Model Tax Convention on Income and on Capital

CONDENSED VERSION

(as it read on 21 November 2017)



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CONDENSED VERSION

21 NOVEMBER 2017

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FOREWORD

This is the tenth edition of the condensed version of the publication entitled *Model Tax Convention on Income and on Capital*, first published in 1992 and periodically updated since then.

This condensed version includes the text of the Model Tax Convention as it read on 21 November 2017 after the adoption of the tenth update by the Council of the OECD. Historical notes included in Volume I of the full version and the background reports that are included in Volume II of the full version have not been reproduced in this version.

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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 recognised among the member countries of the Organisation for Economic Co-operation and Development that it is desirable to clarify, standardise, 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. These countries have also long recognised the need to improve administrative co-operation in tax matters, notably through exchange of information and assistance in collection of taxes, for the purpose of preventing tax evasion and avoidance.

3. These are the main purposes 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 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

1 See Annex.

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*.[1] 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 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.[2]

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

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

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

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.[1]

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.

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.

11.2 Since the publication of the first ambulatory version in 1992, the Model Convention was updated 10 times (in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and 2017). The last such update, which was adopted in 2017, included a large number of changes resulting from the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, from the final reports on Actions 2, 6, 7 and 14[2] produced as part of that project.

1 A number of these reports were published and appear in Volume II of the full version of the OECD Model Tax Convention.

2 OECD (2015), *Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241138-en; OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241695-en; OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241220-en; OECD (2015), *Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241633-en.

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 but also by the fact that, in 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 original drafting and the subsequent revision of the *United Nations Model Double Taxation Convention between Developed and Developing Countries*,[1] 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.

C. Tax policy considerations that are relevant to the decision of whether to enter into a tax treaty or amend an existing treaty

15.1 In 1997, the OECD Council adopted a recommendation that the Governments of member countries pursue their efforts to conclude bilateral tax treaties with those

1 *United Nations Model Double Taxation Convention between Developed and Developing Countries*, United Nations Publications, New York, first edition 1980, third edition 2011.

member countries, and where appropriate with non-member countries, with which they had not yet entered into such conventions. Whilst the question of whether or not to enter into a tax treaty with another country is for each State to decide on the basis of different factors, which include both tax and non-tax considerations, tax policy considerations will generally play a key role in that decision. The following paragraphs describe some of these tax policy considerations, which are relevant not only to the question of whether a treaty should be concluded with a State but also to the question of whether a State should seek to modify or replace an existing treaty or even, as a last resort, terminate a treaty (taking into account the fact that termination of a treaty often has a negative impact on large number of taxpayers who are not concerned by the situations that result in the termination of the treaty).

15.2 Since a main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border services, trade and investment, the existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern. Such risks of double taxation will generally be more important where there is a significant level of existing or projected cross-border trade and investment between two States. Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between the two States and it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy.

15.3 Accordingly, two States that consider entering into a tax treaty should evaluate the extent to which the risk of double taxation actually exists in cross-border situations involving their residents. A large number of cases of residence-source juridical double taxation can be eliminated through domestic provisions for the relief of double taxation (ordinarily in the form of either the exemption or credit method) which operate without the need for tax treaties. Whilst these domestic provisions will likely address most forms of residence-source juridical double taxation, they will not cover all cases of double taxation, especially if there are significant differences in the source rules of the two States or if the domestic law of these States does not allow for unilateral relief of economic double taxation (e.g. in the case of a transfer pricing adjustment made in another State).

15.4 Another tax policy consideration that is relevant to the conclusion of a tax treaty is the risk of excessive taxation that may result from high withholding taxes in the source State. Whilst mechanisms for the relief of double taxation will normally ensure that such high withholding taxes do not result in double taxation, to the extent that such taxes levied in the State of source exceed the amount of tax normally levied on

profits in the State of residence, they may have a detrimental effect on cross-border trade and investment.

15.5 Further tax considerations that should be taken into account when considering entering into a tax treaty include the various features of tax treaties that encourage and foster economic ties between countries, such as the protection from discriminatory tax treatment of foreign investment that is offered by the non-discrimination rules of Article 24, the greater certainty of tax treatment for taxpayers who are entitled to benefit from the treaty and the fact that tax treaties provide, through the mutual agreement procedure, together with the possibility for Contracting States of moving to arbitration, a mechanism for the resolution of cross-border tax disputes.

15.6 An important objective of tax treaties being the prevention of tax avoidance and evasion, States should also consider whether their prospective treaty partners are willing and able to implement effectively the provisions of tax treaties concerning administrative assistance, such as the ability to exchange tax information, this being a key aspect that should be taken into account when deciding whether or not to enter into a tax treaty. The ability and willingness of a State to provide assistance in the collection of taxes would also be a relevant factor to take into account. It should be noted, however, that in the absence of any actual risk of double taxation, these administrative provisions would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[1]

D. 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 avoidance as well as non-discrimination, it was decided, in 1992, to use a shorter title which did not include this reference. This change was made both on the cover page of this publication and in the Model Convention itself. However, it was understood that the practice of many member countries was 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 since both approaches emphasised these important purposes of the Convention.

1 Available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

16.1 As a result of work undertaken as part of the OECD/G20 Base Erosion and Profit Shifting Project, in 2014 the Committee decided to amend the title of the Convention and to include a preamble. The changes made expressly recognise that the purposes of the Convention are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of the Convention to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Given the particular base erosion and profit shifting concerns arising from treaty-shopping arrangements, it was also decided to refer expressly to such arrangements as one example of tax avoidance that should not result from tax treaties, it being understood that this was only one example of tax avoidance that the Contracting States intend to prevent.

16.2 Since the title and preamble form part of the context of the Convention[1] and constitute a general statement of the object and purpose of the Convention, they should play an important role in the interpretation of the provisions of the Convention. According to the general rule of treaty interpretation contained in Article 31(1) of the *Vienna Convention on the Law of Treaties*, "[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."

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.

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

1 See Art. 31(2) of the *Vienna Convention on the Law of Treaties*.

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) as well as gains from the alienation of shares deriving more than 50 per cent of their value from such property (paragraph 4 of Article 13);

— 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 and 22); an exception is made, however, if the permanent establishment is maintained for the purposes of international shipping and international air transport (see paragraph 23 below);

— income from the activities of entertainers and sportspersons 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;

— 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 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, during a 365-day period, 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 5 of Article 13, subject to the exception of paragraph 4 of Article 13), remuneration in respect of an employment exercised aboard a ship or aircraft operated in international traffic (paragraph 3 of Article 15), private sector pensions (Article 18), payments received by a student for the purposes of his education or training (Article 20), and capital represented by shares or securities (paragraph 4 of Article 22). Similarly, profits from the operation of ships or aircraft in international traffic, gains from the alienation of such ships or aircraft, and capital represented by them, are taxable only in the State of residence (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 also 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.

25.1 It follows from the preceding explanations that, throughout the Convention, the words "may be taxed in" a Contracting State mean that that State is granted the right to tax the income to which the relevant provision applies and that these words do not

affect the right to tax of the other Contracting State, except through the application of Article 23 A or 23 B when that other State is the State of residence.

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);
- the assistance by Contracting States in the collection of each other's taxes (Article 27);
- the tax treatment of members of diplomatic missions and consular posts in accordance with international law (Article 28);
- the entitlement to the benefits of the Convention (Article 29);
- the territorial extension of the Convention (Article 30).

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 and the choice of method for eliminating double taxation. 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.

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 worldwide 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. Since the observations are related to the interpretations of the Articles given in the Commentaries, no observation is needed to indicate a country's wish to modify the wording of an alternative or additional provision that the Commentaries allow countries to include in their bilateral conventions.

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 or to modify the wording of a provision of the Model to confirm or incorporate an interpretation of that provision put forward in the Commentary. 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.

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 (see, for instance, paragraph 4 of the Commentary on Article 5). 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.

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 recognised, 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,[1] 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. Another relevant multilateral convention is the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, which was drafted in order to facilitate the implementation of the treaty-related measures resulting from the OECD/G20 Base Erosion and Profit Shifting Project and which was opened for signature on 31 December 2016.

40. Despite these multilateral conventions, there are no reasons to believe that the conclusion of a multilateral tax convention involving a large number of countries that could replace the network of current bilateral tax conventions 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.

Tax avoidance and evasion; improper use of conventions

41. Issues related to the improper use of tax conventions and international tax avoidance and evasion have been a constant preoccupation of the Committee on Fiscal Affairs since the publication of the 1963 Draft Convention. Over the years, a number of provisions (such as Article 29, which was added in 2017) have been added to the Model Convention, or have been modified, in order to address various forms of tax avoidance and evasion. The Committee on Fiscal Affairs will continue to monitor the application of tax treaties in order to ensure that, as stated in the preamble of the Convention, the provisions of the Convention are not used for the purposes of tax avoidance or evasion.

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

MODEL CONVENTION
WITH RESPECT TO TAXES
ON INCOME AND ON CAPITAL

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TITLE OF THE CONVENTION

Convention between (State A) and (State B)
for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance

PREAMBLE TO THE CONVENTION

(State A) and (State B),

Desiring to further develop their economic relationship and to enhance their co-operation in tax matters,

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States),

Have agreed as follows:

Chapter I

SCOPE OF THE CONVENTION

ARTICLE 1

PERSONS COVERED

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

2. For the purposes of this Convention, income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State but only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

3. This Convention shall not affect the taxation, by a Contracting State, of its residents except with respect to the benefits granted under paragraph 3 of Article 7, paragraph 2 of Article 9 and Articles 19, 20, 23 [A] [B], 24, 25 and 28.

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.

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 except when the ship or aircraft is operated solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State;

f) the term "competent authority" means:

(i) (in State A): .....

(ii) (in State B): .....

g) the term "national", in relation to a Contracting State, means:

(i) any individual possessing the nationality or citizenship of that Contracting State; and

(ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State;

h) the term "business" includes the performance of professional services and of other activities of an independent character.

i) the term "recognised pension fund" of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:

(i) that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or

(ii) that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (i).

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 or the competent authorities agree to a different meaning pursuant to the provisions of Article 25, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

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 as well as a recognised pension fund of that State. 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, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

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;

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *a)* to *e)*,

provided that such activity or, in the case of subparagraph *f)*, the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State

and

a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 6, where a person is acting in a Contracting State on behalf of an enterprise and, in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are

a) in the name of the enterprise, or

b) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or

c) for the provision of services by that 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 (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.

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.

8. For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one

possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.

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 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.

ARTICLE 7
BUSINESS PROFITS

1. 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 that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

2. For the purposes of this Article and Article [23 A] [23 B], the profits that are attributable in each Contracting State to the permanent establishment referred to in paragraph 1 are the profits it might be expected to make, in particular in its dealings with other parts of the enterprise, if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise.

3. Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, the competent authorities of the Contracting States shall if necessary consult each other.

4. 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.

ARTICLE 8

INTERNATIONAL SHIPPING AND AIR TRANSPORT

1. 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.

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

ARTICLE 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 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, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State 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 which holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);

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 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.

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, interest arising in a Contracting State may also be taxed in that State 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.

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.

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.

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 that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or of movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

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

[ARTICLE 14 - INDEPENDENT PERSONAL SERVICES]

[DELETED]

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 by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, shall be taxable only in the first-mentioned State.

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.

ARTICLE 17
ENTERTAINERS AND SPORTSPERSONS

1. Notwithstanding the provisions of Article 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 sportsperson, from that resident's 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 sportsperson acting as such accrues not to the entertainer or sportsperson but to another person, that income may, notwithstanding the provisions of Article 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

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.

ARTICLE 19
GOVERNMENT SERVICE

1. *a)* Salaries, wages and other similar remuneration 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)* Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

   b) However, such pensions and other similar remuneration 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, pensions, and other similar remuneration 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.

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.

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.

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 of an enterprise of a Contracting State that operates ships or aircraft in international traffic represented by such ships or aircraft, and by movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.

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

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 may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that 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 may be taxed in the other Contracting State in accordance with the provisions of Articles 10 and 11 (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that 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.

ARTICLE 23 B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that 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.

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.

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.

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 either Contracting State. 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.

5. Where,

a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities,

any unresolved issues arising from the case shall be submitted to arbitration if the person so requests in writing. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

ARTICLE 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement 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.

2. Any information received under paragraph 1 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, the determination of appeals in relation to the taxes referred to in paragraph 1, or the oversight of the above. 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. Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorises such use.

3. In no case shall the provisions of paragraphs 1 and 2 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*).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

ARTICLE 27

ASSISTANCE IN THE COLLECTION OF TAXES[1]

1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

2. The term "revenue claim" as used in this Article means an amount owed in respect of 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 this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.

1 In some countries, national law, policy or administrative considerations may not allow or justify the type of assistance envisaged under this Article or may require that this type of assistance be restricted, e.g. to countries that have similar tax systems or tax administrations or as to the taxes covered. For that reason, the Article should only be included in the Convention where each State concludes that, based on the factors described in paragraph 1 of the Commentary on the Article, they can agree to provide assistance in the collection of taxes levied by the other State.

3. When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.

4. When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the first-mentioned State or is owed by a person who has a right to prevent its collection.

5. Notwithstanding the provisions of paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.

6. Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.

7. Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be

a) in the case of a request under paragraph 3, a revenue claim of the first-mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or

b) in the case of a request under paragraph 4, a revenue claim of the first-mentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection

the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first-mentioned State shall either suspend or withdraw its request.

8. In no case shall the provisions of this Article 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 carry out measures which would be contrary to public policy (*ordre public*);

c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;

d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.

ARTICLE 28

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.

ARTICLE 29

ENTITLEMENT TO BENEFITS[1]

1. [Provision that, subject to paragraphs 3 to 5, restricts treaty benefits to a resident of a Contracting State who is a "qualified person" as defined in paragraph 2].

2. [Definition of situations where a resident is a qualified person, which covers

— an individual;

— a Contracting State, its political subdivisions and their agencies and instrumentalities;

— certain publicly-traded companies and entities;

1 The drafting of this Article will depend on how the Contracting States decide to implement their common intention, reflected in the preamble of the Convention and incorporated in the minimum standard agreed to as part of the OECD/G20 Base Erosion and Profit Shifting Project, to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. This may be done either through the adoption of paragraph 9 only, through the adoption of the detailed version of paragraphs 1 to 7 that is described in the Commentary on Article 29 together with the implementation of an anti-conduit mechanism as described in paragraph 187 of that Commentary, or through the adoption of paragraph 9 together with any variation of paragraphs 1 to 7 described in the Commentary on Article 29.

— certain affiliates of publicly-listed companies and entities;

— certain non-profit organisations and recognised pension funds;

— other entities that meet certain ownership and base erosion requirements;

— certain collective investment vehicles.]

3. [Provision that provides treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income emanates from, or is incidental to, that business].

4. [Provision that provides treaty benefits to a person that is not a qualified person if at least more than an agreed proportion of that entity is owned by certain persons entitled to equivalent benefits].

5. [Provision that provides treaty benefits to a person that qualifies as a "headquarters company"].

6. [Provision that allows the competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied under paragraph 1].

7. [Definitions applicable for the purposes of paragraphs 1 to 7].

8. *a)* Where

(i) an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and

(ii) the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State,

the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.

b) The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).

c) If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a

resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request

9. Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

ARTICLE 30

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 32 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.

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.

Chapter VII

FINAL PROVISIONS

ARTICLE 31

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): .....

ARTICLE 32

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): .....

TERMINAL CLAUSE[1]

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

COMMENTARIES ON THE ARTICLES OF THE MODEL TAX CONVENTION

COMMENTARY ON ARTICLE 1
CONCERNING THE PERSONS COVERED BY THE CONVENTION

Paragraph 1

1. Whereas many conventions concluded in the first part of the 20th century were applicable to "citizens" of the Contracting States, conventions concluded afterwards almost always apply to "residents" of one or both of the Contracting States irrespective of nationality. That approach is reflected in paragraph 1. The term "resident" is defined in Article 4. The fact that a person is a resident of a Contracting State does not mean, however, that the person is automatically entitled to the benefits of the Convention since some or all of these benefits may be denied under various provisions of the Convention, including those of Article 29.

Paragraph 2

2. This paragraph addresses the situation of the income of entities or arrangements that one or both Contracting States treat as wholly or partly fiscally transparent for tax purposes. The provisions of the paragraph ensure that income of such entities or arrangements is treated, for the purposes of the Convention, in accordance with the principles reflected in the 1999 report of the Committee on Fiscal Affairs entitled "The Application of the OECD Model Tax Convention to Partnerships".[1] That report therefore provides guidance and examples on how the provision should be interpreted and applied in various situations.

3. The report, however, dealt exclusively with partnerships and whilst the Committee recognised that many of the principles included in the report could also apply with respect to other non-corporate entities, it expressed the intention to examine the application of the Model Tax Convention to these other entities at a later stage. As indicated in paragraph 37 of the report, the Committee was particularly concerned with "cases where domestic tax laws create intermediary situations where a partnership is partly treated as a taxable unit and partly disregarded for tax purposes." According to the report

> Whilst 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.

4. Paragraph 2 addresses this particular situation by referring to entities that are "wholly or partly" treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(15)-1.

report (subject to the application of specific provisions dealing with collective investment vehicles, see paragraphs 22 to 48 below).

5. The paragraph not only ensures that the benefits of the Convention are granted in appropriate cases but also ensures that these benefits are not granted where neither Contracting State treats, under its domestic law, the income of an entity or arrangement as the income of one of its residents. The paragraph therefore confirms the conclusions of the report in such a case (see, for example, example 3 of the report). Also, as recognised in the report, States should not be expected to grant the benefits of a bilateral tax convention in cases where they cannot verify whether a person is truly entitled to these benefits. Thus, if an entity is established in a jurisdiction from which a Contracting State cannot obtain tax information, that State would need to be provided with all the necessary information in order to be able to grant the benefits of the Convention. In such a case, the Contracting State might well decide to use the refund mechanism for the purposes of applying the benefits of the Convention even though it normally applies these benefits at the time of the payment of the relevant income. In most cases, however, it will be possible to obtain the relevant information and to apply the benefits of the Convention at the time the income is taxed (see for example paragraphs 43 to 45 below which discuss a similar issue in the context of collective investment vehicles).

6. The following example illustrates the application of the paragraph:

Example: State A and State B have concluded a treaty identical to the Model Tax Convention. State A considers that an entity established in State B is a company and taxes that entity on interest that it receives from a debtor resident in State A. Under the domestic law of State B, however, the entity is treated as a partnership and the two members in that entity, who share equally all its income, are each taxed on half of the interest. One of the members is a resident of State B and the other one is a resident of a country with which States A and B do not have a treaty. The paragraph provides that in such case, half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B.

7. The reference to "income derived by or through an entity or arrangement" has a broad meaning and covers any income that is earned by or through an entity or arrangement, regardless of the view taken by each Contracting State as to who derives that income for domestic tax purposes and regardless of whether or not that entity or arrangement has legal personality or constitutes a person as defined in subparagraph *a*) of paragraph 1 of Article 3. It would cover, for example, income of any partnership or trust that one or both of the Contracting States treats as wholly or partly fiscally transparent. Also, as illustrated in example 2 of the report, it does not matter where the entity or arrangement is established: the paragraph applies to an entity established in a third State to the extent that, under the domestic tax law of one of the Contracting States, the entity is treated as wholly or partly fiscally transparent and income of that entity is attributed to a resident of that State.

8. The word "income" must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are

covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.

9. The concept of "fiscally transparent" used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share so that the tax will depend on whether that person is taxable or not, on the other income that the person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result.[1] States wishing to clarify the definition of "fiscally transparent" in their bilateral conventions are free to include a definition of that term based on the above explanations.

10. In the case of an entity or arrangement which is treated as partly fiscally transparent under the domestic law of one of the Contracting States, only part of the income of the entity or arrangement might be taxed at the level of the persons who have an interest in that entity or arrangement as described in the preceding paragraph whilst the rest would remain taxable at the level of the entity or arrangement. This, for example, is how some trusts and limited liability partnerships are treated in some countries (i.e. in some countries, the part of the income derived through a trust that is distributed to beneficiaries is taxed in the hands of these beneficiaries whilst the part of that income that is accumulated is taxed in the hands of the trust or trustees; similarly, in some countries, income derived through a limited partnership is taxed in the hands of the general partner as regards that partner's share of that income but is considered to be the income of the limited partnership as regards the limited partners' share of the income). To the extent that the entity or arrangement qualifies as a resident of a Contracting State, the paragraph will ensure that the benefits of the treaty also apply to the share of the income that is attributed to the entity or arrangement under the domestic law of that State (subject to any anti-abuse provision such as a limitation-on-benefits rule).

11. As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement. Assume, for example, that the document that establishes a trust provides that all dividends received by the trust must be distributed to a beneficiary during the lifetime of that beneficiary but must be

1 See paragraphs 37-40 of the report, "The Application of the OECD Model Tax Convention to partnerships", reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(15)-1.

accumulated afterwards. If one of the Contracting States considers that, in such a case, the beneficiary is taxable on the dividends distributed to that beneficiary but that the trustees are taxable on the dividends that will be accumulated, the paragraph will apply differently to these two categories of dividends even if both types of dividends are received within the same month.

12. By providing that the income to which it applies will be considered to be income of a resident of a Contracting State for the purposes of the Convention, the paragraph ensures that the relevant income is attributed to that resident for the purposes of the application of the various allocative rules of the Convention. Depending on the nature of the income, this will therefore allow the income to be considered, for example, as "income derived by" for the purposes of Articles 6, 13 and 17, "profits of an enterprise" for the purposes of Articles 7, 8 and 9 (see also paragraph 4 of the Commentary on Article 3) or dividends or interest "paid to" for the purposes of Articles 10 and 11. The fact that the income is considered to be derived by a resident of a Contracting State for the purposes of the Convention also means that where the income constitutes a share of the income of an enterprise in which that resident holds a participation, such income shall be considered to be the income of an enterprise carried on by that resident (e.g. for the purposes of the definition of enterprise of a Contracting State in Article 3 and paragraph 2 of Article 21).

13. Whilst the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as income of a resident of a Contracting State, the paragraph does not prejudge the issue of whether the recipient is the beneficial owner of the relevant income. Where, for example, a fiscally transparent partnership receives dividends as an agent or nominee for a person who is not a partner, the fact that the dividend may be considered as income of a resident of a Contracting State under the domestic law of that State will not preclude the State of source from considering that neither the partnership nor the partners are the beneficial owners of the dividend.

14. The paragraph only applies for the purposes of the Convention and does not, therefore, require a Contracting State to change the way in which it attributes income or characterises entities for the purposes of its domestic law. In the example in paragraph 6 above, whilst paragraph 2 provides that half of the interest shall be considered, for the purposes of Article 11, to be income of a resident of State B, this will only affect the maximum amount of tax that State A will be able to collect on the interest and will not change the fact that State A's tax will be payable by the entity. Thus, assuming that the domestic law of State A provides for a 30 per cent withholding tax on the interest, the effect of paragraph 2 will simply be to reduce the amount of tax that State A will collect on the interest (so that half of the interest would be taxed at 30 per cent and half at 10 per cent under the treaty between States A and B) and will not change the fact that the entity is the relevant taxpayer for the purposes of State A's domestic law. Also, the provision does not deal exhaustively with all treaty issues that may arise from the legal nature of certain entities and arrangements and may therefore need to be supplemented by other provisions to address such issues (such as

a provision confirming that a trust may qualify as a resident of a Contracting State despite the fact that, under the trust law of many countries, a trust does not constitute a "person").

15. As confirmed by paragraph 3, paragraph 2 does not restrict in any way a State's right to tax its own residents. This conclusion is consistent with the way in which tax treaties have been interpreted with respect to partnerships (see paragraph 6.1 of this Commentary as it read after 2000 and before the inclusion of paragraph 3 in 2017).

16. Paragraphs 2 and 3 do not, however, restrict the Contracting States' obligation to provide relief of double taxation under Articles 23 A and 23 B where income of a resident of that State may be taxed by the other State in accordance with the Convention. There may be cases, however, where the same income is taxed by each Contracting State as income of one of its residents and where relief of double taxation will be necessary with respect to tax paid by a different person. Where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income, relief of double taxation will need to take into account the tax that is paid by different taxpayers in the two States. In such a case, however, it will be important to determine, under Articles 23 A and 23 B, to what extent the income of a resident of one Contracting State "may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State [...])". In general, this requirement will result in one State having to provide relief of double taxation only to the extent that the provisions of the Convention authorise the other State to tax the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable (see paragraphs 11.1 and 11.2 of the Commentary on Articles 23 A and 23 B).

Paragraph 3

17. Whilst some provisions of the Convention (e.g. Articles 23 A and 23 B) are clearly intended to affect how a Contracting State taxes its own residents, the object of the majority of the provisions of the Convention is to restrict the right of a Contracting State to tax the residents of the other Contracting State. In some limited cases, however, it has been argued that some provisions could be interpreted as limiting a Contracting State's right to tax its own residents in cases where this was not intended (see, for example, paragraph 81 below, which addresses the case of controlled foreign company provisions).

18. Paragraph 3 confirms the general principle that the Convention does not restrict a Contracting State's right to tax its own residents except where this is intended and lists the provisions with respect to which that principle is not applicable.

19. The exceptions so listed are intended to cover all cases where it is envisaged in the Convention that a Contracting State may have to provide treaty benefits to its own

residents (whether or not these or similar benefits are provided under the domestic law of that State). These provisions are:

— Paragraph 3 of Article 7, which requires a Contracting State to grant to an enterprise of that State a correlative adjustment following an initial adjustment made by the other Contracting State, in accordance with paragraph 2 of Article 7, to the amount of tax charged on the profits of a permanent establishment of the enterprise.

— Paragraph 2 of Article 9, which requires a Contracting State to grant to an enterprise of that State a corresponding adjustment following an initial adjustment made by the other Contracting State, in accordance with paragraph 1 of Article 9, to the amount of tax charged on the profits of an associated enterprise.

— Article 19, which may affect how a Contracting State taxes an individual who is resident of that State if that individual derives income in respect of services rendered to the other Contracting State or a political subdivision or local authority thereof.

— Article 20, which may affect how a Contracting State taxes an individual who is resident of that State if that individual is also a student who meets the conditions of that Article.

— Articles 23 A and 23 B, which require a Contracting State to provide relief of double taxation to its residents with respect to the income that the other State may tax in accordance with the Convention (including profits that are attributable to a permanent establishment situated in the other Contracting State in accordance with paragraph 2 of Article 7).

— Article 24, which protects residents of a Contracting State against certain discriminatory taxation practices by that State (such as rules that discriminate between two persons based on their nationality).

— Article 25, which allows residents of a Contracting State to request that the competent authority of that State consider cases of taxation not in accordance with the Convention.

— Article 28, which may affect how a Contracting State taxes an individual who is resident of that State when that individual is a member of the diplomatic mission or consular post of the other Contracting State.

20. The list of exceptions included in paragraph 3 should include any other provision that the Contracting States may agree to include in their bilateral convention where it is intended that this provision should affect the taxation, by a Contracting State, of its own residents. For instance, if the Contracting States agree, in accordance with paragraph 27 of the Commentary on Article 18, to include in their bilateral convention a provision according to which pensions and other payments made under the social security legislation of a Contracting State shall be taxable only in that State, they should include a reference to that provision in the list of exceptions included in paragraph 3. Other examples include the alternative provisions in paragraphs 23, 30,

37, 38 and 68 of the Commentary on Article 18 because these provisions provide benefits that are typically intended to be granted to an individual who participated in a foreign pension scheme before becoming a resident of a Contracting State.

21. The term "resident", as used in paragraph 3 and throughout the Convention, is defined in Article 4. Where, under paragraph 1 of Article 4, a person is considered to be a resident of both Contracting States based on the domestic laws of these States, paragraphs 2 and 3 of that Article make it generally possible to determine a single State of residence for the purposes of the Convention. Thus, paragraph 3 does not apply to an individual or legal person who is a resident of one of the Contracting States under the laws of that State but who, for the purposes of the Convention, is deemed to be a resident only of the other Contracting State.

Cross-border issues relating to collective investment vehicles

22. Most countries have dealt with the domestic tax issues arising from groups of small investors who pool their funds in collective investment vehicles (CIVs). In general, the goal of such systems is to provide for neutrality between direct investments and investments through a CIV. Whilst those systems generally succeed when the investors, the CIV and the investment are all located in the same country, complications frequently arise when one or more of those parties or the investments are located in different countries. These complications are discussed in the report by the Committee on Fiscal Affairs entitled "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles",[1] the main conclusions of which have been incorporated below. For purposes of the Report and for this discussion, the term "CIV" is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.

