3 Cases where the paragraph apply must be distinguished from cases where the qualification of an item of income under the domestic law of the State of source interacts with the provisions of the Convention to preclude that State from taxing an item of income or capital in

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circumstances where the qualification of that item under the domestic law of the State of residence would not have had the same result. In such a case, which is discussed in paragraphs 32.6 and 32.7 above, paragraph 1 does not impose an obligation on the State of residence to give exemption because the item of income may not be taxed in the State of source in accordance with the Convention. Since paragraph 1 does not apply, the provisions of paragraph 4 are not required in such a case to ensure the taxation right of the State of residence."

11. Replace paragraph 59 of the Commentary on Article 23 by the following:

"59. ***The obligation imposed by Article 23 B on a State R to give credit for the tax levied in the other State E (or S) on an item of income or capital depends on whether this item may be taxed by the State E (or S) in accordance with the Convention. Paragraphs 32.1 to 32.7 above discuss how this condition should be interpreted.*** ~~It is to be noted that Article 23 B applies in a State R only to items of income or capital which, in accordance with the Convention, "may be taxed" in the other State E (or S).~~ Items of income or capital which according to Article 8, to paragraph 3 of Article 13, to sub-paragraph a) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22, "shall be taxable only" in the other State, are from the outset exempt from tax in State R (cf. paragraph 6 above), and the Commentary on Article 23 A applies to such exempted income and capital. As regards progression, reference is made to paragraph 2 of the Article (and paragraph 79 below).

12. Add the following paragraphs 69.1 to 69.3 to the Commentary on Article 23:

"69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State of source treats a partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of source may, subject to the applicable provisions of the Convention, tax the partnership on its income when that income is realized and, subject to the limitations of paragraph 2 of Article 10, may also tax the distribution of profits by the partnership to its non-resident partners. The State of residence, however, will only tax the partner on his share of

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the partnership's income when that income is realized by the partnership.

69.2 The first issue that arises in this case is whether the State of residence, which taxes the partner on his share in the partnership's income, is obliged, under the Convention, to give credit for the tax that is levied in the State of source on the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that the State of residence flows-through the income of the partnership to the partner for the purpose of taxing him, it must adopt a coherent approach and flow-through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.

69.3 A second issue that arises in this case is the extent to which the State of residence must provide credit for the tax levied by the State of source on the distribution, which is not taxed in the State of residence. The answer to that question lies in that last fact. Since the distribution is not taxed in the State of residence, there is simply no tax in the State of residence against which to credit the tax levied by the State of source upon the distribution. A clear distinction must be made between the generation of profits and the distribution of those profits and the State of residence should not be expected to credit the tax levied by the State of source upon the distribution against its own tax levied upon generation (cf. the first sentence of paragraph 64 above)."

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ANNEX II: RESERVATIONS BY FRANCE, GERMANY, THE NETHERLANDS, PORTUGAL AND SWITZERLAND

France

1. France considers that the criteria mentioned in paragraphs 40 to 42 in order to decide whether a partnership is "liable to tax" or not are not sufficient to take into account situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes.

2. For the purposes of French tax law, a partnership would always be regarded as liable to tax, even if in fact taxation is applied not against the partnership as such but on the partners on behalf of the partnership according to the share corresponding to their participation in the partnership.

3. Consequently, France does not share the conclusions of Section II.3 *b).*

4. France also disagrees with the conclusions mentioned in paragraph 35 under which, if the application of the Convention to the partnership is refused, the partners would always be entitled to the benefits provided by the Convention entered into by the countries of which they are residents. The opinion of France is that such a solution depends to some extent upon the provisions included in the Convention concluded with the State where the partnership is situated.

5. The implications of the above comments with regard to the introductory examples examined in sections II.4 and II.5 are as follows:

A. France considers that it is not appropriate to refer to a single criterion to determine whether a partnership is "liable to tax".

6. The systems which different States use to impose tax on partnerships and their constituent partners are highly complex.

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7. It is not sufficient to note that the amount of tax due payable on the partnership income is determined in relation to the personal characteristics of the partners to conclude that the partnership should not itself be considered to be "liable to tax".

8. The use of such reasoning to determine whether the provisions of Conventions are applicable is likely to lead to a situation in which some States are placed in the category of those which apply a fiscally transparent approach to partnerships despite the fact their own domestic legislation considers such entities to be liable to tax.

9. If this line of reasoning were to be pursued further, then despite the fact that under French tax law a partnership is always considered to be liable to tax France would have to be classified among those States which do not recognise their own partnerships are being "resident" within the meaning of the report.

10. To the extent that it does not recognise itself as a State which treats partnerships as being fiscally transparent, France cannot endorse the conclusions of the Committee with regard to the examples presented in section II.4.

11. In example 2, for instance, France's opinion, in the event that it were State P in which the partnership was established, is that:

- firstly, the partnership, given that it is liable to tax, is entitled to claim the benefits of the Convention;
- secondly, the applicable Convention is that between S and P and not the one between S and R.

B. France does not share the view that in cases where the application of the Convention is denied to a partnership the members of that partnership may claim the benefits of the Conventions entered into by the States of which they are residents by virtue of the fact that they are liable to tax in those States on their share of the partnership income.

12. Even when the partnership is established in a State which applies a fiscally transparent approach, the fact that the partnership is a legal person precludes the view that income simply "flows through" this entity to the partners.

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13. Since a partnership constitutes a separate legal entity, it cannot be ignored for tax purposes.

14. Although treating partnerships as being liable to tax, France therefore cannot agree with the conclusions reached by the Committee with regard to the examples reviewed in section II.5.

15. In example 4, for instance, were France to be placed in the position of State S, it would refuse to apply the provisions of the Convention with State P because the fact that the partnership was not liable to tax in the State in which it was established would preclude it from claiming the benefits of the Convention.

16. We therefore cannot approve the proposed amendment of the Commentary on Article 1 in the Model Tax Convention with regard to the new paragraphs 6.5, 6.6 and 8.2 (Annex 1 of the report).

Administrative difficulties

17. Furthermore, France considers that the administrative difficulties with regard to implementation noted in example 9 (partnerships with many partners residing in different States), the problems regarding the flow in information mentioned in example 10 (partnership established in a State which does not have a tax convention with the source State, which nonetheless has signed a Convention with the State of which the partners are residents), and the risks of double-exemptions in triangular cases in which the State of residence of the partners and the State in which the partnership has its head office apply the principle of transparency are of a such a nature as to invalidate the solution whereby the partnership is disregarded in order to allow the partners to benefit from application of the Convention.

Germany

Observations by Germany on paragraph 45

18. Germany does not share the views expressed in paragraph 45. Under the special provisions mentioned in paragraph 43 one may have to determine when the income is attributable to a permanent establishment in the State of the partnership or in a third State, but this is not more difficult with respect to a partnership than in other instances where it has to be determined whether

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income is effectively connected with a permanent establishment. How the reduction of a withholding tax should be calculated where only a "part" of the partnership is treated as a treaty resident may not always be clear. But as a rule this question would not arise, since the whole amount of the income of the partnership would normally be subject to tax in the State of the partnership. On the other hand, the question would always arise if the special provisions would not be inserted. In that case withholding tax reduction would have to be granted on the basis of the status of each partner for his share of the income. It is an extremely difficult task, particularly if there is a great number of partners being residents of different States, to attribute the income subject to withholding tax to the partners, because the withholding agent does not know the often very complicated and sometimes even abusive arrangements between the partners on the division of profits (and losses). This is the main reason why Germany proposes special provisions on partnerships. As for the last argument put forward in paragraph 45, it is true that the special provision would allow a third State partner to qualify for treaty benefits where the existence of a direct permanent establishment would not, but a strict rule to treat partnership income attributable to a third State partner always in the same way as income attributable to a direct permanent establishment does not exist. There are some particularities of partnerships which justify a different treatment.

Observations by Germany on paragraph 91 and 92

19. Germany would prefer an approach under which the partnership as such would be considered as the employer (as under the national law of most OECD member States including Germany even if these States do not tax the partnership as such). Since this employer has to reside somewhere, his residence would have to be determined hypothetically assuming the partnership were liable to tax by reason of one of the criteria mentioned in Article 4. In a case where a partnership established in one Contracting State sends an employee to carry on activities in the other contracting State where it has no permanent establishment, but where one of the partners is resident the difficulties described in paragraph 92 would not arise.

The Netherlands

20. The conclusions on the treatment of partnerships in the various situations described in the Report are presented as a matter of interpretation of the relevant

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articles of the Model Convention. We doubt whether these specific conclusions can be said to fully and directly flow from the original intentions underlying the respective articles. We also feel that the conclusions and the reasonings leading to them are not altogether consistent one with the other. In general it seems to us that the wish to provide a certain solution is allowed precedence over the question whether there actually is a legal base for such solution. Furthermore, we are uncertain whether it would be possible under Netherlands domestic law to fully implement the conclusions. Some conclusions might require adaptation of domestic rules (e.g. the participation exemption) that are not governed by a tax treaty. We finally note that the Report does not provide a comprehensive solution for all situations of juridical or economic double taxation or double non-taxation that might arise in the context of partnerships.

21. According to paragraph 47 of the Report "Member countries may in their bilateral relations develop different solutions to the problems of double taxation which may arise in connection with partnerships". This means that in the absence of such deviating bilateral solutions the conclusions in the Report would automatically prevail. Since bilateral solutions to the issue are still scarce -- we are at this moment in the process of discussing such solutions with some of our major treaty partners and plan to have similar discussions with other treaty partners in the future -- the conclusions in the Report would thus for the time being constitute the main rule. Given the difficulties we have with these conclusions, we would find that an unsatisfactory situation. We therefore prefer it to be up to our own initiative to decide, depending on the circumstances of the case at hand, whether, and to which extent, the conclusions of the Report are applicable.

22. For similar reasons we prefer also in respect of conflicts of qualification in general to maintain the right to decide ourselves whether the conclusions in the Report may be followed or instead any other solution that appears to be more suitable.

Observations to the proposed paragraphs 2-6 of the Commentary on Article 1

23. In the case of the Netherlands, the conclusions on the application of the Model Convention to partnerships in paragraphs 2-6 and in the Commentaries on other relevant articles are applicable only, and to the extent in which, it is explicitly stated so in a specific double taxation convention, as the result of

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mutual agreement between competent authorities according to Article 25 or as unilateral policy.

Observation to the proposed paragraphs 32.1-32.7 of the Commentary on Article 23 in respect of conflicts of qualification

24. In the case of the Netherlands, the paragraphs 32.1 to 32.7 regarding conflicts of qualification are applicable only if, and to the extent in which, it is explicitly stated so in a specific double taxation convention, as the result of mutual agreement between competent authorities according to Article 25 or as unilateral policy.

Portugal

25. Portugal, where all partnerships are taxed as such, makes observations on the report since the solutions put forward in that document should be incorporated in special provisions only applicable when included in tax conventions. This is the case, for example, of the treatment of the situation of partners of partnerships — a concept which is considerably fluid given the differences between States — that are fiscally transparent, including the situation where a third State is inserted between the State of source and the State of residence of the partners. The administrative difficulties resulting from some of the solutions put forward should also be noted, as indicated in the report itself in certain cases.

26. Also, the proposed drafting of paragraph 4 of Article 23A could or does raise difficulties with respect to the drafting of paragraph 2 of Article 23A.

Switzerland

27. The rules laid down in proposed paragraph 32 of the Commentary on Article 23 are helpful to avoid double taxation. On the other side they imply the danger that the State of residence becomes dependent on the State of source. If the State of source changes its internal law to enlarge its taxing right the State of residence has to accept it. This could lead to undesirable results. To avoid such results it seems necessary to limit the scope of the rules in paragraphs 32.1-7 to the internal law of both States as it existed in the moment when the Convention was concluded. Problems arising due to changes in the internal law of a State

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after the conclusion of the Convention should be solved by a revision of the Convention. We would therefore like to insert the following observation to paragraph 32 of the proposed Commentary on Article 23:

> "Switzerland reserves its right not to apply the rules laid down in paragraph 32 in cases where a conflict of qualification results from a modification to the internal law of the State of source subsequent to the conclusion of a Convention."

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ANNEX III: LIST OF ENTITIES IN SELECTED COUNTRIES

This annex presents, following a standard format, the main tax treaty characteristics of the various legal forms that a business or investment can take under the domestic laws of the countries that have co-operated to the preparation of this report. It does not cover, however, the case of the individual who has sole ownership or control of a business (i.e. sole proprietorship) or investment. It also does not cover contractual arrangements (i.e. pension funds or investment funds in most countries) which do not create specific new legal forms by themselves but merely use existing legal vehicles (i.e. trusts or companies).

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AUSTRALIA

1. Name of entity and common abbreviation	Partnership	Corporate Limited Partnership[1]	Proprietary Company
2. English translation			
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The entity	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	Retains its fiscal nature	N/A	N/A
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Rate determined in relation to each partner	Corporate tax rate is applied	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	N/A[2]	Yes [3]	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?		Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	Yes	Yes

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AUSTRALIA

1. Name of entity and common abbreviation	Public Listed Company	Trusts	Corporate Unit Trusts and Public Trading Trusts [4]
2. English translation			
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Not generally [5]	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The members [6]	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	N/A	Retains its fiscal nature	N/A
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	Rate determined in relation to each beneficiary.	Corporate tax rate is applied
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	N/A	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend		Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes, if trustee is liable to tax	Yes

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NOTES (AUSTRALIA)

1. Must consist of a general partner, who has unlimited liability for the debts and obligations of the partnership, and one or more limited partners whose liability to the partnership is limited to the amount of money or property which each has contributed.

2. Partnership income is assessed to partners in year of derivation, not year of receipt.

3. Franking credits are available for tax paid directly by the company and for franking credits attached to dividends received. Resident shareholders deriving dividends (including franked dividends) are taxable, but imputation credits apply. A tax liability arises in the hands of the shareholder to the extent that the overall tax burden is higher then the credits attached to any franked dividends received. Franking credits are currently non-refundable and cannot be carried forward or back. For non-residents, dividends are exempt from Australian tax to the extent that they are franked (similar arguments for all entities treated as companies apply.)

4. Must be an eligible unit trust, whose units are traded on the stock exchange. Eligible unit trusts are a type of fixed trusts made up of unit holders having fixed interests in the income and capital of the trust. Common features of these unit trusts are:
   - An independent agent is employed to act as trustee.
   - Units are transferable. The ability to transfer units is often subject to the approval of specified people.
   - Additional units may be issued.
   - Unit holders may attend meetings and vote.

5. Beneficiaries are taxed on income to which they are presently entitled. Trustee will be taxed on any income to which beneficiaries are not entitled or where the beneficiaries are under legal disability or not resident. Non-resident beneficiaries are entitled to a credit for tax paid by trustee.

6. The trustee would also be liable to tax, subject to set off by the beneficiary i.e. reimbursed out of the beneficiary's share of trust property, if the beneficiary is under legal disability.

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AUSTRIA

1. Name of entity and common abbreviation	Aktienge-sellschaft (AG)	Gesellschaft mit beschränkter Haftung (GmbH)	Offene Handelsge-sellschaft (OHG)
2. English translation	Company	Limited liability company	General partnership
3. Does the entity file a tax return?	Yes	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Fiscal nature is unchanged[2]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	As a dividend	As a dividend	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	No

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AUSTRIA

1. Name of entity and common abbreviation	Offene Erwerbsge-sellschaft (OEG)	Kommandit gesellschaft (KG)	Kommandit Erwerbsgesellschaft (KEG)
2. English translation	General partnership type 2[1]	Limited partnership	Limited partnership type 2[5]
3. Does the entity file a tax return?	No	No	No
4. Is tax on the income of the entity assessed on the entity itself?	No	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The partners	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	Fiscal nature is unchanged[3]	Fiscal nature is unchanged[6]	Fiscal nature is unchanged[7]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	No

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AUSTRIA

1. Name of entity and common abbreviation	Gesellschaft nach bürgerlichem Recht (GesnbR)	Stille Gesellschaft[4]
2. English translation	Civil law partnership	Sleeping partnership
3. Does the entity file a tax return?	No	No
4. Is tax on the income of the entity assessed on the entity itself?	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	Fiscal nature is unchanged[8]	Fiscal nature is unchanged[9]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No

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NOTES (AUSTRIA)

1. This form of partnership corresponds to the OHG and was designed for businesses which cannot be carried on in the legal form of an OHG (small - sized businesses, farmers and liberal professions).

2. If, however, part of the activities of the partnership is in the nature of "business income" then the entire partnership income will be reclassified as "business income"

3. See footnote 2.

4. The sleeping partnership is not considered as being a "partnership" under commercial law, because the "sleeping partner" is not made known to third parties. The tax regime for partnerships applies only to those sleeping partnership contracts where the sleeping partner participates not only in the profits but also in the capital gains of the enterprise.

5. This form of partnership corresponds to the KG and was designed for businesses which cannot be carried on in the legal form of a KG (small - sized businesses, farmers and liberal professions).

6. See footnote 2.

7. See footnote 2.

8. See footnote 2.

9. See footnote 2.

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BELGIUM

1. Name of entity and common abbreviation	Société anonyme/ Naamloze Vennootschap	Société en commandite par actions/ Commanditaire venootschap op aandelen	Société privée à responsabilité limitée / Besloten venootschap met beperkte aansprakelijkheid
2. English translation	Limited company	Company limited by shares	Limited liability partnership
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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BELGIUM

1. Name of entity and common abbreviation	Société coopérative à responsabilité limitée /Coöperative venootschap met beperkte aansprakelijkheid	Société coopérative à responsabilité illimitée/ Coöperatieve venootschap met onbeperkte aansprakelijk-heid
2. English translation	Co-operative society with limited liability	Co-operative society with unlimited liability
3. Does the entity file a tax return?	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes

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BELGIUM

1. Name of entity and common abbreviation	Société en commandite simple/ Gewone commanditaire venootschap	Société en nom collectif/ Vennotschap onder firma
2. English translation	Limited partnership	General partnership
3. Does the entity file a tax return?	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes

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CANADA

1. Name of entity and common abbreviation	Corporation	Limited Liability Company (LLC)	Partnership (General and Limited)	Trust
2. English translation				
3. Does the entity file a tax return?	Yes	Yes (considered to be a corporation)	No (an information return may be required)	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No	Yes, to the extent that income of the trust is not paid to beneficiaries[1]
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The entity	The members	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Fiscal nature unchanged	Income from property, with some exceptions in the case of Canadian resident beneficiaries[2]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	Yes	No, to the extent taxed at the level of the trust
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes, except certain dividends[3]	Yes, except certain dividends[4]	No	See 6 above
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	-	Trust income or retains its nature (see 6 above)
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	No	Yes

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NOTES (CANADA)

1. A trust which is resident in Canada is entitled to a deduction from its income for a taxation year to the extent it is paid or payable to a beneficiary in the year. In this way the trust is not taxed on such income.

2. For Canadian resident beneficiaries certain income (e.g. dividends, capital gains) retains its source and character for the purpose of calculating taxable income and tax payable of the beneficiary.

3. Dividends received by a Canadian corporation from another are tax free (by way of deduction from income), except certain dividends received by Canadian private corporations.

4. See previous footnote.

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CZECH REPUBLIC

1. Name of entity and common abbreviation	Akciová společnost, a.s.	Společnost s ručením omezeným, s.r.o.	Komanditní společnost, k.s.[1]	Veřejná obchodní společnost, v.o.s.
2. English translation	Joint-stock company	Limited liability company	Limited partnership	General partnership
3. Does the entity file a tax return?	Yes	Yes	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes	-
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	Both	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Business income	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	Yes	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes (25% withholding)	Yes (25% withholding)	Yes	-
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends	Shares	Shares	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes	No

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NOTES (CZECH REPUBLIC)

1. A limited partnership is considered, in accordance with the Czech Commercial Law, as a legal entity in the Czech Republic. The tax base is calculated under the same rules as for a joint stock company and a limited liability company. However, from the tax point of view, the limited partnership is a person the tax base of which is divided among its general partners and limited partners. The income which corresponds to the income of the general partners is taxed as business income in the hands of these partners. The general partner has to include this income in his income tax return. The income which corresponds to the income of the limited partners is taxed as a business income of a company (taxation of a legal person - the share of the general partners is deducted form the tax base of the company); distributions made to the limited partners from the after-tax profits of the company are taxed in their hands (at 25 %).

2 A general partnership is also considered, in accordance with the Czech Commercial Law, as a legal entity in the Czech Republic. From the tax point of view, however, the income of the general partnership is divided among the partners according to their respective share (transparency). The income of the partnership is therefore taxable in the hands of the partners. Income such as dividends and interest (when withholding tax is applicable) constitutes an exception to this rule. In that respect, a general partnership is a taxpayer in the Czech Republic only to a very limited extent.

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DENMARK

1. Name of entity and common abbreviation	Skattesinteres-sentskab[1]	Interessentskab I/S Partrederi[2]	Kommandit-Selskab K/S
2. English translation	General partnership	General partnership, owned shipping firm	Limited partnership
3. Does the entity file a tax return?	No	No	No
4. Is tax on the income of the entity assessed on the entity itself?	No	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The partners	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	Business income	Capital income[3]	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	No

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DENMARK

1. Name of entity and common abbreviation	Udloddende investerings - forening[4]	Andelsforening[5]	Institutioner[9]
2. English translation	Distributing investment fund	Co-operative association	Association
3. Does the entity file a tax return?	No	Yes[6]	Yes[10]
4. Is tax on the income of the entity assessed on the entity itself?	No	Yes[7]	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The members	The association	The association
6. If the tax is paid by the members, how is the income classified for tax purposes?	Fiscal nature is unchanged	Business income	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?		No[8]	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Fiscal nature is unchanged	Dividends	Dividends or ordinary income[11]
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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NOTES (DENMARK)

1. A general partnership is also called a limited liability company. The characteristic of such a company is that there are more than 10 partners and that the partners do not take an active part in the company's activity.

2. Unlike the partners in a general partnership, the part owners of an owned shipping firm are liable pro rata in accordance with the Maritime Code.

3. There is only limited access to loss carry forward

4. Funds which annually distribute almost all profits

5. The association must buy, produce or sell commercial goods for the use of members' commercial undertakings and distribute profits in proportion to the turnover of individual members. There must be at least 10 members and sales to non-members must not exceed 25% of total sales.

6. Only income from commercial activity must be returned.

7. Income is assumed to be 4% of the association's capital and this is taxed at 14.3%.

8. But taxation of the association is affected by the value of transactions with non-members, if such transactions consistently exceed 25% of sales the association will be taxed as a normal company.

9. The association is liable to pay tax only on income from commercial activity. Profits earned by internal sale, i.e. by delivery to the members are not earned by commercial activity.

10. See footnote 6.

11. Dividends where members participate in the co-operative share capital, otherwise ordinary income.

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FINLAND

1. Name of entity and common abbreviation	Avoin yhtiö / Öppet bolag	Kommandiitiyhtiö (Ky)/ Kommanditbolag (Kb)	Osakeyhtiö (Oy) /Aktiebolag (Ab)
2. English translation	General partnership	Limited partnership	Limited company
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?[1]	No	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?[2]	Each partner	Each partner	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?[3]	Investment income	Investment income	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Yes	Yes	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	Yes

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NOTES (FINLAND)

1. The total taxable income is computed at the level of the partnership. The tax, however, is assessed on each partner separately (i.e. tax demand notes are issued on each partner) on the basis of his share of the partnership income. The partner is responsible for his own tax.

2. See previous footnote.

3. The income of individuals is categorised either as investment income or as earned income. Investment income is defined as the proceeds from capital, gains from the disposal of assets (capital gains) and other income yielded by assets. The following items of income are examples of investment income: interest and rental income, dividends from companies listed on the stock exchange, income from forestry (with exceptions) and income from patents or copyrights (on certain conditions). Earned income is defined as any income other than investment income. Investment income includes, in addition to the items listed above, the investment income *share* of certain types of "mixed" income, such as dividends from companies *not* listed on a stock exchange, profits from business, income from agriculture and income from partnerships. Corporate income and the investment income of individuals are taxed at the same flat rate (28 per cent).

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FRANCE

1. Name of entity and common abbreviation	Société anonyme (S.A.)	Société à responsabilité limitée (S.A.R.L.)[1]	Société en nom collectif (S.N.C.)[7]
2. English translation	Company limited by shares	Limited liability company	General partnership
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	Of the entity	Of the entity	Of the partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	The answer depends on the characteristics of the partners or on the nature of the partnership's activity[2]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends	Dividends	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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FRANCE

1. Name of entity and common abbreviation	Société en commandite simple (S.C.S.)[3 & 7]	Société en commandite par actions (S.C.A.)	Groupement d'intérêt économique (G.I.E.)[7]
2. English translation	Limited partnership	Limited partnership with share capital	Economic interest grouping
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes/No[3]	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	Of the entity and of the partners[4]	Of the entity	Of the partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	The answer depends on the characteristics of the partners or on the nature of the partnership's activity[5]	-	The answer depends on the characteristics of the partners or on the nature of the partnership's activity[5]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Yes/No[6]	No	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes/No[3]	Yes	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends in the hands of the limited partners	Dividends	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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FRANCE

1. Name of entity and common abbreviation	Société civile[7]	Société en participation[7 & 8]
2. English translation	Civil partnership	Undeclared partnership
3. Does the entity file a tax return?	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	Of the partners	Of the partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	The answer depends on the characteristics of the partners or on the nature of the partnership's activity[5]	The answer depends on the characteristics of the partners or on the nature of the partnership's activity[5]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Yes	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes

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NOTES (FRANCE)

1. With the exception of limited liability companies set up by members of the same family, which can opt for the tax regime applicable to partnerships. If so, the regime is equivalent to that applicable to a general partnership.

2. The methods used to calculate taxable profits differ according to the quality of the members of the partnership:

   a) the share in profits corresponding to the rights of partners which are legal entities liable to corporation tax or individual farmers who come under a real business profits system (BIC) or a farm profits system (BA) is calculated in accordance with the relevant rules regarding corporation tax, business profits or farm profits (Article 238 bis K I of the general tax code);

   b) the shares in profits accruing to other companies are calculated and taxed on the basis of the nature of the activity and the amount of earnings of the company or partnership (Article 238 bis K II of the general tax code).

3. Unlike a general partnership, in which all the members have unlimited liability, a limited partnership is a company in which at least one of the partners is held indefinitely liable for the company's debts. The share of profits accruing to that partner or those partners is taxable according to the rules of French tax law applying to partnerships (the same system as for a general partnership). By contrast, the share of profits accruing to the sleeping partners is taxed in France according to the rules applying to joint-stock companies (corporation tax in the name of the company and taxation as dividends of the income distributed by the company to its general partners).

4. Of the company where the share of profits accruing to sleeping partners is concerned; of the partners where the share of profits accruing to general partners is concerned.

5. See footnote 2.

6. Yes, where the profits corresponding to general partners' earnings entitlements are concerned; no, where the share in profits accruing to sleeping partners is concerned.

7. With the exception of civil partnerships, general partnerships, undeclared partnerships, economic interest groupings, and limited partnerships with respect to the share of profits accruing to general partners, which, if they have elected to be liable to corporation tax, are subjected to the same tax regime as that applying to limited companies.

8. In proportion to the share of profits accruing to their members who are indefinitely liable and whose names and addresses have been given to the authorities.

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GERMANY

1. Name of entity and common abbreviation	Aktien-gesellschaft (AG)	Gesellschaft mit beschrankter Haftung (GmbH)	Kommanditge-sellschaft auf Aktien (KGaA)
2. English translation	Limited liability company	Limited liability company	Partnership limited by shares
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The partners / company[1]
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?			
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes[2]
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends	Dividends	Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes[3]

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GERMANY

1. Name of entity and common abbreviation	Gesellschaft bürgerlichen Rechts (GbR)	Offene Handelsge-sellschaft (OHG)	Kommandit Gesellschaft (KG)	Stille Gesellschaft
2. English translation	Civil law partnership	General partnership	Limited partnership	Silent partnership
3. Does the entity file a tax return?	No	No	No	No
4. Is tax on the income of the entity assessed on the entity itself?	No	No	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The partners	The partners	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	Dependent upon nature of activity[4]	Business income	Business income	Investment income[5]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?				
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	No[6]	No[7]	No[8]	No

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NOTES (GERMANY)

1. The share of the general partner is deducted from the tax base of the company. The general partner must include this share in his income tax return.

2. No, in the case of the general partner.

3. Unclear as far as the general partner is concerned.

4. Income from agriculture or forestry, from independent services, business income or investment income.

5. The active partner earns business income.

6. Under specific provisions of conventions the entity may be deemed to be a resident for the purposes of the convention.

7. See footnote 6.

8. See footnote 6

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HUNGARY

1. Name of entity and common abbreviation	Korlátolt felelösségü társaság (Kft)	Részvény-társaság (Rt.)	Egyesülés
2. English translation	Limited liability company	Company limited by shares	Professional association
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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HUNGARY

1. Name of entity and common abbreviation	Közkereseti társaság (Kkt)	Betéti társaság (Bt.)	Közös vállalat	Szövetkezet
2. English translation	Unlimited partnership	Limited partnership	Joint enterprises	Co-operative
3. Does the entity file a tax return?	Yes	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The company	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-	-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes	Yes

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ICELAND

1. Name of entity and common abbreviation	Hlutafélag	Sameignarfélag skráð sem sjálfstaeður skattaðili	Sameignarfélag
2. English translation	Public limited liability company	Partnership registered as a taxable entity	Partnership
3. Does the entity file a tax return?	Yes	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	No

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JAPAN

1. Name of entity and common abbreviation	Kabushiki-kaisha[1]	Yugen-kaisha[2]	Gomei-kaisha[3]	Goshi-kaisha[4]
2. English translation	Joint Stock Company	Limited Liability Company	•	•
3. Does the entity file a tax return?	Yes	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The entity	The entity	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends	Dividends	Dividends	Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes	Yes

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JAPAN

1. Name of entity and common abbreviation	Kumiai[5]	Tokumei Kumiai[6]	Kyodo-Kumiai[7]	Jinkaku-naki-shadan[8]
2. English translation	-		Cooperative Association	-
3. Does the entity file a tax return?	No	No	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	No	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The members	The members	The entity	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	Fiscal nature is unchanged	Fiscal nature is unchanged[9]	-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-		-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	Yes Withholding at the rate of 20%[10]	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?		Fiscal nature is unchanged[11]	Dividends	Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	Yes	Yes

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NOTES (JAPAN)

1. An ordinary corporation, organized under the Commercial Code. All shareholders have limited liability.

2. Commonly used by small businesses and organized under the Limited Liability Company Law. All members have limited liability.

3. Members have unlimited liability for the debts of the entity. It is a legal entity organized under the Commercial Code and subject to corporate taxation.

4. There must be at least one member with unlimited liability and one member with limited liability. A limited liability member may not participate in the management. It is a legal entity organized under the Commercial Code and subject to corporate taxation.

5. A joint contract, under the Civil Code, and not a separate legal entity itself.

6. Formed under the Commercial Code and completely different from "*Kumiai*". It might be compared to the German "stille gesellshaft", one distinctive feature of this type of contract is that only the entrepreneur is recognized as an entity that undertakes its business.

7. Incorporated by special legislation. These entities are listed in Schedule III of the Corporation Tax Law and subject to corporate taxation at a lower rate.

8. Might be translated as "non-juridical organisation": an unincorporated organisation which has designated managers or representatives. Subject to corporate taxation only when it undertakes profit-making activities prescribed under the law.

9. The entrepreneur reports all profits under the *Tokumei-kumiai*. When the entrepreneur distributes profits to the investors, the distribution is subject to withholding tax unless the number of investors is less than ten. If the investors are non-resident, the income is classified as income arising from property located in Japan.

10. See previous footnote.

11. See previous footnote.

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LUXEMBOURG

1. Name of entity and common abbreviation	Société anonyme (S.A.)	Société à responsabilité limitée (SARL)	Société en commandite simple (SECS)	Société en commandite par actions (SECA)
2. English translation	Company limited by shares	Limited liability company	Limited partnership	Limited partnership with share capital
3. Does the entity file a tax return?	Yes	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The partners	The partners / the company[1]
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Business profits	Business profits
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?				
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	No	Yes[2]
9. If the answer to 8 is yes, how is that income classified for tax purposes?	As a dividend	As a dividend		As a dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	No	Yes

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LUXEMBOURG

1. Name of entity and common abbreviation	Société en nom collectif (SENC)	Société coopérative	Société civile	Association en participation
2. English translation	General partnership	Co-operative	Civil partnership	Undeclared partnership
3. Does the entity file a tax return?	Yes	Yes	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	No	Yes	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The entity	The partners	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	Business profits		Depends on the nature of the activity[3]	Investment income[4]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?				
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	Yes	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?		As a dividend		
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	Yes	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	Yes	No	No

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NOTES (LUXEMBOURG)

1. The share of the general partner is deducted from the tax base of the partnership. The general partner must report that share in his income tax return.

2. No, in the case of the general partner.

3. Income from farming or forestry, rents, income from independent services, business profits or investment income.

4. Income of the active partner is considered to be business profits.

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MEXICO

1. Name of entity and common abbreviation	Asosiación en Participación[1] (A en P)
2. English translation	
3. Does the entity file a tax return?	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity[2]
6. If the tax is paid by the members, how is the income classified for tax purposes?	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes[3]
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes

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NOTES (MEXICO)

1. According to Mexican Civil Law, the A en P is a non-corporate entity, since its legal nature is that of a contract.

2. The tax shall be paid by one of the members on behalf of the entity with respect to its total income which is considered as business income. If such member does not pay the tax, the other members are jointly liable for the tax.

3. Although the A en P is not considered a company under Mexican Civil Law, it is taxed as a corporation for tax purposes, as of 1999.