Application of the Convention to CIVs

23. The primary question that arises in the cross-border context is whether a CIV should qualify for the benefits of the Convention in its own right. In order to do so under treaties that, like the Convention, do not include a specific provision dealing with CIVs, a CIV would have to qualify as a "person" that is a "resident" of a Contracting State and, as regards the application of Articles 10 and 11, that is the "beneficial owner" of the income that it receives.

24. The determination of whether a CIV should be treated as a "person" begins with the legal form of the CIV, which differs substantially from country to country and between the various types of vehicles. In many countries, most CIVs take the form of a company. In others, the CIV typically would be a trust. In still others, many CIVs are simple contractual arrangements or a form of joint ownership. In most cases, the CIV

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(24)-1.

would be treated as a taxpayer or a "person" for purposes of the tax law of the State in which it is established; for example, in some countries where the CIV is commonly established in the form of a trust, either the trust itself, or the trustees acting collectively in their capacity as such, is treated as a taxpayer or a person for domestic tax law purposes. In view of the wide meaning to be given to the term "person", the fact that the tax law of the country where such a CIV is established would treat it as a taxpayer would be indicative that the CIV is a "person" for treaty purposes. Contracting States wishing to expressly clarify that, in these circumstances, such CIVs are persons for the purposes of their conventions may agree bilaterally to modify the definition of "person" to include them.

25. Whether a CIV is a "resident" of a Contracting State depends not on its legal form (as long as it qualifies as a person) but on its tax treatment in the State in which it is established. Although a consistent goal of domestic CIV regimes is to ensure that there is only one level of tax, at either the CIV or the investor level, there are a number of different ways in which States achieve that goal. In some States, the holders of interests in the CIV are liable to tax on the income received by the CIV, rather than the CIV itself being liable to tax on such income. Such a fiscally transparent CIV would not be treated as a resident of the Contracting State in which it is established because it is not liable to tax therein.

26. By contrast, in other States, a CIV is in principle liable to tax but its income may be fully exempt, for instance, if the CIV fulfils certain criteria with regard to its purpose, activities or operation, which may include requirements as to minimum distributions, its sources of income and sometimes its sectors of operation. More frequently, CIVs are subject to tax but the base for taxation is reduced, in a variety of different ways, by reference to distributions paid to investors. Deductions for distributions will usually mean that no tax is in fact paid. Other States tax CIVs but at a special low tax rate. Finally, some States tax CIVs fully but with integration at the investor level to avoid double taxation of the income of the CIV. For those countries that adopt the view, reflected in paragraph 8.11 of the Commentary on Article 4, that a person may be liable to tax even if the State in which it is established does not impose tax, the CIV would be treated as a resident of the State in which it is established in all of these cases because the CIV is subject to comprehensive taxation in that State. Even in the case where the income of the CIV is taxed at a zero rate, or is exempt from tax, the requirements to be treated as a resident may be met if the requirements to qualify for such lower rate or exemption are sufficiently stringent.

27. Those countries that adopt the alternative view, reflected in paragraph 8.12 of the Commentary on Article 4, that an entity that is exempt from tax therefore is not liable to tax may not view some or all of the CIVs described in the preceding paragraph as residents of the States in which they are established. States taking the latter view, and those States negotiating with such States, are encouraged to address the issue in their bilateral negotiations.

28 Some countries have questioned whether a CIV, even if it is a "person" and a "resident", can qualify as the beneficial owner of the income it receives. Because a

"CIV" as defined in paragraph 22 above must be widely-held, hold a diversified portfolio of securities and be subject to investor-protection regulation in the country in which it is established, such a CIV, or its managers, often perform significant functions with respect to the investment and management of the assets of the CIV. Moreover, the position of an investor in a CIV differs substantially, as a legal and economic matter, from the position of an investor who owns the underlying assets, so that it would not be appropriate to treat the investor in such a CIV as the beneficial owner of the income received by the CIV. Accordingly, a vehicle that meets the definition of a widely-held CIV will also be treated as the beneficial owner of the dividends and interest that it receives, so long as the managers of the CIV have discretionary powers to manage the assets generating such income (unless an individual who is a resident of that State who would have received the income in the same circumstances would not have been considered to be the beneficial owner thereof).

29. Because these principles are necessarily general, their application to a particular type of CIV might not be clear to the CIV, investors and intermediaries. Any uncertainty regarding treaty eligibility is especially problematic for a CIV, which must take into account amounts expected to be received, including any withholding tax benefits provided by treaty, when it calculates its net asset value ("NAV"). The NAV, which typically is calculated daily, is the basis for the prices used for subscriptions and redemptions. If the withholding tax benefits ultimately obtained by the CIV do not correspond to its original assumptions about the amount and timing of such withholding tax benefits, there will be a discrepancy between the real asset value and the NAV used by investors who have purchased, sold or redeemed their interests in the CIV in the interim.

30. In order to provide more certainty under existing treaties, tax authorities may want to reach a mutual agreement clarifying the treatment of some types of CIVs in their respective States. With respect to some types of CIVs, such a mutual agreement might simply confirm that the CIV satisfies the technical requirements discussed above and therefore is entitled to benefits in its own right. In other cases, the mutual agreement could provide a CIV an administratively feasible way to make claims with respect to treaty-eligible investors (see paragraphs 36 to 40 of the report "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" for a discussion of this issue). Of course, a mutual agreement could not cut back on benefits that otherwise would be available to the CIV under the terms of a treaty.

Policy issues raised by the current treatment of collective investment vehicles

31. The same considerations would suggest that treaty negotiators address expressly the treatment of CIVs. Thus, even if it appears that CIVs in each of the Contracting States would be entitled to benefits, it may be appropriate to confirm that position publicly (for example, through an exchange of notes) in order to provide certainty. It may also be appropriate to expressly provide for the treaty entitlement of CIVs by including, for example, a provision along the following lines:

> Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated, for purposes of applying the Convention to such income, as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof). For purposes of this paragraph, the term "collective investment vehicle" means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

32. However, in negotiating new treaties or amendments to existing treaties, the Contracting States would not be restricted to clarifying the results of the application of other treaty provisions to CIVs, but could vary those results to the extent necessary to achieve policy objectives. For example, in the context of a particular bilateral treaty, the technical analysis may result in CIVs located in one of the Contracting States qualifying for benefits, whilst CIVs in the other Contracting State may not. This may make the treaty appear unbalanced, although whether it is so in fact will depend on the specific circumstances. If it is, then the Contracting States should attempt to reach an equitable solution. If the practical result in each of the Contracting States is that most CIVs do not in fact pay tax, then the Contracting States should attempt to overcome differences in legal form that might otherwise cause those in one State to qualify for benefits and those in the other to be denied benefits. On the other hand, the differences in legal form and tax treatment in the two Contracting States may mean that it is appropriate to treat CIVs in the two States differently. In comparing the taxation of CIVs in the two States, taxation in the source State and at the investor level should be considered, not just the taxation of the CIV itself. The goal is to achieve neutrality between a direct investment and an investment through a CIV in the international context, just as the goal of most domestic provisions addressing the treatment of CIVs is to achieve such neutrality in the wholly domestic context.

33. A Contracting State may also want to consider whether existing treaty provisions are sufficient to prevent CIVs from being used in a potentially abusive manner. It is possible that a CIV could satisfy all of the requirements to claim treaty benefits in its own right, even though its income is not subject to much, if any, tax in practice. In that case, the CIV could present the opportunity for residents of third countries to receive treaty benefits that would not have been available had they invested directly. Accordingly, it may be appropriate to restrict benefits that might otherwise be available to such a CIV, either through generally applicable anti-abuse or anti-treaty shopping rules (as discussed under "Improper use of the Convention" below) or through a specific provision dealing with CIVs.

34. In deciding whether such a provision is necessary, Contracting States will want to consider the economic characteristics, including the potential for treaty shopping, presented by the various types of CIVs that are prevalent in each of the Contracting States. For example, a CIV that is not subject to any taxation in the State in which it is established may present more of a danger of treaty shopping than one in which the CIV itself is subject to an entity-level tax or where distributions to non-resident investors are subject to withholding tax.

Possible provisions modifying the treatment of CIVs

35. Where the Contracting States have agreed that a specific provision dealing with CIVs is necessary to address the concerns described in paragraphs 32 through 34, they could include in the bilateral treaty the following provision:

a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), but only to the extent that the beneficial interests in the collective investment vehicle are owned by equivalent beneficiaries.

b) For purposes of this paragraph:

(i) the term "collective investment vehicle" means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph; and

(ii) the term "equivalent beneficiary" means a resident of the Contracting State in which the CIV is established, and a resident of any other State with which the Contracting State in which the income arises has an income tax convention that provides for effective and comprehensive information exchange who would, if he received the particular item of income for which benefits are being claimed under this Convention, be entitled under that convention, or under the domestic law of the Contracting State in which the income arises, to a rate of tax with respect to that item of income that is at least as low as the rate claimed under this Convention by the CIV with respect to that item of income.

36. It is intended that the Contracting States would provide in subdivision *b*)(i) specific cross-references to relevant tax or securities law provisions relating to CIVs. In deciding which treatment should apply with respect to particular CIVs, Contracting States should take into account the policy considerations discussed above. Negotiators

may agree that economic differences in the treatment of CIVs in the two Contracting States, or even within the same Contracting State, justify differential treatment in the tax treaty. In that case, some combination of the provisions in this section might be included in the treaty.

37. The effect of allowing benefits to the CIV to the extent that it is owned by "equivalent beneficiaries" as defined in subdivision b)(ii) is to ensure that investors who would have been entitled to benefits with respect to income derived from the source State had they received the income directly are not put in a worse position by investing through a CIV located in a third country. The approach thus serves the goals of neutrality as between direct investments and investments through a CIV. It also decreases the risk of double taxation as between the source State and the State of residence of the investor, to the extent that there is a tax treaty between them. It is beneficial for investors, particularly those from small countries, who will consequently enjoy a greater choice of investment vehicles. It also increases economies of scale, which are a primary economic benefit of investing through CIVs. Finally, adopting this approach substantially simplifies compliance procedures. In many cases, nearly all of a CIV's investors will be "equivalent beneficiaries", given the extent of bilateral treaty coverage and the fact that rates in those treaties are nearly always 10-15 per cent on portfolio dividends.

38. At the same time, the provision prevents a CIV from being used by investors to achieve a better tax treaty position than they would have achieved by investing directly. This is achieved through the rate comparison in the definition of "equivalent beneficiary". Accordingly, the appropriate comparison is between the rate claimed by the CIV and the rate that the investor could have claimed had it received the income directly. For example, assume that a CIV established in State B receives dividends from a company resident in State A. Sixty-five per cent of the investors in the CIV are individual residents of State B; ten per cent are pension funds established in State C and 25 per cent are individual residents of State C. Under the A-B tax treaty, portfolio dividends are subject to a maximum tax rate at source of ten per cent. Under the A-C tax treaty, pension funds are exempt from taxation in the source State and other portfolio dividends are subject to tax at a maximum tax rate of 15 per cent. Both the A-B and A-C treaties include effective and comprehensive information exchange provisions. On these facts, 75 per cent of the investors in the CIV — the individual residents of State B and the pension funds established in State C — are equivalent beneficiaries.

39. A source State may also be concerned about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis. Such States may be tempted to limit benefits to the CIV to the proportion of the CIV's investors who are currently taxable on their share of the income of the CIV. However, such an approach has proven difficult to apply to widely-held CIVs in practice. Those States that are concerned about the possibility of such deferral may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently.

Other States may be less concerned about the potential for deferral, however. They may take the view that, even if the investor is not taxed currently on the income received by the CIV, it will be taxed eventually, either on the distribution, or on any capital gains if it sells its interest in the CIV before the CIV distributes the income. Those States may wish to negotiate provisions that grant benefits to CIVs even if they are not obliged to distribute their income on a current basis. Moreover, in many States, the tax rate with respect to investment income is not significantly higher than the treaty withholding rate on dividends, so there would be little, if any, residence State tax deferral to be achieved by earning such income through an investment fund rather than directly. In addition, many States have taken steps to ensure the current taxation of investment income earned by their residents through investment funds, regardless of whether the funds accumulate that income, further reducing the potential for such deferral. When considering the treatment of CIVs that are not required to distribute income currently, States may want to consider whether these or other factors address the concerns described above so that the type of limits described herein might not in fact be necessary.

40. Some States believe that taking all treaty-eligible investors, including those in third States, into account would change the bilateral nature of tax treaties. These States may prefer to allow treaty benefits to a CIV only to the extent that the investors in the CIV are residents of the Contracting State in which the CIV is established. In that case, the provision would be drafted as follows:

a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), but only to the extent that the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.

b) For purposes of this paragraph, the term "collective investment vehicle" means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

41. Although the purely proportionate approach set out in paragraphs 35 and 40 protects against treaty shopping, it may also impose substantial administrative burdens as a CIV attempts to determine the treaty entitlement of every single investor. A Contracting State may decide that the fact that a substantial proportion of the CIV's investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be

provided with respect to all income received by the CIV. Including such a threshold would also mitigate some of the procedural burdens that otherwise might arise. If desired, therefore, the following sentence could be added at the end of subparagraph *a*):

> However, if at least [ ] per cent of the beneficial interests in the collective investment vehicle are owned by [equivalent beneficiaries][residents of the Contracting State in which the collective investment vehicle is established], the collective investment vehicle shall be treated as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of all of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof).

42. In some cases, the Contracting States might wish to take a different approach from that put forward in paragraphs 31, 35 and 40 with respect to certain types of CIVs and to treat the CIV as making claims on behalf of the investors rather than in its own name. This might be true, for example, if a large percentage of the owners of interests in the CIV as a whole, or of a class of interests in the CIV, are pension funds that are exempt from tax in the source country under terms of the relevant treaty similar to those described in paragraph 69 of the Commentary on Article 18. To ensure that the investors would not lose the benefit of the preferential rates to which they would have been entitled had they invested directly, the Contracting States might agree to a provision along the following lines with respect to such CIVs (although likely adopting one of the approaches of paragraphs 31, 35 or 40 with respect to other types of CIVs):

a) A collective investment vehicle described in subparagraph *c*) which is established in a Contracting State and which receives income arising in the other Contracting State shall not be treated as a resident of the Contracting State in which it is established, but may claim, on behalf of the owners of the beneficial interests in the collective investment vehicle, the tax reductions, exemptions or other benefits that would have been available under this Convention to such owners had they received such income directly.

b) A collective investment vehicle may not make a claim under subparagraph *a*) for benefits on behalf of any owner of the beneficial interests in such collective investment vehicle if the owner has itself made an individual claim for benefits with respect to income received by the collective investment vehicle.

c) This paragraph shall apply with respect to, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State to which the competent authorities of the Contracting States agree to apply this paragraph.

This provision would, however, limit the CIV to making claims on behalf of residents of the same Contracting State in which the CIV is established. If, for the reasons described in paragraph 37, the Contracting States deemed it desirable to allow the CIV to make claims on behalf of treaty-eligible residents of third States, that could be accomplished by replacing the words “this Convention” with “any Convention to which the other

Contracting State is a party" in subparagraph *a*). If, as anticipated, the Contracting States would agree that the treatment provided in this paragraph would apply only to specific types of CIVs, it would be necessary to ensure that the types of CIVs listed in subparagraph *c*) did not include any of the types of CIVs listed in a more general provision such as that in paragraph 31, 35 or 40 so that the treatment of a specific type of CIV would be fixed, rather than elective. Countries wishing to allow individual CIVs to elect their treatment, either with respect to the CIV as a whole or with respect to one or more classes of interests in the CIV, are free to modify the paragraph to do so.

43. Under either the approach in paragraphs 35 and 40 or in paragraph 42, it will be necessary for the CIV to make a determination regarding the proportion of holders of interests who would have been entitled to benefits had they invested directly. Because ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries, the CIV and its managers often do not themselves know the names and treaty status of the beneficial owners of interests. It would be impractical for the CIV to collect such information from the relevant intermediaries on a daily basis. Accordingly, Contracting States should be willing to accept practical and reliable approaches that do not require such daily tracing.

44. For example, in many countries the CIV industry is largely domestic, with an overwhelming percentage of investors resident in the country in which the CIV is established. In some cases, tax rules discourage foreign investment by imposing a withholding tax on distributions, or securities laws may severely restrict offerings to non-residents. Governments should consider whether these or other circumstances provide adequate protection against investment by non-treaty-eligible residents of third countries. It may be appropriate, for example, to assume that a CIV is owned by residents of the State in which it is established if the CIV has limited distribution of its shares or units to the State in which the CIV is established or to other States that provide for similar benefits in their treaties with the source State.

45. In other cases, interests in the CIV are offered to investors in many countries. Although the identity of individual investors will change daily, the proportion of investors in the CIV that are treaty-entitled is likely to change relatively slowly. Accordingly, it would be a reasonable approach to require the CIV to collect from other intermediaries, on specified dates, information enabling the CIV to determine the proportion of investors that are treaty-entitled. This information could be required at the end of a calendar or fiscal year or, if market conditions suggest that turnover in ownership is high, it could be required more frequently, although no more often than the end of each calendar quarter. The CIV could then make a claim on the basis of an average of those amounts over an agreed-upon time period. In adopting such procedures, care would have to be taken in choosing the measurement dates to ensure that the CIV would have enough time to update the information that it provides to other payers so that the correct amount is withheld at the beginning of each relevant period.

46. An alternative approach would provide that a CIV that is publicly traded in the Contracting State in which it is established will be entitled to treaty benefits without

regard to the residence of its investors. This provision has been justified on the basis that a publicly-traded CIV cannot be used effectively for treaty shopping because the shareholders or unitholders of such a CIV cannot individually exercise control over it. Such a provision could read:

a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), if the principal class of shares or units in the collective investment vehicle is listed and regularly traded on a regulated stock exchange in that State.

b) For purposes of this paragraph, the term "collective investment vehicle" means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph.

47. Each of the provisions in paragraphs 31, 35, 40 and 46 treats the CIV as the resident and the beneficial owner of the income it receives for the purposes of the application of the Convention to such income, which has the simplicity of providing for one reduced rate of withholding with respect to each type of income. As confirmed by paragraph 3 of the Article, these provisions, however, do not restrict in any way the right of the State of source from taxing its own residents who are investors in the CIV. Clearly, these provisions are intended to deal with the source taxation of the CIV's income and not the residence taxation of its investors.

48. Also, each of these provisions is intended only to provide that the specific characteristics of the CIV will not cause it to be treated as other than the beneficial owner of the income it receives. Therefore, a CIV will be treated as the beneficial owner of all of the income it receives. The provision is not intended, however, to put a CIV in a different or better position than other investors with respect to aspects of the beneficial ownership requirement that are unrelated to the CIV's status as such. Accordingly, where an individual receiving an item of income in certain circumstances would not be considered as the beneficial owner of that income, a CIV receiving that income in the same circumstances could not be deemed to be the beneficial owner of the income. This result is confirmed by the parenthetical limiting the application of the provision to situations in which an individual in the same circumstances would have been treated as the beneficial owner of the income.

Application of the Convention to States, their subdivisions and their wholly-owned entities

49. Paragraph 1 of Article 4 provides that the Contracting States themselves, their political subdivisions and their local authorities are included in the definition of a "resident of a Contracting State" and are therefore entitled to the benefits of the Convention (paragraph 8.4 of the Commentary on Article 4 explains that the inclusion of these words in 1995 confirmed the prior general understanding of most member States).

50. Issues may arise, however, in the case of entities set up and wholly-owned by a State or one of its political subdivisions or local authorities. Some of these entities may derive substantial income from other countries and it may therefore be important to determine whether tax treaties apply to them (this would be the case, for instance, of sovereign wealth funds: see paragraph 8.5 of the Commentary on Article 4). In many cases, these entities are totally exempt from tax and the question may arise as to whether they are entitled to the benefits of the tax treaties concluded by the State in which they are set up. In order to clarify the issue, some States modify the definition of "resident of a Contracting State" in paragraph 1 of Article 4 and include in that definition a "statutory body", an "agency or instrumentality" or a "legal person of public law" [*personne morale de droit public*] of a State, a political subdivision or local authority, which would therefore cover wholly-owned entities that are not considered to be a part of the State or its political subdivisions or local authorities.

51. In addition, many States include specific provisions in their bilateral conventions that grant an exemption to other States, and to some State-owned entities such as central banks, with respect to certain items of income such as interest (see paragraph 13.2 of the Commentary on Article 10 and paragraph 7.4 of the Commentary on Article 11). Treaty provisions that grant a tax exemption with respect to the income of pension funds (see paragraph 69 of the Commentary on Article 18) may similarly apply to pension funds that are wholly-owned by a State, depending on the wording of these provisions and the nature of the fund.

52. The application of the Convention to each Contracting State, its political subdivisions, and local authorities (and their statutory bodies, agencies or instrumentalities in the case of bilateral treaties that apply to such entities) should not be interpreted, however, as affecting in any way the possible application by each State of the customary international law principle of sovereign immunity. According to this principle, a sovereign State (including its agents, its property and activities) is, as a general rule, immune from the jurisdiction of the courts of another sovereign State. There is no international consensus, however, on the precise limits of the sovereign immunity principle. Most States, for example, would not recognise that the principle applies to business activities and many States do not recognise any application of this principle in tax matters. There are therefore considerable differences between States as regards the extent, if any, to which that principle applies to taxation. Even among States that would recognise its possible application in tax matters, some apply it only

to the extent that it has been incorporated into domestic law and others apply it as customary international law but subject to important limitations. The Convention does not prejudge the issues of whether and to what extent the principle of sovereign immunity applies with respect to the persons covered under Article 1 and the taxes covered under Article 2 and each Contracting State is therefore free to apply its own interpretation of that principle as long as the resulting taxation, if any, is in conformity with the provisions of its bilateral tax conventions.

53. States often take account of various factors when considering whether and to what extent tax exemptions should be granted, through specific treaty or domestic law provisions or through the application of the sovereign immunity doctrine, with respect to the income derived by other States, their political subdivisions, local authorities, or their statutory bodies, agencies or instrumentalities. These factors would include, for example, whether that type of income would be exempt on a reciprocal basis, whether the income is derived from activities of a governmental nature as opposed to activities of a commercial nature, whether the assets and income of the recipient entity are used for public purposes, whether there is any possibility that these could inure to the benefit of a non-governmental person and whether the income is derived from a portfolio or direct investment.

Improper use of the Convention

54. The principal 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. As confirmed in the preamble of the Convention, it is also a part of the purposes of tax conventions to prevent tax avoidance and evasion.

55. The extension of the network of tax conventions increases the risk of abuse by facilitating the use of arrangements aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in these conventions.

56. 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 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.

Addressing tax avoidance through tax conventions

57. Paragraph 9 of Article 29 and the specific treaty anti-abuse rules included in tax conventions are aimed at these and other transactions and arrangements entered into for the purpose of obtaining treaty benefits in inappropriate circumstances. Where,

however, a tax convention does not include such rules, the question may arise whether the benefits of the tax convention should be granted when transactions that constitute an abuse of the provisions of that convention are entered into.

58. Many States address that question by taking account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the question addressed in paragraphs 66 to 80 below. As explained in these paragraphs, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.

59. Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the *Vienna Convention on the Law of Treaties*).

60. Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.

61. It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. That principle applies independently from the provisions of paragraph 9 of Article 29, which merely confirm it.

62. The potential application of these principles or of paragraph 9 of Article 29 does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 58 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy..

63. For instance, some forms of tax avoidance have already been expressly 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 such as paragraph 2 of Article 17

dealing with so-called artiste-companies. Such problems are also mentioned in the Commentaries on Article 10 (paragraphs 17 and 22), Article 11 (paragraph 12) and Article 12 (paragraph 7).

64. Also, in some cases, claims to treaty benefits by subsidiary companies, in particular companies established in tax havens or benefiting from harmful preferential regimes, may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes (this will be relevant where the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

65. Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits were properly attributable.

Addressing tax avoidance through domestic anti-abuse rules and judicial doctrines

66. Domestic anti-abuse rules and judicial doctrines may also be used to address transactions and arrangements entered into for the purpose of obtaining treaty benefits in inappropriate circumstances. These rules and doctrines may also address situations where transactions or arrangements are entered into for the purpose of abusing both domestic laws and tax conventions.

67. For these reasons, domestic anti-abuse rules and judicial doctrines play an important role in preventing treaty benefits from being granted in inappropriate circumstances. The application of such domestic anti-abuse rules and doctrines, however, raises the issue of possible conflicts with treaty provisions, in particular where treaty provisions are relied upon in order to facilitate the abuse of domestic law provisions (e.g. where it is claimed that treaty provisions protect the taxpayer from the application of certain domestic anti-abuse rules). This issue is discussed below in relation to specific legislative anti-abuse rules, general legislative anti-abuse rules and judicial doctrines.

Specific legislative anti-abuse rules

68. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.

69. Many specific anti-abuse rules found in domestic law apply primarily in cross-border situations and may be relevant for the application of tax treaties. For instance, thin capitalisation rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a

resident enterprise to an enterprise that is resident of a treaty country; exit or departure tax rules may prevent the avoidance of capital gains tax through a change of residence before the realisation of a treaty-exempt capital gain; dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains; and anti-conduit rules may prevent certain avoidance transactions involving the use of conduit arrangements.

70. Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the *Vienna Convention on the Law of Treaties*. Thus, if the application of specific anti-abuse rules found in domestic law were to result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should prevail under public international law.[1]

71. As explained below, however, such conflicts will often be avoided and each case must be analysed based on its own circumstances.

72. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 specifically authorises the application of domestic rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict or, even if there is a conflict, allowing the application of the domestic rules. This would be the case, for example, for a treaty rule that expressly allows the application of a thin capitalisation rule found in the domestic law of one or both Contracting States.

73. Second, many provisions of the Convention depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person (see paragraph 1 of Article 4), the determination of what is immovable property (see paragraph 2 of Article 6) and the determination of when income from corporate rights might be treated as a dividend (see paragraph 3 of Article 10). More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the Convention. In many cases, therefore, the application of specific anti-abuse rules found in domestic law will have an impact on how the treaty provisions are applied rather than produce conflicting results. This would be the case, for example, if a domestic law provision treats the profits realised by a shareholder when a company redeems some of its shares as dividends: although such a redemption could be considered to constitute an alienation for the purposes of paragraph 5 of Article 13, paragraph 28 of the Commentary on Article 10 recognises that such profits will constitute dividends for the purposes of Article 10 if the profits are treated as dividends under domestic law.

1 Under Article 60 of the *Vienna Convention on the Law of Treaties* "[a] material breach of a bilateral treaty by one of the parties entitles the other to invoke the breach as a ground for terminating the treaty or suspending its operation in whole or in part".

74. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied under paragraph 9 of Article 29 or, in the case of a treaty that does not include that paragraph, under the principles put forward in paragraphs 60 and 61 above. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both paragraph 9 of Article 29 (or the principles in paragraphs 60 and 61 above) and the relevant domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted with reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. Whilst this facilitates their application and provides greater certainty, it may sometimes result in the application of such a rule in a case where the rule conflicts with a provision of the Convention and where paragraph 9 of Article 29 does not apply to deny the benefits of that provision (and where the principles of paragraphs 60 and 61 above also do not apply). In such a case, the Convention will not allow the application of the domestic rule to the extent of the conflict. An example of such a case would be where a domestic law rule that State A adopted to prevent temporary changes of residence for tax purposes would provide for the taxation of an individual who is a resident of State B on gains from the alienation of property situated in a third State if that individual was a resident of State A when the property was acquired and was a resident of State A for at least seven of the 10 years preceding the alienation. In such a case, to the extent that paragraph 5 of Article 13 would prevent the taxation of that individual by State A upon the alienation of the property, the Convention would prevent the application of that domestic rule unless the benefits of paragraph 5 of Article 13 could be denied, in that specific case, under paragraph 9 of Article 29 or the principles in paragraphs 60 and 61 above.