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NETHERLANDS

1. Name of entity and common abbreviation	Vennootschap onder firma (V.O.F.)	Commanditaire vennootschap (C.V.)	Open Commanditaire vennootschap (open C.V.)
2. English translation	General partnership	Limited partnership	"Open" limited partnership – free transferability of shares
3. Does the entity file a tax return?	No	No	Yes – only for income attributed to the limited members (partners)
4. Is tax on the income of the entity assessed on the entity itself?	No	No	As for 3.
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The members	The members	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	Fiscal nature unchanged	Fiscal nature unchanged	Fiscal nature unchanged
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Rate determined in relation to each member	Rate determined in relation to each member	Rate determined in relation to each general member (partner)
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	Only if the recipient is a limited member (partner)
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	Yes

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NETHERLANDS

1. Name of entity and common abbreviation	Naamloze vennootschap (N.V.)	Besloten vennootschap (B.V.)	Maatschap
2. English translation	Joint stock company	Limited company	Partnership
3. Does the entity file a tax return?	Yes	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The entity	The members
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Fiscal nature unchanged
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No, same for all income	No, same for all income	Yes, rate determined in relation to each member
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	No

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NEW ZEALAND

1. Name of entity and common abbreviation	Partnerships (ordinary)	Special Partnerships[1]	Qualifying Companies[2]
2. English translation	-	-	-
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	Partners	Partners	Company pays the tax in the first instance, but shareholders liable if Company defaults
6. If the tax is paid by the members, how is the income classified for tax purposes?	Retains its original character	Retains its original character	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Yes	Yes	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	Yes

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NOTES (NEW ZEALAND)

1. Some of the partners of Special Partnerships have limited liability status.

2. Qualifying Companies may not earn more than NZ$10,000 otherwise status reverts to that of an ordinary company

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NORWAY

1. Name of entity and common abbreviation	Ansvarlig selskap	Kommandit selskap	Indre selskap	Aksjeselskap
2. English translation	General partnership[1]	Limited partnership[2]	Silent partnership[3]	Limited liability company
3. Does the entity file a tax return?	No	No	No	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	No	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The partners	The partners	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?	Business income[4]	Business income	Business income	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?				
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	No	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	-	Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	No	Yes

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NOTES (NORWAY)

1. A General partnership is an enterprise where the partners have an unlimited personal responsibility for the aggregate liabilities of the enterprise, jointly, or partly if the parts put together constitute the whole of the liabilities of the enterprise and the enterprise acts as such towards third parties.For taxation purposes there are no differences.

2. A limited partnership is an enterprise where at least one of the partners has an unlimited responsibility for the liabilities of the enterprise and there is at least one partner who has a limited responsibility for a stated amount of the liabilities of the enterprise unless that partner is a silent partner.

3. Silent partnership is an enterprise which does not act as such towards third parties. The partners may have either limited or unlimited responsibility.

4. The income of the partnership will be regarded as business income. In relation to partners resident abroad, the result will depend upon whether the partners have a permanent establishment or not. If they have a p.e., the income will be regarded as business income. If the partners receive only passive income (no p.e.), the nature of the income (e.g. dividends, interest or royalty) is considered and the relevant article of the convention is applied.

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POLAND

1. Name of entity and common abbreviation	Spólka komadytowa	Spólka jawna	Spólka prawa cywolnego (s.c)
2. English translation	Limited partnership	Registered partnership	Civil law partnership
3. Does the entity file a tax return?	No	No	No
4. Is tax on the income of the entity assessed on the entity itself?	No	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partners	The partners	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	Fiscal nature is unchanged	Fiscal nature is unchanged	Fiscal nature is unchanged
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-	-	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	No

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SLOVAK REPUBLIC

1. Name of entity and common abbreviation	Spoločnost's ručenim obmedzením (s.r.o.)	Verejná obchodná spoločnost' (v.o.s)	Komanditná spoločnost'[1] (k.s.)
2. English translation	Limited liability company	General partnership	Limited partnership
3. Does the entity file a tax return?	Yes	No	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The partners	Both the partners and the entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	Business income	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	Yes	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	No	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividends		Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	No	No

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NOTES (SLOVAK REPUBLIC)

1. The tax base of the limited partnership is divided among its general partners and limited partners. The income of general partners is taxed as business income in the hands of these partners. The general partner must include this income in his income tax return. The income of limited partners is taxed as business income of a company. The income shared by the general partners is deducted from the tax base of the company.

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SPAIN

1. Name of entity and common abbreviation	Sociedad Colectiva	Sociedad Comanditaria	Sociedad Anónima
2. English translation	General partnership	Limited partnership	Company limited by shares
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The company	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?		-	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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SPAIN

1. Name of entity and common abbreviation	Sociedad limitada	Sociedad civil
2. English translation	Limited company	Civil law partnership
3. Does the entity file a tax return?	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	Fiscal nature unchanged
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	No

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SWEDEN

1. Name of entity and common abbreviation	Handelsbolag (HB)	Kommanditbolag (KB)	Aktiebolag (AB)
2. English translation	General partnership	Limited partnership	Limited company
3. Does the entity file a tax return?	Yes	Yes	
4. Is tax on the income of the entity assessed on the entity itself?[1]	No	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	Each partner	Each partner	The company
6. If the tax is paid by the members, how is the income classified for tax purposes?[2]	Business profits	Business profits	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Yes	Yes	-
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	No	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	-	Dividends
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	No	Yes

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NOTES (SWEDEN)

1. The total taxable income is computed at the level of the partnership. However the tax is assessed on each partner separately on the basis of his share of the partnership income and the partner is responsible for his own tax.

2. Where part of the activity of the partnership is in the nature of business then the entire partnership income will be classified as “business profits”.

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SWITZERLAND

1. Name of entity and common abbreviation	Gesellschaft mit beschrankter Haftung (GmbH)	Kollektiv-gesellschaft (Co, Cie)	Kommandit-gesellschaft (Co, Cie)	Einfachege-sellschaft
2. English translation	Limited liability company	General partnership	Limited partnership	Civil law partnership
3. Does the entity file a tax return?	Yes	No	No	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	No	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The company			
6. If the tax is paid by the members, how is the income classified for tax purposes?	-			
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	-			
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	No	No	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	-	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	No	No	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	No[1]	No	No[1]

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NOTES (SWITZERLAND)

1. Under specific provisions of Swiss Double Taxation Conventions the entity may be deemed to be a resident of Switzerland for the purpose of the Convention.

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TURKEY

1. Name of entity and common abbreviation	Anonim Şirket (AŞ)	Limited Şirket (Ltd/Ş)	Kollektif Şirket
2. English translation	Joint Stock Company	Limited Liability Company	General partnership
3. Does the entity file a tax return?	Yes	Yes	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The entity	The partner
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	-	Business income
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	No
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	No
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	No

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TURKEY

1. Name of entity and common abbreviation	Adi Şirket	Eshamlı Komandit Şirket
2. English translation	Partnership	Limited Partnership
3. Does the entity file a tax return?	No	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The partner	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	Business income	Business income or dividends[1]
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	No	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	-	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	No	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	No	Yes

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NOTES (TURKEY)

1. Income derived by partners with unlimited liability is deemed to be business income and income derived by partners with limited liability is deemed to be dividends.

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UNITED KINGDOM

1. Name of entity and common abbreviation	Limited Liability Company (Ltd/Plc)	Unlimited Company	Unincorporated Association
2. English translation			
3. Does the entity file a tax return?	Yes	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	Yes	Yes
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The entity	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?			
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No- Same for all income of entity	No- Same for all income of entity	No- Same for all income of entity
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc.?	Yes	Yes	Yes
9. If the answer to 8 is yes, how is that income classified for tax purposes?	Dividend	Dividend	Dividend
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes	Yes
11. Do you consider the entity a "resident" for purposes of tax treaties?	Yes	Yes	Yes

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UNITED KINGDOM

1. Name of entity and commonly used abbreviation	Industrial & Provident Societies (IPS)	Ordinary Partnerships	Limited Partnerships
2. English translation			
3. Does the entity file an income tax return?	Yes	No	No
4. Is tax on the income of the entity assessed on the entity itself?	Yes	No	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The partner	The partner
6. If the tax is paid by the members, how is the income classified for tax purposes?		Fiscal nature unchanged	Fiscal nature unchanged
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No - Same for all income of entity	Rate determined in relation to each partner	Rate determined in relation to each partner
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc?	Yes	No	No
9. If the answer to 8 is yes, how is the income then classified for tax purposes?	Dividend	-	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	No	No
11. Does your country consider the entity as a "resident" for purposes of tax treaties?	Yes	No	No

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UNITED STATES

1. Name of entity and commonly used abbreviation	Corporation[1] (including federal or state law corporations, publicly traded partnerships, insurance companies, and banks)	Partnership[2]
2. English translation		
3. Does the entity file an income tax return?	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	Yes	No
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The entity	The partners
6. If the tax is paid by the members, how is the income classified for tax purposes?	-	Retains its fiscal nature
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	No	Yes
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc?	Yes	No
9. If the answer to 8 is yes, how is the income then classified for tax purposes?	Dividend	-
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	No
11. Does your country consider the entity as a "resident" for purposes of tax treaties?	Yes	Income, profit or gain is treated as derived by a resident only to the extent the partners are residents

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UNITED STATES

1. Name of entity and commonly used abbreviation	S Corporation	Real Estate Investment Trust (REIT), and Regulated Investment Company (RIC)
2. English translation		
3. Does the entity file an income tax return?	Yes	Yes
4. Is tax on the income of the entity assessed on the entity itself?	No	Yes[3]
5. Is the tax which is imposed on the income of the entity as it arises a liability of the entity or a liability of the members?	The members	The entity
6. If the tax is paid by the members, how is the income classified for tax purposes?	Retains its fiscal nature	-
7. Is the rate and type of tax applicable to the entity's income determined on the basis of the members?	Yes	No
8. Is tax imposed on the recipient when the income of the entity is distributed to its members etc?	No	Yes
9. If the answer to 8 is yes, how is the income then classified for tax purposes?	-	Dividend or capital gain
10. Does your country consider the entity as a "company" for purposes of tax treaties?	Yes	Yes
11. Does your country consider the entity as a "resident" for purposes of tax treaties?	Income, profit or gain is treated as derived by a resident only to the extent the members are residents[4]	Yes

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NOTES (UNITED STATES)

1. General partnerships, limited partnerships, limited liability companies (LLC), limited liability partnerships (LLP), trusts engaged in business activities, and other entities not explicitly included in the list of corporations may elect to be taxed as either a corporation or a partnership.

2. See footnote 1.

3. However, a deduction is allowed for dividends paid.

4. All members of an S Corporation must be either U.S. citizens or resident alien individuals (as determined under internal law).

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ISSUES RELATED TO ARTICLE 14 OF THE MODEL TAX CONVENTION

(adopted by the OECD Committee on Fiscal Affairs on 27 January 2000)

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FOREWORD

This publication, the seventh in the series "Issues in International Taxation", includes the report entitled "Issues Related to Article 14 of the Model Tax Convention", which the Committee on Fiscal Affairs adopted, and decided to make available to the public, on 27 January 2000.

Article 14 of the OECD Model Tax Convention deals with the taxation of professional services and other activities of an independent character. The report deals with a number of problems relating to the interpretation and application of Article 14. It recommends the elimination of Article 14 from the Model Tax Convention and identifies a number of changes to the Model that will be required as a consequence. Those changes will be included in the next update to the Model.

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ISSUES RELATED TO ARTICLE 14 OF THE MODEL TAX CONVENTION

Introduction

1. In 1996, the Committee set up a working group to examine a number of problems of interpretation and application of Article 14 of the OECD Model Tax Convention. This publication contains the report of that working group, which was approved by the Committee on 27 January 2000[1]. The main recommendation of this report is that Article 14 be eliminated from the Model Tax Convention. Section I of this report presents the recommendation to eliminate Article 14. Sections II to V contain the analysis of the relationship between Articles 7 and 14 on which that recommendation is based. The Annex includes a description of the changes to the Model Tax Convention that will result from the elimination of Article 14.

I. The elimination of Article 14

2. Having examined the various problems of application and interpretation raised by Article 14, the Committee found that all these issues raised the more fundamental question of whether it was appropriate to maintain that article in the Model Tax Convention.

3. In order to reach a conclusion on that question, the Committee examined the relationship between Articles 7 and 14. The following questions, which are discussed in sections II to IV below, were found to be especially relevant:

- Which activities fall within Article 14 as opposed to Article 7? Is the distinction between these activities satisfactory and easy to apply?

1 . At the time of adopting the report, Italy and Portugal indicated that they reserved the right to continue to include Article 14 concerning the taxation of independent personal services in their Conventions."

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- Which entities fall within Article 14 as opposed to Article 7?
- What are the practical differences concerning taxation under Article 7 and 14? In particular, are there differences between the concepts of permanent establishment and fixed base?
- If Article 14 were eliminated, would there need to be changes to Article 7?

4. As the paragraphs below will indicate, the Committee concluded that, with respect to these various aspects of Articles 7 and 14, there was either no practical difference between the two Articles or, where such differences existed, there did not appear to be any valid policy justification for them. Having concluded that any practical differences between Articles 7 and 14 did not appear to be justified, the Committee considered two approaches: trying to eliminate these differences by making Article 14 a mirror image of Article 7 or merely deleting Article 14. The Committee concluded that the elimination of Article 14 from the Model Tax Convention would be the more logical approach.

5. Deleting Article 14 from the Model requires a number of changes to the provisions of the Model and to the Commentary thereon, as would have required any attempt to solve the issues whilst retaining Article 14 in the Model Tax Convention. These changes are presented in the Annex.

II. Which activities fall within Article 14?

6. If there are no differences in result whether Article 7 or 14 applies, there is no need to distinguish the activities that fall within the first Article from those that fall within the second. Where, however, there are such differences (e.g. if the rule of paragraph 3 of Article 5 could apply or if a 183 day rule were included in Article 14 but not in Article 7 — cf. below), such a need arises.

7. It is, however, far from clear which activities fall within Article 14. To a large extent, the uncertainty results from the fact that, whilst the 1963 Draft Double Taxation Convention referred to “professional services or other independent activities of a similar character”, the current Model refers to “professional services or other activities of an independent character”, a broader formulation.

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8. For instance, it has been suggested that the activities of sub-contractors in the construction industry, which would otherwise come under Article 7, may be caught by this broader formulation. That has led to a suggestion that the new formulation should be replaced by "other similar activities" or "similar services" to avoid that result, therefore partly reversing the change made in the 1977 Model.

9. A number of Member countries indicated that, in practice, they only applied Article 14 to professional services, thereby ignoring *de facto* the reference to "other activities of an independent character". The Committee could not readily define that phrase, noting that, if read literally, it could potentially apply to any activity falling under Article 7. Whilst paragraph 1 of the Commentary on Article 14 states that the Article excludes "industrial and commercial activities", it has been suggested that the strict wording of the paragraph and the priority given to Article 14 over Article 7 by paragraph 7 of the latter Article support a different conclusion. It was also noted that the reference to "services or other activities" in paragraph 1 suggests that there is also a discrepancy between the text of the Article, which covers services and other activities, and its title, which only refers to personal services.

10. The Committee considered whether the wording of paragraph 1 of the Article should be amended so as to read as it did in the 1963 Draft Double Taxation Convention. This, however, would have required the clarification of what activities are of a "similar character" to professional services. Whilst the Committee felt that it would be difficult to determine what are activities of a "similar character", it expressed the view that these would not include the activities of building subcontractors.

11. The fact that the 1977 change does not appear to have led to practical difficulties in determining which activities fall under Article 14 must be attributed to the fact that the rules of Articles 7 and 14 are similar and that Article 14 has generally been considered to be applicable only to individuals, so as to minimise the importance of the distinction between activities that fall within Article 7 and those that fall under Article 14. It must be recognised, however, that the 1977 change could eventually create practical difficulties, especially in cases where the provisions of paragraphs 3 to 6 of Article 5 would be relevant. Also, as stated below, it is questionable whether it is appropriate to restrict the application of Article 14 to individuals. All these difficulties justify the decision to eliminate Article 14.

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12. The Committee also examined the relationship between Articles 14 and 15. On the basis of the second sentence of paragraph 1 of the Commentary on Article 14 and of the title of Article 14, which refers to "independent" services as opposed to the phrase "dependent services" found in the title of Article 15, it is clear that the activities covered by Article 14 exclude those carried on in an employment relationship. It is, however, sometimes difficult to distinguish between particular activities carried out in an employment relationship and those carried out in an independent capacity (e.g. university professors and teachers being asked to perform research or give a few lectures in another country). The elimination of Article 14 will not solve that issue as the distinction is also relevant for the purposes of Articles 7 and 15. Whilst paragraph 2 of Article 3 would require that such cases be solved on the basis of the domestic law of the state that applies the Convention, it is recognised that this could result in conflicts of qualification, which would then need to be resolved using, where appropriate, the mutual agreement procedure (see also section III of the report on the Application of Tax Conventions to Partnerships).

III. Which entities fall within Article 14?

13. The personal scope of application of Article 14 is also unclear. The main issue is whether the Article applies to individuals only or whether it is also applicable to legal persons. Another issue is to what extent it applies to partnerships.

14. It has sometimes been argued that the use of the pronoun "his", in paragraph 1 of Article 14, indicates that the Article was intended to apply to individuals only. The Committee, however, found the argument to be far from convincing as paragraph 1 of Article 4, which clearly applies to both individuals and legal persons, also uses the pronoun "his" when referring to the various criteria for full liability to tax.

15. Whilst the Commentary on Article 14 does not directly deal with this issue, the Commentary on the United Nations Model notes that the Experts Group generally agreed that a payment for services made to an individual would fall under Article 14 whilst "payments made to an enterprise in respect of the furnishing by that enterprise of the activities of employees or other personnel are subject to Article 5" [i.e. would fall under Article 7 because of the definition of permanent establishment under Article 5]. That statement, however, can be

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explained by the fact that the United Nations Model includes a 183 day rule applicable to services in both Articles but that only the provision in Article 5 is drafted in a way that makes it readily applicable to a legal person. Also, the Commentary of the United Nations Model expressly allows parties that believe that the relationship between Articles 5 and 14 needs to be clarified to do so in the course of negotiations, thereby recognising the potential uncertainty.

16. In an observation included in the Commentary on Article 14 (cf. paragraph 4.1 of that Commentary), Mexico has officially stated its position that Article 14 also applies to legal persons. This view is shared by other countries, such as Turkey, which have interpreted Article 14 as applying to legal persons.

17. The Committee noted that it was now more frequent for professionals to incorporate than it was when Article 14 was drafted. Since it could not see any justification for imposing different rules to services depending on whether they were provided by an individual (Article 14) or a legal person (Article 7)[2], or to have different Articles if the rules were the same, it considered this as another reason to eliminate Article 14.

18. The application of Article 14 to partnerships presents other problems. Countries that treat partnerships as fiscally transparent would generally recognise that Article 14 applies to the individuals who are partners in that partnership.[3] This, however, raises the question as to whether the partners must then personally perform services in the source country to be taxable therein on their share of the partnership's income attributable to a fixed base of the partnership located in that country. This issue is discussed below.

19. In the case of countries that treat partnerships as non-fiscally transparent, the result would likely be different since, in that case, the problem

2. One example of a possible exploitation of the perceived differences between Articles 7 and 14 would be that of an individual who is in business on his own account as an architect or surveyor and who decides to undertake a contract in another country through a one-man company in order to fall under Article 7 and take advantage of the exclusion provided for under paragraph 3 of Article 5 (see paragraphs 31 to 33).

3. Sweden, however, adopts a different approach since it treats most foreign partnerships as legal persons for Swedish tax purposes, with the result that fiscally transparent foreign partnerships and their partners are not entitled to the benefits of tax treaties with respect to the partnership's income.

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of the application of Article 14 to legal persons, which is discussed above, would arise.

20. Mixed partnerships, where some partners are individuals and others are legal persons, would create a particular problem if Article 14 were found to apply only to individuals. In that case, either the partners who are legal persons would be covered by Article 7 whilst the partners who are individuals would be covered by Article 14 or, alternatively, Article 14 would not apply to any partner of a partnership where at least one partner were a legal person. Neither approach would be satisfactory.

IV. What are the practical differences concerning taxation under Articles 7 and 14?

21. At the outset, the Committee agreed that if there were significant practical differences between the rules of Article 7 and Article 14, there would not appear to be a valid justification for the resulting different treatment of large professional partnerships and incorporated professionals. Such a different treatment would not appear to be adapted to modern ways of providing cross-border professional services, where a number of professionals, in particular engineers, provide their services through companies.

22. For the purpose of determining whether there were significant practical differences between the rules of Articles 7 and 14, the Committee analysed the following various questions:

- Are there differences between the concepts of “permanent establishment” and “fixed base”?
- Does Article 14 restrict source taxation to income from services performed personally by the taxpayer?
- Are the specific rules of paragraphs 2-7 of Article 7 applicable to Article 14?
- Are there differences in the source taxation rights granted under Articles 7 and 14?
- Does the distinction between Articles 7 and 14 have any impact on domestic law distinctions?

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a) Are there differences between the concepts of "permanent establishment" and "fixed base"?

23. Whilst Article 7 refers to the concept of "permanent establishment", which is defined in Article 5, Article 14 refers to the undefined concept of "fixed base". The Committee examined whether there were any practical differences between the two concepts and, if yes, whether this was intended. It concluded that, except where the provisions of paragraphs 3 to 6 of Article 5 applied, there were no practical differences between the two concepts.

24. The Committee noted that it had sometimes been suggested in the literature that a permanent establishment might require a greater degree of permanence than a fixed base. Also, it noted that the definition of "permanent establishment" requires that a business be actually carried on in a fixed place of business whilst there is no such requirement with respect to a fixed base, which needs only be regularly available.

25. To the extent that the concept of permanent establishment is narrower than that of fixed base, it might be argued that eliminating Article 14 would increase the threshold for taxation, which could in turn raise concerns, for instance, with respect to Articles 10, 11 and 12. One example that was discussed in that respect is that of an office opened to provide services, but which, because of subsequent events, is never used for that purpose. Whilst the office would not fall within the definition of permanent establishment as long as no business was carried on therein, it could arguably constitute a fixed base.

26. The Committee, however, felt that such lower threshold, assuming that it existed, would not be a significant practical issue. In the above example, there would be no income from services to tax and the provisions of paragraphs 4 of Article 10 and 11 and paragraph 3 of Article 12 would not be applicable as these paragraphs require that independent personal services be performed from the fixed base.

27. The Committee also noted that it would be difficult to see any difference between the phrases "fixed place of business" and "fixed base". As a matter of fact, it could be argued that a "base" from which activities are performed is somewhat narrower than a "place of business" and that the "regularly available" requirement found in Article 14 but not in Article 7 might in fact restrict the scope of Article 14 so as to impose, in some cases, a higher

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taxation threshold than in Article 7. For instance, one could argue that there are cases where income is attributable to a fixed place that is sometimes, but not regularly, available for performing the services and that this income therefore escapes source taxation under Article 14.

28. Notwithstanding any such theoretical differences, the Committee could not, in practice, find examples of fixed bases that would not be permanent establishments or vice-versa. The examples of "fixed bases" found in paragraph 4 of the Commentary on Article 14, i.e. a physician's consulting room or the office of a lawyer or architect, would, for instance, equally constitute permanent establishments.

29. In reaching that conclusion, however, the Committee distinguished the case of the rules of paragraphs 3 to 6 of Article 5. Whilst the Commentary on Article 14 "imports" the principles of Article 7, it does not refer at all to Article 5. This would support the conclusion, based on a strict reading of Articles 5 and 14, that the rules of these paragraphs have no application to fixed bases. Whilst it could be argued that the reference, in the Commentary on Article 14, to the rules of Article 7 concerning "allocation of profits between head office and permanent establishment" might constitute an indirect reference to Article 5, this would seem to be a tenuous link.

30. In trying to decide whether the principles of Article 5 should apply to fixed bases, the most relevant rules to examine are those of paragraphs 3, 5 and 6 of that Article.

1) Paragraph 3: construction site

31. The question of whether the rule of paragraph 3 of Article 5, which provides that a construction site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months, should apply to a fixed base, has practical significance especially with respect to services rendered by engineers and architects.

32. On the one hand, most Member countries indicated that, in practice, they would consider that engineers or architects who maintain an office on a particular construction site that lasts more than twelve months would be

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considered to have a fixed base. On the other hand, they did not rule out that a fixed base could exist even if the construction site lasted for a shorter period.

33. This approach appears consistent with the conclusion that the construction site rule of paragraph 3 of Article 5 is not applicable to fixed bases since that rule is drafted as an exclusion from the permanent establishment concept rather than as a rule that creates a deemed permanent establishment. It raises, however, the issue of whether it is appropriate to have different treatment of various activities conducted on the same construction site. Eliminating Article 14 will mean that activities of supervising engineers on a construction site will become subject to the general taxation threshold applicable to other non-residents performing activities on a construction site, a result that the Committee considers appropriate.

2) Paragraphs 5 and 6: dependent and independent agent rules

34. A similar issue is whether the so-called dependent and independent agents rules of paragraphs 5 and 6 of Article 5 should be applicable to fixed bases.

35. In some cases, the independent agent rule of paragraph 6 has been applied to determine that a fixed base did not exist. U.S. Revenue ruling 75-131, which has been followed by a number of similar rulings,[4] referred to the pre-1977 Commentary on Article 14, which stated that Article 14 was based on the same principles of Article 7, to conclude that the "independent agent" rule of Article 5 applied so that a U.S. corporation that acted as an agent for a French concert player did not constitute a fixed base of the artiste. Also, in a 1992 decision, the Dutch *Hoge Raad* held that a photo model resident in the Netherlands did not have a fixed base through her commission agent in France and in Germany.

36. There does not appear to have been cases, however, where paragraph 5 would have been applied to deem a fixed base to exist. Because the application of paragraph 5, unlike that of paragraph 6, would result in additional source taxation, it would be a more serious test.

4. See for instance Revenue rulings 78-12-038, 78-12-045, 78-38-063 and-82-49-047.

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37. Again, the Committee found no justification for not applying the rules of paragraphs 5 and 6 to the activities covered by Article 14, and therefore finds it appropriate to make these rules applicable to such income through the elimination of Article 14.

b) Does Article 14 restrict source taxation to income from services performed personally by the taxpayer?

38. An issue that has attracted some attention is whether the application of source taxation under Article 14 is restricted to the person who provides the services or whether it applies also to anyone who derives income from these services. The following example illustrates the problem. A, B and C, three lawyers who are residents of State A, form a partnership. The partnership opens an office in State B, where only D, a new partner resident of State B, will provide services. It is agreed that the partnership's income will be divided equally among the four partners so that each partner will derive a share of the income from services rendered in State A as well as in State B. The issue, in that case, is whether Article 14 allows State B to tax that part of the income related to the services rendered therein that accrues to the partners resident in State A, even though these partners have not, themselves, rendered any services in State B.

39. The first approach is to consider that Article 14, like Article 7, applies to any person who derives income from the services performed through a fixed base so that partners A, B and C are taxable in State B. Under that approach, it is argued that since paragraph 1 of Article 14 refers to "income derived by a resident ... in respect of ... services" rather than to "income derived by a resident... in respect of... his services", the paragraph may be applied to someone who is not performing the services referred to in the paragraph but who derives income from these services. That approach reduces the differences between Article 14 and Article 7 but would indirectly seem to support the view that Article 14 also applies to companies.

40. The second approach is to consider that Article 14 only allows State B to tax income attributable to a fixed base that is used by a non-resident to provide his personal services so that A, B and C are not taxable in State B as long as they do not personally provide any services therein. Under that approach, the words "for the purpose of performing his activities" are

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interpreted so that the office in State B is not considered to be a fixed base regularly available to A, B, C for the purposes of performing their activities, since they do not perform any activities in that office.

41. The second approach narrows considerably the scope of source taxation under Article 14. It would seem to create tax avoidance opportunities since it would allow all the profits related to professional services rendered through a fixed base, as long as they are allocated to non-resident partners, to escape source taxation. Similarly, that approach would prevent the State where the fixed base is located from taxing any of the partnership's profits attributable to that fixed base if the partnership's activities in that State were exclusively carried out by employees.

42. The second approach, clearly, would produce a result that would be at odds with that under Article 7, particularly when taking into account the implications of paragraph 5 of Article 5 (the "agency permanent establishment" rule) in the legal context of a partnership.

43. It has been argued, however, that the second approach solves the important administrative difficulties that would result from the first approach, which would require each of the partners of a partnership that has offices in many countries to comply with the tax requirements of all these countries (e.g. possibly having to file a great number of tax returns). This might explain why that approach has sometimes been applied.[5] For example, in a 1993 Revenue ruling, the Internal Revenue Service of the U.S. adopted the second approach and decided that the German resident partners in a German partnership that had an office in the U.S. would not be liable to U.S. tax on their distributive share attributable to the U.S. office as they did not perform any services in the United States. That approach, however, has now been expressly rejected by the United States in its most recent tax treaties. It should also be noted that specific

5. It has also been suggested that the second approach provides a better result with respect to the application of personal allowances and progressive rates. This, however, is a consideration that generally supports residence as opposed to source taxation. It should also be noted that, as regards taxation by the country of residence of the partner, a system of foreign tax credit or exemption with progression will reduce the difficulties that the first approach may create in that respect.

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legislation has been adopted in the United States to provide for regulations that would alleviate some of the administrative difficulties described above.[6]

44. The Committee concluded that the first approach was the correct one. It considered that the second approach, apart from producing an inappropriate result, was based on a deficient interpretation of Article 14. According to the Committee, when applying Article 14 to the income allocated to each partner, the activities of the partnership must be attributed to the partners to the same extent as is the fixed base of the partnership, so that it may be said that each partner "has a fixed base ... for the purpose of performing his activities". This is consistent with the views expressed in the report on the Application of Model Tax Convention to Partnerships. Clearly, eliminating Article 14 will make sure that the second approach is no longer argued.

45. The Committee noted, however, that the administrative difficulties described in paragraph 48 above in relation to Article 14 would also exist under Article 7. For that reason, the Committee favours a more general solution to these difficulties.[7] It considers, for instance, that the legislative approach adopted in the United States is a useful way of addressing this issue. The Committee also discussed to what extent these administrative difficulties constitute a practical, as opposed to a theoretical, problem.

46. It was suggested in that respect that taxpayers can avoid the administrative difficulties noted above by providing in their partnership's agreement that the income arising in a particular country will only, or primarily, be allocated to the partners who are residents in that country ("special allocation" rules).

47. It seems, however, that countries adopt different positions as regards the extent to which such special allocation rules can be recognised for tax purposes. Some countries feel bound to follow the provisions of the

6. See section 1141(a) of the United States Taxpayer Relief Act of 1997.

7. As noted above (see note 3), Sweden treats most foreign partnerships as taxpayers for Swedish tax purposes, thereby avoiding these administrative difficulties in the case of foreign partnerships. The Committee, however, concluded that the general adoption of that approach would create more difficulties than it would solve with respect to the application of tax conventions to partnerships' income.

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partnership's agreement as regards both the amount and the nature or source of the part of the partnership's income that is allocated to a partner. Other countries consider that a partner's share of the partnership's income includes the same pro rata share of all items of income earned by the partnership regardless of any contractual arrangement purporting to allocate these items of income on the basis of their nature or source. There are also intermediary positions as some countries may agree to recognise such special allocation rules for tax purposes as long as they have economic substance or subject to general or specific anti-avoidance rules allowing them to disregard any income allocation that is primarily tax-motivated. A country may also condition its acceptance of special allocation rules to a requirement that these rules not allow for top-up payments to a partner in the event that the type or source of income allocated to him produces a lower share of income.

48. This is another example of the many differences that exist in the tax treatment of partnerships under the domestic laws of Member countries. As the provisions of the Model Tax Convention do not restrict the application of domestic law with respect to this particular issue, it is recognised that conflicts may arise in that respect. The following example illustrates such a conflict.

Example: *Partnership P has been established in State A. Partner X is a resident of State A, a credit country that recognises special allocations for tax purposes. Partner Y is a resident of State B, an exemption country that does not recognise special allocations. Partnership P maintains office 1 in State A which generates income of 1 000 in year 01; it also maintains office 2 in state B which generates income of 500 in the same year. The partnership's agreement provides that, subject to an "equalisation" adjustment, partner X is entitled to the income realised by the partnership in State A and partner Y to the income realised in State B. The "equalisation" adjustment is the amount required to be added or subtracted to such income in order to ensure that X and Y's shares of the overall profit of the partnership equal 60% and 40% respectively.*

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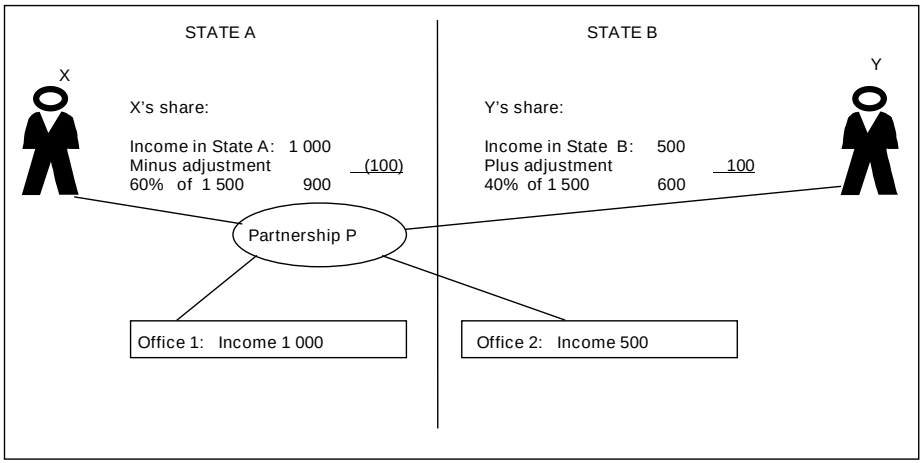

49. In that example, State B will consider, on the basis of its domestic law, that Partner X derives 300 (60% of 500) from a fixed base situated on its territory and that Partner Y, who is taxed as a resident, derives 200 (40% of 500) from its territory and is entitled to an exemption for the 400 (40% of 1 000) that he derives from State A.

50. State A, which recognizes special allocations, will consider that Partner X derives all of his income (900) from State A. It will also consider that only the adjustment amount (i.e. 100) constitutes income of Partner Y derived from a fixed base situated on its territory.

51. As a result, Partner X will be taxed on 900 in State A and State A will consider that that income arises from its territory. He will also be taxed on 300 in State B, which that country will consider as arising on its territory. The result will be double taxation on 300 of income because of the different allocation rules and the resulting conflict concerning the source of the income of Partner X. By contrast, Partner Y will only be taxed on 200 in State B and 100 in State A, the amount that State A considers as attributable to a fixed base located on its territory; there will therefore be double non taxation of 300 in his case.

52. The Committee concluded that this is an example of a conflict of source. It noted that some conventions solve this type of conflict by providing that income which may be taxed in a State in accordance with the Convention shall be deemed to arise from sources situated in that State for purposes of the

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application of the provisions of the Convention dealing with the elimination of double taxation. It also noted that the conclusions put forward in Part III of the report on the Application of the Model Tax Convention to Partnerships may also be relevant to the extent that a conflict of source could also constitute a conflict of qualification.