75. Fourth, the application of tax treaty provisions may be denied under judicial doctrines or principles applicable to the interpretation of the treaty (see paragraph 78 below). In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both a proper interpretation of the treaty and as result of the application of domestic specific anti-abuse rules. Assume, for example, that the domestic law of State A provides for the taxation of gains derived from the alienation of shares of a domestic company in which the alienator holds more than 25 per cent of the capital if that alienator was a resident of State A for at least seven of the 10 years preceding the alienation. In year 2, an individual who was a resident of State A for the previous 10 years becomes a resident of State B. Shortly after becoming a resident of State B, the individual sells the totality of the shares of a small company that he previously established in State A. The facts reveal, however, that all the elements of the sale were finalised in year 1, that an interest-free "loan" corresponding to the sale price was made by the purchaser to the seller at that time, that the purchaser cancelled the loan when the shares were sold to the purchaser in year 2 and that the purchaser exercised de facto control of the company from year 1. Although the gain from the sale of the shares might otherwise fall under paragraph 5 of Article 13 of the State A-State B treaty, the circumstances of the transfer of the shares are such that the alienation in year 2 constitutes a sham within the meaning given to that term by the courts of State A. In that case, to the extent that the sham transaction doctrine developed by the

courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting paragraph 5 of Article 13 of the State A-State B treaty, which will allow State A to tax the relevant gain under its domestic law rule.

General legislative anti-abuse rule

76. Many countries have included in their domestic law a legislative anti-abuse rule of general application intended to prevent abusive arrangements that are not adequately dealt with through specific anti-abuse rules or judicial doctrines.

77. The application of such general anti-abuse rules also raises the question of a possible conflict with the provisions of a tax treaty. In the vast majority of cases, however, no such conflict will arise. Conflicts will first be avoided for reasons similar to those presented in paragraphs 72 and 73 above. In addition, where the main aspects of these domestic general anti-abuse rules are in conformity with the principle of paragraph 61 above and are therefore similar to the main aspects of paragraph 9 of Article 29, which incorporates this guiding principle, it is clear that no conflict will be possible since the relevant domestic general anti-abuse rule will apply in the same circumstances in which the benefits of the Convention would be denied under paragraph 9 of Article 29, or, in the case of a treaty that does not include that paragraph, under the guiding principle in paragraph 61 above.

Judicial doctrines that are part of domestic law

78. In the process of interpreting tax legislation in cases dealing with tax avoidance, the courts of many countries have developed a number of judicial doctrines or principles of interpretation. These include doctrines such as substance over form, economic substance, sham, business purpose, step-transaction, abuse of law and *fraus legis*. These doctrines and principles of interpretation, which vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions, are essentially views expressed by courts as to how tax legislation should be interpreted. Whilst the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*, these general rules do not prevent the application of similar judicial doctrines and principles to the interpretation of the provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach from being adopted with respect to the application of the provisions of a tax treaty to similar transactions. This is illustrated by the example in paragraph 75 above.

79. As a general rule and having regard to paragraph 61, therefore, the preceding analysis leads to the conclusion that there will be no conflict between tax conventions and judicial anti-abuse doctrines or general domestic anti-abuse rules. For example, to the extent that the application of a general domestic anti-abuse rule or a judicial

doctrine such as "substance over form" or "economic substance" results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.

80. Whilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused.

Controlled foreign company provisions

81. A significant number of countries have adopted controlled foreign company provisions to address issues related to the use of foreign base companies. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign company legislation conflicted with these provisions. Since such legislation results in a State taxing its own residents, paragraph 3 of Article 1 confirms that it does not conflict with tax conventions. The same conclusion must be reached in the case of conventions that do not include a provision similar to paragraph 3 of Article 1; for the reasons explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10, the interpretation according to which these Articles would prevent the application of controlled foreign company provisions does not accord with the text of paragraph 1 of Article 7 and paragraph 5 of Article 10. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign company legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign company legislation structured in this way is not contrary to the provisions of the Convention.

Restricting treaty benefits with respect to income that is subject to certain features of another State's tax system

82. As indicated in paragraph 15.2 of the Introduction

> … it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the

risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy

83. A State may conclude that certain features of the tax system of another State are not sufficient to prevent the conclusion of a tax treaty but may want to prevent the application of that treaty to income that is subject to no or low tax because of these features. Where the relevant features of the tax system of the other State are known at the time the treaty is being negotiated, it is possible to draft provisions that specifically deny treaty benefits with respect to income that benefits from these features (see, for example, paragraph 108 below).

84. Such features might, however, be introduced in the tax system of a treaty partner only after the conclusion of a tax treaty or might be discovered only after the treaty has entered into force. When concluding a tax treaty, a Contracting State may therefore be concerned about features of the tax system of a treaty partner of which it is not aware at that time or that may subsequently become part of the tax system of that treaty partner. Controlled foreign company provisions (see paragraph 81 above) and other approaches discussed in the above section on "Improper use of the Convention" may assist in dealing with some of these features but since the difficulties created by these features arise from the design of the tax laws of treaty partners rather than from tax avoidance strategies designed by taxpayers or their advisers, Contracting States may wish to address these difficulties though specific treaty provisions. The following include examples of provisions that might be adopted for that purpose.

Provision on special tax regimes

85. Provisions could be included in a tax treaty in order to deny the application of specific treaty provisions with respect to income benefiting from regimes that satisfy the criteria of a general definition of "special tax regimes". For instance, the benefits of the provisions of Articles 11 and 12 could be denied with respect to interest and royalties that would be derived from a connected person if such interest and royalties benefited, in the State of residence of their beneficial owner, from such a special tax regime; this would be done by adding to Articles 11 and 12 a provision drafted along the following lines (which could be amended to fit the circumstances of the Contracting States or for inclusion in other Articles of the Convention):

> Notwithstanding the provisions of [(in the case of Article 11): paragraphs 1 and 2 but subject to the provisions of paragraph 4] [(in the case of Article 12): paragraph 1 but subject to the provisions of paragraph 3] of this Article, [interest] [royalties] arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is connected to the payer may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits from a special tax regime with respect to the [interest] [royalties] in the State of which it is resident.

For the purposes of the above provision, the reference to a resident that is "connected" to the payer should be interpreted in accordance with the definition of "connected

person" which is found in the Commentary on paragraph 7 of Article 29. As indicated in paragraph 127 of that Commentary, if the above provision is included in the Convention, it would seem appropriate to include that definition in paragraph 1 of Article 3, which includes the definitions that apply throughout the Convention. Some States, however, may prefer to replace the reference to a resident that is "connected" to the payer by a reference to a resident that is "closely related" to the payer, the main difference being that, unlike the definition of "connected" person, the definition of "closely related" person found in paragraph 8 of Article 5 does not apply where a person possesses directly or indirectly exactly 50 per cent of the aggregate vote and value of another person (if the definition of "closely related" person is used for the purposes of the above provision, that definition would be more appropriately included in paragraph 1 of Article 3).

86. Also, the above provision would require a definition of "special tax regime", which could be drafted as follows and added to the list of general definitions included in paragraph 1 of Article 3:

> the term "special tax regime" means any statute, regulation or administrative practice in a Contracting State with respect to a tax described in Article 2 that meets all of the following conditions:
>
> *(i)* results in one or more of the following:
>
> *A)* a preferential rate of taxation for interest, royalties or any combination thereof as compared to income from sales of goods or services;
>
> *B)* a permanent reduction in the tax base with respect to interest, royalties or any combination thereof without a comparable reduction for income from sales of goods or services, by allowing:
>
> *1)* an exclusion from gross receipts;
>
> *2)* a deduction without regard to any corresponding payment or obligation to make a payment;
>
> *3)* a deduction for dividends paid or accrued; or;
>
> *4)* taxation that is inconsistent with the principles of Article 7 or 9; or
>
> *C)* a preferential rate of taxation or a permanent reduction in the tax base of the type described in subclauses *1*), *2*), *3*) or *4*) of clause *B*) of this subdivision with respect to substantially all of a company's income or substantially all of a company's foreign source income, for companies that do not engage in the active conduct of a business in that Contracting State;
>
> *(ii)* in the case of any preferential rate of taxation or permanent reduction in the tax base for royalties, does not condition such benefits on
>
> *A)* the extent of research and development activities that take place in the Contracting State; or
>
> *B)* expenditures (excluding any expenditures which relate to subcontracting to a related party or any acquisition costs), which the

person enjoying the benefits incurs for the purpose of actual research and development activities;

(iii) is generally expected to result in a rate of taxation that is less than the lesser of either:

A) [rate to be determined bilaterally]; or

B) 60 per cent of the general statutory rate of company tax applicable in the other Contracting State;

(iv) does not apply principally to:

A) recognised pension funds;

B) organisations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes;

C) persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the Contracting State and the interests in which are marketed primarily to retail investors; or

D) persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral) and that hold predominantly immovable property; and

(v) after consultation with the first-mentioned Contracting State, has been identified by the other Contracting State through diplomatic channels to the first-mentioned Contracting State as satisfying subdivisions (*i*) through (*iv*) of this subparagraph.

No statute, regulation or administrative practice shall be treated as a special tax regime until 30 days after the date when the other Contracting State issues a written public notification identifying the regime as satisfying subdivisions (*i*) through (*iv*) of this subparagraph.

87. The above definition of the term "special tax regime" applies to any legislation, regulation or administrative practice (including a ruling practice) that exists before or comes into effect after the treaty is signed and that meets all of the following five conditions.

88. Under the first condition, described in subdivision (*i*) of the definition, the regime must result in one or more of the following:

A. a preferential rate of taxation for interest, royalties or any combination thereof as compared to income from sales of goods or services;

B. certain permanent reductions in the tax base with respect to interest, royalties or any combination thereof without a comparable reduction for sales or services income; or

C. a preferential rate of taxation or certain permanent reductions in the tax base with respect to substantially all income or substantially all foreign source income

for companies that do not engage in the active conduct of a business in that Contracting State. This part of the definition is intended to identify regimes that, in general, tax mobile income more favourably than non-mobile income.

89. As provided in clause *A*), subdivision (*i*) shall be met if a regime provides a preferential rate of taxation for interest, royalties or a combination of the two as compared to sales or services income. For example, a regime that provides a preferential rate of taxation on royalty income earned by resident companies, but does not provide such preferential rate to income from sales or services, would meet this condition. Furthermore, a regime that provides a preferential rate of taxation for all classes of income, but such preferential rate is in effect available primarily for interest, royalties or a combination of the two, would satisfy subdivision (i) despite the fact that the beneficial treatment is not explicitly limited to those classes of income. For example, a tax authority's administrative practice of issuing routine rulings that provide a preferential rate of taxation for companies that represent that they earn primarily interest income (such as group financing companies) would satisfy subdivision (i) even if such rulings as a technical matter provide that preferential rate to all forms of income.

90. Similarly, as provided in clause *B*), subdivision (i) shall be met if a regime provides for a permanent reduction in the tax base with respect to interest, royalties or a combination thereof as compared to income from sales of goods or services, in one or more of the following ways: an exclusion from gross receipts (such as an automatic fixed reduction in the amount of royalties included in income, whereas such reduction is not also available for income from the sale of goods or services); a deduction without any corresponding payment or obligation to make a payment; a deduction for dividends paid or accrued; or taxation that is inconsistent with the principles of Articles 7 or 9 of the Convention. An example of a tax regime that results in taxation that is inconsistent with the principles of Article 9 is that of a regime under which no interest income would be imputed on an interest-free note that is held by a company resident of a Contracting State and is issued by an associated enterprise that is a resident of the other Contracting State.

91. A permanent reduction in a State's tax base does not arise merely from timing differences. For example, the fact that a particular country does not tax interest until it is actually paid, rather than when it economically accrues, is not regarded as a regime that provides a permanent reduction in the tax base, because such a rule represents an ordinary timing difference. However, a regime that results in excessive deferral over a period of many years shall be regarded as providing for a permanent reduction in the tax base, because such a rule in substance constitutes a permanent difference in the base of the taxing country.

92. Alternatively, as provided in clause *C*), subdivision (*i*) shall be satisfied if a regime provides a preferential rate of taxation or a permanent reduction in the tax base (of the type described above), with respect to substantially all income or substantially all foreign source income, for companies that do not engage in the active conduct of a business in the Contracting State. For example, regimes that provide preferential rates

of taxation only to income of group financing companies or holding companies would generally satisfy subdivision (*i*).

93. A regime that provides for beneficial tax treatment that is generally applicable to all income (in particular to income from sales and services) and across all industries should not meet subdivision (*i*). Examples of generally applicable provisions that would not meet subdivision (*i*) include regimes permitting standard deductions, accelerated depreciation, corporate tax consolidation, dividends received deductions, loss carryovers and foreign tax credits.

94. The second condition, described in subdivision (*ii*) of the definition, applies only with respect to royalties and is met if a regime does not condition benefits either on the extent of research and development activities that take place in the Contracting State or on expenditures (excluding any expenditures which relate to subcontracting to a related party or any acquisition costs), which the person enjoying the benefits incurs for the purpose of actual research and development activities. Subdivision (*ii*) is intended to ensure that royalties benefiting from patent box or innovation box regimes are eligible for treaty benefits only if such regimes satisfy one of these two requirements. Some States, however, would prefer that the requirements of subdivision (*ii*) be restricted so as to only be met if a regime conditions benefits on the extent of research and development activities that take place in the Contracting State. States that share that view may prefer to use the following alternative version of subdivision (*ii*):

> *(ii)* in the case of any preferential rate of taxation or permanent reduction in the tax base for royalties, does not condition such benefits on the extent of research and development activities that take place in the Contracting State;

Under either version of subdivision (*ii*), royalty regimes that have been considered by the OECD's Forum on Harmful Tax Practices and were not determined to be "actually harmful" generally would not meet subdivision (*ii*) and, if so, would not be treated as special tax regimes.

95. The third condition, described in subdivision (*iii*) of the definition, requires that a regime be generally expected to result in a rate of taxation that is less than the lesser of a rate that would be agreed bilaterally between the Contracting States and 60 per cent of the general statutory rate of company tax applicable in the Contracting State that considers the regime of the other State as a potential "special tax regime".

96. States may consider it useful to clarify the reference to "rate of taxation" for the purposes of subdivision (*iii*) by including the following in an instrument reflecting the agreed interpretation of the treaty:

> Except as provided below, the rate of taxation shall be determined based on the income tax principles of the Contracting State that has implemented the regime in question. Therefore, in the case of a regime that provides only for a preferential rate of taxation, the generally expected rate of taxation under the regime shall equal such preferential rate. In the case of a regime that provides only for a permanent reduction in the tax base, the rate of taxation shall equal the statutory rate of

company tax generally applicable in the Contracting State to companies subject to the regime in question less the product of such rate and the percentage reduction in the tax base (with the baseline tax base determined under the principles of the Contracting State, but without regard to any permanent reductions in the tax base described in clause *B*) of subdivision (*i*)) that the regime is generally expected to provide. For example, a regime that generally provides for a 20 per cent permanent reduction in a company's tax base would have a rate of taxation equal to the applicable statutory rate of company tax reduced by 20 per cent of such statutory rate. In the case of a regime that provides for both a preferential rate of taxation and a permanent reduction in the tax base, the rate of taxation would be based on the preferential rate of taxation reduced by the product of such rate and the percentage reduction in the tax base.

97. The preceding would clarify that the rate of taxation should be determined based on the income tax principles of the Contracting State that has implemented the regime in question. Therefore, in the case of a regime that provides only for a preferential rate of taxation, the generally expected rate of taxation under the regime will equal such preferential rate. In the case of a regime that provides only for a permanent reduction in the tax base, the rate of taxation will equal the statutory rate of company tax in the Contracting State that is generally applicable to companies subject to the regime in question less the product of such rate and the percentage reduction in the tax base (with the baseline tax base determined under the principles of the Contracting State, but without regard to any permanent reductions in the tax base described in clause *B*) of subdivision (*i*) of the definition) that the regime is generally expected to provide. For example, a regime that generally provides for a 20 per cent permanent reduction in a company's tax base would have a rate of taxation equal to the applicable statutory rate of company tax reduced by 20 per cent of such statutory rate. Therefore, if the applicable statutory rate of company tax in force in a Contracting State were 25 per cent, the rate of taxation resulting from such a regime would be 20 per cent (25 – (25 x 0.20)). In the case of a regime that provides for both a preferential rate of taxation and a permanent reduction in the tax base, the rate of taxation would be based on the preferential rate of taxation reduced by the product of such rate and the percentage reduction in the tax base.

98. The fourth condition, described in subdivision (*iv*) of the definition, provides that a regime shall not be regarded as a special tax regime if it applies principally to pension funds or organisations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes. Under subdivision (*iv*), a regime shall also not be regarded as a special tax regime if it applies principally to persons the taxation of which achieves a single level of taxation, either in the hands of the person or its shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the residence State, and interests in which are marketed primarily to retail investors. This would generally correspond to the collective investment vehicles referred to in paragraph 22 above. Another exception provided in subdivision (*iv*) applies to regimes

that apply principally to persons the taxation of which achieves a single level of taxation, either in the hands of the person or its shareholders (with at most one year of deferral), and such persons hold predominantly immovable property.

99. The fifth condition, described in subdivision (*v*) of the definition, provides that the Contracting State that wishes to treat a regime of the other State as a "special tax regime" must first consult the other Contracting State and notify that State through diplomatic channels that it has determined that the regime meets the other conditions of the definition.

100. The final part of the definition requires that the Contracting State that wishes to treat a regime of the other State as a "special tax regime" must issue a written public notification stating that the regime satisfies the definition. For the purposes of the Convention, a special tax regime shall be treated as such 30 days after the date of such written public notification.

Provision on subsequent changes to domestic law

101. Whilst the above suggested provision on special tax regimes would address the issue of targeted tax regimes, it would not deal with changes of a more general nature which could be introduced into the domestic law of a treaty partner after the conclusion of a tax treaty and which might have prevented the conclusion of the treaty if they had existed at that time. For instance, some Contracting States might be concerned if the overall tax rate that another State levies on corporate income falls below what they consider to be acceptable for the purposes of the conclusion of a tax treaty. Some States might also be concerned if a State that taxed most types of foreign income at the time of the conclusion of a tax treaty decided subsequently to exempt such income from tax when it is derived by a resident company. The following is an example of a provision that would address these concerns, it being understood that the features of that provision would need to be restricted or extended in order to deal adequately with the specific areas of concern of each State:

1. If at any time after the signing of this Convention, a Contracting State.
   a) reduces the general statutory rate of company tax that applies with respect to substantially all of the income of resident companies with the result that such rate falls below the lesser of either
      (i) [rate to be determined bilaterally] or
      (ii) 60 per cent of the general statutory rate of company tax applicable in the other Contracting State, or;
   b) the first-mentioned Contracting State provides an exemption from taxation to resident companies for substantially all foreign source income (including interest and royalties),

   the Contracting States shall consult with a view to amending this Convention to restore an appropriate allocation of taxing rights between the Contracting States. If such consultations do not progress, the other State may notify the first-mentioned State through diplomatic channels that it shall cease to apply the provisions of

Articles 10, 11, 12 and 21. In such case, the provisions of such Articles shall cease to have effect in both Contracting States with respect to payments to resident companies six months after the date that the other Contracting State issues a written public notification stating that it shall cease to apply the provisions of these Articles.

2. For the purposes of determining the general statutory rate of company tax:

a) the allowance of generally available deductions based on a percentage of what otherwise would be taxable income, and other similar mechanisms to achieve a reduction in the overall rate of tax, shall be taken into account; and

b) the following shall not be taken into account:

(i) a tax that applies to a company only upon a distribution by such company, or that applies to shareholders; and

(ii) the amount of a tax that is refundable upon the distribution by a company of a dividend.

102. This suggested provision provides that if, at any time after the signing of the Convention, either Contracting State enacts certain changes to domestic law, the provisions of Articles 10, 11, 12 and 21 may cease to have effect with respect to payments to companies if, after consultation, the Contracting States fail to agree on amendments to the Convention to restore an appropriate allocation of taxing rights between the Contracting States.

103. Paragraph 1 of the suggested provision addresses two types of subsequent changes that could be made by a State, after the signature of a tax treaty, to the tax rules applicable to companies resident of that State. The first type is when that State reduces the general statutory rate of company tax that applies with respect to substantially all of the income of its resident companies, with the result that such rate falls below the lesser of a minimum rate that would need to be determined bilaterally or 60 per cent of the general rate of company tax applicable in the other State.

104. For the purposes of paragraph 1, the "general statutory rate of company tax" refers to the general rate of company tax provided by legislation; if rates of company taxes are graduated, it refers to the highest marginal rate, provided that such rate applies to a significantly large portion of corporate taxpayers and was not established merely to circumvent the application of this Article. A general statutory rate of company tax that is applicable to business profits generally or to so-called "trading income" (broadly defined to include income from manufacturing, services or dealing in goods or commodities) shall be treated as applying to substantially all of the income of resident companies, even if narrow categories of income (including income from portfolio investments or other passive activities) are excluded. A reduced rate of tax that applies only with respect to capital gains would not fall within the scope of this Article; the distinction between business profits and capital gains shall be made according to the domestic laws of the residence State. Paragraph 2 addresses specific issues that may arise in determining what is a State's general statutory rate of company tax. Subparagraph *a*) of paragraph 2 provides that paragraph 1 applies equally

to reductions to the general statutory company tax rate, as well as to other changes in domestic law that would have the same effect using a different mechanism. For example, if the statutory company tax rate in a Contracting State was 20 per cent, but, after the signing of the Convention, companies resident in the Contracting State are permitted to claim deductions representing 50 per cent of what otherwise would be their taxable income, the general statutory rate of company tax would be 10 per cent (20 - (20 x 0.50)). Similarly, if the statutory company tax rate in a Contracting State was 20 per cent, but after the signing of the Convention, companies resident in the Contracting State are allowed to deduct an amount equal to a percentage of their equity up to 50 per cent of what otherwise would be their taxable income, and in general, most companies are able to utilize the maximum available deduction, the general rate of company tax would be 10 per cent. Subparagraph *b*) of paragraph 2 sets forth taxes that shall not be taken into account for purposes of determining the general statutory rate of company tax. First, as provided in subdivision (i) of subparagraph *b*), taxes imposed at either the company or shareholder level when the company distributes earnings shall not be taken into account when determining the general rate of company tax (e.g. if resident companies are not subject to any taxation at the company level until a distribution is made, the tax levied upon distribution would not be considered part of the general rate of company tax). Second, as provided in subdivision (ii) of subparagraph *b*), any amounts of corporate tax that under a country's domestic law would be refundable upon a company's distribution of earnings shall not be taken into account for purposes of determining the general statutory rate of company tax.

105. The second type of subsequent change in domestic tax law covered by paragraph 1 is when a State provides an exemption from taxation to companies resident of that State with respect to substantially all foreign source income (including interest and royalties) derived by these companies. The reference to an exemption for substantially all foreign source income earned by a resident company is intended to describe a taxation system under which income (including income from interest and royalties) from sources outside a State is exempt from tax solely by reason of its source being outside that State (so-called "territorial" systems). The reference does not include taxation systems under which only foreign source dividends or business profits from foreign permanent establishments are exempt from tax by the residence State (so-called "dividend exemption" systems).

106. When either type of subsequent domestic law change occurs, the Contracting States shall first consult with a view to concluding amendments to the Convention to restore an appropriate allocation of taxing rights between the two Contracting States. In the event that such amendments are agreed, or that the Contracting States agree, after such consultation, that the allocation of taxing rights in the Convention is not disrupted by the relevant change made to the domestic law of one of the States, paragraph 1 has no further application. If, however, after a reasonable period of time, such consultations do not progress, the other State may notify the State whose domestic law has changed, through diplomatic channels, that it shall cease to apply

the provisions of Articles 10, 11, 12 and 21. Once such diplomatic notification has been made, in order for paragraph 1 to apply, the source State must announce by written public notice that it shall cease to apply the provisions of these Articles. Six months after the date of such written public notification, the provisions of these Articles shall cease to have effect in both Contracting States with respect to payments to companies that are residents of either State.

Provision on notional deductions for equity

107. One example of a tax regime with respect to which treaty benefits might be specifically restricted relates to domestic law provisions that provide for a notional deduction with respect to equity. Contracting States which agree to prevent the application of the provisions of Article 11 to interest that is paid to connected persons who benefit from such notional deductions may do so by adding the following provision to Article 11:

> 2. Notwithstanding the provisions of paragraph 1 of this Article, interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State that is connected to the payer (as defined in paragraph 8 of Article 5) may be taxed in the first-mentioned Contracting State in accordance with domestic law if such resident benefits, at any time during the taxable year in which the interest is paid, from notional deductions with respect to amounts that the Contracting State of which the beneficial owner is a resident treats as equity.

The explanations in paragraph 85 above concerning the reference to a resident that is "connected" to the payer apply equally to the above provision

Provision on remittance based taxation

108. Another example of a tax regime with respect to which treaty benefits might be specifically restricted is that of remittance based taxation. Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:

> Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the

provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State.

In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, i.e. that the income in question will be entitled to benefits in the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State

Limitations of source taxation: procedural aspects

109. A number of Articles of the Convention limit the right of a State to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention. As a general rule, in order to ensure expeditious implementation of taxpayers' benefits under a treaty, the first approach is the highly preferable method. If a refund system is needed, it should be based on observable difficulties in identifying entitlement to treaty benefits. Also, where the second approach is adopted, it is extremely important that the refund be made expeditiously, especially if no interest is paid on the amount of the refund, as any undue delay in making that refund is a direct cost to the taxpayer.

Observation on the Commentary

110. With respect to paragraph 81, *Switzerland* considers that controlled foreign corporation legislation may, depending on the relevant concept, be contrary to the spirit of Article 7.

Reservations on the Article

111. 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.

112. *Canada* reserves the right to limit the entities or arrangements covered under paragraph 2 to those that are established in one of the Contracting States.

113. *France* reserves the right, in its conventions, not to include or to amend paragraph 2 in order to specify in which situations France will recognise the fiscal transparency of entities located in the other Contracting State or in a third State.

114. *Germany* reserves the right not to include paragraph 2 in its conventions.

115. *Portugal* reserves the right not to include paragraph 2 in its conventions in view of the administrative difficulties resulting from some of the solutions put forward in the report "The Application of the OECD Model Tax Convention to Partnerships" (as indicated in the report itself in certain cases).

116. *Ireland* reserves the right not to include paragraph 3 in its conventions and to amend paragraph 2 to provide that the paragraph will not be construed to affect a Contracting State's right to tax its own residents.

117. *France*, *Germany*, *Hungary*, *Ireland*, *Luxembourg* and *Switzerland* reserve the right not to include paragraph 3 in their conventions.

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.

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, "*Lohnsummensteuer*"; in France, "*taxe sur les salaires*"). Social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as "taxes on the total amount of wages".

4. Clearly a State possessing the right to tax an item of income or capital under the Convention may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, penalties etc. It has not been considered necessary to specify this in the Article, as it is obvious that a Contracting State that has the right to levy a tax may also levy the accessory duties or charges related to the principal duty. Most States, however, do not consider that interest and penalties accessory to taxes covered by Article 2 are themselves included within the scope of Article 2 and, accordingly, would generally not treat

such interest and penalties as payments to which all the provisions concerning the rights to tax of the State of source (or situs) or of the State of residence are applicable, including the limitations of the taxation by the State of source and the obligation for the State of residence to eliminate double taxation. Nevertheless, where taxation is withdrawn or reduced in accordance with a mutual agreement under Article 25, interest and administrative penalties accessory to such taxation should be withdrawn or reduced to the extent that they are directly connected to the taxation (i.e. a tax liability) that is relieved under the mutual agreement. This would be the case, for example, where the additional charge is computed with reference to the amount of the underlying tax liability and the competent authorities agree that all or part of the underlying taxation is not in accordance with the provisions of the Convention. This would also be the case, for example, where administrative penalties are imposed by reason of a transfer pricing adjustment and that adjustment is withdrawn because it is considered not in accordance with paragraph 1 of Article 9.

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.

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.

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.

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:

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.

Observation on the Commentary

9. *Portugal* does not adhere to the interpretation in the last three sentences of paragraph 4 of the Commentary on Article 2. Portugal holds the view that interest and penalties are not taxes covered by the Convention and, therefore, cannot be dealt with in the mutual agreement procedure.

Reservations on the Article

10. *Canada*, *Chile* 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. *Australia*, *Japan* and *Korea* reserve their position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital.

12. *Greece* and *Latvia* 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 will not be covered by the Convention.

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 subparagraph *a)* is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense (see 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 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.

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 for the purposes of the tax law of the Contracting State of which it is a resident. The definition is drafted with special regard to the Article on dividends. The term "company" has a bearing only on that Article, paragraphs 7 and 8 of Article 5, and Articles 16 and 29.

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.

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 of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic resides only in that State 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 subparagraph *e*) a reference to the State in which the place of effective management of the enterprise is situated. In such a case, the definition should read: "the term 'international traffic' means any transport by a ship or aircraft except when the ship or aircraft is operated solely between places in a Contracting State in which the enterprise that operates the ship or aircraft does not have its place of effective management".

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 enterprise the right to tax purely domestic traffic as well as 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, 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 The definition was amended in 2017 to ensure that it also applied to a transport by a ship or aircraft operated by an enterprise of a third State. Whilst this change does not affect the application of Article 8, which only deals with profits of an enterprise of a Contracting State, it allows the application of paragraph 3 of Article 15 to a resident of a Contracting State who derives remuneration from employment exercised aboard a ship or aircraft operated by an enterprise of a third State.

6.2 A ship or aircraft is operated solely between places in a 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 State. However, the definition applies where the journey of a ship or aircraft between places in a 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 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".

6.3 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 first part of the exception included in the definition, so as to use the following definition:

e) the term "international traffic" means any transport by a ship or aircraft except when such transport is solely between places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State;

6.4 The definition of "international traffic" does not apply when a ship or aircraft is operated between two places in a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State, even if part of the transport takes place outside that State. Thus, for example, a cruise beginning and ending in that 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.

The term "competent authority"

7. The definition of the term "competent authority" recognises 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, in relation to a Contracting State, the term applies to any individual possessing the nationality or citizenship of that Contracting State. Whilst the concept of nationality covers citizenship, the latter term was also included in 2002 because it is more frequently used in some States. It was not judged necessary to include in the text of the Convention any more precise definition of the terms nationality and citizenship, nor did it seem indispensable to make any special comment on the meaning and application of these words. Obviously, in determining what is meant by "national" in the case of an individual, 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 or citizenship.

9. Subparagraph *g)* 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 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.

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".

10.1 The separate mention of partnerships in subparagraph *g)* is not inconsistent with the status of a partnership as a person under subparagraph *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.

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. Subparagraph *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.

The term "recognised pension fund"

10.3 The definition of the term "recognised pension fund" found in subparagraph i) was included in 2017 when this term was added to paragraph 1 of Article 4 in order to ensure that a pension fund that meets the definition is considered as a resident of the Contracting State in which it is established.

10.4 The effect of the definition of "recognised pension fund" and of the reference to that term in paragraph 1 of Article 4 will depend to a large extent on the domestic law and on the legal characteristics of the pension funds established in each Contracting

State as well as on the other provisions of the Convention where the definition might be relevant.

10.5 In some States, a fund might be established within a legal entity (such as a company engaged in commercial activities, an insurance company or the State itself, or a political subdivision or local authority thereof) for the main purpose of providing retirement benefits to individuals, such as the employees of that entity or of other employers, or of investing funds for the benefit of other recognised pension funds. Such a fund might not, however, constitute a separate "person" (as this term is defined in subparagraph *a*)) under the taxation laws of the State in which it is established and, if that is the case, it would not meet the definition of recognised pension fund. To the extent, however, that the income derived from the investment assets of that fund is attributed, under the domestic law of the State in which it is established, to the legal entity (e.g. company engaged in commercial activities, insurance company or State) within which the fund has been established, the provisions of the Convention will apply to that income to the extent that the legal entity itself qualifies as a resident of a Contracting State under paragraph 1 of Article 4. As explained in paragraphs 8.7 to 8.10 of the Commentary on Article 4, the inclusion of the term "recognised pension fund" in paragraph 1 of Article 4 is irrelevant for such a fund.

10.6 There are also some States where a fund established for the main purpose of providing retirement benefits to individuals does not formally constitute a separate person under the taxation laws of the State in which it is established but where these taxation laws provide that the investment assets of the fund constitute a separate and distinct patrimony the income of which is not allocated to any person for tax purposes. These States may want to ensure that their domestic law and the definition of "person" in subparagraph *a*) are broad enough to include such a fund in order to make sure that the Convention, which applies to persons that are residents of the Contracting States, is applicable to the income derived through these funds.

10.7 As indicated in paragraph 69 of the Commentary on Article 18, where two Contracting States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, these States may include in their convention a provision extending that exemption to the investment income that a pension fund established in one State derives from the other State. The definition of "recognised pension fund" might then be used for that purpose. If that is the case, however, it would be necessary to ensure that a fund described in paragraph 10.5 above may qualify as a "recognised pension fund" in its own right notwithstanding the fact that it does not constitute a separate "person" under the taxation laws of the State in which it is established. Doing so, however, would require that, for the purposes of the Convention, the assets and income of such a fund are treated as the assets and income of a separate person so that, for example:

— the fund may constitute a person for the purposes of Article 1 and of all the relevant provisions of the Convention;

— the assets and income of the fund are considered those of a separate person and not those of the person within which the fund is established so that, for example,

for the purposes of subparagraph *a*) of paragraph 2 of Article 10, any part of the capital of a company paying dividends to the fund that is held through the fund would not be aggregated with the capital of the same company that is held by the person within which the fund is established but that is not held through the fund;

— for the purposes of Articles 6 to 21, the income of the fund would be treated as derived, received and beneficially owned by the fund itself and not by the person within which the fund is established;

— the fund's entitlement to treaty benefits under the limitation-on-benefits provisions of Article 29 is determined without consideration of the entitlement to treaty benefits of the person within which the fund is established.

10.8 The following is an example of a provision that could be added to the definition of "recognised pension fund" for that purpose:

Where an arrangement established in a Contracting State would constitute a recognised pension fund under subdivision (*i*) or (*ii*) if it were treated as a separate person under the taxation law of that State, it shall be considered, for the purposes of this Convention, as a separate person treated as such under the taxation law of that State and all the assets and income to which the arrangement applies shall be treated as assets held and income derived by that separate person and not by another person.

10.9 The first part of the definition of "recognised pension fund" refers to "an entity or arrangement established in that State". There is considerable diversity in the legal and organisational characteristics of pension funds around the world and it is therefore necessary to adopt a broad formulation. The reference to an "arrangement" is intended to cover, among other things, cases where pension benefits are provided through vehicles such as a trust which, under the relevant trust law, would not constitute an entity: the definition will apply as long as the trust or the body of trustees is treated, for tax purposes, as a separate entity recognised as a separate person. It is required, however, that the entity or arrangement be treated as a separate person under the taxation laws of the State in which it is established: if that is not the case, it is not necessary to deal with the issue of the residence of the pension fund itself as the income of that fund is treated as the income of another person for tax purposes (see paragraph 10.5 above).

10.10 Subdivision (*i*) provides that in order to qualify as a "recognised pension fund", an entity or arrangement must be established and operated exclusively or almost exclusively to administer or provide retirement and ancillary or incidental benefits to individuals. It does not matter how many individuals are entitled to such retirement benefits: a recognised pension fund may be set up, for instance, for a large group of employees or for a single self-employed individual. States are free to replace the phrase "retirement and ancillary or incidental benefits" by a different formulation, such as "retirement and similar benefits", as long as this formulation is interpreted broadly to include benefits such as death benefits.

10.11 The phrase "exclusively or almost exclusively" makes it clear that all or almost all the activities of a recognised pension fund must be related to the administration or the provision of retirement benefits and ancillary or incidental benefits to individuals. The words "almost exclusively" recognise that a very small part of the activities of a pension fund might involve activities that are not strictly related to the administration or provision of such benefits (e.g. such as marketing the services of the pension fund). Some States, however, have a broader view of the term "recognised pension fund" and may want, for example, to cover entities or arrangements established and operated exclusively or almost exclusively to provide pensions and benefits, such as disability pensions, that are not related to retirement. These States are free to amend the definition so as to adapt it to their circumstances. In doing so, however, these States should take account of the fact that, as noted in paragraph 10.7 above, the definition of recognised pension fund may be used for the purposes of provisions exempting from source taxation the investment income that a pension fund established in one State derives from the other State; it will therefore be important for these States to ensure that the scope of that exemption is not inadvertently extended by changes made to the definition of "recognised pension fund".

10.12 The entity or arrangement must be established and operated exclusively or almost exclusively for the purpose of administering or providing retirement benefits and ancillary or incidental benefits to individuals. A pension paid upon retirement from active employment or when an employee reaches retirement age would be the typical example of a "retirement benefit" but this term is broad enough to cover one or more payments made at or after retirement, or upon reaching retirement age, to an employee, a self-employed person or a director or officer of a company, even if these payments are not made in the form of regular pension payments.

10.13 In many States, pension funds provide a number of benefits that are not strictly linked to retirement and the phrase "ancillary or incidental benefits" is intended to cover such benefits. The words "ancillary or incidental" make it clear that such benefits are provided in addition to retirement benefits: a fund that would be set up primarily in order to provide benefits that are not retirement benefits would therefore not meet the definition. Whilst it would be impossible to provide an exhaustive list of all benefits that would qualify as "ancillary or incidental benefits", the following are typical examples of such benefits:

— payments made as a result of the death or disability of an individual;
— pension or other types of payments made to surviving members of the family of a deceased individual who was entitled to retirement benefits;
— payments made to an individual suffering from a terminal illness;
— income substitution payments made in the case of long-term sickness or unemployment;
— housing benefits, such as a loan at a preferential rate granted from accumulated pension contributions to a pension contributor for the acquisition of a principal residence;

— education benefits, such as the withdrawal of accumulated pension contributions that a pension contributor would be allowed to make for the purpose of financing her education or that of her children;
— the provision of financial advice to pension contributors.

10.14 Subdivision (i) also requires that the entity or arrangement established and operated exclusively or almost exclusively to administer or provide retirement and ancillary or incidental benefits to individuals be "regulated as such". The requirement is intended to restrict the definition to entities or arrangements that are subject to some conditions imposed by the State where it is established (or one of its political subdivisions or local authorities) in order to ensure that the entity or arrangement is used as a vehicle for investment in order to provide retirement and ancillary or incidental benefits to individuals. That part of the definition would therefore exclude an entity, such as a private company, that might be set up and used by a person to invest funds in order to provide retirement benefits to persons related to, or employed by, that person but that would not be subject to any special treatment or to rules imposed by the State, political subdivision or local authority concerning the use of that entity as a vehicle to provide retirement benefits. It does not matter whether the regulatory framework to which the entity or arrangement is subjected is provided in tax laws or in other legal instruments (e.g. the legislation that establishes a State-owned entity that will operate a public pension fund); what matters is that the entity or arrangement be recognised by law as a vehicle established to finance retirement benefits for individuals and be subject to conditions intended to ensure that it is used for that purpose.

10.15 An example of an entity or arrangement that would satisfy the requirements of the definition of "recognised pension fund" is an agency or instrumentality of a State set up exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits under the social security legislation of that State. Another example would be a company or other entity that is established in a State for the purpose of administering or providing retirement benefits and ancillary or incidental benefits to individuals and whose only assets include funds that are covered by a retirement scheme regulated by the tax laws of that State which provide that the income from that scheme is exempt from tax. The definition of recognised pension fund would apply to that company or entity regardless of whether that company or entity otherwise qualifies as a resident of a Contracting State because it is "liable to tax therein" by reason of the criteria mentioned in the first sentence of paragraph 1 of Article 4, e.g. because it must pay tax on any income not derived from the scheme (see paragraphs 8.8 to 8.10 of the Commentary on Article 4).

10.16 Subdivision (i) of the definition applies regardless of whether the benefits to which it refers are provided to individuals who are residents of the State in which the entity or arrangement is established or are residents of other States. Whilst the general anti-abuse rule in paragraph 9 of Article 29 addresses possible treaty-shopping concerns that may arise from that aspect of the rule, States that do not include that general anti-abuse rule in their treaties or for which this is a particular concern are free

to include in the definition of "recognised pension fund" conditions similar to those found in subdivision (*ii*) of subparagraph *e*) of paragraph 2 of the detailed version of the limitation-on-benefits rule found in the Commentary on Article 29.

10.17 Subdivision (*ii*) of the definition covers entities or arrangements that pension funds covered by subdivision (*i*) use to invest indirectly. Pension funds often invest together with other pension funds pooling their assets in certain entities or arrangements and may, for various commercial, legal or regulatory reasons, invest via wholly owned entities or arrangements that are residents of the same State. Since such arrangements and entities act only as intermediaries for the investment of funds used to provide retirement benefits to individuals, it is appropriate to treat them like the pension funds that invest through them.

10.18 The phrase "exclusively or almost exclusively" found in subdivision (*ii*) makes it clear that all or almost all of the activities of such an intermediary entity or arrangement must be related to the investment of funds for the benefit of entities or arrangements that qualify as recognised pension funds under subdivision (*i*). The words "almost exclusively" recognise that a very small part of the activities of such entities or arrangements might involve other activities, such as the investment of funds for pension funds that are established in other States and, for that reason, are not covered by subdivision (*i*). States in which it is common for intermediary entities or arrangements to invest funds obtained from pension funds established in other States are free to broaden the scope of subdivision (*ii*) in order to cover the case where a large part of the funds invested by the intermediary entity or arrangement are invested for the benefit of pension funds established in other States; these States could address any treaty-shopping concerns that may then arise through the provisions of Article 29.

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.

12. However, paragraph 2 specifies that the domestic law meaning of an undefined term applies only if the context does not require an alternative interpretation and the competent authorities do not agree to a different meaning pursuant to the provisions of Article 25. 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.

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).

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 imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws.

13.2. The Commentary was also amended in 1995 to provide that States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meaning of terms not defined in the Convention should take those agreements into account in interpreting those terms. In 2017, the wording of paragraph 2 was amended to remove any doubt that in a case where a mutual agreement reached under Article 25 indicates that the competent authorities have agreed on a common meaning of an undefined term, the domestic law meaning of that term would not be applicable, as is the case when a term is defined in the Convention or when the context requires a meaning that is different from the domestic law meaning. Some States, however, consider that this exception should only be applicable in the case of agreements reached under paragraph 3 of Article 25; these States are free to replace the phrase "pursuant to the provisions of Article 25" by "pursuant to the provisions of paragraph 3 of Article 25". Other States consider that, under their law, the competent authorities cannot be given the power to agree on a meaning of a term that would prevent recourse to the domestic law meaning of that term; these States are free to omit the phrase "or the competent authorities agree to a different meaning pursuant to the provisions of Article 25".

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.

15. *Turkey* reserves the right to use the following definition of the term "international traffic": "the term "international traffic" means any transport by a ship or aircraft operated by an enterprise of a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State".

16. *Israel* reserves the right to include a trust within the definition of a "person".

17. *Chile* and *Mexico* reserve the right to not include the definition of "recognised pension fund" in subparagraph *i*) of paragraph 1 because a determination to include a pension fund as a resident in a tax treaty is best discussed bilaterally between Contracting States due to the diversity of legal arrangements for providing retirement benefits.

18. *Israel* reserves the right not to limit the definition of "recognised pension fund" to a separate person under the taxation laws.

19. *Portugal* reserves the right not to include the definition in subparagraph *i*) of paragraph 1 ("recognised pension fund") in its conventions because it reserves the right not to expressly include "a recognised pension fund" in paragraph 1 of Article 4 and to treat pension funds in accordance with the general definition of "resident" or with bilaterally agreed special provisions.

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.

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 (see 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).

8.1 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.

8.2 According to its wording and spirit the second sentence also excludes 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. It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States. The exclusion of certain companies or other persons from the definition would not of course prevent Contracting States from exchanging information about their activities (see paragraph 2 of the Commentary on

Article 26). Indeed States may feel it appropriate to develop spontaneous exchanges of information about persons who seek to obtain unintended treaty benefits.

8.3 The application of the second sentence, however, has inherent difficulties and limitations. It has to be interpreted in the light of its object and purpose, which is to exclude persons who are not subjected to comprehensive taxation (full liability to tax) in a State, 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.

8.4 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.

8.5 This raises the issue of the application of paragraph 1 to sovereign wealth funds, which are special purpose investment funds or arrangements created by a State or a political subdivision for macroeconomic purposes. These funds hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. They are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses or receipts resulting from commodity exports.[1] Whether a sovereign wealth fund qualifies as a "resident of a Contracting State" depends on the facts and circumstances of each case. For example, when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression "[the] State and any political subdivision or local authority thereof" in Article 4. In other cases, paragraphs 8.11 and 8.12 below will be relevant. States may want to address the issue in the course of bilateral negotiations, particularly in relation to whether a sovereign wealth fund qualifies as a "person" and is "liable to tax" for purposes of the relevant tax treaty (see also paragraphs 50 to 53 of the Commentary on Article 1).

8.6 Paragraph 1 also refers expressly to a "recognised pension fund". Most member countries have long considered that a pension fund established in a Contracting State is a resident of that State regardless of the fact that it may benefit from a limited or complete exemption from taxation in that State. Until 2017, that view was reflected in the previous version of paragraph 8.6, which referred to "pension funds, charities and other organisations" as entities that most States viewed as residents. Paragraph 1 of the Article was modified in 2017 to remove any doubt about the fact that a pension fund that meets the definition of "recognised pension fund" in paragraph 1 of Article 3 constitutes a resident of the Contracting State in which it is established.

1 This definition is drawn from: International Working Group of Sovereign Wealth Funds, *Sovereign Wealth Funds — Generally Accepted Principles and Practices — "Santiago Principles"*, October 2008, Annex 1.

8.7 As indicated in paragraph 10.4 of the Commentary on Article 3, the effect of the definition of "recognised pension fund" and of the reference to that term in paragraph 1 of the Article will depend to a large extent on the domestic law and on the legal characteristics of the pension funds established in each Contracting State. The type of fund established within a legal entity that is described in paragraph 10.5 of the Commentary on Article 3 would not be covered by the definition of "recognised pension fund", which applies to an entity or arrangement that constitutes a separate person, but since the income of these funds is attributed to the legal entity of which it is part, the provisions of the Convention will apply to that income to the extent that the legal entity itself qualifies as a resident of a Contracting State under paragraph 1 of the Article.

8.8 Where, however, a fund constitutes a "person" which is distinct from any other person by whom, or for the benefit of whom, it has been established and is operated, the definition of "recognised pension fund" will be relevant and, to the extent that the conditions of that definition are met, the fund will itself constitute a "resident of a Contracting State". This will be the case in many countries because it is "liable to tax therein" by reason of the criteria mentioned in the first sentence of paragraph 1, as this sentence is interpreted by the Contracting States or, if that is not the case, because of the specific inclusion of the term "recognised pension fund" in paragraph 1.

8.9 Contracting States are of course free to omit the reference to "recognised pension funds" in paragraph 1 if they conclude that the income of the pension arrangements established in both States is derived by persons that otherwise qualify as residents of the Contracting States, although they might prefer to keep that reference in the paragraph simply to remove any uncertainty.

8.10 Given the diversity of arrangements through which retirement benefits are provided, it will therefore often be useful for the Contracting States to review the main types of pension arrangements used in each State and to clarify whether or not the definition of "recognised pension fund" applies to each type of arrangement and, more generally, how the provisions of the tax convention between these States apply to these arrangements. This could be done at the time of the negotiation of that convention or subsequently through the mutual agreement procedure.

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

8.12 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.

8.13 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 that case, however, paragraph 2 of Article 1 clarifies that the Convention will apply to the partnership's income to the extent that the income is treated, for purposes of taxation by that State, as the income of a partner who is a resident of that State. The same treatment will apply to income of other entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting State (see paragraphs 2 to 16 of the Commentary on Article 1).

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 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.

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. Subparagraph *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.). For instance, a house owned by an individual cannot be considered to be available to that individual during a period when the house has been rented out and effectively handed over to an unrelated party so that the individual no longer has the possession of the house and the possibility to stay there.

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 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. Subparagraph *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 but not 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.

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. The application of the criterion provided for in subparagraph *b*) requires a determination of whether the individual lived habitually, in the sense of being customarily or usually present, in one of the two States but not in the other during a given period; the test will not be satisfied by simply determining in which of the two Contracting States the individual has spent more days during that period. The phrase "*séjourne de façon habituelle*", which is used in the French version of subparagraph *b*), provides a useful insight as to the meaning of "habitual abode", a notion that refers to the frequency, duration and regularity of stays that are part of the settled routine of an individual's life and are therefore more than transient. As recognised in subparagraph *c*), it is possible for an individual to have an habitual abode in the two States, which would be the case if the individual was customarily or usually present in each State during the relevant period, regardless of the fact that he spent more days in one State than in the other. Assume, for instance, that over a period of five years, an individual owns a house in both States A and B but the facts do not allow the determination of the State in which the individual's centre of vital interests is situated. The individual works in State A where he habitually lives but returns to State B two days a month and once a year for a three-week holiday. In that case, the individual will have an habitual abode in State A but not in State B. Assume, however, that over the same period of five years, the individual works short periods of time in State A, where he returns 15 times a year for stays of two weeks each time, but is present in State B the rest of the time (assume also that the facts of the case do not allow the determination of the State in which the individual's centre of vital interests is situated). In that case, the individual will have an habitual abode in both State A and State B.

19.1 Subparagraph *b*) does not specify over what length of time the determination of whether an individual has an habitual abode in one or both States must be made. The determination must cover a sufficient length of time for it to be possible to ascertain the frequency, duration and regularity of stays that are part of the settled routine of the individual's life. Care should be taken, however, to consider a period of time during which there were no major changes of personal circumstances that would clearly affect the determination (such as a separation or divorce). The relevant period for purposes of the determination of whether an individual has an habitual abode in one or both States will not always correspond to the period of dual-residence, especially where the period of dual-residence is very short. This is illustrated by the following example. Assume that an individual resident of State C moves to State D to work at different locations for a period of 190 days. During that 190-day period, he is considered a resident of both States C and D under their respective domestic tax laws. The

individual lived in State C for many years before moving to State D, remains in State D for the entire period of his employment there and returns to State C to live there permanently at the end of the 190-day period. During the period of his employment in State D, the individual does not have a permanent home available to him in either State C or State D. In this example, the determination of whether the individual has an habitual abode in one or both States would appropriately consider a period of time longer than the 190-day period of dual-residence in order to ascertain the frequency, duration and regularity of stays that were part of the settled routine of the individual's life.

20. Where, in the two situations referred to in subparagraph *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, subparagraph *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. When paragraph 3 was first drafted, it was considered that it would not be an adequate solution to attach importance to a purely formal criterion like registration and preference was given to a rule based on the place of effective management, which was intended to be based on the place where the company, etc. was actually managed.

23. In 2017, however, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax-avoidance cases involving dual resident companies. It therefore concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis.

24. As a result of these considerations, the current version of paragraph 3 provides that the competent authorities of the Contracting States shall endeavour to resolve by mutual agreement cases of dual residence of a person other than an individual.

24.1 Competent authorities having to apply paragraph 3 would be expected to take account of various factors, such as where the meetings of the person's board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the

Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant.

24.2 A determination under paragraph 3 will normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25. Such a request may be made as soon as it is probable that the person will be considered a resident of each Contracting State under paragraph 1. Due to the notification requirement in paragraph 1 of Article 25, it should in any event be made within three years from the first notification to that person of taxation measures taken by one or both States that indicate that reliefs or exemptions have been denied to that person because of its dual-residence status without the competent authorities having previously endeavoured to determine a single State of residence under paragraph 3. The competent authorities to which a request for determination of residence is made under paragraph 3 should deal with it expeditiously and should communicate their response to the taxpayer as soon as possible.

24.3 Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

24.4 The last sentence of paragraph 3 provides that in the absence of a determination by the competent authorities, the dual-resident person shall not be entitled to any relief or exemption under the Convention except to the extent and in such manner as may be agreed upon by the competent authorities. This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions to that person. This will mean, for example, that the condition in subparagraph *b*) of paragraph 2 of Article 15 will not be met with respect to an employee of that person who is a resident of either Contracting State exercising employment activities in the other State. Similarly, if the person is a company, it will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it will pay.

24.5 Some States, however, consider that it is preferable to deal with cases of dual residence of entities through the rule based on the "place of effective management" that was included in the Convention before 2017. These States also consider that this rule can be interpreted in a way that prevents it from being abused. States that share that view and that agree on how the concept of "place of effective management" should be interpreted are free to include in their bilateral treaty the following version of paragraph 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.

Observations on the Commentary

25. *Chile* wishes to clarify that, with respect to paragraph 8.12, entities that are not regarded as residents may also include pension funds unless expressly covered by the convention.

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.

27. *Hungary* cannot fully share the interpretation in paragraph 19 of the Commentary regarding the term "habitual abode". Hungary considers that during the examination of a person's habitual abode priority should be given to the comparison of the number of days of presence in each State over a given period of time.

Reservations on the Article

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".

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. For this 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 and to indicate in which situations and under which conditions flow-through partnerships located in the other Contracting State or in a third State will be entitled to benefit from the recognition by France of their flow-through nature.

30. *France* reserves the right not to include the reference to "recognised pension funds" in paragraph 1 and thus to treat pension funds like other entities that do not meet the requirements relative to residence.

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.

32. *Portugal* and *Sweden* reserve the right not to include the words "as well as a recognised pension fund of that State" in paragraph 1 and to treat pension funds in accordance with the general definition of "resident" or with bilaterally agreed special provisions.

33. *Israel* reserves the right to include a separate provision regarding a trust that is a resident of both Contracting States.

34. *Estonia* and *Latvia* reserve the right to include the place of incorporation or similar criterion in paragraph 1.

35. *Japan* reserves the right to omit the phrase "except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States" in paragraph 3.

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.

2. 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.

3. In 2017, a number of changes were made to this Commentary. Some of these changes were intended to clarify the interpretation of the Article and, as such, should be taken into account for the purposes of 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 (see paragraph 35 of the Introduction).

4. Changes to this Commentary related to the addition of paragraph 4.1 and the modification of paragraphs 4, 5 and 6 of the Article that were made as a result of the adoption of the Report on Action 7 of the OECD/G20 Base Erosion and Profit Shifting Project were, however, prospective only and, as such, do not affect the interpretation of the former provisions of the OECD Model Tax Convention and of treaties in which these provisions are included, in particular as regards the interpretation of paragraphs 4 and 5 of the Article as they read before these changes (see paragraph 4 of that Report).

5. In many States, a foreign enterprise may be allowed or required to register for the purposes of a value added tax or goods and services tax (VAT/GST) regardless of whether it has in that State a fixed place of business through which its business is wholly or partly carried on or whether it is deemed to have a permanent establishment in that State under paragraph 5 of Article 5. By itself, however, treatment under VAT/GST is irrelevant for the purposes of the interpretation and

application of the definition of permanent establishment in the Convention; when applying that definition, one should not, therefore, draw any inference from the treatment of a foreign enterprise for VAT/GST purposes, including from the fact that a foreign enterprise has registered for VAT/GST purposes.[1]

Paragraph 1

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

7. 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

1 See paragraph 337 of the Report on Action 1 of the BEPS Project ("… it is important to underline that registration for VAT purposes is independent from the determination of whether there is a permanent establishment (PE) for income tax purposes."), OECD (2015), *Addressing the Tax Challenges of the Digital Economy, Action 1 - 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264241046-en. Cf. footnote 24 of the International VAT/GST Guidelines ("For the purpose of these Guidelines, it is assumed that an establishment comprises a fixed place of business with a sufficient level of infrastructure in terms of people, systems and assets to be able to receive and/or make supplies. Registration for VAT purposes by itself does not constitute an establishment for the purposes of these Guidelines. Countries are encouraged to publicise what constitutes an "establishment" under their domestic VAT legislation."), OECD (2017), *International VAT/GST Guidelines*, OECD Publishing, Paris, http://dx.doi.org/10.1787/9789264271401-en.

be attributed for the purpose of tax in a particular territory (see Commentary on paragraph 4).

8. It is also important to note that the way in which business is carried on evolves over the years so that the facts and arrangements applicable at one point in time may no longer be relevant after a change in the way that the business activities are carried on in a given State. Clearly, whether or not a permanent establishment exists in a State during a given period must be determined on the basis of the circumstances applicable during that period and not those applicable during a past or future period, such as a period preceding the adoption of new arrangements that modified the way in which business is carried on.

9. Also, the determination of whether or not an enterprise of a Contracting State has a permanent establishment in the other Contracting State must be made independently from the determination of which provisions of the Convention apply to the profits derived by that enterprise. For instance, a farm or apartment rental office situated in a Contracting State and exploited by a resident of the other Contracting State may constitute a permanent establishment regardless of whether or not the profits attributable to such permanent establishment would constitute income from immovable property covered by Article 6; whilst the existence of a permanent establishment in such cases may not be relevant for the application of Article 6, it would remain relevant for the purposes of other provisions such as paragraphs 4 and 5 of Article 11, subparagraph c) of paragraph 2 of Article 15 and paragraph 3 of Article 24.

10. 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.