53. The Committee also discussed the treatment of "salary" or similar payments which may be paid to a partner to supplement income attributed to him under special allocation rules (e.g. in the case of a partner who is asked to work in a new office established in an emerging market economy). Under the domestic law of some countries, such payments would be considered as employment income of the partner rather than as a share of the partnership income, thereby reducing the amount of income attributable to non-resident partners. The fact that other countries would take the opposite view could result in conflicts of qualification. Again, the principles put forward in Part III of the report on the Application of the Model Tax Convention to Partnerships would help avoiding situations where such conflicts would result in double taxation or double non-taxation.

54. Another possibility is that of an office of a partnership located in a particular country which would be offered "guaranteed" fees by other offices of the same partnership in order to artificially increase the income attributable to that office for purposes of the application of special allocation rules. The Committee concluded that such arrangements might be problematic in light of paragraph 2 of Article 7, which, under the Commentary thereon, is implicitly applicable in determining the income attributable to a fixed base.

c) Are the specific rules of paragraphs 2-7 of Article 7 rules applicable to Article 14?

55. Whilst paragraph 3 of the Commentary on Article 14 indicates that the provisions of Article 7 and the Commentary thereon could be used as guidance for interpreting and applying Article 14, it has been suggested that there is no clear authority in the text of Article 14 for such conclusion. Also, whilst the Commentary on Article 14 expressly confirms the application to Article 14 of the provisions of paragraphs 2 and 3 of Article 7, it does not mention paragraphs 4 to 7 of that Article.

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56. The Committee found that Member countries have generally considered that paragraphs 2-6 of Article 7 are applicable, so far as they may be relevant in a particular case, to the income currently treated under Article 14. It concluded that the elimination of Article 14 made it unnecessary to clarify that position. It was unclear, however, to what extent the priority rule of paragraph 7 of Article 7 can apply to Article 14**.**

d) Are there differences in the source taxation rights granted under Articles 7 and 14?

57. Whilst Article 7 provides for the source taxation of "profits" attributable to a permanent establishment, Article 14 allows the source State to tax the "income" attributable to a fixed base.

58. On the one hand, it is clear that the concept of profits corresponds to the "net" income, i.e. after the deduction of relevant expenses, a result that is confirmed by paragraph 3 of Article 7. On the other hand, the concept of income, which is used in Article 14, can be interpreted more broadly so as to allow taxation on either a gross or net basis. This interpretation is confirmed by the fact that the phrase "income derived", which is found in Article 14, is also found in other Articles, such as Articles 6 (Income from Immovable Property) and 17 (Artistes and Sportsmen), where it has been interpreted to allow taxation of gross payments[8]. Arguably, a further confirmation of that interpretation is the fact that paragraph 3 of Article 24 (Non-discrimination), which has a direct effect on the deduction of expenses related to a permanent establishment, is not applicable to fixed bases.

59. Paragraph 3 of the Commentary on Article 14, however, clearly states that the expenses incurred for the purposes of a fixed base should be allowed as a deduction in determining the income attributable to a fixed base in the same way as is provided by paragraph 3 of Article 7. Most Member countries confirmed that, in practice, their country would allow the deduction of expenses in taxing the income attributable to a fixed base and agreed that there would be no policy justification for allowing tax to be levied differently under Articles 7 and 14. They did, however, recognise the difficulty created by the use, in

8. See, for instance, the last sentence of paragraph 4 of the Commentary on Article 6 as well as paragraph 10 of the Commentary on Article 17.

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Article 14, of the phrase "income derived". Again, any uncertainty in that respect will be removed through the elimination of Article 14.

e) Does the distinction between Articles 7 and 14 have any impact on domestic law distinctions?

60. The Committee discussed the extent to which any differences between Articles 7 and 14 might have an impact where, under domestic laws, there exist separate rules for the taxation of professional services and other business profits (e.g. where cash accounting applies to professional services but not to other activities).

61. It was noted that whilst Member countries may have such separate rules in their domestic laws, the application of these rules would not be influenced by the distinction between Article 7 and 14 as the distinctions made by tax treaties would generally not matter for the application of distinctions made under domestic laws, except maybe for the application of foreign tax credit provisions.

62. On that basis, the Committee concluded that the elimination of Article 14 will not prevent countries from continuing to apply any distinction between professional services and other business profits that might exist under their domestic tax laws.

V. Does the elimination of Article 14 require changes to Article 7?

63. By eliminating Article 14, the income previously covered by that Article will fall under Article 7. The Committee found it important to confirm that result to prevent arguments that either Article 21 or Article 15, for example, could apply to that income. The Committee agreed that, apart from changes resulting directly from the elimination of the Article, changes to the Commentary on Articles 5 and 7 and to some of the Articles in the Model themselves would be useful, in particular to make sure that the concept of enterprise applied to the provision of professional services.

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ANNEX

CHANGES TO THE MODEL TAX CONVENTION RESULTING FROM THE DECISION TO ELIMINATE ARTICLE 14

The following are the changes to the Model Tax Convention resulting from the decision to eliminate Article 14. Changes to the existing text of the Model Tax Convention and the Commentary are indicated by ~~strikethrough~~ for deletions and ***bold italics*** for additions.

Changes to the Articles

Article 3

1. In paragraph 1 of Article 3, renumber existing subparagraphs c) to f) as subparagraphs d) to g) and add the following new subparagraphs c) and h):

> ***c) the term "enterprise" applies to the carrying on of any business;***
>
> ***h) the term "business" includes the performance of professional services and of other activities of an independent character."***

Article 6

2. Replace paragraph 4 of Article 6 by the following:

> "4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise~~ and to income from immovable property used for the performance of independent personal services~~."

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Article 10

3. Replace paragraph 4 of Article 10 by the following:

"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."

4. Replace paragraph 5 of Article 10 by the following:

"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 insofar as such dividends are paid to a resident of that other State or insofar 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."

Article 11

5. Replace paragraph 4 of Article 11 by the following:

"4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein~~, or performs in that other State independent personal services from a fixed base situated therein,~~ and the debt-claim in respect of which the interest is 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."

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6. Replace paragraph 5 of Article 11 by the following:

"5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment ~~or a fixed base~~ in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment ~~or fixed base~~, then such interest shall be deemed to arise in the State in which the permanent establishment ~~or fixed base~~ is situated."

Article 12

7. Replace paragraph 3 of Article 12 by the following:

"3. The provisions of paragraph 1 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 such permanent establishment ~~or fixed base~~. In such case the provisions of Article 7 ~~or Article 14, as the case may be,~~ shall apply."

Article 13

8. Replace paragraph 2 of Article 13 by the following:

"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."

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Article 14

9. Delete Article 14. The remaining Articles of the Model will not be renumbered. Article 14 and its title will therefore be shown in brackets with the phrase "Deleted".

Article 15

10. Replace the title of Article 15 by the following:

"***INCOME FROM EMPLOYMENT*** ~~DEPENDENT PERSONAL SERVICES~~

11. Replace subparagraph 2(c) of Article 15 by the following:

"*c*) the remuneration is not borne by a permanent establishment ~~or a fixed base~~ which the employer has in the other State.

Article 17

12. Replace paragraph 1 of Article 17 by the following:

"1. Notwithstanding the provisions of Articles ~~14~~ ***7*** and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State."

13. Replace paragraph 2 of Article 17 by the following:

"2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7~~, 14~~ and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised."

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Article 21

14. Replace paragraph 2 of Article 21 by the following:

> "2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State 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 income is 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."

Article 22

15. Replace paragraph 2 of Article 22 by the following:

> "2. Capital represented by 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 by 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~~, may be taxed in that other State."

Changes to the Commentary

Commentary on Article 1

16. Replace paragraph 4 of the Commentary on Article 1 by the following:

> "4. Moreover, different rules of the Convention may be applied in the Contracting States to income derived by a partner from the partnership, depending on the approach of such States. In States where partnerships are treated as companies, distributions of profits to the partners may be considered to be dividends (paragraph 3 of Article 10), whilst for other States all profits of a partnership, whether distributed or not, are considered as business profits of the partners (Article 7). In many States, business profits

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of partnerships include, for tax purposes, all or some special remuneration paid by a partnership to its partners (such as rents, interest, royalties, remuneration for services), whilst in other States such payments are not dealt with as business profits (Article 7) but under other headings (in the above-mentioned examples: Articles 6, 11, 12~~, 14~~ and 15, respectively).

Commentary on Article 3

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

"4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No ***exhaustive*** definition of the term "enterprise" has therefore been attempted in this Article. ***However, it is provided that the term "enterprise" applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary are free to omit the definition of the term "enterprise" from their bilateral conventions.***"

18. Add the following heading and paragraph 10.1 to the Commentary on Article 3:

"THE TERM "BUSINESS"

10.1 The Convention does not contain an exhaustive definition of the term "business", which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies the Convention. Sub-paragraph h), however, provides expressly that the term includes the performance of professional services and of other activities of an independent character. This provision was added in 2000 at the same time as Article 14, which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term "business" includes the performance of the activities which were

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previously covered by Article 14, was intended to prevent that the term "business" be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting States for which this is not the case are free to agree bilaterally to omit the definition."

Commentary on Article 5

19. Add the following paragraph 1.1 to the Commentary on Article 5:

"***1.1 Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.***"

Commentary on Article 6

20. Replace paragraphs 3 and 4 of the Commentary on Article 6 by the following:

"3. Paragraph 3 indicates that the general rule applies irrespective of the form of exploitation of the immovable property. Paragraph 4 makes it clear that the provisions of paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises ~~and to income from immovable property used for the performance of independent personal services~~.

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4. It should be noted in this connection that the right to tax of the State of source has priority over the right to tax of the other State and applies also where, in the case of an enterprise ~~or of non-industrial and non-commercial activities,~~ income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudge the application of domestic law as regards the manner."

Commentary on Article 7

21. Add the following new paragraph 2.1 to the Commentary on Article 7:

"***2.1 Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. However, it was not always clear which activities fell within Article 14 as opposed to Article 7. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits. This was confirmed by the addition of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character.***"

22. Replace paragraph 35 of the Commentary on Article 7 by the following:

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"35. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to ~~industrial and commercial~~ ***business*** income which does not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within this Article (cf. paragraphs 12 to 18 of the Commentary on Article 12 which discusses the principles governing whether, in the particular case of computer software, payments should be classified as ~~commercial~~ income within Articles 7 ~~or 14~~ or as a capital gains matter within Article 13 on the one hand or as royalties within Article 12 on the other). It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as ~~industrial and commercial~~ ***business*** profits, in conformity with the tax laws of the Contracting States."

Commentary on Article 10

23. Replace paragraphs 2, and 34 of the Commentary on Article 10 by the following:

"2. The profits of a business carried on by a partnership are the partners' profits derived from their own exertions; for them they are ~~industrial or commercial~~ ***business*** profits. So the partner is ordinarily taxed personally on his share of the partnership capital and partnership profits.

32. ~~The rules set out above also apply where the beneficiary of the dividends has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the holding in respect of which the dividends are paid is effectively connected.~~

34. Paragraph 5 rules out the extra-territorial taxation of dividends, i.e. the practice by which States tax dividends distributed by a non-resident

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company solely because the corporate profits from which the distributions are made originated in their territory (for example, realised through a permanent establishment situated therein). There is, of course, no question of extra-territorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment ~~or fixed base~~ situated in that State."

Commentary on Article 11

24. Replace paragraphs 25 and 30 of the Commentary on Article 11 by the following:

"25. ~~The rules set out above also apply where the beneficiary of the interest has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the debt-claim in respect of which the interest is paid is effectively connected.~~

30. Moreover, in the case—not settled in paragraph 5—where whichever of the two Contracting States is that of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence from concerting measures to avoid the double taxation that would result from such claims. The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph 5. Another solution would be for two Contracting States to word the second sentence of paragraph 5 in the following way:

"Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment ~~or a fixed base~~ in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment ~~or fixed base~~, then such interest shall be deemed to arise

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in the State in which the permanent establishment ~~or fixed base~~ is situated."

C*ommentary on Article 12*

25. Replace paragraphs 10, 11, 14, 16 and 21 of the Commentary on Article 12 by the following:

"1. In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an ~~industrial or commercial~~ enterprise (e.g. the use of literary copyright granted by a publisher~~) or an independent profession (e.g.~~ ***or the*** use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. ***the*** use of a patent granted by the inventor's heirs).

10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as ~~industrial and commercial~~ ***business*** profits and, in consequence, subjected to the provisions of Articles 7 and 9.

11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the "Association des Bureaux pour la Protection de la Propriété Industrielle" (ANBPPI), states that "know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique." In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not

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required to play any part himself in the application of the formulas granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Thus, payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments generally fall under Article 7 ~~or Article 14~~. In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.

14. In other cases, the acquisition of the software will generally be for the personal or business use of the purchaser. The payment will then fall to be dealt with as ***business profits*** ~~commercial income~~ in accordance with Article~~s~~ 7 ~~or 14~~. It is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it**.**

16. Each case will depend on its particular facts but in general such payments are likely to be ***business profits*** ~~commercial income~~ within Article 7 ~~or 14~~ or a capital gains matter within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated in full or in part, the consideration

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cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency.

~~21. The rules set out above also apply where the beneficiary of the royalties has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the right or property in respect of which the royalties are paid is effectively connected.~~"

Commentary on Article 13

26. Replace paragraphs 9, 22, 24, 25 and 27 of the Commentary on Article 13 by the following:

"9. Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment ~~or pertaining to a fixed base~~, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below.

22. Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise. ~~or used for performing independent personal services.~~ For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of Article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other

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Contracting State. It does not, therefore, apply to gains derived from the alienation of immovable property situated in the Contracting State of which the alienator is a resident in the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such gains.

24. Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise ~~or pertaining to a fixed base used for performing independent personal services~~. The term "movable property" means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment ~~or fixed base~~ is situated, which corresponds to the rules for business profits ~~and for income from independent personal services~~ (Article~~s~~ 7 ~~and 14~~).

25. The paragraph makes clear that its rules apply when movable property of a permanent establishment ~~or fixed base~~ is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) ~~or the fixed base as such~~ is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply *mutatis mutandis* without express reference thereto. For the transfer of an asset from a permanent establishment in one State to a permanent establishment (or the head office) in another State, cf. paragraph 10 above.

27. Certain States consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. Paragraph 2 is not based on such a conception which is sometimes referred to as "the force of attraction of the permanent establishment". The paragraph merely provides that gains from the alienation of movable property forming part of the business property of a permanent establishment ~~or of movable property pertaining to a fixed base used for performing independent personal services~~ may be taxed in the State where the permanent establishment ~~or the fixed base~~ is situated. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in paragraph 4. The foregoing explanations accord with those in the Commentary on Article 7.

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Commentary on Article 14

27. Replace the whole of the Commentary on Article 14 by the following:

"***[COMMENTARY ON ARTICLE 14***
CONCERNING THE TAXATION OF INDEPENDENT PERSONAL SERVICES]

[Article 14 was deleted from the Model Tax Convention on 27 January 2000. That decision reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. In addition, it was not always clear which activities fell within Article 14 as opposed to Article 7. The effect of the deletion of Article 14 is that income derived from professional services or other activities of an independent character is now dealt with under Article 7 as business profits.]"

~~1. The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment, e.g. a physician serving as a medical officer in a factory. It should, however, be observed that the Article does not concern independent activities of artistes and sportsmen, these being covered by Article 17.~~

~~2. The meaning of the term "professional services" is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive. Difficulties of interpretation which might arise in special cases may be solved by mutual agreement between the competent authorities of the Contracting States concerned.~~

~~3. The provisions of the Article are similar to those for business profits and rest in fact on the same principles as those of Article 7. The provisions of Article 7 and the Commentary thereon could therefore be used as guidance for interpreting and applying Article 14. Thus the principles laid down in~~

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Article 7 for instance as regards allocation of profits between head office and permanent establishment could be applied also in apportioning income between the State of residence of a person performing independent personal services and the State where such services are performed from a fixed base. Equally, expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment (cf. paragraph 3 of Article 7). Also in other respects Article 7 and the Commentary thereon could be of assistance for the interpretation of Article 14, e.g. in determining whether computer software payments should be classified as commercial income within Articles 7 or 14 or as royalties within Article 12.

4. Even if Articles 7 and 14 are based on the same principles, it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities. The term "fixed base" has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities.

Observation on the Commentary

4.1 *Mexico* considers that this Article is applicable to companies that perform professional services.

Reservations on the Article

5. *Turkey* reserves the right to tax persons performing professional services or other activities of an independent character if they are present in this country for a period or periods exceeding in the aggregate 183 days in the calendar year, even if they do not have a fixed base available to them for the purpose of performing such services or activities.

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6. *Portugal* and *Spain* reserve their position on paragraph 1.

7. *Denmark*, *Mexico* and *Norway* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their respective territory for a period or periods exceeding in the aggregate 183 days in any twelve month period.

8. *Denmark*, *Ireland*, *Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from independent personal services relating to offshore hydrocarbon exploration and exploitation and related activities.

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

10. *Greece* reserves the right to insert special provisions regarding income derived from independent personal services relating to offshore activities.

Commentary on Article 15

28. Replace the heading of the Commentary on Article 15 and add a footnote to it as follows:

"COMMENTARY ON ARTICLE 15
CONCERNING THE TAXATION OF *INCOME FROM EMPLOYMENT*[1]
~~DEPENDENT PERSONAL SERVICES~~

1. Before 2000, the title of Article 15 referred to "Dependent Personal Services" by contrast to the title of Article 14, which referred to "Independent Personal Services". As a result of the elimination of the latter Article, the title of Article 15 was changed to refer to "Employment", a term

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that is more commonly used to describe the activities to which the Article applies. This change was not intended to affect the scope of the Article in any way."