11. As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

12. Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a "place of business through which the

business of [that] enterprise is wholly or partly carried on" will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This is illustrated by the following examples. Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise's own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise. This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a continuous basis during an extended period of time. This will not be the case, however, where the enterprise's presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise (e.g. where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time). Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise (see also paragraphs 65, 66 and 121 below). It is also important to remember that even if a place is a place of business through which the activities of an enterprise are partly carried on, that place will be deemed not to be a permanent establishment if paragraph 4 applies to the business activities carried on at that place.

13. These principles are illustrated by the following additional examples where representatives of one enterprise are present on the premises of another enterprise.

14. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

15. A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 28 to 34) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

16. A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

17. A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

18. Even though part of the business of an enterprise may be carried on at a location such as an individual's home office, that should not lead to the automatic conclusion that that location is at the disposal of that enterprise simply because that location is used by an individual (e.g. an employee) who works for the enterprise. Whether or not a home office constitutes a location at the disposal of the enterprise will depend on the facts and circumstances of each case. In many cases, the carrying on of business activities at the home of an individual (e.g. an employee) will be so intermittent or incidental that the home will not be considered to be a location at the disposal of the enterprise (see paragraph 12 above). Where, however, a home office is used on a continuous basis for carrying on business activities for an enterprise and it is clear from the facts and circumstances that the enterprise has required the individual to use that location to carry on the enterprise's business (e.g. by not providing an office to an employee in circumstances where the nature of the employment clearly requires an office), the home office may be considered to be at the disposal of the enterprise.

19. A clear example is that of a non-resident consultant who is present for an extended period in a given State where she carries on most of the business activities of her own consulting enterprise from an office set up in her home in that State; in that case, that home office constitutes a location at the disposal of the enterprise. Where, however, a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, one should not consider that the home is at the disposal of the enterprise because the enterprise did not require that the home be used for its business activities. It should be noted, however, that since the vast majority of employees reside in a State where their employer has at its disposal one or more places of business to which these employees report, the question of whether or not a home office constitutes a location at the disposal of an enterprise will rarely be a practical issue. Also, the activities carried on at a home office will often be merely auxiliary and will therefore fall within the exception of paragraph 4.

20. The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

21. 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 see paragraph 57 below).

22. Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 51 and 57 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

23. This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

24. By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

25. Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of

business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

26. A ship that navigates in international waters or within one or more States is not fixed and does not, therefore, constitute a fixed place of business (unless the operation of the ship is restricted to a particular area that has commercial and geographic coherence). Business activities carried on aboard such a ship, such as the operation of a shop or restaurant, must be treated the same way for the purposes of determining whether paragraph 1 applies (paragraph 5 could apply, however, to some of these activities, e.g. where contracts are concluded when such shops or restaurants are operated within a State).

27. Clearly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State. The question of whether a satellite in geostationary orbit could constitute a permanent establishment for the satellite operator relates in part to how far the territory of a State extends into space. No member country would agree that the location of these satellites can be part of the territory of a Contracting State under the applicable rules of international law and could therefore be considered to be a permanent establishment situated therein. Also, the particular area over which a satellite's signals may be received (the satellite's "footprint") cannot be considered to be at the disposal of the operator of the satellite so as to make that area a place of business of the satellite's operator.

28. 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. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to

whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

29. One exception to this general practice has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). That exception is illustrated by the following example. An enterprise of State R carries on drilling operations at a remote arctic location in State S. The seasonal conditions at that location prevent such operations from going on for more than three months each year but the operations are expected to last for five years. In that case, given the nature of the business operations at that location, it could be considered that the time requirement for a permanent establishment is met due to the recurring nature of the activity regardless of the fact that any continuous presence lasts less than six months; the time requirement could similarly be met in the case of shorter recurring periods of time that would be dictated by the specific nature of the relevant business.

30. Another exception to this general practice has been where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. That exception is illustrated by the following example. An individual resident of State R has learned that a television documentary will be shot in a remote village in State S where her parents still own a large house. The documentary will require the presence of a number of actors and technicians in that village during a period of four months. The individual contractually agrees with the producer of the documentary to provide catering services to the actors and technicians during the four-month period and, pursuant to that contract, she uses the house of her parents as a cafeteria that she operates as sole proprietor during that period. These are the only business activities that she has carried on and the enterprise is terminated after that period; the cafeteria will therefore be the only location where the business of that enterprise will be wholly carried on. In that case, it could be considered that the time requirement for a permanent establishment is met since the restaurant is operated during the whole existence of that particular business. This would not be the situation, however, where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four-month production of a documentary. In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S.

31. For ease of administration, countries may want to consider the practices reflected in paragraphs 28 to 30 when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

32. As mentioned in paragraphs 44 and 55, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of

time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

33. Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraphs 52 and 53 on arrangements intended to abuse the twelve-month period provided for in paragraph 3 would equally apply to such cases.

34. Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated.

35. 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.

36. 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 responsibilities, 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 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.

37. 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]

38. Another example where an enterprise cannot be considered to carry on its business wholly or partly through a place of business is that of a telecommunications operator of a Contracting State who enters into a "roaming" agreement with a foreign operator in order to allow its users to connect to the foreign operator's telecommunications network. Under such an agreement, a user who is outside the geographical coverage of that user's home network can automatically make and receive voice calls, send and receive data or access other services through the use of the foreign network. The foreign network operator then bills the operator of that user's home network for that use. Under a typical roaming agreement, the home network operator merely transfers calls to the foreign operator's network and does not operate or have physical access to that network. For these reasons, any place where the foreign network is located cannot be considered to be at the disposal of the home network operator and cannot, therefore, constitute a permanent establishment of that operator.

39. There are different ways in which an enterprise may carry on its business. In most cases, the business of an enterprise is carried on 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 of the enterprise (see paragraph 100 below). As explained in paragraph 8.11 of the Commentary on Article 15, however, there may be cases where individuals who are formally employed by an enterprise will actually be carrying on the business of another enterprise and where, therefore, the first enterprise should not be considered to be carrying on its own business at the location where these individuals will perform that work. Within a multinational group, it is relatively common for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company. In such cases, administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract. The analysis described in paragraphs 8.13 to 8.15 of the Commentary on Article 15 will be relevant for the

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(3)-1.

purposes of distinguishing these cases from other cases where employees of a foreign enterprise perform that enterprise's own business activities.

40. An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met (this, however, does not address the separate question of how much profit is attributable to such a permanent establishment). In the context of paragraph 1, the existence of a permanent establishment in these circumstances will require that these subcontractors perform the work of the enterprise at a fixed place of business that is at the disposal of the enterprise. Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 12; in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. Paragraph 54 illustrates such a situation in the case of a construction site; this could also happen in other situations. An example would be where an enterprise that owns a small hotel and rents out the hotel's rooms through the Internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis.

41. Also, a permanent establishment may 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 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.

42. It follows from the definition of "enterprise of a Contracting State" in Article 3 that this term, as used in Article 7, and the term "enterprise" used in Article 5, refer to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form. Different enterprises may collaborate on the same project and the question of whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State. Clearly, if two persons each carrying on a separate enterprise decide to form a company in which these persons are shareholders, the company constitutes a legal person that will carry on what becomes another separate enterprise. It will often be the case, however, that different enterprises will simply agree to each carry on a separate part of the same project and that these enterprises will not jointly carry on business

activities, will not share the profits thereof and will not be liable for each other's activities related to that project even though they may share the overall output from the project or the remuneration for the activities that will be carried on in the context of that project. In such a case, it would be difficult to consider that a separate enterprise has been set up. Although such an arrangement would be referred to as a "joint venture" in many countries, the meaning of "joint venture" depends on domestic law and it is therefore possible that, in some countries, the term "joint venture" would refer to a distinct enterprise.

43. In the case of an enterprise that takes the form of a fiscally transparent partnership, the enterprise is carried on by each partner and, as regards the partners' respective shares of the profits, is therefore an enterprise of each Contracting State of which a partner is a resident. If such a partnership has a permanent establishment in a Contracting State, each partner's share of the profits attributable to the permanent establishment will therefore constitute, for the purposes of Article 7, profits derived by an enterprise of the Contracting State of which that partner is a resident (see also paragraph 56 below).

44. 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.

Paragraph 2

45. This paragraph contains a list, by no means exhaustive, of examples of places of business, each of which can be regarded as constituting a permanent establishment under paragraph 1 provided that it meets the requirements of that paragraph. As these examples are to be read in the context of the general definition given in paragraph 1, the terms listed, "a place of management", "a branch", "an office", etc. must be interpreted in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1 and are not places of business to which paragraph 4 applies.

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

47. Subparagraph *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.

48. Subparagraph *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.

Paragraph 3

49. The paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more 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. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than twelve months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed through that office or workshop, taking into account the assets used and the risks assumed through that office or workshop, are attributed to the permanent establishment. This could include profits attributable to

functions performed in relation to the various construction sites but only to the extent that these functions are properly attributable to the office.

50. 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 renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Additionally, the term "installation project" is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

51. 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).

52. 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 of 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, these abuses could also be addressed through the application of the anti-abuse rule of paragraph 9 of Article 29, as shown by example J in paragraph 182 of the Commentary on Article 29. Some States may nevertheless wish to deal expressly with such abuses. Moreover, States that do not include paragraph 9 of Article 29 in their treaties should include an additional provision to address contract splitting. Such a provision could, for example, be drafted along the following lines:

> For the sole purpose of determining whether the twelve-month period referred to in paragraph 3 has been exceeded,
>
> *a)* where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without exceeding twelve months, and
>
> *b)* connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,

these different periods of time shall be added to the period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.

The concept of "closely related enterprises" that is used in the above provision is defined in paragraph 8 of the Article (see paragraphs 119 to 121 below).

53. For the purposes of the alternative provision found in paragraph 52, the determination of whether activities are connected will depend on the facts and circumstances of each case. Factors that may especially be relevant for that purpose include:

— whether the contracts covering the different activities were concluded with the same person or related persons;

— whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;

— whether the activities would have been covered by a single contract absent tax planning considerations;

— whether the nature of the work involved under the different contracts is the same or similar;

— whether the same employees are performing the activities under the different contracts.

54. 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. If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts all or 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 for purposes of determining whether a permanent establishment exists for the general contractor. In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period. The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.

55. In general, a construction site continues to exist until the work is completed or permanently abandoned. The period during which the building or its facilities are being tested by the contractor or subcontractor should therefore generally be included in the period during which the construction site exists. In practice, the delivery of the building or facilities to the client will usually represent the end of the period of work, provided that the contractor and subcontractors no longer work on the site after its delivery for the purposes of completing its construction. 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 1 May, stopped on 1 November because of bad weather conditions or a lack of materials but resumed work on 1 February the following year, completing the road on 1 June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1 May) and the date he finally finished (1 June of the following year). Work that is undertaken on a site after the construction work has been completed pursuant to a guarantee that requires an enterprise to make repairs would normally not be included in the original construction period. Depending on the circumstances, however, any subsequent work (including work done under a guarantee) performed on the site during an extended period of time may need to be taken into account in order to determine whether such work is carried on through a distinct permanent establishment. For example, where after delivery of a technologically advanced construction project, employees of the contractor or subcontractor remain for four weeks on the construction site to train the owner's employees, that training work shall not be considered work done for the purposes of completing the construction project. Concerns related to the splitting-up of contracts for the purposes of avoiding the inclusion of subsequent construction work in the original construction project are dealt with in paragraph 52 above.

56. 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 months, the enterprise carried on through 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. Assume for instance that a resident of State A and a resident of State B are partners in a partnership established in State B which carries on its construction activities on a construction site situated in State C that lasts 10 months. Whilst the tax treaty between States A and C is identical to the OECD Model, paragraph 3 of Article 5 of the treaty between State B and State C provides that a construction site constitutes a permanent establishment only if it lasts more than 8 months. In that case, the time-threshold of each treaty would be applied at the level of the partnership but only with respect to each partner's share of the profits covered by that treaty; since the treaties provide for different time-thresholds, State C will have the right to tax the share of the profits of the partnership attributable to the partner who is a resident of State B but will not have the right to tax the share attributable to the partner who is a resident of State A. This results from the fact that whilst the provisions of paragraph 3 of each treaty are applied at the level of the same enterprise (i.e. the partnership), the outcome differs with respect to the different shares of the profits of the partnership depending on the time-threshold of the treaty that applies to each share.

57. 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. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases, the fact that the work force is not present for twelve months in one particular location 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.

Paragraph 4

58. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which when carried on through fixed places of business, are not sufficient for these places to constitute permanent establishments. The final part of the paragraph provides that these exceptions only apply if the listed activities have a preparatory or auxiliary character. Since subparagraph *e*) applies to any activity that is not otherwise listed in the paragraph (as long as that activity has a preparatory or auxiliary character), the provisions of the paragraph actually amount to a general restriction of the scope of the definition of permanent establishment contained in paragraph 1 and, when read with that paragraph, provide a more selective test by which to determine what constitutes a permanent establishment. To a considerable degree, these provisions limit the definition in paragraph 1 and exclude from its rather wide scope a number of fixed places of business which, because the business activities exercised through these places are merely preparatory or auxiliary, 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. Moreover subparagraph *f*) provides that combinations of activities mentioned in subparagraphs *a*) to *e*) in the same fixed place of business shall be deemed not to be a permanent establishment, subject to the condition, expressed in the final part of the paragraph, 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 only carries on activities of a purely preparatory or auxiliary character in that State. The provisions of paragraph 4.1 (see below) complement that principle by ensuring that the preparatory or auxiliary character of activities carried on at a fixed place of business must be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or closely related enterprises carry on in the same State.

59. 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.

60. As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

61. Subparagraphs *a*) to *e*) refer to activities that are carried on for the enterprise itself. A permanent establishment would therefore exist if such activities were performed on behalf of other enterprises at the same fixed place of business. If, for instance, an enterprise that maintained an office for the advertising of its own products or services were also to engage in advertising on behalf of other enterprises at that location, that office would be regarded as a permanent establishment of the enterprise by which it is maintained.

62. Subparagraph *a*) relates to a fixed place of business constituted by facilities used by an enterprise for storing, displaying or delivering its own goods or merchandise. Whether the activity carried on at such a place of business has a preparatory or auxiliary character will have to be determined in the light of factors that include the overall business activity of the enterprise. Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise's sale/distribution business and do not have, therefore, a preparatory or auxiliary character.

63. Subparagraph *a*) would cover, for instance, a bonded warehouse with special gas facilities that an exporter of fruit from one State maintains in another State for the sole purpose of storing fruit in a controlled environment during the customs clearance

process in that other State. It would also cover a fixed place of business that an enterprise maintained solely for the delivery of spare parts to customers for machinery sold to those customers. Paragraph 4 would not apply, however, where an enterprise maintained a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers and, in addition, for the maintenance or repair of such machinery, as this would go beyond the pure delivery mentioned in subparagraph *a*) and would not constitute preparatory or auxiliary activities since these after-sale activities constitute an essential and significant part of the services of an enterprise vis-à-vis its customers.

64. Issues may arise concerning the application of the definition of permanent establishment to facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where these facilities constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether subparagraph *a*) applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a*), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e*) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a*) would be applicable. A separate question is whether the cable or pipeline could constitute a permanent establishment for the customer of the operator of the cable or pipeline, i.e. the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.

65. Subparagraph *b*) relates to the maintenance of a stock of goods or merchandise belonging to the enterprise. This subparagraph is irrelevant in cases where a stock of goods or merchandise belonging to an enterprise is maintained by another person in facilities operated by that other person and the enterprise does not have the facilities at its disposal as the place where the stock is maintained cannot therefore be a permanent establishment of that enterprise. Where, for example, a logistics company operates a warehouse in State S and continuously stores in that warehouse goods or merchandise belonging to an enterprise of State R to which the logistics company is not closely related, the warehouse does not constitute a fixed place of business at the

disposal of the enterprise of State R and subparagraph b) is therefore irrelevant. Where, however, that enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, subparagraph *b*) is applicable and the question of whether a permanent establishment exists will depend on whether these activities constitute a preparatory or auxiliary activity.

66. For the purposes of the application of subparagraphs *a*) and *b*), it does not matter whether the storage or delivery takes place before or after the goods or merchandise have been sold, provided that the goods or merchandise belong to the enterprise whilst they are at the relevant location (e.g. the subparagraphs could apply regardless of the fact that some of the goods that are stored at a location have already been sold as long as the property title to these goods only passes to the customer upon or after delivery). Subparagraphs a) and *b*) also cover situations where a facility is used, or a stock of goods or merchandise is maintained, for any combination of storage, display and delivery since facilities used for the delivery of goods will almost always be also used for the storage of these goods, at least for a short period. For the purposes of subparagraphs a) to *d*), the words "goods" and "merchandise" refer to tangible property and would not cover, for example, immovable property and data (although the subparagraphs would apply to tangible products that include data such as CDs and DVDs).

67. Subparagraph *c*) covers the situation where 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. As explained in the paragraph 65, the mere presence of goods or merchandise belonging to an enterprise does not mean that the fixed place of business where these goods or merchandise are stored is at the disposal of that enterprise. Where, for example, a stock of goods belonging to RCO, an enterprise of State R, is maintained by a toll-manufacturer located in State S for the purposes of processing by that toll-manufacturer, no fixed place of business is at the disposal of RCO and the place where the stock is maintained cannot therefore be a permanent establishment of RCO. If, however, RCO is allowed unlimited access to a separate part of the facilities of the toll-manufacturer for the purpose of inspecting and maintaining the goods stored therein, subparagraph *c*) will apply and it will be necessary to determine whether the maintenance of that stock of goods by RCO constitutes a preparatory or auxiliary activity. This will be the case if RCO is merely a distributor of products manufactured by other enterprises as in that case the mere maintenance of a stock of goods for the purposes of processing by another enterprise would not form an essential and significant part of RCO's overall activity. In such a case, unless paragraph 4.1 applies, paragraph 4 will deem a permanent establishment not to exist in relation to such a fixed place of business that is at the disposal of the enterprise of State R for the purposes of maintaining its own goods to be processed by the toll-manufacturer.

68. The first part of subparagraph *d*) relates to the case where premises are used solely for the purpose of purchasing goods or merchandise for the enterprise. Since this exception only applies if that activity has a preparatory or auxiliary character, it

will typically not apply in the case of a fixed place of business used for the purchase of goods or merchandise where the overall activity of the enterprise consists in selling these goods and where purchasing is a core function in the business of the enterprise. The following examples illustrate the application of paragraph 4 in the case of fixed places of business where purchasing activities are performed:

— Example 1: RCO is a company resident of State R that is a large buyer of a particular agricultural product produced in State S, which RCO sells from State R to distributors situated in different countries. RCO maintains a purchasing office in State S. The employees who work at that office are experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type/quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products by RCO. In this example, although the only activity performed through the office is the purchasing of products for RCO, which is an activity covered by subparagraph *d*), paragraph 4 does not apply and the office therefore constitutes a permanent establishment because that purchasing function forms an essential and significant part of RCO's overall activity.

— Example 2: RCO, a company resident of State R which operates a number of large discount stores, maintains an office in State S during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow RCO to establish stores in State S. During that period, employees of RCO occasionally purchase supplies for their office. In this example, paragraph 4 applies because subparagraph *f*) applies to the activities performed through the office (since subparagraphs *d*) and *e*) would apply to the purchasing, researching and lobbying activities if each of these was the only activity performed at the office) and the overall activity of the office has a preparatory character.

69. The second part of subparagraph *d*) relates to a fixed place of business that is used solely to collect information for the enterprise. An enterprise will frequently need to collect information before deciding whether and how to carry on its core business activities in a State. If the enterprise does so without maintaining a fixed place of business in that State, subparagraph *d*) will obviously be irrelevant. If, however, a fixed place of business is maintained solely for that purpose, subparagraph *d*) will be relevant and it will be necessary to determine whether the collection of information goes beyond the preparatory or auxiliary threshold. Where, for example, an investment fund sets up an office in a State solely to collect information on possible investment opportunities in that State, the collecting of information through that office will be a preparatory activity. The same conclusion would be reached in the case of an insurance enterprise that sets up an office solely for the collection of information, such as statistics, on risks in a particular market and in the case of a newspaper bureau set up in a State solely to collect information on possible news stories without engaging in

any advertising activities: in both cases, the collecting of information will be a preparatory activity.

70. Subparagraph *e*) applies to a fixed place of business maintained solely for the purpose of carrying on, for the enterprise, any activity that is not expressly listed in subparagraphs *a*) to *d*); as long as that activity has a preparatory or auxiliary character, that place of business is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of the activities to which the paragraph may apply, the examples listed in subparagraphs a) to *d*) being merely common examples of activities that are covered by the paragraph because they often have a preparatory or auxiliary character.

71. Examples of places of business covered by subparagraph *e*) are fixed places of business used 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. Paragraph 4 would not apply, however, if a fixed place of business used for the supply of information would not only give information but would also furnish plans etc. specially developed for the purposes of the individual customer. Nor would it apply if a research establishment were to concern itself with manufacture. Similarly, where 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 paragraph 4. 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. If an enterprise with international ramifications establishes a so-called "management office" in a State in which it maintains subsidiaries, permanent establishments, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, subparagraph *e*) will not apply to that "management office" because 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 paragraph 4.

72. Also, where an enterprise that sells goods worldwide establishes an office in a State and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State without habitually concluding contracts or playing the principal role leading to the conclusion of contracts (e.g. by participating in decisions related to the type, quality or quantity of products covered by these contracts), such activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph *e*) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment.

73. As already mentioned in paragraph 58 above, paragraph 4 is designed to provide 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 subparagraph *f*), the fact that one fixed place of business combines any of the activities mentioned in subparagraphs *a*) to *e*) 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.

74. Unless the anti-fragmentation provisions of paragraph 4.1 are applicable (see below), subparagraph *f*) is of no relevance in a case where an enterprise maintains several fixed places of business to which subparagraphs *a*) to *e*) apply as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists.

75. The fixed places of business to which paragraph 4 applies do not constitute permanent establishments so long as the business activities performed through those fixed places of business are restricted to the activities referred to in that paragraph. This will be the case even if the contracts necessary for establishing and carrying on these business activities are concluded by those in charge of the places of business themselves. The conclusion of such contracts by these employees will not constitute a permanent establishment of the enterprise under paragraph 5 as long as the conclusion of these contracts satisfies the conditions of paragraph 4 (see paragraph 97 below). An example would be where the manager of a place of business where preparatory or auxiliary research activities are conducted concludes the contracts necessary for establishing and maintaining that place of business as part of the activities carried on at that location.

76. If, under paragraph 4, a fixed place of business 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 at that place (see paragraph 44 above and paragraph 2 of Article 13). Where, for example, the display of merchandise during a trade fair or convention is excepted under subparagraphs *a*) and *b*), the sale of that merchandise at the termination of the trade fair or convention is covered by subparagraph *e*) as such sale is merely an auxiliary activity. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

77. Where paragraph 4 does not apply because a fixed place of business used by an enterprise for activities that are listed in that paragraph is also used for other activities that go beyond what is preparatory or auxiliary, that place of business constitutes a single permanent establishment of the enterprise and the profits attributable to the permanent establishment with respect to both types of activities may be taxed in the State where that permanent establishment is situated.

78. Some States consider that some of the activities referred to in paragraph 4 are intrinsically preparatory or auxiliary and, in order to provide greater certainty for both tax administrations and taxpayers, take the view that these activities should not be subject to the condition that they be of a preparatory or auxiliary character, any concern about the inappropriate use of these exceptions being addressed through the provisions of paragraph 4.1. States that share that view are free to amend paragraph 4 as follows (and may also agree to delete some of the activities listed in subparagraphs *a*) to *d*) below if they consider that these activities should be subject to the preparatory or auxiliary condition in subparagraph *e*)):

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 activity not listed in subparagraphs a) to *d*), provided that this activity has a preparatory or auxiliary character; or

f) the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs *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

Paragraph 4.1

79. The purpose of paragraph 4.1 is to prevent an enterprise or a group of closely related enterprises from fragmenting a cohesive business operation into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity. Under paragraph 4.1, the exceptions provided for by paragraph 4 do not apply to a place of business that would otherwise constitute a permanent establishment where the activities carried on at that place and other activities of the same enterprise or of closely related enterprises exercised at that place or at another place in the same State constitute complementary functions that are part of a cohesive business operation. For paragraph 4.1 to apply, however, at least one of the places where these activities are exercised must constitute a permanent establishment or, if that is not the case, the overall activity resulting from the combination of the relevant activities must go beyond what is merely preparatory or auxiliary.

80. The provisions of paragraph 8 are applicable in order to determine whether an enterprise is a closely related enterprise with respect to another one (see paragraphs 119 to 121 below).

81. The following examples illustrate the application of paragraph 4.1:

— Example A: RCO, a bank resident of State R, has a number of branches in State S which constitute permanent establishments. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of RCO in State R where other employees analyse the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (i.e. any of the other branches where the loan applications are made) constitutes a permanent establishment of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e. providing loans to clients in State S).

— Example B: RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse. In this case, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph *a*) thereof, applies to the warehouse. The conditions for the application of paragraph 4.1 are met because

  - SCO and RCO are closely related enterprises;
  - SCO's store constitutes a permanent establishment of SCO (the definition of permanent establishment is not limited to situations where a resident of one Contracting State uses or maintains a fixed place of business in the other State; it applies equally where an enterprise of one State uses or maintains a fixed place of business in that same State); and
  - The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions that are part of a cohesive business operation (i.e. storing goods in one place for the purpose of delivering these goods as part of the obligations resulting from the sale of these goods through another place in the same State).

Paragraph 5

82. 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.

83. Persons whose activities may create a permanent establishment for the enterprise are persons, whether or not employees of the enterprise, who act on behalf of the enterprise and are not doing so in the course of carrying on a business as an independent agent falling under paragraph 6. Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. It would not have been in the interest of international economic relations to provide that any person undertaking activities on behalf of the enterprise would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of 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 habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise, can lead to a permanent establishment for the enterprise. In such a case the person's actions on behalf of the enterprise, since they result in the conclusion of such contracts and go beyond mere promotion or advertising, are sufficient to conclude that the enterprise participates in a business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that the conclusion of contracts by that person, or as a direct result of the actions of that person, takes place repeatedly and not merely in isolated cases.

84. For paragraph 5 to apply, all the following conditions must be met:.

- — a person acts in a Contracting State on behalf of an enterprise;
- — in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and
- — these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.

85. Even if these conditions are met, however, paragraph 5 will not apply if the activities performed by the person on behalf of the enterprise are covered by the independent agent exception of paragraph 6 or are limited to activities mentioned in paragraph 4 which, if exercised through a fixed place of business, would be deemed

not to create a permanent establishment. This last exception is explained by the fact that since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for the purposes of preparatory or auxiliary activities is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes should not create a permanent establishment either. Where, for example, a person acts solely as a buying agent for an enterprise and, in doing so, habitually concludes purchase contracts in the name of that enterprise, paragraph 5 will not apply even if that person is not independent of the enterprise as long as such activities are preparatory or auxiliary (see paragraph 68 above).

86. A person is acting in a Contracting State on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the State concerned. This will be the case, for example, where an agent acts for a principal, where a partner acts for a partnership, where a director acts for a company or where an employee acts for an employer. A person cannot be said to be acting on behalf of an enterprise if the enterprise is not directly or indirectly affected by the action performed by that person. As indicated in paragraph 83, the person acting on behalf of an enterprise can be a company; in that case, the actions of the employees and directors of that company are considered together for the purpose of determining whether and to what extent that company acts on behalf of the enterprise.

87. The phrase "concludes contracts" focusses on situations where, under the relevant law governing contracts, a contract is considered to have been concluded by a person. A contract may be concluded without any active negotiation of the terms of that contract; this would be the case, for example, where the relevant law provides that a contract is concluded by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise. Also, a contract may, under the relevant law, be concluded in a State even if that contract is signed outside that State; where, for example, the conclusion of a contract results from the acceptance, by a person acting on behalf of an enterprise, of an offer to enter into a contract made by a third party, it does not matter that the contract is signed outside that State. In addition, a person who negotiates in a State all elements and details of a contract in a way binding on the enterprise can be said to conclude the contract in that State even if that contract is signed by another person outside that State.

88. The phrase "or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" is aimed at situations where the conclusion of a contract directly results from the actions that the person performs in a Contracting State on behalf of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State. Whilst the phrase "concludes contracts" provides a relatively well-known test based on contract law, it was found necessary to supplement that test with a test focusing on substantive activities taking place in one State in order to address cases where the conclusion of contracts is clearly the direct result of these activities although the relevant rules of contract law provide that the conclusion of the contract takes place outside that State. The phrase must be interpreted in the light of the object

and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of the enterprise. The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. The words "contracts that are routinely concluded without material modification by the enterprise" clarify that where such principal role is performed in that State, the actions of that person will fall within the scope of paragraph 5 even if the contracts are not formally concluded in the State, for example, where the contracts are routinely subject, outside that State, to review and approval without such review resulting in a modification of the key aspects of these contracts.

89. The phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" therefore applies where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions. It does not apply, however, where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts. Where, for example, representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs, that marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity.

90. The following is another example that illustrates the application of paragraph 5. RCO, a company resident of State R, distributes various products and services worldwide through its websites. SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO's employees send emails, make telephone calls to, or visit large organisations in order to convince them to buy RCO's products and services and are therefore responsible for large accounts in State S; SCO's employees, whose remuneration is partially based on the revenues derived by RCO from the holders of these accounts, use their relationship building skills to try to anticipate the needs of these account holders and to convince them to acquire the products and services offered by RCO. When one of these account holders is persuaded by an employee of SCO to purchase a given quantity of goods or services, the employee indicates the price that will be payable for that quantity, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO's contracts, including the fixed price structure used by RCO, which the employee is not authorised to modify. The account holder subsequently concludes that contract online for the quantity discussed with SCO's employee and in accordance with the price structure presented by that employee. In this example, SCO's employees play the principal role leading to the conclusion of the

contract between the account holder and RCO and such contracts are routinely concluded without material modification by the enterprise. The fact that SCO's employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and RCO.

91. The wording of subparagraphs *a*), *b*) and *c*) ensures that paragraph 5 applies not only to contracts that create rights and obligations that are legally enforceable between the enterprise on behalf of which the person is acting and the third parties with which these contracts are concluded but also to contracts that create obligations that will effectively be performed by such enterprise rather than by the person contractually obliged to do so.

92. A typical case covered by these subparagraphs is where contracts are concluded with clients by an agent, a partner or an employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and these clients. These subparagraphs also cover cases where the contracts concluded by a person who acts on behalf of an enterprise do not legally bind that enterprise to the third parties with which these contracts are concluded but are contracts for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise. A typical example would be the contracts that a "commissionnaire" would conclude with third parties under a commissionnaire arrangement with a foreign enterprise pursuant to which that commissionnaire would act on behalf of the enterprise but, in doing so, would conclude in its own name contracts that do not create rights and obligations that are legally enforceable between the foreign enterprise and the third parties even though the results of the arrangement between the commissionnaire and the foreign enterprise would be such that the foreign enterprise would directly transfer to these third parties the ownership or use of property that it owns or has the right to use.

93. The reference to contracts "in the name of" in subparagraph *a*) does not restrict the application of the subparagraph to contracts that are literally in the name of the enterprise; it may apply, for example, to certain situations where the name of the enterprise is undisclosed in a written contract.

94. The crucial condition for the application of subparagraphs *b*) and *c*) is that the person who habitually concludes the contracts, or habitually plays the principal role leading to the conclusion of the contracts that are routinely concluded without material modification by the enterprise, is acting on behalf of an enterprise in such a way that the parts of the contracts that relate to the transfer of the ownership or use of property, or the provision of services, will be performed by the enterprise as opposed to the person that acts on the enterprise's behalf.

95. For the purposes of subparagraph *b*), it does not matter whether or not the relevant property existed or was owned by the enterprise at the time of the conclusion of the contracts between the person who acts for the enterprise and the third parties. For example, a person acting on behalf of an enterprise might well sell property that the enterprise will subsequently produce before delivering it directly to the customers. Also, the reference to "property" covers any type of tangible or intangible property.

96. The cases to which paragraph 5 applies must be distinguished from situations where a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises or arranges for other enterprises to deliver such goods or services. In these cases, the person is not acting "on behalf" of these other enterprises and the contracts concluded by the person are neither in the name of these enterprises nor for the transfer to third parties of the ownership or use of property that these enterprises own or have the right to use or for the provision of services by these other enterprises. Where, for example, a company acts as a distributor of products in a particular market and, in doing so, sells to customers products that it buys from an enterprise (including an associated enterprise), it is neither acting on behalf of that enterprise nor selling property that is owned by that enterprise since the property that is sold to the customers is owned by the distributor. This would still be the case if that distributor acted as a so-called "low-risk distributor" (and not, for example, as an agent) but only if the transfer of the title to property sold by that "low-risk" distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold) so that the distributor would derive a profit from the sale as opposed to a remuneration in the form, for example, of a commission.

97. The contracts referred to in paragraph 5 cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person concluded employment contracts for the enterprise to assist that person's activity for the enterprise or if the person concluded, in the name of the enterprise, similar contracts relating to internal operations only. Moreover, whether or not a person habitually concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise should be determined on the basis of the commercial realities of the situation. The mere fact that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has concluded contracts or played the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise.

98. The requirement that an agent must "habitually" conclude contracts or play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise reflects the underlying principle in

Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually" concluding contracts or playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraphs 28 to 30 would be relevant in making that determination.

99. 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 concludes contracts or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise.

100. 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.

101. Whilst one effect of paragraph 5 will typically be that the rights and obligations resulting from the contracts to which the paragraph refers will be allocated to the permanent establishment resulting from the paragraph (see paragraph 21 of the Commentary on Article 7), it is important to note that this does not mean that the entire profits resulting from the performance of these contracts should be attributed to the permanent establishment. The determination of the profits attributable to a permanent establishment resulting from the application of paragraph 5 will be governed by the rules of Article 7; clearly, this will require that activities performed by other enterprises and by the rest of the enterprise to which the permanent establishment belongs be properly remunerated so that the profits to be attributed to the permanent establishment in accordance with Article 7 are only those that the permanent establishment would have derived if it were a separate and independent enterprise performing the activities that paragraph 5 attributes to that permanent establishment.

Paragraph 6

102. Where an enterprise of a Contracting State carries on business dealings through an independent agent carrying on business as such, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of that business (see paragraph 83 above). The activities of such an agent, who represents a separate and independent enterprise, should not result in the finding of a permanent establishment of the foreign enterprise.

103. The exception of paragraph 6 only applies where a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent. It would therefore not apply where a person acts on behalf of an enterprise in a different capacity, such as where an employee acts on behalf of her employer or a partner acts on behalf of a partnership. As explained in paragraph 8.1 of the Commentary on Article 15, it is sometimes difficult to determine whether the services rendered by an individual constitute employment services or services rendered by a separate enterprise and the guidance in paragraphs 8.2 to 8.28 of the Commentary on Article 15 will be relevant for that purpose. Where an individual acts on behalf of an enterprise in the course of carrying on his own business and not as an employee, however, the application of paragraph 6 will still require that the individual do so as an independent agent; as explained in paragraph 111 below, this independent status is less likely if the activities of that individual are performed exclusively or almost exclusively on behalf of one enterprise or closely related enterprises.

104. Whether a person acting as an agent 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. In any event, the last sentence of paragraph 6 provides that in certain circumstances a person shall not be considered to be an independent agent (see paragraphs 119 to 121 below). The following considerations should be borne in mind when determining whether an agent to whom that last sentence does not apply may be considered to be independent.

105. It should be noted that, where the last sentence of paragraph 6 does not apply because a subsidiary does not act exclusively or almost exclusively for closely related enterprises, the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5 (see also paragraph 113 below).

106. An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

107. Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

108. It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

109. Another factor to be considered in determining independent status is the number of principals represented by the agent. As indicated in paragraph 111, independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent, dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

110. An independent agent cannot be said to act in the ordinary course of its business as agent when it performs activities that are unrelated to that agency business. Where, for example, a company that acts on its own account as a distributor for a number of companies also acts as an agent for another enterprise, the activities that the company undertakes as a distributor will not be considered to be part of the activities that the company carries on in the ordinary course of its business as an agent for the purposes of the application of paragraph 6. Activities that are part of the ordinary course of a business that an enterprise carries on as an agent will, however, include intermediation activities which, in line with the common practice in a particular business sector, are performed sometimes as agent and sometimes on the enterprise's own account, provided that these intermediation activities are, in substance, indistinguishable from each other. Where, for example, a broker-dealer in the financial sector performs a variety of market intermediation activities in the same way but, informed by the needs of the clients, does it sometimes as an agent for another enterprise and sometimes on its own account, the broker-dealer will be considered to be acting in the ordinary course of its business as an agent when it performs these various market intermediation activities.

111. The last sentence of paragraph 6 provides that a person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is closely related. That last sentence does not mean, however, that paragraph 6 will apply automatically where a person acts for one or more enterprises to which that person is not closely related. Paragraph 6 requires that the person must be carrying on a business as an independent agent and be acting in the

ordinary course of that business. Independent status is less likely if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are closely related to each other) over the lifetime of that person's business or over a long period of time. Where, however, a person is acting exclusively for one enterprise, to which it is not closely related, for a short period of time (e.g. at the beginning of that person's business operations), it is possible that paragraph 6 could apply. As indicated in paragraph 109 above, all the facts and circumstances would need to be taken into account to determine whether the person's activities constitute the carrying on of a business as an independent agent.

112. The last sentence of paragraph 6 applies only where the person acts "exclusively or almost exclusively" on behalf of closely related enterprises, as defined in paragraph 8. This means that where the person's activities on behalf of enterprises to which it is not closely related do not represent a significant part of that person's business, that person will not qualify as an independent agent. Where, for example, the sales that an agent concludes for enterprises to which it is not closely related represent less than 10 per cent of all the sales that it concludes as an agent acting for other enterprises, that agent should be viewed as acting "exclusively or almost exclusively" on behalf of closely related enterprises.

113. The rule in the last sentence of paragraph 6 and the fact that the definition of "closely related" in paragraph 8 covers situations where one company controls or is controlled by another company do not restrict in any way the scope of paragraph 7 of Article 5. As explained in paragraph 117 below, it is possible that a subsidiary will act on behalf of its parent company in such a way that the parent will be deemed to have a permanent establishment under paragraph 5; if that is the case, a subsidiary acting exclusively or almost exclusively for its parent will be unable to benefit from the "independent agent" exception of paragraph 6. This, however, does not imply that the parent-subsidiary relationship eliminates the requirements of paragraph 5 and that such a relationship could be sufficient in itself to conclude that any of these requirements are met.

114. 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 before 2017 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 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. Also, the changes to paragraphs 5 and 6 made in 2017 have addressed some of the concerns that such a provision is intended to address. 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.

Paragraph 7

115. 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.

116. A parent company may, however, be found, under the rules of paragraph 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs 10 to 19 above) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraphs 3 and 4 of the Article (see for instance, the example in paragraph 15 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the conditions of that paragraph are met (see paragraphs 82 to 99 above), unless paragraph 6 of the Article applies.

117. The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal (see paragraphs 10 to 19 above) and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article (see paragraphs 82 to 99 above). The determination of the existence of a permanent establishment under the rules of paragraph 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

118. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the

place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

Paragraph 8

119. Paragraph 8 explains the meaning of the concept of a person or enterprise "closely related to an enterprise" for the purposes of the Article and, in particular, of paragraphs 4.1 and 6. That concept is to be distinguished from the concept of "associated enterprises" which is used for the purposes of Article 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent.

120. The first part of paragraph 8 includes the general definition of a person or enterprise closely related to an enterprise. It provides that a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. This general rule would cover, for example, situations where a person or enterprise controls an enterprise by virtue of a special arrangement that allows that person or enterprise to exercise rights that are similar to those that it would hold if it possessed directly or indirectly more than 50 per cent of the beneficial interests in the enterprise. As in most cases where the plural form is used, the reference to the "same persons or enterprises" at the end of the first sentence of paragraph 8 covers cases where there is only one such person or enterprise.

121. The second part of paragraph 8 provides that the requirements of the definition of a person or enterprise closely related to an enterprise are automatically met in certain circumstances. Under that second part, a person or enterprise is considered to be closely related to an enterprise if either one possesses directly or indirectly more than 50 per cent of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50 per cent of the beneficial interests in both the person and the enterprise or in both enterprises. In the case of a company, this condition is met where a person holds directly or indirectly more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company.

Electronic commerce

122. There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a

permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

123. Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 6 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

124. The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraphs 10 to 19 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

125. Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

126. Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the

enterprise has facilities at its disposal where business functions of the enterprise are performed.

127. Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

128. Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

— providing a communications link — much like a telephone line — between suppliers and customers;
— advertising of goods or services;
— relaying information through a mirror server for security and efficiency purposes;
— gathering market data for the enterprise;
— supplying information.

129. Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 123 to 127 above), there would be a permanent establishment.

130. What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an "e-tailer") that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the

nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

131. A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISPs. Whilst this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not conclude contracts or play the principal role leading to the conclusion of contracts in the name of these enterprises, or for the transfer of property belonging to these enterprises or the provision of services by these enterprises, or because they will act in the ordinary course of a business as an independent agent, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph.

The taxation of services

132. The combined effect of this Article and Article 7 is that the profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein (as long as they are not covered by other Articles of the Convention that would allow such taxation). This result, under which these profits are only taxable in the other State, is supported by various policy and administrative considerations. It is consistent with the principle of Article 7 that until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State. Also, the provision of services should, as a general rule subject to a few exceptions for some types of service (e.g. those covered by Articles 8 and 17), be treated the same way as other business activities and, therefore, the same permanent establishment

threshold of taxation should apply to all business activities, including the provision of independent services.

133. One of the administrative considerations referred to above is that the extension of the cases where source taxation of profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State would be allowed would increase the compliance and administrative burden of enterprises and tax administrations. This would be especially problematic with respect to services provided to non-business consumers, which would not need to be disclosed to the source country's tax administration for purposes of claiming a business expense deduction. Since the rules that have typically been designed for that purpose are based on the amount of time spent in a State, both tax administrations and enterprises would need to take account of the time spent in a country by personnel of service enterprises and these enterprises would face the risk of having a permanent establishment in unexpected circumstances in cases where they would be unable to determine in advance how long personnel would be present in a particular country (e.g. in situations where that presence would be extended because of unforeseen difficulties or at the request of a client). These cases create particular compliance difficulties as they require an enterprise to retroactively comply with a number of administrative requirements associated with a permanent establishment. These concerns relate to the need to maintain books and records, the taxation of the employees (e.g. the need to make source deductions in another country) as well as other non-income tax requirements.

134. Also, the source taxation of profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State that does not have a fixed place of business in the first-mentioned State would create difficulties concerning the determination of the profits to be taxed and the collection of the relevant tax. In most cases, the enterprise would not have the accounting records and assets typically associated with a permanent establishment and there would be no dependent agent which could comply with information and collection requirements. Moreover, whilst it is a common feature of States' domestic law to tax profits from services performed in their territory, it does not necessarily represent optimal tax treaty policy.

135. Some States, however, are reluctant to adopt the principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated in their territory but that are performed in that territory. These States propose changes to the Article in order to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. States that believe that additional source taxation rights should be allocated under a treaty with respect to services performed in their territory rely on various arguments to support their position.

136. These States may consider that profits from services performed in a given state should be taxable in that state on the basis of the generally-accepted policy principles for determining when business profits should be considered to have their source within a jurisdiction. They consider that, from the exclusive angle of the pure policy

question of where business profits originate, the State where services are performed should have a right to tax even when these services are not attributable to a permanent establishment as defined in Article 5. They would note that the domestic law of many countries provides for the taxation of services performed in these countries even in the absence of a permanent establishment (even though services performed over very short periods of time may not always be taxed in practice).

137. These States are concerned that some service businesses do not require a fixed place of business in their territory in order to carry on a substantial level of business activities therein and consider that these additional rights are therefore appropriate.

138. Also, these States consider that even if the taxation of profits of enterprises carried on by non-residents that are not attributable to a permanent establishment raises certain compliance and administrative difficulties, these difficulties do not justify exempting from tax the profits from all services performed on their territory by such enterprises. Those who support that view may refer to mechanisms that are already in place in some States to ensure taxation of services performed in these States but not attributable to permanent establishments (such mechanisms are based on requirements for resident payers to report, and possibly withhold tax on, payments to non-residents for services performed in these States).

139. It should be noted, however, that all member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State, or that such consideration is borne by a permanent establishment situated in that State or that the result of the services is used within the State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.

140. Another fundamental issue on which there is general agreement relates to the determination of the amount on which tax should be levied. In the case of non-employment services (and subject to possible exceptions such as Article 17) only the profits derived from the services should be taxed. Thus, provisions that are sometimes included in bilateral conventions and that allow a State to tax the gross amount of the fees paid for certain services if the payer of the fees is a resident of that State do not seem to provide an appropriate way of taxing services. First, because these provisions are not restricted to services performed in the State of source, they have the effect of allowing a State to tax business activities that do not take place in that State. Second, these rules allow taxation of the gross payments for services as opposed to the profits therefrom.

141. Also, member States agree that it is appropriate, for compliance and other reasons, not to allow a State to tax the profits from services performed in their territory

in certain circumstances (e.g. when such services are provided during a very short period of time).

142. The Committee therefore considered that it was important to circumscribe the circumstances in which States that did not agree with the conclusion in paragraph 132 above could, if they wished to, provide that profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State would be taxable by that State even if there was no permanent establishment, as defined in Article 5, to which the profits were attributable.

143. Clearly, such taxation should not extend to services performed outside the territory of a State and should apply only to the profits from these services rather than to the payments for them. Also, there should be a minimum level of presence in a State before such taxation is allowed.

144. The following is an example of a provision that would conform to these requirements; States are free to agree bilaterally to include such a provision in their tax treaties:

> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> *a)* through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
>
> *b)* for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State
>
> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business (other than a fixed place of business to which paragraph 4.1 would apply), would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

145. That alternative provision constitutes an extension of the permanent establishment definition that allows taxation of income from services provided by enterprises carried on by non-residents but does so in conformity with the principles described in paragraph 143. The following paragraphs discuss various aspects of the alternative provision; clearly these paragraphs are not relevant in the case of treaties that do not include such a provision and do not, therefore, allow a permanent

establishment to be found merely because the conditions described in this provision have been met.

146. The provision has the effect of deeming a permanent establishment to exist where one would not otherwise exist under the definition provided in paragraph 1 and the examples of paragraph 2. It therefore applies notwithstanding these paragraphs. As is the case of paragraph 5 of the Article, the provision provides a supplementary basis under which an enterprise may be found to have a permanent establishment in a State; it could apply, for example, where a consultant provides services over a long period in a country but at different locations that do not meet the conditions of paragraph 1 to constitute one or more permanent establishments. 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 apply the provision in order to find a permanent establishment. Since the provision simply creates a permanent establishment when none would otherwise exist, it does not provide an alternative definition of the concept of permanent establishment and obviously cannot limit the scope of the definition in paragraph 1 and of the examples in paragraph 2.

147. The provision also applies notwithstanding paragraph 3. Thus, an enterprise may be deemed to have a permanent establishment because it performs services in a country for the periods of time provided for in the suggested paragraph even if the various locations where these services are performed do not constitute permanent establishments pursuant to paragraph 3. The following example illustrates that result. A self-employed individual resident of one Contracting State provides services and is present in the other Contracting State for more than 183 days during a twelve month period but his services are performed for equal periods of time at a location that is not a construction site (and are not in relation to a construction or installation project) as well as on two unrelated building sites which each lasts less than the period of time provided for in paragraph 3. Whilst paragraph 3 would deem the two sites not to constitute permanent establishments, the proposed paragraph, which applies notwithstanding paragraph 3, would deem the enterprise carried on by that person to have a permanent establishment (since the individual is self-employed, it must be assumed that the 50 per cent of gross revenues test will be met with respect to his enterprise).

148. Another example is that of a large construction enterprise that carries on a single construction project in a country. If the project is carried on at a single site, the provision should not have a significant impact as long as the period required for the site to constitute a permanent establishment is not substantially different from the period required for the provision to apply. States that wish to use the alternative provision may therefore wish to consider referring to the same periods of time in that provision and in paragraph 3 of Article 5; if a shorter period is used in the alternative provision, this will reduce, in practice, the scope of application of paragraph 3.

149. The situation, however, may be different if the project, or connected projects, are carried out in different parts of a country. If the individual sites where a single project

is carried on do not last sufficiently long for each of them to constitute a permanent establishment (see, however, paragraph 57 above), a permanent establishment will still be deemed to exist if the conditions of the alternative provision are met. That result is consistent with the purpose of the provision, which is to subject to source taxation foreign enterprises that are present in a country for a sufficiently long period of time notwithstanding the fact that their presence at any particular location in that country is not sufficiently long to make that location a fixed place of business of the enterprise. Some States, however, may consider that paragraph 3 should prevail over the alternative provision and may wish to amend the provision accordingly.

150. The suggested paragraph only applies to services. Other types of activities that do not constitute services are therefore excluded from its scope. Thus, for instance, the paragraph would not apply to a foreign enterprise that carries on fishing activities in the territorial waters of a State and derives revenues from selling its catches (in some treaties, however, activities such as fishing and oil extraction may be covered by specific provisions).

151. The provision applies to services performed by an enterprise. Thus, services must be provided by the enterprise to third parties. Clearly, the provision could not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. For example, services might be provided by an individual to his employer without that employer performing any services (e.g. an employee who provides manufacturing services to an enterprise that sells manufactured products). Another example would be where the employees of one enterprise provide services in one country to an associated enterprise under detailed instructions and close supervision of the latter enterprise; in that case, assuming the services in question are not for the benefit of any third party, the latter enterprise does not itself perform any services to which the provision could apply.

152. Also, the provision only applies to services that are performed in a State by a foreign enterprise. Whether or not the relevant services are furnished to a resident of the State does not matter; what matters is that the services are performed in the State through an individual present in that State.

153. The alternative provision does not specify that the services must be provided "through employees or other personnel engaged by the enterprise", a phrase that is sometimes found in bilateral treaties. It simply provides that the services must be performed by an enterprise. As explained in paragraph 39 above, the business of an enterprise (which, in the context of the paragraph, would include the services performed in a Contracting State) "is carried on by the entrepreneur or persons who are in paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents)." For the purposes of the alternative provision, the individuals through which an enterprise provides services will therefore be the individuals referred to in paragraph 39, subject to the exception included in the last sentence of that provision (see paragraph 164 below).

154. The alternative provision will apply in two different sets of circumstances. Subparagraph *a)* looks at the duration of the presence of the individual through whom an enterprise derives most of its revenues in a way that is similar to that of subparagraph *a)* of paragraph 2 of Article 15; subparagraph *b)* looks at the duration of the activities of the individuals through whom the services are performed.

155. Subparagraph *a)* deals primarily with the situation of an enterprise carried on by a single individual. It also covers, however, the case of an enterprise which, during the relevant period or periods, derives most of its revenues from services provided by one individual. Such extension is necessary to avoid a different treatment between, for example, a case where services are provided by an individual and a case where similar services are provided by a company all the shares of which are owned by the only employee of that company.

156. The subparagraph may apply in different situations where an enterprise performs services through an individual, such as when the services are performed by a sole proprietorship, by the partner of a partnership, by the employee of a company etc. The main conditions are that

— the individual through whom the services are performed be present in a State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and

— more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during the period or periods of presence be derived from the services performed in that State through that individual.

157. The first condition refers to the days of presence of an individual. Since the formulation is identical to that of subparagraph *a*) of paragraph 2 of Article 15, the principles applicable to the computation of the days of presence for purposes of that last subparagraph are also applicable to the computation of the days of presence for the purpose of the suggested paragraph.

158. For the purposes of the second condition, according to which more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during the relevant period or periods must be derived from the services performed in that State through that individual, the gross revenues attributable to active business activities of the enterprise would represent what the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes. Such active business activities are not restricted to activities related to the provision of services. Gross revenues attributable to "active business activities" would clearly exclude income from passive investment activities, including, for example, receiving interest and dividends from investing surplus funds. States may, however, prefer to use a different test, such as "50 per cent of the business profits of the enterprise during this period or periods is derived from the services" or "the services represent the most important part of the business activities of the enterprise", in order

to identify an enterprise that derives most of its revenues from services performed by an individual on their territory.

159. The following examples illustrate the application of subparagraph *a)* (assuming that the alternative provision has been included in a treaty between States R and S):

— Example 1: W, a resident of State R, is a consultant who carries on her business activities in her own name (i.e. that enterprise is a sole proprietorship). Between 2 February 00 and 1 February 01, she is present in State S for a period or periods of 190 days and during that period all the revenues from her business activities are derived from services that she performs in State S. Since subparagraph *a)* applies in that situation, these services shall be deemed to be performed through a permanent establishment in State S.

— Example 2: X, a resident of State R, is one of the two shareholders and employees of XCO, a company resident of State R that provides engineering services. Between 20 December 00 and 19 December 01, X is present in State S for a period or periods of 190 days and during that period, 70 per cent of all the gross revenues of XCO attributable to active business activities are derived from the services that X performs in State S. Since subparagraph *a)* applies in that situation, these services shall be deemed to be performed through a permanent establishment of XCO in State S.

— Example 3: X and Y, who are residents of State R, are the two partners of X&Y, a partnership established in State R which provides legal services. For tax purposes, State R treats partnerships as transparent entities. Between 15 July 00 and 14 July 01, Y is present in State S for a period or periods of 240 days and during that period, 55 per cent of all the fees of X&Y attributable to X&Y's active business activities are derived from the services that Y performs in State S. Subparagraph *a)* applies in that situation and, for the purposes of the taxation of X and Y, the services performed by Y are deemed to be performed through a permanent establishment in State S.

— Example 4: Z, a resident of State R, is one of 10 employees of ACO, a company resident of State R that provides accounting services. Between 10 April 00 and 9 April 01, Z is present in State S for a period or periods of 190 days and during that period, 12 per cent of all the gross revenues of ACO attributable to its active business activities are derived from the services that Z performs in State S. Subparagraph *a)* does not apply in that situation and, unless subparagraph *b)* applies to ACO, the alternative provision will not deem ACO to have a permanent establishment in State S.

160. Subparagraph *b)* addresses the situation of an enterprise that performs services in a Contracting State in relation to a particular project (or for connected projects) and which performs these through one or more individuals over a substantial period. The period or periods referred to in the subparagraph apply in relation to the enterprise and not to the individuals. It is therefore not necessary that it be the same individual or individuals who perform the services and are present throughout these periods. As long as, on a given day, the enterprise is performing its services through at least one

individual who is doing so and is present in the State, that day would be included in the period or periods referred to in the subparagraph. Clearly, however, that day will count as a single day regardless of how many individuals are performing such services for the enterprise during that day.

161. The reference to an "enterprise … performing these services for the same project" should be interpreted from the perspective of the enterprise that provides the services. Thus, an enterprise may have two different projects to provide services to a single customer (e.g. to provide tax advice and to provide training in an area unrelated to tax) and whilst these may be related to a single project of the customer, one should not consider that the services are performed for the same project.

162. The reference to "connected projects" is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects have a commercial coherence (see paragraphs 24 and 25 above). The determination of whether projects are connected will depend on the facts and circumstances of each case but factors that would generally be relevant for that purpose include:

— whether the projects are covered by a single master contract;
— where the projects are covered by different contracts, whether these different contracts were concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;
— whether the nature of the work involved under the different projects is the same;
— whether the same individuals are performing the services under the different projects.

163. Subparagraph *b)* requires that during the relevant periods, the enterprise is performing services through individuals who are performing such services in that other State. For that purpose, a period during which individuals are performing services means a period during which the services are actually provided, which would normally correspond to the working days of these individuals. An enterprise that agrees to keep personnel available in case a client needs the services of such personnel and charges the client standby charges for making such personnel available is performing services through the relevant individuals even though they are idle during the working days when they remain available.

164. As indicated in paragraph 153 above, for the purposes of the alternative provision, the individuals through whom an enterprise provides services will be the individuals referred to in paragraph 39 above. If, however, an individual is providing the services on behalf of one enterprise, the exception included in the last sentence of the provision clarifies that the services performed by that individual will only be taken into account for another enterprise if the work of that individual is exercised under the supervision, direction or control of the last-mentioned enterprise. Thus, for example, where a company that has agreed by contract to provide services to third parties provides these services through the employees of a separate enterprise (e.g. an

enterprise providing outsourced services), the services performed through these employees will not be taken into account for purposes of the application of subparagraph *b)* to the company that entered into the contract to provide services to third parties. This rule applies regardless of whether the separate enterprise is associated to, or independent from, the company that entered into the contract.