29. Replace paragraphs 3, 7.1, 17 and 21 of the Commentary on Article 15 by the following:

"3. Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception covers all individuals rendering ~~dependent personal~~ services ***in the course of an employment*** (sales representatives, construction workers, engineers, etc.), to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen.

7.1 Under the third condition, if the employer has in the State in which the employment is exercised a permanent establishment, ~~(or a fixed base if he performs professional services or other activities of an independent character),~~ the exemption is given only on condition that the remuneration is not borne by a permanent establishment ~~or a fixed base~~ which he has in that State.

17. *Ireland*, *Norway* and the *United Kingdom* reserve the right to insert in a special article provisions regarding income derived from ***employment*** ~~dependent personal~~ relating to offshore hydrocarbon exploration and exploitation and related activities.

21. *Greece* reserves the right to insert special provisions regarding income from ***employment*** ~~dependent personal~~ relating to offshore activities."

Commentary on Article 17

30. Replace paragraphs 1, 2, 9, 11 and 15.1 of the Commentary on Article 17 by the following:

"1. Paragraph 1 provides that artistes and sportsmen who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are ***of a business or employment nature*** ~~an independent or of a dependent nature~~.

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This provision is an exception to the rules in Article ~~14~~ ***7*** and to that in paragraph 2 of Article 15, respectively.

2. This provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to ~~independent~~ ***business*** activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article ***7*** ~~14~~. In such a case, artistes and sportsmen performing ~~for a salary or wages~~ ***in the course of an employment*** would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

9. Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (cf. paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article ~~14~~ ***7*** or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7~~, 14~~ or 15, as the case may be.

11. Paragraph 1 of the Article deals with income derived by individual artistes and sportsmen from their personal activities. Paragraph 2 deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in the hands of the person receiving the

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remuneration. If the person receiving the income ***carries on business activities*** ~~is an enterprise~~, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. ~~If the person receiving the income is an individual, the income may be taxed even in the absence of a fixed base~~. But it will not always be so. There are three main situations of this kind~~.~~***:***

a) The first is the management company which receives income for the appearance of e.g. a group of sportsmen (which is not itself constituted as a legal entity).

b) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed periodic remuneration and it would be difficult to allocate a portion of that income to particular performances, Member countries may decide, unilaterally or bilaterally, not to tax it. The profit element accruing from a performance to the legal entity would be liable to tax under paragraph 2.

c) The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits it to impose a tax on the profits diverted from the income of the artiste or sportsman to the enterprise. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to other solutions or to leave paragraph 2 out of their bilateral conventions.

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15.1 *France* considers that the statement in the first sentence of paragraph 13, which is at variance with the wording prior to the 1995 revision, is incorrect, because it does not conform with reality to characterise *a priori* as ~~industrial or commercial~~ ***business*** the public activities at issue — and in particular cultural activities — that do not ordinarily have a profit motive. In addition, this statement is not consistent with the second sentence of the same paragraph or with paragraph 14, which explicitly provides the right to apply a special exemption regime to the public activities in question: if applied generally to ~~industrial or commercial~~ ***business*** activities, such a regime would be unjustified, because it would then be contrary to fiscal neutrality and tax equality."

Commentary on Article 18

31. Replace paragraphs 9, 11, 12 and 35 of the Commentary on Article 18 by the following:

"9. The provision is confined to the tax treatment of contributions to pension schemes by or on behalf of individuals who exercise employments within the meaning of Article 15 away from their home State. It does not deal with contributions by individuals who ***perform business activities covered by Article 7*** ~~who render independent personal services within the meaning of Article 14~~. However, Member countries may wish, in bilateral negotiations, to agree on a provision covering individuals rendering services within both Article ~~14~~ ***7*** and Article 15.

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

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

(i) pension scheme, immediately before he began to exercise employment in that State; and

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

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

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

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

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

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

Commentary on Article 19

32. Replace paragraph 13 of the Commentary on Article 19 by the following:

"13. *France* considers that the scope of the application of Article 19 should cover:

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— remuneration paid by public legal entities of the State or a political subdivision or local authority thereof, because the identity of the payer is less significant than the public nature of the income;
— public remuneration of artistes and sportsmen in conformity with the wording of the Model prior to 1995 (without applying the criterion of ~~industrial or commercial~~ ***business*** activity, seldom relevant in these cases), as long as Article 17 does not contain a provision along the lines suggested in paragraph 14 of the Commentary on Article 17."

Commentary on Article 21

33. Replace paragraphs 4 and 5 of the Commentary on Article 21 by the following:

"4. This paragraph provides for an exception from the provisions of paragraph 1 where the income is associated with the activity of a permanent establishment ~~or fixed base~~ which a resident of a Contracting State has in the other Contracting State. The paragraph includes income from third States. In such a case, a right to tax is given to the Contracting State in which the permanent establishment ~~or the fixed base~~ is situated. Paragraph 2 does not apply to immovable property for which, according to paragraph 4 of Article 6, the State of situs has a primary right to tax (cf. paragraphs 3 and 4 of the Commentary on Article 6). Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is in consistency with the rules laid down in Articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable property of a permanent establishment.

5. The paragraph also covers the case where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment ~~or a fixed base~~, which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment ~~or the fixed base~~ is situated. Where double taxation occurs, the State of residence should give relief under the provisions of Article 23 A or 23 B. However, a problem may arise as regards the taxation of dividends

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and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws."

Commentary on Article 22

34. Replace paragraph 3 of the Commentary on Article 22 by the following:

"3. The Article, therefore, enumerates first property which may be taxed in the State in which they are situated. To this category belong immovable property referred to in Article 6 which a resident of a Contracting State owns and which is situated in the other Contracting State (paragraph 1), and 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 pertaining to a fixed base which a resident of a Contracting State has in the other Contracting State for the performance of independent personal services~~ (paragraph 2)."

Commentary on Articles 23A and 23B

35. Replace paragraphs 3, 5, 9 and 10 of the Commentary on Article 23A and 23B by the following:

"3. International juridical double taxation may arise in three cases:

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a) where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax, cf. paragraph 4 below);

b) where a person is a resident of a Contracting State (R)[9] and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital (cf. paragraph 5 below);

c) where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment ~~or fixed base~~ in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability, cf. paragraph 11 below).

5. The conflict in case *b*) may be solved by allocation of the right to tax between the Contracting States. Such allocation may be made by renunciation of the right to tax either by the State of source or situs (S) or of the situation of the permanent establishment ~~or the fixed base~~ (E), or by the State of residence (R), or by a sharing of the right to tax between the two States. The provisions of the Chapters III and IV of the Convention, combined with the provisions of Article 23 A or 23 B, govern such allocation.

9. Where a resident of the Contracting State R derives income from the same State R through a permanent establishment ~~or a fixed base~~ which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment ~~or fixed base~~ (paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment ~~or fixed base~~ situated in State E, notwithstanding the fact that the income in question originally arises in State R (cf. paragraph 5 of the Commentary on Article 21). However, where the Contracting States agree to give to State R which applies the exemption method a limited right to tax as the State of source of

1. Throughout the Commentary on Articles 23 A and 23 B, the letter "R" stands for the State of residence within the meaning of the Convention, "S" for the State of source or situs, and "E" for the State where a permanent establishment ~~of a fixed base~~ is situated.

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dividends or interest within the limits fixed in paragraph 2 of the Articles 10 or 11 (cf. paragraph 5 of the Commentary on Article 21), then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.

10. Where a resident of State R derives income from a third State through a permanent establishment ~~or a fixed base~~ which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment ~~or fixed base~~ (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment ~~or fixed base~~ in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 4 of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R (cf. paragraphs 49 to 54 of the Commentary on Article 24)."

Commentary on Article 24

36. Replace paragraphs 7, 21 and 26 of the Commentary on Article 24 by the following:

"7. To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private ~~industrial and commercial~~ ***business*** undertakings, the provisions of paragraph 1 will apply to them.

21. By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in

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the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on ~~industrial and commercial~~ ***business*** activities, and especially taxes on business profits.

26. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in ~~industrial or commercial~~ ***business*** activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States."

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APPENDIX I

LIST OF TAX CONVENTIONS ON INCOME AND ON CAPITAL BETWEEN OECD MEMBER COUNTRIES

(as of 1st January 2000)

AUSTRALIA

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Austria	8/7/86	1/9/88		
Belgium	13/10/77	1/11/79	20/3/84	20/9/86
Canada	21/5/80	29/4/81		
Czech Republic	28/3/95	27/11/95		
Denmark	1/4/81	27/10/81		
Finland	12/9/84	28/3/86	5/11/97	not in force
France	13/4/76	21/9/77	19/6/89	19/7/90
Germany	24/11/72	15/2/75		
Greece				
Hungary	29/11/90	10/4/92		
Iceland				
Ireland	31/5/83	21/12/83		
Italy	14/12/82	5/11/85		
Japan	20/3/69	4/7/70		
Korea	12/7/82	1/1/84		
Luxembourg				
Mexico				
Netherlands	17/3/76	27/9/76	30/6/86	1/5/87
New Zealand	27/1/95	29/3/95		
Norway	6/5/82	19/10/83		
Poland	7/5/91	4/3/92		

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Portugal				
Spain	24/3/92	10/12/92		
Sweden	14/1/81	4/9/81		
Switzerland	28/2/80	13/2/81		
Turkey				
United Kingdom	7/12/67	8/5/68	29/1/80	21/5/80
United States	6/8/82	31/10/83		

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AUSTRIA

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	8/7/86	1/9/88		
Belgium	29/12/71	28/6/73		
Canada	9/12/76	17/2/81	15/6/99	not in force
Czech Republic	7/3/78	12/2/79		
Denmark	23/10/61	26/2/62	29/10/70	17/12/71
Finland	8/10/63	29/1/64	21/9/70	25/2/72
France	26/3/93	1/9/94		
Germany	4/10/54	7/9/55	8/7/92	1/7/94
Greece	22/9/70	5/1/72		
Hungary	25/2/75	9/2/76		
Iceland				
Ireland	24/5/66	5/1/68	19/6/87	1/3/89
Italy	29/6/81	6/4/85	25/11/87	1/5/90
Japan	20/12/61	4/4/63		
Korea	8/10/85	1/12/87		
Luxembourg	18/10/62	7/2/64	21/5/92	1/2/94
Mexico				
Netherlands	1/9/70	21/4/71	18/12/89	28/12/90
New Zealand				
Norway	28/11/95	1/12/96		
Poland	2/10/74	22/7/75		
Portugal	29/12/70	27/2/72		
Spain	20/12/66	1/1/68	24/2/95	1/11/95

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Sweden	14/5/59	29/12/59	6/4/70 5/11/91	5/11/70 1/5/93
Switzerland	30/1/74	4/12/74	18/1/94	1/5/95
Turkey	3/11/70	24/9/73		
United Kingdom	30/4/69	13/11/70	17/11/77 18/5/93	30/12/78 1/12/94
United States	31/5/96	1/2/98		

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BELGIUM

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	13/10/77	1/11/79	20/3/84	20/9/86
Austria	29/12/71	28/6/73		
Canada	29/5/75	12/8/76		
Czech Republic	19/6/75 16/12/96	17/12/77 not in force		
Denmark	16/10/69	31/12/70		
Finland	18/5/76	27/12/78	13/3/91	16/7/97
France	10/3/64	17/6/65	15/2/71 8/2/99	19/7/73 not in force
Germany	11/4/67	30/7/69		
Greece	24/5/68	27/5/70		
Hungary	19/7/82	25/2/84		
Iceland				
Ireland	24/6/70	31/12/73		
Italy	29/4/83	29/7/89	19/12/84	29/7/89
Japan	28/3/68	16/4/70	9/11/88	16/11/90
Korea	29/8/77	19/9/79	20/4/94	31/12/96
Luxembourg	17/9/70	30/12/72		
Mexico	24/11/92	1/2/97		
Netherlands	19/10/70	1/10/71		
New Zealand	15/9/81	8/12/83		
Norway	14/4/88	4/10/91		
Poland	14/9/76	21/9/78		
Portugal	16/7/69	19/2/71	6/3/95	not in force

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Spain	24/9/70 14/6/95	8/10/72 not in force		
Sweden	5/2/91	24/2/93		
Switzerland	28/8/78	26/9/80		
Turkey	2/6/87	8/10/91		
United Kingdom	1/6/87	21/10/89		
United States	9/7/70	13/10/72	31/12/87	3/8/89

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CANADA

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	21/5/80	29/4/81		
Austria	9/12/76	17/2/81	15/6/99	not in force
Belgium	29/5/75	12/8/76		
Czech Republic	30/8/90	22/7/92		
Denmark	17/9/97	2/3/98		
Finland	28/5/90	20/8/92		
France	2/5/75	29/7/76	16/1/87 30/11/95	1/10/88 1/9/98
Germany	17/7/81	23/9/83		
Greece				
Hungary	15/4/92	1/10/94	3/5/94	26/4/96
Iceland	19/6/97	30/1/98		
Ireland	23/11/66	6/12/67		
Italy	17/11/77	24/12/80	20/3/89	22/2/94
Japan	7/5/86	14/11/87	19/2/99	not in force
Korea	10/2/78	19/12/80		
Luxembourg	17/1/89 10/9/99	8/7/91 not in force		
Mexico	8/4/91	11/5/92		
Netherlands	27/5/86	21/8/87	4/3/93 25/8/97	30/7/94 15/1/99
New Zealand	31/5/80	29/5/81		
Norway	23/11/66	24/8/67		

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Poland	4/5/87	30/11/89		
Portugal	14/6/99	not in force		
Spain	23/11/76	26/12/80		
Sweden	27/8/96	23/12/97		
Switzerland	5/5/97	21/4/98		
Turkey				
United Kingdom	8/9/78	17/12/80	15/4/80 16/10/85	18/12/80 23/12/85
United States	26/9/80	16/8/84	14/6/83 28/3/84 17/3/95 29/7/97	16/8/84 16/8/84 9/11/95 16/12/97

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CZECH REPUBLIC

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	28/3/95	27/11/95		
Austria	7/3/78	12/2/79		
Belgium	19/6/75 16/12/96	17/12/77 not in force		
Canada	30/8/90	22/7/92		
Denmark	5/5/82	27/12/82	11/9/92	18/12/92
Finland	2/12/94	12/12/95		
France	1/6/73	25/1/75		
Germany	19/12/80	17/11/83		
Greece	23/10/86	23/5/89		
Hungary	14/1/93	27/12/94		
Iceland				
Ireland	14/11/95	21/4/96		
Italy	5/5/81	26/6/84		
Japan	11/10/77	25/11/78		
Korea	27/4/92	3/3/95		
Luxembourg	18/3/91	30/12/92		
Mexico				
Netherlands	4/3/74	5/11/74	26/6/96	11/4/97
New Zealand				
Norway	27/6/79	28/12/79		
Poland	24/6/93	20/12/93		
Portugal	24/5/94	1/10/97		

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Spain	8/5/80	5/6/81		
Switzerland	4/12/95	23/10/96		
Turkey				
United Kingdom	5/11/90	20/12/91		
United States	16/9/93	23/12/93		

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DENMARK

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	1/4/81	27/10/81		
Austria	23/10/61	26/2/62	29/10/70	17/12/71
Belgium	16/10/69	31/12/70		
Canada	30/9/55 17/9/97	5/9/56 2/3/98	27/11/64	25/6/65
Czech Republic	5/5/82	27/12/82	11/9/92	18/12/92
Finland	23/9/96	11/5/97	6/10/97	31/12/97
France	8/2/57	30/4/58		
Germany	22/11/95	25/12/96		
Greece	18/5/89	18/1/92		
Hungary	24/10/78	28/9/79		
Iceland	23/9/96	11/5/97	6/10/97	31/12/97
Ireland	26/3/93	8/10/93		
Italy	26/2/80 5/5/99	25/3/83 not in force	25/11/88	28/7/92
Japan	3/2/68	26/7/68		
Korea	11/10/77	8/11/79		
Luxembourg	17/11/80	22/3/82		
Mexico	11/6/97	not in force		
Netherlands	20/2/57 1/7/96	29/1/58 not in force	20/1/66	31/8/66
New Zealand	10/10/80	22/6/81	12/3/85	22/7/85
Norway	23/9/96	11/5/97	6/10/97	31/12/97
Poland	6/4/76	20/12/76	17/5/94	13/1/95

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Portugal				
Spain	3/7/72	21/6/73		
Sweden	23/9/96	11/5/97	6/10/97	31/12/97
Switzerland	23/11/73	15/10/74	11/3/97	30/12/97
Turkey	30/5/91	23/6/93		
United Kingdom	11/11/80	17/12/80	1/7/91 15/10/96	19/12/91 20/6/97
United States	6/5/48 19/8/99	1/12/48 not in force	23/8/83	not in force

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FINLAND

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	12/9/84	28/3/86	5/11/97	not in force
Austria	8/10/63	29/1/64	21/9/70	25/2/72
Belgium	18/5/76	27/12/78	13/3/91	13/7/97
Canada	28/5/90	20/8/92		
Czech Republic	2/12/94	12/12/95		
Denmark	23/9/96	11/5/97	6/10/97	31/12/97
France	11/9/70	1/3/72		
Germany	5/7/79	4/6/82		
Greece	21/1/80	4/10/81		
Hungary	25/10/78	24/7/81		
Iceland	23/9/96	11/5/97	6/10/97	31/12/97
Ireland	27/3/92	26/12/93		
Italy	12/6/81	23/10/83		
Japan	29/2/72	30/12/72	4/3/91	28/12/91
Korea	8/2/79	23/12/81		
Luxembourg	1/3/82	27/3/83	24/1/90	18/7/92
Mexico	12/2/97	14/7/98		
Netherlands	28/12/95	20/12/97		
New Zealand	12/3/82	22/9/84	5/12/86	8/5/88
Norway	23/9/96	11/5/97	6/10/97	31/12/97

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Poland	26/10/77	30/3/79	28/4/94	21/1/95
Portugal	27/4/70	14/7/71		
Spain	15/11/67	30/10/68	24/8/70 22/2/73 27/4/90	11/2/74 24/4/74 27/12/91
Sweden	23/9/96	11/5/97	6/10/97	31/12/97
Switzerland	16/12/91	26/12/93		
Turkey	9/5/86	30/12/88		
United Kingdom	17/7/69	5/2/70	17/5/73 16/11/79 1/10/85 26/9/91 31/7/96	27/6/74 25/4/81 20/2/87 23/12/91 8/8/97
United States	21/9/89	30/12/90		

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FRANCE

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	13/4/76	21/9/77	19/6/89	19/7/90
Austria	26/3/93	1/9/94		
Belgium	10/3/64	17/6/65	15/2/71 8/2/99	19/7/73 not in force
Canada	2/5/75	29/7/76	16/1/87 30/11/95	1/10/88 1/9/98
Czech Republic	1/6/73	25/1/75		
Denmark	8/2/57	30/4/58		
Finland	11/9/70	1/3/72		
Germany	21/7/59	4/11/61	9/6/69 28/9/89	8/10/70 1/10/90
Greece	21/8/63	31/1/65		
Hungary	28/4/80	1/12/81		
Iceland	29/8/90	1/6/92		
Ireland	21/3/68	15/6/71		
Italy	5/10/89	1/5/92		
Japan	3/3/95	24/3/96		
Korea	19/6/79	1/2/81	9/4/91	1/3/92
Luxembourg	1/4/58	9/2/60	8/9/70	15/11/71
Mexico	7/11/91	31/12/92		
Netherlands	16/3/73	29/3/74		
New Zealand	30/11/79	19/3/81		
Norway	19/12/80	10/9/81	14/11/84 7/4/95	1/10/85 1/9/96

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Poland	20/6/75	12/9/76		
Portugal	14/1/71	18/11/72		
Spain	10/10/95	1/7/97		
Sweden	27/11/90	1/4/92		
Switzerland	9/9/66	26/7/67	3/12/69 22/7/97	24/9/70 1/8/98
Turkey	18/2/87	1/7/89		
United Kingdom	22/5/68	27/10/69	10/2/71 14/5/73 12/6/86 15/10/87	7/5/71 2/8/73 7/4/87 23/12/87
United States	31/8/94	30/12/95		

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GERMANY

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	24/11/72	15/2/75		
Austria	4/10/54	7/9/55	8/7/92	1/7/94
Belgium	11/4/67	30/7/69		
Canada	17/7/81	23/9/83		
Czech Republic	19/12/80	17/11/83		
Denmark	12/11/95	25/12/96		
Finland	5/7/79	4/6/82		
France	21/7/59	4/11/61	9/6/69 28/9/89	8/10/70 1/10/90
Greece	18/4/66	8/12/67		
Hungary	18/7/77	24/9/79		
Iceland	18/3/71	2/11/73		
Ireland	17/10/62	2/4/64		
Italy	18/10/89	24/12/92		
Japan	22/4/66	9/6/67	17/4/79 17/2/83	10/11/80 4/5/84
Korea	14/12/76	4/5/78		
Luxembourg	23/8/58	6/5/60	15/6/73	25/11/78
Mexico	23/2/93	30/12/93		
Netherlands	16/6/59	18/9/60	13/3/80 21/5/91	12/11/80 20/2/92
New Zealand	20/10/78	21/12/80		
Norway	4/10/91	7/10/93		
Poland	18/12/72	14/9/75	24/10/79	20/12/81

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Portugal	15/7/80	8/10/82		
Spain	5/12/66	14/3/68		
Sweden	14/7/92	13/10/94		
Switzerland	11/8/71	29/12/72	30/11/78 17/10/89 21/12/92	5/9/80 30/11/90 29/12/93
Turkey	16/4/85	30/12/89		
United Kingdom	26/11/64	30/1/67	23/3/70	30/5/71
United States	29/8/89	21/8/91		

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GREECE

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia				
Austria	22/9/70	5/1/72		
Belgium	24/5/68	27/5/70		
Canada				
Czech Republic	23/10/86	23/5/89		
Denmark	18/5/89	18/1/92		
Finland	21/1/80	4/10/81		
France	21/8/63	31/1/65		
Germany	18/4/66	8/12/67		
Hungary	25/5/83	1/7/85		
Iceland				
Ireland				
Italy	3/9/87	20/9/91		
Japan				
Korea	20/3/95	not in force		
Luxembourg	22/11/91	26/8/95		
Mexico				
Netherlands	16/7/81	17/7/84		
New Zealand				
Norway	27/4/88	16/9/91		
Poland	20/11/87	28/9/91		
Portugal				
Spain				

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Sweden	6/10/61	20/8/63		
Switzerland	16/6/83	21/2/85		
Turkey				
United Kingdom	25/6/53	15/1/54		
United States	20/2/50	30/12/53		

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HUNGARY

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	29/11/90	10/4/92		
Austria	25/2/75	9/2/76		
Belgium	19/7/82	25/2/84		
Canada	15/4/92	1/10/94	3/5/94	26/6/96
Czech Republic	14/1/93	27/12/94		
Denmark	24/10/78	28/9/79		
Finland	25/10/78	24/7/81		
France	28/4/80	1/12/81		
Germany	18/7/77	24/9/79		
Greece	25/5/83	1/7/85		
Iceland				
Ireland	25/4/95	5/12/96		
Italy	16/5/77	1/12/80		
Japan	13/2/80	25/10/80		
Korea	29/3/89	1/4/90		
Luxembourg	15/1/90	21/4/91		
Mexico				
Netherlands	5/6/86	25/9/87		
New Zealand				
Norway	21/10/80	20/9/81		
Poland	23/9/92	10/9/95		
Portugal	16/5/95	not in force		
Spain	9/7/84	20/5/87		

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Sweden	12/10/81	15/8/82		
Switzerland	9/4/81	27/6/82		
Turkey	10/3/93	9/11/95		
United Kingdom	28/11/77	27/8/78		
United States	12/2/79	12/9/79		

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ICELAND

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia				
Austria				
Belgium				
Canada	19/6/97	30/1/98		
Czech Republic				
Denmark	23/9/96	11/5/97	6/10/97	31/12/97
Finland	23/9/96	11/5/97		
France	29/8/90	1/6/92		
Germany	18/3/71	2/11/73		
Greece				
Hungary				
Ireland				
Italy				
Japan				
Korea				
Luxembourg	4/10/99	not in force		
Mexico				
Netherlands	25/9/97	not in force		
New Zealand				
Norway	23/9/96	11/5/97	6/10/97	31/12/97
Poland				
Portugal				
Spain				

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Sweden	23/9/96	11/5/97		
Switzerland	3/6/88	20/6/89		
Turkey				
United Kingdom	30/9/91	19/12/91		
United States	7/5/75	26/12/75		

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IRELAND

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	31/5/83	21/12/83		
Austria	24/5/66	5/1/68	19/6/87	1/3/89
Belgium	24/6/70	31/12/73		
Canada	23/11/66	6/12/67		
Czech Republic	14/11/95	21/4/96		
Denmark	26/3/93	8/10/93		
Finland	27/3/92	26/12/93		
France	21/3/68	15/6/71		
Germany	17/10/62	2/4/64		
Greece				
Hungary	25/4/95	5/12/96		
Iceland				
Italy	11/6/71	14/2/75		
Japan	18/1/74	4/12/74		
Korea	18/7/90	27/12/91		
Luxembourg	14/1/72	25/2/75		
Mexico				
Netherlands	11/2/69	12/5/70		
New Zealand	19/9/86	26/9/88		
Norway	21/10/69	21/8/70		
Poland	13/11/95	22/12/95		
Portugal	1/6/93	11/7/94		
Spain	10/2/94	21/11/94		

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Sweden	8/10/86	5/4/88	1/7/93	20/1/94
Switzerland	8/11/66	16/2/68	24/10/80	25/4/84
Turkey				
United Kingdom	2/6/76	23/12/76	28/10/76 7/11/94	23/12/76 21/9/95
United States	13/9/49 28/7/97	20/12/51 not in force		

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ITALY

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	14/12/82	5/11/85		
Austria	29/6/81	6/4/85	25/11/87	1/5/90
Belgium	29/4/83	29/7/89	19/12/84	29/7/89
Canada	17/11/77	24/12/80	20/3/89	22/2/94
Czech Republic	5/5/81	26/6/84		
Denmark	26/2/80 5/5/99	25/3/83 not in force	25/11/88	28/7/92
Finland	12/6/81	23/10/83		
France	5/10/89	1/5/92		
Germany	18/10/89	24/12/92		
Greece	3/9/87	20/9/91		
Hungary	16/5/77	1/12/80		
Iceland				
Ireland	11/6/71	14/2/75		
Japan	20/3/69	17/3/73	14/2/80	28/1/82
Korea	10/1/89	14/7/92		
Luxembourg	3/6/81	4/2/83		
Mexico	8/7/91	10/3/95		
Netherlands	8/5/90	3/10/93		
New Zealand	6/12/79	23/3/83		
Norway	17/6/85	25/5/87		
Poland	21/6/85	26/9/89		
Portugal	14/5/80	15/1/83		
Spain	8/9/77	24/11/80		

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Sweden	6/3/80	5/7/83		
Switzerland	9/3/76	27/3/79	28/4/78	27/3/79
Turkey	27/7/90	1/12/93		
United Kingdom	21/10/88	31/12/90		
United States	17/4/84 25/8/99	30/12/85 not in force		

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JAPAN

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	20/3/69	4/7/70		
Austria	20/12/61	4/4/63		
Belgium	28/3/68	16/4/70	9/11/88	16/11/90
Canada	7/5/86	14/11/87	19/12/99	not in force
Czech Republic	11/10/77	25/11/78		
Denmark	3/2/68	26/7/68		
Finland	29/2/72	30/12/72	4/3/91	28/12/91
France	3/3/95	24/3/96		
Germany	22/4/66	9/6/67	17/4/79 17/2/83	10/11/80 4/5/84
Greece				
Hungary	13/2/80	25/10/80		
Iceland				
Ireland	18/1/74	4/12/74		
Italy	20/3/69	17/3/73	14/2/80	28/1/82
Korea	3/3/70	29/10/70		
Luxembourg	5/3/92	27/12/92		
Mexico	9/4/96	6/11/96		
Netherlands	3/3/70	23/10/70	4/3/92	16/12/92
New Zealand	30/1/63	19/4/63	22/3/67	30/9/67
Norway	4/3/92	16/12/92		
Poland	20/2/80	23/12/82		
Portugal				
Spain	13/2/74	20/11/74		

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Sweden	21/1/83	18/9/83		
Switzerland	19/1/71	26/12/71		
Turkey	8/3/93	28/12/94		
United Kingdom	10/2/69	25/12/70	14/2/80	31/10/80
United States	8/3/71	9/7/72		

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KOREA

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	12/7/82	1/1/84		
Austria	8/10/85	1/12/87		
Belgium	29/8/77	19/9/79	20/4/94	31/12/96
Canada	10/2/78	19/12/80		
Czech Republic	27/4/92	3/3/95		
Denmark	11/10/77	8/11/79		
Finland	8/2/79	23/12/81		
France	19/6/79	1/2/81	9/4/91	1/3/92
Germany	14/12/76	4/5/78		
Greece	20/3/95	not in force		
Hungary	29/3/89	1/4/90		
Iceland				
Ireland	18/7/90	27/12/91		
Italy	10/1/89	14/7/92		
Japan	3/3/70	29/10/70		
Luxembourg	7/11/84	26/12/86		
Mexico	6/10/94	11/2/95		
Netherlands	25/10/78	17/4/81		
New Zealand	6/10/81	22/4/83	14/7/97	10/10/97
Norway	5/10/82	1/3/84		
Poland	21/6/91	21/2/92		
Portugal	26/1/96	not in force		
Spain	17/1/94	21/11/94		

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Sweden	27/5/81	9/9/82		
Switzerland	12/2/80	22/4/81		
Turkey	24/12/83	27/3/86		
United Kingdom	25/10/96	30/12/96		
United States	4/6/76	20/10/79		

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LUXEMBOURG

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia				
Austria	18/10/62	7/2/64	21/5/92	1/2/94
Belgium	17/9/70	30/12/72		
Canada	17/1/89 10/9/99	8/7/91 not in force		
Czech Republic	18/3/91	30/12/92		
Denmark	17/11/80	22/3/82		
Finland	1/3/82	27/3/83	24/1/90	18/7/92
France	1/4/58	9/2/60	8/9/70	15/11/71
Germany	23/8/58	6/5/60	15/6/73	25/11/78
Greece	22/11/91	26/8/95		
Hungary	15/1/90	21/4/91		
Iceland	4/10/99	not in force		
Ireland	14/1/72	25/2/75		
Italy	3/6/81	4/2/83		
Japan	5/3/92	27/12/92		
Korea	7/11/84	26/12/86		
Mexico				
Netherlands	8/5/68	20/10/69	16/10/90	27/9/92
New Zealand				
Norway	6/5/83	27/1/85		
Poland	14/6/95	31/7/96		
Portugal	25/5/99	not in force		
Spain	3/6/86	19/5/87		

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Sweden	14/10/96	13/2/98		
Switzerland	21/1/93	19/2/94		
Turkey				
United Kingdom	24/5/67	3/7/68	18/7/78 28/1/83	21/5/80 19/3/84
United States	18/12/62 3/4/96	22/12/64 not in force		

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MEXICO

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia				
Austria				
Belgium	24/11/92	1/2/97		
Canada	8/4/91	11/5/92		
Czech Republic				
Denmark	11/6/97	not in force		
Finland	12/2/97	14/7/98		
France	7/11/91	31/12/92		
Germany	23/2/93	30/12/93		
Greece				
Hungary				
Iceland				
Ireland				
Italy	8/7/91	10/3/95		
Japan	9/4/96	6/11/96		
Korea	6/10/94	11/2/95		
Luxembourg				
Netherlands	27/9/93	13/10/94		
New Zealand				
Norway	23/3/95	23/1/96		
Poland				
Portugal				
Spain	24/7/92	6/10/94		

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Sweden	21/9/92	18/12/92		
Switzerland	3/8/93	8/9/94		
Turkey				
United Kingdom	2/6/94	15/12/94		
United States	18/9/92	28/12/93	8/9/94	26/10/95

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NETHERLANDS

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	17/3/76	27/9/76	30/6/86	1/5/87
Austria	1/9/70	21/4/71	18/12/89	28/12/90
Belgium	19/10/70	1/10/71		
Canada	27/5/86	21/8/87	4/3/93 25/8/97	30/7/94 15/1/99
Czech Republic	4/3/74	5/11/74	26/6/96	11/4/97
Denmark	20/2/57 1/7/96	29/1/58 not in force	20/1/66	31/8/66
Finland	28/12/95	20/12/97		
France	16/3/73	29/3/74		
Germany	16/6/59	18/9/60	13/3/80 21/5/91	12/11/80 20/2/92
Greece	16/7/81	17/7/84		
Hungary	5/6/86	25/9/87		
Iceland	25/9/97	not in force		
Ireland	11/2/69	12/5/70		
Italy	8/5/90	3/10/93		
Japan	3/3/70	23/10/70	4/3/92	16/12/92
Korea	25/10/78	17/4/81		
Luxembourg	8/5/68	20/10/69	16/10/90	27/9/92
Mexico	27/9/93	13/10/94		
New Zealand	15/10/80	18/3/81		
Norway	12/1/90	31/12/90		

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Poland	20/9/79	7/11/81		
Portugal	20/9/99	not in force		
Spain	16/6/71	20/9/72		
Sweden	18/6/91	12/8/92		
Switzerland	12/11/51	9/1/52	22/6/66	22/12/66
Turkey	27/3/86	30/9/88		
United Kingdom	7/11/80	6/4/81	12/7/83 24/8/89	20/12/90 20/12/90
United States	18/12/92	31/12/93	13/10/93	30/12/93

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NEW ZEALAND

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	27/1/95	29/3/95		
Austria				
Belgium	15/9/81	8/12/83		
Canada	31/5/80	29/5/81		
Czech Republic				
Denmark	10/10/80	22/6/81	12/3/85	22/7/85
Finland	12/3/82	22/9/84	5/12/86	8/5/88
France	30/11/79	19/3/81		
Germany	20/10/78	21/12/80		
Greece				
Hungary				
Iceland				
Ireland	19/9/86	26/9/88		
Italy	6/12/79	23/3/83		
Japan	30/1/63	19/4/63	22/3/67	30/9/67
Korea	6/10/81	22/4/83	14/7/99	10/10/97
Luxembourg				
Mexico				
Netherlands	15/10/80	18/3/81		
Norway	20/4/82	31/3/83		
Poland				
Portugal				
Spain				