165. The following examples illustrate the application of subparagraph *b)* (assuming that the alternative provision has been included in a treaty between States R and S):

— Example 1: X, a company resident of State R, has agreed with company Y to carry on geological surveys in various locations in State S where company Y owns exploration rights. Between 15 May 00 and 14 May 01, these surveys are carried on over 185 working days by employees of X as well as by self-employed individuals to whom X has sub-contracted part of the work but who work under the direction, supervision or control of X. Since subparagraph *b)* applies in that situation, these services shall be deemed to be performed through a permanent establishment of X in State S.

— Example 2: Y, a resident of State T, is one of the two shareholders and employees of WYCO, a company resident of State R that provides training services. Between 10 June 00 and 9 June 01, Y performs services in State S under a contract that WYCO has concluded with a company which is a resident of State S to train the employees of that company. These services are performed in State S over 185 working days. During the period of Y's presence in State S, the revenues from these services account for 40 per cent of the gross revenues of WYCO from its active business activities. Whilst subparagraph *a)* does not apply in that situation, subparagraph *b)* applies and these services shall be deemed to be performed through a permanent establishment of WYCO in State S.

— Example 3: ZCO, a resident of State R, has outsourced to company OCO, which is a resident of State S, the technical support that it provides by telephone to its clients. OCO operates a call centre for a number of companies similar to ZCO. During the period of 1 January 00 to 31 December 00, the employees of OCO provide technical support to various clients of ZCO. Since the employees of OCO are not under the supervision, direction or control of ZCO, it cannot be considered, for the purposes of subparagraph *b)*, that ZCO is performing services in State S through these employees. Additionally, whilst the services provided by OCO's employees to the various clients of ZCO are similar, these are provided under different contracts concluded by ZCO with unrelated clients: these services cannot, therefore, be considered to be rendered for the same or connected projects.

166. The 183-day thresholds provided for in the alternative provision may give rise to the same type of abuse as is described in paragraph 52 above. As indicated in that paragraph, apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, these abuses could also be addressed through the application of the anti-abuse rule of paragraph 9 of Article 29. Some States, however, may prefer to deal with them by including a

specific provision in the Article. Such a provision could be drafted along the following lines:

> For the purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, closely related to another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are present and performing such services in that State, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals.

167. According to the provision, the activities carried on in the other State by the individuals referred to in subparagraph *a)* or *b)* through which the services are performed by the enterprise during the period or periods referred to in these subparagraphs are deemed to be carried on through a permanent establishment that the enterprise has in that other State. The enterprise is therefore deemed to have a permanent establishment in that other State for the purposes of all the provisions of the Convention (including, for example, paragraph 5 of Article 11 and paragraph 2 of Article 15) and the profits derived from the activities carried on in the other State in providing these services are attributable to that permanent establishment and are therefore taxable in that State pursuant to Article 7.

168. By deeming the activities carried on in performing the relevant services to be carried on through a permanent establishment that the enterprise has in a Contracting State, the provision allows the application of Article 7 and therefore, the taxation, by that State, of the profits attributable to these activities. As a general rule, it is important to ensure that only the profits derived from the activities carried on in performing the services are taxed; whilst there may be certain exceptions, it would be detrimental to the cross-border trade in services if payments received for these services were taxed regardless of the direct or indirect expenses incurred for the purpose of performing these services.

169. This alternative provision will not apply if the services performed are limited to those mentioned in paragraph 4 of Article 5 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. Since the provision refers to the performance of services by the enterprise and this would not cover services provided to the enterprise itself, most of the provisions of paragraph 4 would not appear to be relevant. It may be, however, that the services that are performed are exclusively of a preparatory or auxiliary character (e.g. the supply of information to prospective customers when this is merely preparatory to the conduct of the ordinary business activities of the enterprise; see paragraph 71 above) and in that case, it is logical not to consider that the performance of these services will constitute a permanent establishment.

Observations on the Commentary

170. Concerning paragraph 64, *Germany* reserves its position on whether and under which circumstances the acquisition of a right of disposal over the transport capacity of pipelines or the capacity of technical installations, lines and cables for the transmission of electrical power or communications (including the distribution of radio and television programs) owned by an unrelated third party could result in disposal over the pipeline, cable or line as a fixed place of business.

171. Regarding paragraph 104, *Mexico* believes that the arm's length principle should also be considered in determining whether or not an agent is of an independent status for purposes of paragraph 6 of the Article and wishes, when necessary, to add wording to its conventions to clarify that this is how the paragraph should be interpreted.

172. *Germany*, as regards sentence 3 of paragraph 50, takes the view that business activities limited to on-site planning and supervision over a construction project can only constitute a permanent establishment if they meet the requirements specified in paragraph 1 of Article 5.

173. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the third sentence of paragraph 2 — 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.

174. The *Czech Republic* has expressed a number of explanations and reservations on the report on "Issues Arising Under Article 5 of the OECD Model Tax Convention". In particular, the Czech Republic does not agree with the interpretation mentioned in paragraphs 24 (first part of the paragraph) and 25 (first part of the paragraph). According to its policy, these examples could also be regarded as constituting a permanent establishment if the services are furnished on its territory over a substantial period of time.

175. As regards paragraph 50, the *Czech Republic* adopts a narrower interpretation of the term "installation project" and therefore, it restricts it to an installation and assembly related to a construction project. Furthermore, the Czech Republic adheres to an interpretation that supervisory activities will be automatically covered by paragraph 3 of Article 5 only if they are carried on by the building contractor. Otherwise, they will be covered by it, but only if they are expressly mentioned in this special provision. In the case of an installation project not in relation with a construction project and in the case that supervisory activity is carried on by an enterprise other than the building contractor and it is not expressly mentioned in paragraph 3 of Article 5, then these activities are automatically subject to the rules concerning the taxation of income derived from the provision of other services.

176. In relation to paragraphs 122 to 131, the *United Kingdom* takes the view that a server used by an e-tailer, either alone or together with web sites, could not as such constitute a permanent establishment.

177. *Chile* and *Greece* do not adhere to all the interpretations in paragraphs 122 to 131.

178. *Germany* does not agree with the interpretation of the "painter example" in paragraph 17 which it regards as inconsistent with the principle stated in the first sentence of paragraph 12, thus not giving rise to a permanent establishment under Article 5 paragraph 1 of the Model Convention. As regards the example described in paragraph 25, Germany would require that the consultant has disposal over the offices used apart from his mere presence during the training activities.

179. *Germany* reserves its position concerning the scope and limits of application of guidance in sentence 2 of paragraph 28 and paragraphs 29 and 30, taking the view that in order to permit the assumption of a fixed place of business, the necessary degree of permanency requires a certain minimum period of presence during the year concerned, irrespective of the recurrent or other nature of an activity. Germany does in particular not agree with the criterion of economic nexus — as described in sentence 1 of paragraph 30 — to justify an exception from the requirements of qualifying presence and duration.

180. *Germany*, as regards paragraph 98 (with reference to paragraphs 83, and 28 to 30), attaches increased importance to the requirement of minimum duration of representation of the enterprise under Article 5 paragraph 5 of the Model Convention in the absence of a residence and/or fixed place of business of the agent in the source country. Germany therefore in these cases takes a particularly narrow view on the applicability of the factors mentioned in paragraphs 28 to 30.

181. *Italy* wishes to clarify that, with respect to paragraphs 97, 116, 117 and 118, its jurisprudence is not to be ignored in the interpretation of cases falling in the above paragraphs.

182. *Mexico* and *Portugal* wish to reserve their right not to follow the position expressed in paragraphs 122 to 131.

183. *Turkey* reserves its position on whether and under which circumstances the activities referred to in paragraphs 122 to 131 constitute a permanent establishment.

184. *Finland* and *Sweden* consider that when a State chooses to include in a convention the alternative version of paragraph 4 of Article 5 in paragraph 78 of the Commentary, it is not necessary also to include paragraph 4.1 of Article 5 in the convention.

185. *Germany* reserves its position regarding the application of the first sentence of paragraph 9.

186. *Greece* does not adhere to all of the interpretations in paragraph 45.

Reservations on the Article

187. The *United States* reserves its right to follow the versions of paragraphs 5 and 6 as they stood before the 2017 update of the Model Tax Convention.

Paragraph 1

188. *Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if it carries on activities relating to natural resources or

operates substantial equipment in that State with a certain degree of continuity, or a person — acting in that State on behalf of the enterprise — manufactures or processes in that State goods or merchandise belonging to the enterprise.

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

190. *Chile* reserves the right to deem an enterprise to have a permanent establishment in certain circumstances where services are provided.

191. The *Czech Republic* and the *Slovak Republic*, whilst agreeing with the "fixed place of business" requirement of paragraph 1, reserve 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.

192. *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 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).

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

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

195. *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 or uses or leases substantial equipment.

196. *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 either directly or through the employees of a separate enterprise.

197. *Latvia* reserves 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.

Paragraph 2

198. *Canada*, *Chile* and *Israel* reserve the right in subparagraph 2 *f*) to replace the words "of extraction" with the words "relating to the exploration for or the exploitation".

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

200. *Greece* and *Mexico* reserve the right in subparagraph 2 *f*) to replace the words "of extraction" with the words "relating to the extraction, exploration for or the exploitation".

Paragraph 3

201. *Australia*, *Chile*, *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.

202. *Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if it carries on in that State supervisory or consultancy activities for more than 183 days in any twelve month period in connection with a building site or construction or installation project in that State.

203. *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.

204. *Slovenia* reserves the right to include connected supervisory or consultancy activities in paragraph 3 of the Article.

205. *Mexico* and the *Slovak Republic* reserve 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.

206. *Mexico* and the *Slovak Republic* reserve their position on paragraph 3 and consider that any building site or construction, assembly, or installation project that lasts more than six months should be regarded as a permanent establishment.

207. *Poland* and *Slovenia* reserve the right to replace "construction or installation project" with "construction, assembly, or installation project".

208. *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.

209. 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 twelve month threshold test in paragraph 3.

Paragraph 4

210. *Chile* reserves the right to amend paragraph 4 by eliminating subparagraph *f*), replacing the text of subparagraph *e*) with "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, for the enterprise;", and deleting "or, in the case of subparagraph *f*), the overall activity of the fixed place of business," from the final part of paragraph 4.

211. *Mexico* reserves the right to exclude subparagraph *f*) of paragraph 4 of the Article to consider that a permanent establishment could exist where a fixed place of business is maintained for any combination of activities mentioned in subparagraphs *a*) to *e*) of paragraph 4.

Paragraph 4.1

212. *Finland*, *Luxembourg*, *Sweden* and *Switzerland* reserve the right not to include paragraph 4.1 in their conventions.

Paragraph 5

213. *Finland*, *Germany*, *Luxembourg*, *Sweden* and *Switzerland* reserve the right to use the previous version of paragraph 5 of Article 5 (i.e. the version included in the Model Tax Convention immediately before the 2017 update of the Model Tax Convention).

Paragraph 6

214. *Finland*, *Luxembourg* and *Sweden* reserve the right to use the previous version of paragraph 6 of Article 5 (i.e. the version included in the Model Tax Convention immediately before the 2017 update of the Model Tax Convention).

215. *Germany* reserves the right to use the previous version of paragraph 6 (i.e. the version included in the Model Tax Convention immediately before the 2017 update of the Model Tax Convention) because it does not agree that a person should not be considered an independent agent only because the person acts exclusively or almost exclusively on behalf of one or more closely related enterprises.

Paragraph 8

216. *Finland* and *Sweden* reserve the right not to include paragraph 8 in their conventions.

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 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.

2.1 The phrase "including income from agriculture or forestry" in paragraph 1 extends the scope of Article 6 to include not only income derived from immovable property as defined in paragraph 2 but also income from activities that constitute agriculture or forestry. Income from agriculture and forestry includes not only the income that an enterprise engaged in agriculture or forestry derives from selling its agricultural and forestry production but also income that is an integral part of the carrying on of agriculture or forestry activities — for instance, income derived from the acquisition or trading of emissions permits (the nature of these permits is explained in paragraph 75.1 of the Commentary on Article 7) where such acquisition or trading is an integral part of the carrying on of agriculture or forestry activities, e.g. where the permits are acquired for the purpose of carrying on these activities or where permits acquired for that purpose are subsequently traded when it is realised that they will not be needed.

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. Income in the form of distributions from Real Estate Investment Trusts (REITs), however, raises particular issues which are discussed in paragraphs 67.1 to 67.7 of the Commentary on Article 10.

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 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.

Reservations on the Article

5. *Finland* and *Latvia* 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 countries and held by the company, where such right is based on the ownership of shares or other corporate rights in the company.

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.

8. *Canada* and *Latvia* reserve the right to include in paragraph 3 a reference to income from the alienation of immovable property.

9. *New Zealand* reserves the right to include fishing and rights relating to all natural resources under this Article.

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.

11. *Australia* reserves the right to include rights relating to all natural resources under this Article.

12. *Mexico* reserves the right to treat as immovable property any right that allows the use or enjoyment of immovable property situated in a Contracting State where that use or enjoyment relates to time sharing since under its domestic law such right is not considered to constitute immovable property.

13. *Estonia* reserves the right to include in the definition of the term "immovable property" any right of claim in respect of immovable property because such right of claim may not be included in its domestic law meaning of the term.

14. *Israel* and *Latvia* reserve the right to include in paragraph 2 "any option or similar right to acquire immovable property".

15. *Portugal* reserves the right to extend the scope of Article 6 to cover income from movable property or income derived from services, which are connected with the use or the right to use immovable property, either of which, under the taxation law of the Contracting State in which the property is situated, is assimilated to income from immovable property.

16. *Greece* reserves the right to include boats along with ships in the definition provided for in paragraph 2.

COMMENTARY ON ARTICLE 7
CONCERNING THE TAXATION OF BUSINESS PROFITS

I. Preliminary remarks

1. This Article allocates taxing rights with respect to the business profits of an enterprise of a Contracting State to the extent that these profits are not subject to different rules under other Articles of the Convention. It incorporates the basic principle that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State unless these profits fall into special categories of income for which other Articles of the Convention give taxing rights to that other State.

2. Article 5, which includes the definition of the concept of permanent establishment, is therefore relevant to the determination of whether the business profits of an enterprise of a Contracting State may be taxed in the other State. That Article, however, does not itself allocate taxing rights: when an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, it is necessary to determine what, if any, are the profits that the other State may tax. Article 7 provides the answer to that question by determining that the other State may tax the profits that are attributable to the permanent establishment.

3. The principles underlying Article 7, and in particular paragraph 2 of the Article, have a long history. When the OECD first examined what criteria should be used in attributing profits to a permanent establishment, this question had previously been addressed in a large number of tax conventions and in various models developed by the League of Nations. The separate entity and arm's length principles, on which paragraph 2 is based, had already been incorporated in these conventions and models and the OECD considered that it was sufficient to restate these principles with some slight amendments and modifications for the main purpose of clarification.

4. Practical experience has shown, however, that there was considerable variation in the interpretation of these general principles and of other provisions of earlier versions of Article 7. This lack of a common interpretation created problems of double taxation and non-taxation. Over the years, the Committee on Fiscal Affairs spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.[1] In 1987, noting that

1 "The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*, OECD, Paris, 1984.

the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"[1] and to subsequent changes to the Commentary.

5. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[2] (the "OECD Transfer Pricing Guidelines"), it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled *Attribution of Profits to Permanent Establishments*[3] (the "2008 Report").

6. The approach developed in the 2008 Report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus was on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade. When it approved the 2008 Report, the Committee considered that the guidance included therein represented a better approach to attributing profits to permanent establishments than had previously been available. It also recognised, however, that there were differences between some of the conclusions of the 2008 Report and the interpretation of Article 7 previously given in this Commentary.

7. In order to provide maximum certainty on how profits should be attributed to permanent establishments, the Committee therefore decided that the 2008 Report's full conclusions should be reflected in a new version of Article 7, together with accompanying Commentary, to be used in the negotiation of future treaties and the amendment of existing treaties. In addition, in order to provide improved certainty for the interpretation of treaties that had already been concluded on the basis of the previous wording of Article 7, the Committee decided that a revised Commentary for that previous version of the Article should also be prepared, to take into account those aspects of the report that did not conflict with the Commentary as it read before the adoption of the 2008 Report.

8. The new version of the Article, which now appears in the Model Tax Convention, was adopted in 2010. At the same time, the Committee adopted a revised version of the 2008 Report in order to ensure that the conclusions of that report could be read harmoniously with the new wording and modified numbering of this new version of

1 *Attribution of Income to Permanent Establishments*, Issues in International Taxation No. 5, OECD, Paris, 1994; reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(13)-1.

2 The original version of that report was approved by the Council of the OECD on 27 June 1995 and was updated a number of times since then. Published by the OECD as *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*.

3 Available at http://www.oecd.org/dataoecd/20/36/41031455.pdf.

the Article. Whilst the conclusions and interpretations included in the revised report that was thus adopted in 2010[1] (hereinafter referred to as "the Report") are identical to those of the 2008 Report, that revised version takes account of the drafting of the Article as it now reads (the Annex to this Commentary includes, for historical reference, the text of the previous wording of Article 7 and that revised Commentary, as they read before the adoption of the current version of the Article).

9. The current version of the Article therefore reflects the approach developed in the Report and must be interpreted in light of the guidance contained in it. The Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

II. Commentary on the provisions of the Article

Paragraph 1

10. Paragraph 1 incorporates the rules for the allocation of taxing rights on the business profits of enterprises of each Contracting State. First, it states that unless an enterprise of a Contracting State has a permanent establishment situated in the other State, the business profits of that enterprise may not be taxed by that other State. Second, it provides that if such an enterprise carries on business in the other State through a permanent establishment situated therein, the profits that are attributable to the permanent establishment, as determined in accordance with paragraph 2, may be taxed by that other State. As explained below, however, paragraph 4 restricts the application of these rules by providing that Article 7 does not affect the application of other Articles of the Convention that provide special rules for certain categories of profits (e.g. those derived from the operation of ships and aircraft in international traffic) or for certain categories of income that may also constitute business profits (e.g. income derived by an enterprise in respect of personal activities of an entertainer or sportsperson).

11. The first principle underlying paragraph 1, i.e. that the profits of an enterprise of one Contracting State shall not be taxed in the other State unless the enterprise carries on business in that other State through a permanent establishment situated therein, has a long history and reflects the international consensus that, as a general rule, until an enterprise of one State has 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 the other State should have taxing rights on its profits.

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

12. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general "force of attraction" according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax 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, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. 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. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent establishment is situated wished to go so far as to try to determine, and tax, 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, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

13. As indicated in the second sentence of paragraph 1, the profits that are attributable to the permanent establishment are determined in accordance with the provisions of paragraph 2, which provides the meaning of the phrase "profits that are attributable to the permanent establishment" found in paragraph 1. Since paragraph 1 grants taxing rights to the State in which the permanent establishment is situated only with respect to the profits that are attributable to that permanent establishment, the paragraph therefore prevents that State, subject to the application of other Articles of the Convention, from taxing the enterprise of the other Contracting State on profits that are not attributable to the permanent establishment.

14. The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. As confirmed by paragraph 3 of Article 1, the paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 81 of the Commentary on Article 1).

Paragraph 2

15. Paragraph 2 provides the basic rule for the determination of the profits that are attributable to a permanent establishment. According to the paragraph, these profits are the profits that the permanent establishment might be expected to make if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed through the permanent establishment and through other parts of the enterprise. In addition, the paragraph clarifies that this rule applies with respect to the dealings between the permanent establishment and the other parts of the enterprise.

16. The basic approach incorporated in the paragraph for the purposes of determining what are the profits that are attributable to the permanent establishment is therefore to require the determination of the profits under the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part as well as from any other person. The second part of that fiction corresponds to the arm's length principle which is also applicable, under the provisions of Article 9, for the purpose of adjusting the profits of associated enterprises (see paragraph 1 of the Commentary on Article 9).

17. Paragraph 2 does not seek to allocate the overall profits of the whole enterprise to the permanent establishment and its other parts but, instead, requires that the profits attributable to a permanent establishment be determined as if it were a separate enterprise. Profits may therefore be attributed to a permanent establishment even though the enterprise as a whole has never made profits. Conversely, paragraph 2 may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

18. Clearly, however, where an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the first State has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with either Article 23 A or 23 B, eliminate double taxation on the profits properly attributable to the permanent establishment (see paragraph 27 below). In other words, if the State where the permanent

establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

19. As indicated in paragraphs 8 and 9 above, Article 7, as currently worded, reflects the approach developed in the Report adopted by the Committee on Fiscal Affairs in 2010. The Report dealt primarily with the application of the separate and independent enterprise fiction that underlies paragraph 2 and the main purpose of the changes made to that paragraph following the adoption of the Report was to ensure that the determination of the profits attributable to a permanent establishment followed the approach put forward in that Report. The Report therefore provides a detailed guide as to how the profits attributable to a permanent establishment should be determined under the provisions of paragraph 2.

20. As explained in the Report, the attribution of profits to a permanent establishment under paragraph 2 will follow from the calculation of the profits (or losses) from all its activities, including transactions with independent enterprises, transactions with associated enterprises (with direct application of the OECD Transfer Pricing Guidelines) and dealings with other parts of the enterprise. This analysis involves two steps which are described below. The order of the listing of items within each of these two steps is not meant to be prescriptive, as the various items may be interrelated (e.g. risk is initially attributed to a permanent establishment as it performs the significant people functions relevant to the assumption of that risk but the recognition and characterisation of a subsequent dealing between the permanent establishment and another part of the enterprise that manages the risk may lead to a transfer of the risk and supporting capital to the other part of the enterprise).

21. Under the first step, a functional and factual analysis is undertaken which will lead to:

- the attribution to the permanent establishment, as appropriate, of the rights and obligations arising out of transactions between the enterprise of which the permanent establishment is a part and separate enterprises;
- the identification of significant people functions relevant to the attribution of economic ownership of assets, and the attribution of economic ownership of assets to the permanent establishment;
- the identification of significant people functions relevant to the assumption of risks, and the attribution of risks to the permanent establishment;
- the identification of other functions of the permanent establishment;
- the recognition and determination of the nature of those dealings between the permanent establishment and other parts of the same enterprise that can appropriately be recognised, having passed the threshold test referred to in paragraph 26; and
- the attribution of capital based on the assets and risks attributed to the permanent establishment.

22. Under the second step, any transactions with associated enterprises attributed to the permanent establishment are priced in accordance with the guidance of the OECD Transfer Pricing Guidelines and these Guidelines are applied by analogy to dealings between the permanent establishment and the other parts of the enterprise of which it is a part. The process involves the pricing on an arm's length basis of these recognised dealings through:

— the determination of comparability between the dealings and uncontrolled transactions, established by applying the Guidelines' comparability factors directly (characteristics of property or services, economic circumstances and business strategies) or by analogy (functional analysis, contractual terms) in light of the particular factual circumstances of the permanent establishment; and

— the application by analogy of one of the Guidelines' methods to arrive at an arm's length compensation for the dealings between the permanent establishment and the other parts of the enterprise, taking into account the functions performed by and the assets and risks attributed to the permanent establishment and the other parts of the enterprise.

23. Each of these operations is discussed in greater detail in the Report, in particular as regards the attribution of profits to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (see Part II of the Report, which deals with permanent establishments of banks; Part III, which deals with permanent establishments of enterprises carrying on global trading, and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities).

24. Paragraph 2 refers specifically to the dealings between the permanent establishment and other parts of the enterprise of which the permanent establishment is a part in order to emphasise that the separate and independent enterprise fiction of the paragraph requires that these dealings be treated the same way as similar transactions taking place between independent enterprises. That specific reference to dealings between the permanent establishment and other parts of the enterprise does not, however, restrict the scope of the paragraph. Where a transaction that takes place between the enterprise and an associated enterprise affects directly the determination of the profits attributable to the permanent establishment (e.g. the acquisition by the permanent establishment from an associated enterprise of goods that will be sold through the permanent establishment), paragraph 2 also requires that, for the purpose of computing the profits attributable to the permanent establishment, the conditions of the transaction be adjusted, if necessary, to reflect the conditions of a similar transaction between independent enterprises. Assume, for instance, that the permanent establishment situated in State S of an enterprise of State R acquires property from an associated enterprise of State T. If the price provided for in the contract between the two associated enterprises exceeds what would have been agreed to between independent enterprises, paragraph 2 of Article 7 of the treaty between State R and State S will authorise State S to adjust the profits attributable to the permanent establishment to reflect what a separate and independent enterprise

would have paid for that property. In such a case, State R will also be able to adjust the profits of the enterprise of State R under paragraph 1 of Article 9 of the treaty between State R and State T, which will trigger the application of the corresponding adjustment mechanism of paragraph 2 of Article 9 of that treaty.

25. Dealings between the permanent establishment and other parts of the enterprise of which it is a part have no legal consequences for the enterprise as a whole. This implies a need for greater scrutiny of these dealings than of transactions between two associated enterprises. This also implies a greater scrutiny of documentation (in the inevitable absence, for example, of legally binding contracts) that might otherwise exist.

26. It is generally not intended that more burdensome documentation requirements be imposed in connection with such dealings than apply to transactions between associated enterprises. Moreover, as in the case of transfer pricing documentation referred to in the OECD Transfer Pricing Guidelines, the requirements should not be applied in such a way as to impose on taxpayers costs and burdens disproportionate to the circumstances. Nevertheless, considering the uniqueness of the nature of a dealing, countries would wish to require taxpayers to demonstrate clearly that it would be appropriate to recognise the dealing. Thus, for example, an accounting record and contemporaneous documentation showing a dealing that transfers economically significant risks, responsibilities and benefits would be a useful starting point for the purposes of attributing profits. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies regarding application of the approach. Tax administrations would give effect to such documentation, notwithstanding its lack of legal effect, to the extent that:

— the documentation is consistent with the economic substance of the activities taking place within the enterprise as revealed by the functional and factual analysis;

— the arrangements documented in relation to the dealing, viewed in their entirety, do not differ from those which would have been adopted by comparable independent enterprises behaving in a commercially rational manner, or if they do, the structure as presented in the taxpayer's documentation does not practically impede the tax administration from determining an appropriate transfer price; and

— the dealing presented in the taxpayer's documentation does not violate the principles of the approach put forward in the Report by, for example, purporting to transfer risks in a way that segregates them from functions.

27. The opening words of paragraph 2 and the phrase "in each Contracting State" indicate that paragraph 2 applies not only for the purposes of determining the profits that the Contracting State in which the permanent establishment is situated may tax in accordance with the last sentence of paragraph 1 but also for the application of Articles 23 A and 23 B by the other Contracting State. Where an enterprise of one State carries on business through a permanent establishment situated in the other State, the first-mentioned State must either exempt the profits that are attributable to the

permanent establishment (Article 23 A) or give a credit for the tax levied by the other State on these profits (Article 23 B). Under both these Articles, that State must therefore determine the profits attributable to the permanent establishment in order to provide relief from double taxation and is required to follow the provisions of paragraph 2 for that purpose.

28. The separate and independent enterprise fiction that is mandated by paragraph 2 is restricted to the determination of the profits that are attributable to a permanent establishment. It does not extend to create notional income for the enterprise which a Contracting State could tax as such under its domestic law by arguing that such income is covered by another Article of the Convention which, in accordance with paragraph 4 of Article 7, allows taxation of that income notwithstanding paragraph 1 of Article 7. Assume, for example, that the circumstances of a particular case justify considering that the economic ownership of a building used by the permanent establishment should be attributed to the head office (see paragraph 75 of Part I of the Report). In such a case, paragraph 2 could require the deduction of a notional rent in determining the profits of the permanent establishment. That fiction, however, could not be interpreted as creating income from immovable property for the purposes of Article 6. Indeed, the fiction mandated by paragraph 2 does not change the nature of the income derived by the enterprise; it merely applies to determine the profits attributable to the permanent establishment for the purposes of Articles 7, 23 A and 23 B. Similarly, the fact that, under paragraph 2, a notional interest charge could be deducted in determining the profits attributable to a permanent establishment does not mean that any interest has been paid to the enterprise of which the permanent establishment is a part for the purposes of paragraphs 1 and 2 of Article 11. The separate and independent enterprise fiction does not extend to Article 11 and, for the purposes of that Article, one part of an enterprise cannot be considered to have made an interest payment to another part of the same enterprise. Clearly, however, if interest paid by an enterprise to a different person is paid on indebtedness incurred in connection with a permanent establishment of the enterprise and is borne by that permanent establishment, this real interest payment may, under paragraph 2 of Article 11, be taxed by the State in which the permanent establishment is located. Also, where a transfer of assets between a permanent establishment and the rest of the enterprise is treated as a dealing for the purposes of paragraph 2 of Article 7, Article 13 does not prevent States from taxing profits or gains from such a dealing as long as such taxation is in accordance with Article 7 (see paragraphs 4, 8 and 10 of the Commentary on Article 13).