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Sweden	21/2/79	14/11/80		
Switzerland	6/6/80	21/11/81		
Turkey				
United Kingdom	4/8/83	16/3/84		
United States	23/7/82	2/11/83		

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NORWAY

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	6/5/82	19/10/83		
Austria	28/11/95	1/12/96		
Belgium	14/4/88	4/10/91		
Canada	23/11/66	24/8/67		
Czech Republic	27/6/79	28/12/79		
Denmark	23/9/96	11/5/97	6/10/97	31/12/97
Finland	23/9/96	11/5/97	6/10/97	31/12/97
France	19/12/80	10/9/81	14/11/84 7/4/95 16/8/99	1/10/85 1/9/96 not in force
Germany	4/10/91	7/10/93		
Greece	27/4/88	16/9/91		
Hungary	21/10/80	20/9/81		
Iceland	23/9/96	11/5/97	6/10/97	31/12/97
Ireland	21/10/69	21/8/70		
Italy	17/6/85	25/5/87		
Japan	4/3/92	16/12/92		
Korea	5/10/82	1/3/84		
Luxembourg	6/5/83	27/1/85		
Mexico	23/3/95	23/1/96		
Netherlands	12/1/90	31/12/90		
New Zealand	20/4/82	31/3/83		
Poland	24/5/77	30/10/79		
Portugal	24/6/70	1/10/71		
Spain	25/4/63 8/10/99	24/5/64 not in force		

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Sweden	23/9/96	11/5/97	6/10/97	31/12/97
Switzerland	7/9/87	2/5/89		
Turkey	16/12/71	30/1/76		
United Kingdom	3/10/85	19/12/85		
United States	3/12/71	29/11/72	19/9/80	15/12/81

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POLAND

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	7/5/91	4/3/92		
Austria	2/10/74	22/7/75		
Belgium	14/9/76	21/9/78		
Canada	4/5/87	30/11/89		
Czech Republic	24/6/93	20/12/93		
Denmark	6/4/76	20/12/76	17/5/94	13/1/95
Finland	26/10/77	30/3/79	28/4/94	21/1/95
France	20/6/75	12/9/76		
Germany	18/12/72	14/9/75	24/10/79	20/12/81
Greece	20/11/87	28/9/91		
Hungary	23/9/92	10/9/95		
Iceland				
Ireland	13/11/95	22/12/95		
Italy	21/6/85	26/9/89		
Japan	20/2/80	23/12/82		
Korea	21/6/91	21/2/92		
Luxembourg	14/6/95	31/7/96		
Mexico				
Netherlands	20/9/77	7/11/81		
New Zealand				
Norway	24/5/77	30/10/79		
Portugal	9/5/95	not in force		
Spain	15/11/79	6/5/82		

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Sweden	5/6/75	18/2/77		
Switzerland	2/9/91	25/9/92		
Turkey	3/11/93	1/4/97		
United Kingdom	16/12/76	25/2/78		
United States	8/10/74	22/7/76		

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PORTUGAL

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia				
Austria	29/12/70	27/2/72		
Belgium	16/7/69	19/2/71	6/3/95	not in force
Canada	14/6/99	not in force		
Czech Republic	24/5/94	1/10/97		
Denmark				
Finland	27/4/70	14/7/71		
France	14/1/71	18/11/72		
Germany	15/7/80	8/10/82		
Greece				
Hungary	16/5/95	not in force		
Iceland				
Ireland	1/6/93	11/7/94		
Italy	14/5/80	15/1/83		
Japan				
Korea	26/1/96	not in force		
Luxembourg	25/5/99	not in force		
Mexico				
Netherlands	20/9/99	not in force		
New Zealand				
Norway	24/6/70	1/10/71		
Poland	9/5/95	not in force		
Spain	26/10/93	29/6/95		

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Sweden				
Switzerland	26/9/74	17/12/75		
Turkey				
United Kingdom	27/3/68	17/1/69		
United States	6/9/94	18/12/95		

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SPAIN

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	24/3/92	10/12/92		
Austria	20/12/66	1/1/68	24/2/94	1/11/95
Belgium	24/9/70 14/6/95	8/10/72 not in force		
Canada	23/11/76	26/12/80		
Czech Republic	8/5/80	5/6/81		
Denmark	3/7/72	21/6/73		
Finland	15/11/67	30/10/68	24/8/70 22/2/73 27/4/90	11/2/74 24/4/74 27/12/91
France	10/10/95	1/7/97		
Germany	5/12/66	14/3/68		
Greece				
Hungary	9/7/84	20/5/87		
Iceland				
Ireland	10/2/94	21/11/94		
Italy	8/9/77	14/11/80		
Japan	13/2/74	20/11/74		
Korea	17/1/94	21/11/94		
Luxembourg	3/6/86	19/5/87		
Mexico	24/7/92	6/10/94		
Netherlands	16/6/71	20/9/72		
New Zealand				
Norway	25/4/63 8/10/99	24/5/64 not in force		

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Poland	15/11/79	6/5/82		
Portugal	26/10/93	29/6/95		
Sweden	16/6/76	21/12/76		
Switzerland	26/4/66	2/2/67		
Turkey				
United Kingdom	21/10/75	26/10/76	17/6/94	26/5/95
United States	22/2/90	21/11/90		

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SWEDEN

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments:	
			date of signature	date of entry into force
Australia	14/1/81	4/9/81		
Austria	14/5/59	29/12/59	6/4/70 5/11/91	5/11/70 1/5/93
Belgium	5/2/91	24/2/93		
Canada	14/10/83 27/8/96	30/10/84 23/12/97		
Czech Republic	16/2/79	8/10/80		
Denmark	23/9/96	11/5/97	6/10/97	31/12/97
Finland	23/9/96	11/5/97	6/10/97	31/12/97
France	27/11/90	1/4/92		
Germany	14/7/92	13/10/94		
Greece	6/10/61	20/8/63		
Hungary	12/10/81	15/8/82		
Iceland	23/9/96	11/5/97	6/10/97	31/12/97
Ireland	8/10/86	5/4/88	1/7/93	20/1/94
Italy	6/3/80	5/7/83		
Japan	21/1/83	18/9/83		
Korea	27/5/81	9/9/82		
Luxembourg	14/10/96	13/2/98		
Mexico	21/9/92	18/12/92		
Netherlands	18/6/91	12/8/92		
New Zealand	21/2/79	14/11/80		

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Norway	23/9/96	11/5/97	6/10/97	31/12/97
Poland	5/6/75	18/2/77		
Portugal				
Spain	16/6/76	21/12/76		
Switzerland	7/5/65	6/6/66	10/3/92	8/7/93
Turkey	21/1/88	18/11/90		
United Kingdom	30/8/83	26/3/84		
United States	1/9/94	26/10/95		

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SWITZERLAND

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	28/2/80	13/2/81		
Austria	30/1/74	4/12/74	18/1/94	1/5/95
Belgium	28/8/78	26/9/80		
Canada	20/8/76 5/5/97	19/8/77 21/4/98		
Czech Republic	4/12/95	23/10/96		
Denmark	23/11/73	15/10/74	11/3/97	30/12/97
Finland	16/12/91	26/12/93		
France	9/9/66	26/7/67	3/12/69 22/7/97	24/9/70 1/8/98
Germany	11/8/71	29/12/72	30/11/78 17/10/89 21/12/92	5/9/80 30/11/90 29/12/93
Greece	16/6/83	21/2/85		
Hungary	9/4/81	27/6/82		
Iceland	3/6/88	20/6/89		
Ireland	8/11/66	16/2/68	24/10/80	25/4/84
Italy	9/3/76	27/3/79	28/4/78	27/3/79
Japan	19/1/71	26/12/71		
Korea	12/2/80	22/4/81		
Luxembourg	21/1/93	19/2/94		
Mexico	3/8/93	8/9/94		
Netherlands	12/11/51	9/1/52	22/6/66	22/12/66
New Zealand	6/6/80	21/11/81		

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Norway	7/9/87	2/5/89		
Poland	2/9/91	25/9/92		
Portugal	26/9/74	17/12/75		
Spain	26/4/66	2/2/67		
Sweden	7/5/65	6/6/66	10/3/92	8/7/93
Turkey				
United Kingdom	8/12/77	7/10/78	5/3/81 17/12/93	10/5/82 19/12/94
United States	2/10/96	19/12/97		

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TURKEY

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia				
Austria	3/11/70	24/9/73		
Belgium	2/6/87	8/10/91		
Canada				
Czech Republic				
Denmark	30/5/91	23/6/93		
Finland	9/5/86	30/12/88		
France	18/2/87	1/7/89		
Germany	16/4/85	30/12/89		
Greece				
Hungary	10/3/93	9/11/95		
Iceland				
Ireland				
Italy	27/7/90	1/12/93		
Japan	8/3/93	28/12/94		
Korea	24/12/83	25/3/86		
Luxembourg				
Mexico				
Netherlands	27/3/86	30/9/88		
New Zealand				
Norway	16/12/71	30/1/76		
Poland	3/11/93	1/4/97		
Portugal				

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Spain				
Sweden	21/1/88	18/11/90		
Switzerland				
United Kingdom	19/2/86	26/10/88		
United States	28/3/96	19/12/97		

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UNITED KINGDOM

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	7/12/67	8/5/68	29/1/80	21/5/80
Austria	30/4/69	13/11/70	17/11/77 18/5/93	30/12/78 1/12/94
Belgium	1/6/87	21/10/89		
Canada	8/9/78	17/12/80	15//4/80 16/10/85	18/12/80 23/12/85
Czech Republic	5/11/90	20/12/91		
Denmark	11/11/80	17/12/80	1/7/91 15/10/96	19/12/91 20/6/97
Finland	17/7/69	5/2/70	17/5/73 16/11/79 1/10/85 26/9/91 31/7/96	27/6/74 25/4/81 20/2/87 23/12/91 8/8/97
France	22/5/68	27/10/69	10/2/71 14/5/73 12/6/86 15/10/87	7/5/71 2/8/73 7/4/87 23/12/87
Germany	26/11/64	30/1/67	23/3/70	31/5/71
Greece	25/6/53	15/1/54		
Hungary	28/11/77	27/8/78		
Iceland	30/9/91	19/12/91		
Ireland	2/6/76	23/12/76	28/10/76 7/11/94 4/11/98	23/12/76 21/9/95 23/12/98
Italy	21/10/88	31/12/90		
Japan	10/2/69	25/12/70	14/2/80	31/10/80
Korea	25/10/96	30/12/96		

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Luxembourg	24/5/67	3/7/68	18/7/78 28/1/83	21/5/80 19/3/84
Mexico	2/6/94	15/12/94		
Netherlands	7/11/80	6/4/81	12/7/83 24/8/89	20/12/90 20/12/90
New Zealand	4/8/83	16/3/84		
Norway	3/10/85	19/12/85		
Poland	16/12/76	25/2/78		
Portugal	27/3/68	17/1/69		
Spain	21/10/75	26/10/76	17/6/94	26/5/95
Sweden	30/8/83	26/3/84		
Switzerland	8/12/77	7/10/78	5/3/81 17/12/93	10/5/82 19/12/94
Turkey	19/2/86	26/10/88		
United States	31/12/75	25/4/80	26/8/76 31/3/77 15/3/79	25/4/80 25/4/80 25/4/80

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UNITED STATES

Other Contracting State	Date of signature	Date of entry into force	Subsequent Amendments: date of signature	Subsequent Amendments: date of entry into force
Australia	6/8/82	31/10/83		
Austria	31/5/96	1/12/98		
Belgium	9/7/70	13/10/72	31/12/87	3/8/89
Canada	26/9/80	16/8/84	14/6/83 28/3/84 17/3/95 29/7/97	16/8/84 16/8/84 9/11/95 16/12/97
Czech Republic	16/9/93	23/12/93		
Denmark	6/5/48 19/8/99	1/12/48 not in force	23/8/83	not in force
Finland	21/9/89	30/12/90		
France	31/8/94	30/12/95		
Germany	29/8/89	21/8/91		
Greece	20/2/50	30/12/53		
Hungary	12/2/79	12/9/79		
Iceland	7/5/75	26/12/75		
Ireland	13/9/49 28/7/97	20/12/51 not in force		
Italy	17/4/84 25/8/99	30/12/85 not in force		
Japan	8/3/71	9/7/72		
Korea	4/6/76	20/10/79		
Luxembourg	18/12/62 3/4/96	22/12/64 not in force		

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Mexico	18/9/92	28/12/93	8/9/94	26/10/95
Netherlands	18/12/92	31/12/93	13/10/93	30/12/93
New Zealand	23/7/82	2/11/83		
Norway	3/12/71	29/11/72	19/9/80	15/12/81
Poland	8/10/74	22/7/76		
Portugal	6/9/94	18/12/95		
Spain	22/2/90	21/11/90		
Sweden	1/9/94	26/10/95		
Switzerland	2/10/96	19/12/97		
Turkey	28/3/96	19/12/97		
United Kingdom	31/12/75	25/4/80	26/8/76 31/3/77 15/3/79	25/4/80 25/4/80 25/4/80

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NETWORK OF TAX CONVENTIONS BETWEEN OECD MEMBER COUNTRIES AS OF 1ST JANUARY 2000

COUNTRY	Finland	France	Germany	Norway	United Kingdom	United States	Belgium	Italy	Sweden	Switzerland	Denmark	Netherlands	Austria	Canada	Japan	Korea	Czech Republic	Hungary	Ireland	Poland	Spain	Australia	Luxembourg	Greece	New Zealand	Turkey	Mexico	Portugal	Iceland
Finland	x																												
France		x																											
Germany			x																										
Norway				x																	N								
United Kingdom					x																								
United States						x		N			N								N				N						
Belgium							x										N				N								
Italy						N		x			N																		
Sweden									x																				
Switzerland										x																			
Denmark						N		N			x	N															S		
Netherlands											N	x																S	S
Austria													x																
Canada														x									N				S		
Japan															x														
Korea																x								S			S		
Czech Republic							N										x												
Hungary																		x									S		
Ireland						N													x										
Poland																				x							S		
Spain				N			N														x								
Australia																						x							
Luxembourg						N								N									x					S	S
Greece																S								x					
New Zealand																									x				
Turkey																										x			
Mexico											S																x		
Portugal												S		S		S		S		S			S					x	
Iceland												S											S						x
Number of conventions in force	28	28	28	28	28	28	27	27	27	27	26	26	25	25	25	25	24	24	24	24	24	22	22	17	17	16	15	13	10

Convention in force

N New Convention signed (old Convention still in force)

S Convention signed but not in force (no previous Convention)

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APPENDIX II

RECOMMENDATION OF THE OECD COUNCIL CONCERNING THE MODEL TAX CONVENTION ON INCOME AND ON CAPITAL

(Adopted by the Council on 23 October 1997)

THE COUNCIL,

Having regard to Article 5(b) of the Convention on the Organisation for Economic Co-operation and Development of the 14 December 1960;

Having regard to the Recommendation of the Council dated 31 March 1994 concerning the Model Tax Convention on Income and Capital [C(94)11/FINAL] and the Recommendation of the Council dated 21 September 1995 amending the Appendix to that previous Recommendation [C(95)132/FINAL];

Having regard to the Report of the Committee on Fiscal Affairs of 24 June 1997 entitled "The 1997 Update to the Model Tax Convention" [DAFFE/CFA/WP1(97)10/REV2] (hereinafter referred to as "the 1997 Report");

Considering the need to remove the obstacles that international juridical double taxation presents to the free movement of goods, services, capital, and persons between countries by the conclusion of conventions for that purpose;

Considering also the need to harmonise existing bilateral conventions on the basis of uniform principles, definitions, rules, and methods and to extend the existing network of such conventions to all Member countries and where appropriate to non-member countries;

Considering further the need to encourage the common application and interpretation of the provisions of tax conventions that are based on those of the Model Tax Convention on Income and on Capital (hereinafter referred to as the "Model Tax Convention");

Considering that efforts made in this direction by Member countries have already produced substantial results and that the proposed revisions to the Model

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Tax Convention will make it possible to confirm and extend existing international co-operation on tax matters;

Taking note of the Model Tax Convention and the Commentaries thereon (as last modified by the 1997 Report), which may be amended from time to time hereafter;

I. RECOMMENDS the Governments of Member countries :

1. to pursue their efforts to conclude bilateral tax conventions on income and on capital with those Member countries, and where appropriate with non-member countries, with which they have not yet entered into such conventions, and to revise those of the existing conventions that may no longer reflect present-day needs;

2. when concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention, as interpreted by the Commentaries thereon;

3. that their tax administrations follow the Commentaries on the Articles of the Model Tax Convention, as modified from time to time, when applying and interpreting the provisions of their bilateral tax conventions that are based on these Articles.

II. INVITES the Governments of Member countries to continue to notify the Committee on Fiscal Affairs of their reservations on the Articles and observations on the Commentaries.

III. INSTRUCTS the Committee on Fiscal Affairs to continue its ongoing review of situations where the provisions set out in the Model Tax Convention or the Commentaries thereon may require modification in the light of experience gained by Member countries, and to make appropriate proposals for periodic updates.

IV. DECIDES to repeal the Recommendations of the Council C(94)11/FINAL (31 March 1994) and C(95)132/FINAL (21 September 1995).

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