29. Some States consider that, as a matter of policy, the separate and independent enterprise fiction that is mandated by paragraph 2 should not be restricted to the application of Articles 7, 23 A and 23 B but should also extend to the interpretation and application of other Articles of the Convention, so as to ensure that permanent establishments are, as far as possible, treated in the same way as subsidiaries. These States may therefore consider that notional charges for dealings which, pursuant to paragraph 2, are deducted in computing the profits of a permanent establishment

should be treated, for the purposes of other Articles of the Convention, in the same way as payments that would be made by a subsidiary to its parent company. These States may therefore wish to include in their tax treaties provisions according to which charges for internal dealings should be recognised for the purposes of Articles 6 and 11 (it should be noted, however, that tax will be levied in accordance with such provisions only to the extent provided for under domestic law). Alternatively, these States may wish to provide that no internal dealings will be recognised in circumstances where an equivalent transaction between two separate enterprises would give rise to income covered by Article 6 or 11 (in that case, however, it will be important to ensure that an appropriate share of the expenses related to what would otherwise have been recognised as a dealing be attributed to the relevant part of the enterprise). States considering these alternatives should, however, take account of the fact that, due to special considerations applicable to internal interest charges between different parts of a financial enterprise (e.g. a bank), dealings resulting in such charges have long been recognised, even before the adoption of the present version of the Article.

30. Paragraph 2 determines the profits that are attributable to a permanent establishment for the purposes of the rule in paragraph 1 that allocates taxing rights on these profits. Once the profits that are attributable to a permanent establishment have been determined in accordance with paragraph 2 of Article 7, it is for the domestic law of each Contracting State to determine whether and how such profits should be taxed as long as there is conformity with the requirements of paragraph 2 and the other provisions of the Convention. Paragraph 2 does not deal with the issue of whether expenses are deductible when computing the taxable income of the enterprise in either Contracting State. The conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the provisions of the Convention and, in particular, paragraph 3 of Article 24 (see paragraphs 33 and 34 below).

31. Thus, for example, whilst domestic law rules that would ignore the recognition of dealings that should be recognised for the purposes of determining the profits attributable to a permanent establishment under paragraph 2 or that would deny the deduction of expenses not incurred exclusively for the benefit of the permanent establishment would clearly be in violation of paragraph 2, rules that prevent the deduction of certain categories of expenses (e.g. entertainment expenses) or that provide when a particular expense should be deducted are not affected by paragraph 2. In making that distinction, however, some difficult questions may arise as in the case of domestic law restrictions based on when an expense or element of income is actually paid. Since, for instance, an internal dealing will not involve an actual transfer or payment between two different persons, the application of such domestic law restrictions should generally take into account the nature of the dealing and, therefore, treat the relevant transfer or payment as if it had been made between two different persons.

32. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the

deductibility of certain expenses will normally result in a different amount of taxable income in each State even though, for the purposes of the Convention, the amount of profits attributable to the permanent establishment will have been computed on the basis of paragraph 2 in both States (see also paragraphs 39 to 43 of the Commentary on Articles 23 A and 23 B). Thus, even though paragraph 2 applies equally to the Contracting State in which the permanent establishment is situated (for the purposes of paragraph 1) and to the other Contracting State (for the purposes of Articles 23 A or 23 B), it is likely that the amount of taxable income on which an enterprise of a Contracting State will be taxed in the State where the enterprise has a permanent establishment will, for a given taxable period, be different from the amount of taxable income with respect to which the first State will have to provide relief pursuant to Articles 23 A or 23 B. Also, to the extent that the difference results from domestic law variations concerning the types of expenses that are deductible, as opposed to timing differences in the recognition of these expenses, the difference will be permanent.

33. In taxing the profits attributable to a permanent establishment situated on its territory, a Contracting State will, however, have to take account of the provisions of paragraph 3 of Article 24. That paragraph requires, among other things, that expenses be deductible under the same conditions whether they are incurred for the purposes of a permanent establishment situated in a Contracting State or for the purposes of an enterprise of that State. As stated in paragraph 40 of the Commentary on Article 24:

> 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. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

34. The requirement imposed by paragraph 3 of Article 24 is the same regardless of how expenses incurred by an enterprise for the benefit of a permanent establishment are taken into account for the purposes of paragraph 2 of Article 7. In some cases, it will not be appropriate to consider that a dealing has taken place between different parts of the enterprise. In such cases, expenses incurred by an enterprise for the purposes of the activities performed by the permanent establishment will be directly deducted in determining the profits of the permanent establishment (e.g. the salary of a local construction worker hired and paid locally to work exclusively on a construction site that constitutes a permanent establishment of a foreign enterprise). In other cases, expenses incurred by the enterprise will be attributed to functions performed by other parts of the enterprise wholly or partly for the benefit of the permanent establishment and an appropriate charge will be deducted in determining the profits attributable to the permanent establishment (e.g. overhead expenses related to administrative functions performed by the head office for the benefit of the permanent establishment). In both cases, paragraph 3 of Article 24 will require that, as regards the permanent establishment, the expenses be deductible under the same conditions as those applicable to an enterprise of that State. Thus, any expense incurred by the enterprise directly or indirectly for the benefit of the permanent establishment must not, for tax purposes, be treated less favourably than a similar expense incurred by an

enterprise of that State. That rule will apply regardless of whether or not, for the purposes of paragraph 2 of this Article 7, the expense is directly attributed to the permanent establishment (first example) or is attributed to another part of the enterprise but reflected in a notional charge to the permanent establishment (second example).

35. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing profits to them under Article 7.

36. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that profits are attributable to a permanent establishment only with respect to activities carried on by the enterprise through that permanent establishment.

37. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

38. Article 7, as it read before 2010, included the following paragraph 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.

Whilst that paragraph was originally intended to clarify that paragraph 2 required expenses incurred directly or indirectly for the benefit of a permanent establishment to be taken into account in determining the profits of the permanent establishment even if these expenses had been incurred outside the State in which the permanent establishment was located, it had sometimes been read as limiting the deduction of expenses that indirectly benefited the permanent establishment to the actual amount of the expenses.

39. This was especially the case of general and administrative expenses, which were expressly mentioned in that paragraph. Under the previous version of paragraph 2, as interpreted in the Commentary, this was generally not a problem since a share of the

general and administrative expenses of the enterprise could usually only be allocated to a permanent establishment on a cost-basis.

40. As now worded, however, paragraph 2 requires the recognition and arm's length pricing of the dealings through which one part of the enterprise performs functions for the benefit of the permanent establishment (e.g. through the provision of assistance in day-to-day management). The deduction of an arm's length charge for these dealings, as opposed to a deduction limited to the amount of the expenses, is required by paragraph 2. The previous paragraph 3 has therefore been deleted to prevent it from being misconstrued as limiting the deduction to the amount of the expenses themselves. That deletion does not affect the requirement, under paragraph 2, that in determining the profits attributable to a permanent establishment, all relevant expenses of the enterprise, wherever incurred, be taken into account. Depending on the circumstances, this will be done through the deduction of all or part of the expenses or through the deduction of an arm's length charge in the case of a dealing between the permanent establishment and another part of the enterprise.

41. Article 7, as it read before 2010, also included a provision that allowed the attribution of profits to a permanent establishment to be done on the basis of an apportionment of the total profits of the enterprise to its various parts. That method, however, was only to be applied to the extent that its application had been customary in a Contracting State and that the result was in accordance with the principles of Article 7. For the Committee, methods other than an apportionment of total profits of an enterprise can be applied even in the most difficult cases. The Committee therefore decided to delete that provision because its application had become very exceptional and because of concerns that it was extremely difficult to ensure that the result of its application would be in accordance with the arm's length principle.

42. At the same time, the Committee also decided to eliminate another provision that was found in the previous version of the Article and according to which the profits to be attributed to the permanent establishment were to be "determined by the same method year by year unless there is good and sufficient reason to the contrary." That provision, which was intended to ensure continuous and consistent treatment, was appropriate as long as it was accepted that the profits attributable to a permanent establishment could be determined through direct or indirect methods or even on the basis of an apportionment of the total profits of the enterprise to its various parts. The new approach developed by the Committee, however, does not allow for the application of such fundamentally different methods and therefore avoids the need for such a provision.

43. A final provision that was deleted from the Article at the same time provided that "[n]o 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." Subparagraph 4 *d*) of Article 5, as it read at that time, recognised that where an enterprise of a Contracting State maintained in the other State a fixed place of business exclusively for the purpose of purchasing goods for itself, its activity at that location should not be considered to have reached a level that justified taxation in that

other State (changes made to Article 5 in 2017 have restricted the scope of that exception). Where, however, subparagraph 4 *d*) was not applicable because other activities were carried on by the enterprise through that place of business, which therefore constituted a permanent establishment, it was appropriate to attribute profits to all the functions performed at that location. Indeed, if the purchasing activities had been performed by an independent enterprise, the purchaser would have been remunerated on an arm's length basis for its services. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise required that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the permanent establishment, such an exemption could raise administrative problems. The Committee therefore considered that a provision according to which no profits should be attributed to a permanent establishment by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.

Paragraph 3

44. The combination of Articles 7 (which restricts the taxing rights of the State in which the permanent establishment is situated) and 23 A and 23 B (which oblige the other State to provide relief from double taxation) ensures that there is no unrelieved double taxation of the profits that are properly attributable to the permanent establishment. This result may require that the two States resolve differences based on different interpretations of paragraph 2 and it is important that mechanisms be available to resolve all such differences to the extent necessary to eliminate double taxation.

45. As already indicated, the need for the two Contracting States to reach a common understanding as regards the application of paragraph 2 in order to eliminate risks of double taxation has led the Committee to develop detailed guidance on the interpretation of that paragraph. This guidance is reflected in the Report, which draws on the principles of the OECD Transfer Pricing Guidelines.

46. Risks of double taxation will usually be avoided because the taxpayer will determine the profits attributable to the permanent establishment in the same manner in each Contracting State and in accordance with paragraph 2 as interpreted by the Report, which will ensure the same result for the purposes of Articles 7 and 23 A or 23 B (see, however, paragraph 66). Insofar as each State agrees that the taxpayer has done so, it should refrain from adjusting the profits in order to reach a different result under paragraph 2. This is illustrated in the following example.

47. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, the Report provides that a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of

its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional arm's length price of 100 has been used to determine the profits attributable to the permanent establishment. Both States agree that the recognition of the dealing and the price used by the taxpayer are in conformity with the principles of the Report and of the OECD Transfer Pricing Guidelines. In this case, both States should refrain from adjusting the profits on the basis that a different arm's length price should have been used; as long as there is agreement that the taxpayer has conformed with paragraph 2, the tax administrations of both States cannot substitute their judgment for that of the taxpayer as to what are the arm's length conditions. In this example, the fact that the same arm's length price has been used in both States and that both States will recognise that price for the purposes of the application of the Convention will ensure that any double taxation related to that dealing will be eliminated under Article 23 A or 23 B.

48. In the previous example, both States agreed that the recognition of the dealing and the price used by the taxpayer were in conformity with the principles of the Report and of the OECD Transfer Pricing Guidelines. The Contracting States, however, may not always reach such an agreement. In some cases, the Report and the OECD Transfer Pricing Guidelines may allow different interpretations of paragraph 2 and, to the extent that double taxation would otherwise result from these different interpretations, it is essential to ensure that such double taxation is relieved. Paragraph 3 provides the mechanism that guarantees that outcome.

49. For example, as explained in paragraphs 105 to 171 of Part I of the Report, paragraph 2 permits different approaches for determining, on the basis of the attribution of "free" capital to a permanent establishment, the interest expense attributable to that permanent establishment. The Committee recognised that this could create problems, in particular for financial institutions. It concluded that in this and other cases where the two Contracting States have interpreted paragraph 2 differently and it is not possible to conclude that either interpretation is not in accordance with paragraph 2, it is important to ensure that any double taxation that would otherwise result from that difference will be eliminated.

50. Paragraph 3 will ensure that this result is achieved. It is important to note, however, that the cases where it will be necessary to have recourse to that paragraph are fairly limited.

51. First, as explained in paragraph 46 above, where the taxpayer has determined the profits attributable to the permanent establishment in the same manner in each Contracting State and both States agree that the taxpayer has done so in accordance with paragraph 2 as interpreted by the Report, no adjustments should be made to the profits in order to reach a different result under paragraph 2.

52. Second, paragraph 3 is not intended to limit in any way the remedies already available to ensure that each Contracting State conforms with its obligations under Articles 7 and 23 A or 23 B. For example, if the determination, by a Contracting State, of

the profits attributable to a permanent establishment situated in that State is not in conformity with paragraph 2, the taxpayer will be able to use the available domestic legal remedies and the mutual agreement procedure provided for by Article 25 to address the fact that the taxpayer has not been taxed by that State in accordance with the Convention. Similarly, these remedies will also be available if the other State does not, for the purposes of Article 23 A or 23 B, determine the profits attributable to the permanent establishment in conformity with paragraph 2 and therefore does not comply with the provisions of this Article.

53. Where, however, the taxpayer has not determined the profits attributable to the permanent establishment in conformity with paragraph 2, each State is entitled to make an adjustment in order to ensure conformity with that paragraph. Where one State makes an adjustment in conformity with paragraph 2, that paragraph certainly permits the other State to make a reciprocal adjustment so as to avoid any double taxation through the combined application of paragraph 2 and of Article 23 A or 23 B (see paragraph 65 below). It may be, however, that the domestic law of that other State (e.g. the State where the permanent establishment is located) may not allow it to make such a change or that State may have no incentive to do it on its own if the effect is to reduce the amount of profits that was previously taxable in that State. It may also be that, as indicated above, the two Contracting States will adopt different interpretations of paragraph 2 and it is not possible to conclude that either interpretation is not in accordance with paragraph 2.

54. Such concerns are addressed by paragraph 3. The following example illustrates the application of that paragraph.

55. Example. A manufacturing plant located in State R of an enterprise of State R has transferred goods for sale to a permanent establishment of the enterprise situated in State S. For the purpose of determining the profits attributable to the permanent establishment under paragraph 2, a dealing must be recognised and a notional arm's length price must be determined for that dealing. The enterprise's documentation, which is consistent with the functional and factual analysis and which has been used by the taxpayer as the basis for the computation of its taxable income in each State, shows that a dealing in the nature of a sale of the goods by the plant in State R to the permanent establishment in State S has occurred and that a notional price of 90 has been used to determine the profits attributable to the permanent establishment. State S accepts the amount used by the taxpayer but State R considers that the amount is below what is required by its domestic law and the arm's length principle of paragraph 2. It considers that the appropriate arm's length price that should have been used is 110 and adjusts the amount of tax payable in State R accordingly after reducing the amount of the exemption (Article 23 A) or the credit (Article 23 B) claimed by the taxpayer with respect to the profits attributable to the permanent establishment. In that situation, since the price of the same dealing will have been determined as 90 in State S and 110 in State R, profits of 20 may be subject to double taxation. Paragraph 3 will address that situation by requiring State S, to the extent that there is indeed double taxation and that the adjustment made by State R is in conformity with

paragraph 2, to provide a corresponding adjustment to the tax payable in State S on the profits that are taxed in both States.

56. If State S, however, does not agree that the adjustment by State R was warranted by paragraph 2, it will not consider that it has to make the adjustment. In such a case, the issue of whether State S should make the adjustment under paragraph 3 (if the adjustment by State R is justified under paragraph 2) or whether State R should refrain from making the initial adjustment (if it is not justified under paragraph 2) will be solved under a mutual agreement procedure pursuant to paragraph 1 of Article 25 using, if necessary, the arbitration provision of paragraph 5 of Article 25 (since it involves the question of whether the actions of one or both of the Contracting States have resulted or will result for the taxpayer in taxation not in accordance with the Convention). Through that procedure, the two States will be able to agree on the same arm's length price, which may be one of the prices put forward by the taxpayer and the two States or a different one.

57. As shown by the example in paragraph 55, paragraph 3 addresses the concern that the Convention might not provide adequate protection against double taxation in some situations where the two Contracting States adopt different interpretations of paragraph 2 of Article 7 and each State could be considered to be taxing "in accordance with" the Convention. Paragraph 3 ensures that relief of double taxation will be provided in such a case, which is consistent with the overall objectives of the Convention.

58. Paragraph 3 shares the main features of paragraph 2 of Article 9. First, it applies to each State with respect to an adjustment made by the other State. It therefore applies reciprocally whether the initial adjustment has been made by the State where the permanent establishment is situated or by the other State. Also, it does not apply unless there is an adjustment by one of the States.

59. As is the case for paragraph 2 of Article 9, a corresponding adjustment is not automatically to be made under paragraph 3 simply because the profits attributed to the permanent establishment have been adjusted by one of the Contracting States. The corresponding adjustment is required only if the other State considers that the adjusted profits conform with paragraph 2. In other words, paragraph 3 may not be invoked and should not be applied where the profits attributable to the permanent establishment are adjusted to a level that is different from what they would have been if they had been correctly computed in accordance with the principles of paragraph 2. Regardless of which State makes the initial adjustment, the other State is obliged to make an appropriate corresponding adjustment only if it considers that the adjusted profits correctly reflect what the profits would have been if the permanent establishment's dealings had been transactions at arm's length. The other State is therefore committed to make such a corresponding adjustment only if it considers that the initial adjustment is justified both in principle and as regards the amount.

59.1 Under the domestic laws of some countries, a taxpayer may be permitted under appropriate circumstances to amend a previously-filed tax return to adjust the profits

attributable to a permanent establishment in order to reflect an attribution of profits that is, in the taxpayer's opinion, in accordance with the separate entity and arm's length principles underlying Article 7. Where they are made in good faith, such adjustments may facilitate the proper attribution of profits to a permanent establishment in conformity with paragraph 2. However, double taxation may occur, for example, if such a taxpayer-initiated adjustment increases the profits attributed to a permanent establishment located in one Contracting State but there is no appropriate corresponding adjustment in the other Contracting State. The elimination of such double taxation is within the scope of paragraph 3. Indeed, to the extent that taxes have been levied on the increased profits in the first-mentioned State, that State may be considered to have adjusted the profits attributable to the permanent establishment and to have taxed profits that have been charged to tax in the other State. In these circumstances, Article 25 enables the competent authorities of the Contracting States to consult together to eliminate the double taxation; the competent authorities may accordingly, if necessary, use the mutual agreement procedure to determine whether the initial adjustment met the conditions of paragraph 2 and, if that is the case, to determine the amount of the appropriate adjustment to the amount of the tax charged on the profits attributable to the permanent establishment so as to relieve the double taxation.

60. Paragraph 3 does not specify the method by which a corresponding adjustment is to be made. Where the initial adjustment is made by the State in which the permanent establishment is situated, the adjustment provided for by paragraph 3 could be granted in the other State through the adjustment of the amount of income that must be exempted under Article 23 A or of the credit that must be granted under Article 23 B. Where the initial adjustment is made by that other State, the adjustment provided for by paragraph 3 could be made by the State in which the permanent establishment is situated by re-opening the assessment of the enterprise of the other State in order to reduce the taxable income by an appropriate amount.

61. The issue of so-called "secondary adjustments", which is discussed in paragraph 8 of the Commentary on Article 9, does not arise in the case of an adjustment under paragraph 3. As indicated in paragraph 28 above, the determination of the profits attributable to a permanent establishment is only relevant for the purposes of Articles 7 and 23 A and 23 B and does not affect the application of other Articles of the Convention.

62. Like paragraph 2 of Article 9, paragraph 3 leaves open the question whether there should be a period of time after the expiration of which a State would not be obliged to make an appropriate adjustment to the profits attributable to a permanent establishment following an upward revision of these profits in the other State. Some States consider that the commitment should be open-ended — in other words, that however many years the State making the initial adjustment has gone back, the enterprise should in equity be assured of an appropriate adjustment in the other State. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. This problem has not been dealt with in the text

of either paragraph 2 of Article 9 or paragraph 3 but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which a State should be obliged to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25). Contracting States may also wish to address this issue through a provision limiting the length of time during which an adjustment may be made pursuant to paragraph 2 of Article 7; such a solution avoids the double taxation that may otherwise result where there is no adjustment in the other State pursuant to paragraph 3 of the Article following the first State's adjustment pursuant to paragraph 2. Contracting States that wish to achieve that result may agree bilaterally to add the following paragraph after paragraph 4:

> 5. A Contracting State shall make no adjustment to the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States after [bilaterally agreed period] from the end of the taxable year in which the profits would have been attributable to the permanent establishment. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default.

63. There may be cases where the initial adjustment made by one State will not immediately require a corresponding adjustment to the amount of tax charged on profits in the other State (e.g. where the initial adjustment by one State of the profits attributable to the permanent establishment will affect the determination of the amount of a loss attributable to the rest of the enterprise in the other State). The competent authorities may, in accordance with the second sentence of paragraph 3, determine the future impact that the initial adjustment will have on the tax that will be payable in the other State before that tax is actually levied; in fact, in order to avoid the problem described in the preceding paragraph, competent authorities may wish to use the mutual agreement procedure at the earliest opportunity in order to determine to what extent a corresponding adjustment may be required in the other State at a later stage.

64. 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, as is the case for an adjustment under paragraph 2 of Article 9. Indeed, as shown in the example in paragraph 55 above, if one of the two Contracting States adjusts the profits attributable to a permanent establishment without the other State granting a corresponding adjustment to the extent needed to avoid double taxation, the taxpayer will be able to use the mutual agreement procedure of paragraph 1 of Article 25, and if necessary the arbitration provision of paragraph 5 of Article 25, to require the competent authorities to agree that either the initial adjustment by one State or the failure by the other State to make a corresponding adjustment is not in accordance with the provisions of the Convention (the arbitration provision of paragraph 5 of Article 25 will play a critical role in cases where the competent authorities would otherwise be unable to agree as it will ensure that the issues that prevent an agreement are resolved through arbitration).

65. Paragraph 3 only applies to the extent necessary to eliminate the double taxation of profits that result from the adjustment. Assume, for instance, that the State where the permanent establishment is situated adjusts the profits that the taxpayer attributed to the permanent establishment to reflect the fact that the price of a dealing between the permanent establishment and the rest of the enterprise did not conform with the arm's length principle. Assume that the other State also agrees that the price used by the taxpayer was not at arm's length. In that case, the combined application of paragraph 2 and of Article 23 A or 23 B will require that other State to attribute to the permanent establishment, for the purposes of providing relief of double taxation, adjusted profits that would reflect an arm's length price. In such a case, paragraph 3 will only be relevant to the extent that States adopt different interpretations of what the correct arm's length price should be.

66. Paragraph 3 only applies with respect to differences in the determination of the profits attributed to a permanent establishment that result in the same part of the profits being attributed to different parts of the enterprise in conformity with the Article. As already explained (see paragraphs 30 and 31 above), Article 7 does not deal with the computation of taxable income but, instead, with the attribution of profits for the purpose of the allocation of taxing rights between the two Contracting States. The Article therefore only serves to allocate revenues and expenses for the purposes of allocating taxing rights and does not prejudge the issue of which revenues are taxable and which expenses are deductible, which is a matter of domestic law as long as there is conformity with paragraph 2. Where the profits attributed to the permanent establishment are the same in each State, the amount that will be included in the taxable income on which tax will be levied in each State for a given taxable period may be different given differences in domestic law rules, e.g. for the recognition of income and the deduction of expenses. Since these different domestic law rules only apply to the profits attributed to each State, they do not, by themselves, result in double taxation for the purposes of paragraph 3.

67. Also, paragraph 3 does not apply to affect the computation of the exemption or credit under Article 23 A or 23 B except for the purposes of providing what would otherwise be unavailable double taxation relief for the tax paid to the Contracting State in which the permanent establishment is situated on the profits that have been attributed to the permanent establishment in that State. This paragraph will therefore not apply where these profits have been fully exempted by the other State or where the tax paid in the first-mentioned State has been fully credited against the other State's tax under the domestic law of that other State and in accordance with Article 23 A or 23 B.

68. Some States may prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to the adjusting State's preferred position as to the arm's length price or method. These

States would therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over the arm's length price or method to be applied. States that share that view may prefer to use the following alternative version of paragraph 3:

> Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other Contracting State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

69. This alternative version is intended to ensure that the State being asked to give a corresponding adjustment would always be able to require that to be done through the mutual agreement procedure. This version differs significantly from paragraph 3 in that it does not create a legal obligation on that State to agree to give a corresponding adjustment, even where it considers the adjustment made by the other State to have been made in accordance with paragraph 2. The provision would always give the possibility for a State to negotiate with the other State over what is the most appropriate arm's length price or method. Where the State in question does not unilaterally agree to make the corresponding adjustment, this version of paragraph 3 would ensure that the taxpayer has the right to access the mutual agreement procedure to have the case resolved. Moreover, where the mutual agreement procedure is triggered in such a case, the provision imposes a reciprocal legal obligation on the Contracting States to eliminate the double taxation by mutual agreement even though it does not provide a substantive standard to govern which State has the obligation to compromise its position to achieve that mutual agreement. If the two Contracting States do not reach an agreement to eliminate the double taxation, they will both be in violation of their treaty obligation. The obligation to eliminate such cases of double taxation by mutual agreement is therefore stronger than the standard of paragraph 2 of Article 25, which merely requires the competent authorities to "endeavour" to resolve a case by mutual agreement.

70. If Contracting States agree bilaterally to replace paragraph 3 by the alternative above, the comments made in paragraphs 66 and 67 as regards paragraph 3 will also apply with respect to that provision.

Paragraph 4

71. 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.

72. Absent paragraph 4, this interpretation of the term "profits" could have given rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are dealt with separately in other Articles of the Convention, e.g. dividends, the question would have arisen as to which Article should apply to these categories of income, e.g. in the case of dividends, this Article or Article 10.

73. To the extent that the application of this Article and of the relevant other Article would result in the same tax treatment, there is little practical significance to this question. Also, other Articles of the Convention deal specifically with this question with respect to some types of income (e.g. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12, paragraphs 1 and 2 of Article 17 and paragraph 2 of Article 21).

74. The question, however, could arise with respect to other types of income and it has therefore been decided to include a rule of interpretation that ensures that Articles applicable to specific categories of income will have priority over Article 7. It follows from this rule that Article 7 will be applicable to business profits which do not belong to categories of income covered by these other Articles, and, in addition, to income which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21, fall within Article 7. This rule does not, however, govern the manner in which the income will be classified for the purposes of domestic law; thus, if a Contracting State may tax an item of income pursuant to other Articles of this Convention, that State may, for its own domestic tax purposes, characterise such income as it wishes (i.e. as business profits or as a specific category of income) provided that the tax treatment of that item of income is in accordance with the provisions of the Convention. It should also be noted that where an enterprise of a Contracting State derives income from immovable property through a permanent establishment situated in the other State, that other State may not tax that income if it is derived from immovable property situated in the first-mentioned State or in a third State (see paragraph 4 of the Commentary on Article 21 and paragraphs 9 and 10 of the Commentary on Articles 23 A and 23 B).

75. 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 Articles on dividends, interest and royalties.

75.1 Emissions trading programmes have been implemented in a number of countries as part of an international strategy for addressing global warming. Under such programmes, emissions permits may be required in order to perform certain economic activities that generate greenhouse gases and credits issued with respect to emission-reduction or emissions removal projects in other countries may be recognised. Given the multinational character of certain emissions trading programmes (such as the European Union Emissions Trading System), these programmes present specific issues under the Model Tax Convention, most notably the treatment of income from the

issuance and trading of emissions permits and credits. These issues are examined in the Committee's report "Tax treaty issues related to emissions permits/credits".[1] As explained in that report, income derived from the issuance or trading of emissions permits and credits is generally covered by Article 7 and Article 13. Under certain circumstances, however, such income may be covered by Article 6, 8 or 21 (see paragraph 2.1 of the Commentary on Article 6 and paragraph 14.1 of the Commentary on Article 8).

76. Finally, it should be noted that two categories of profits that were previously covered by other Articles of the Convention are now covered by Article 7. First, 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 or Article 8 (see paragraph 9 of the Commentary on that Article), as the case may be, rather than under those of Article 12, a result that the Committee on Fiscal Affairs considers appropriate given the nature of such income.

77. Second, before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but Article 14 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, in Article 3, of a definition of the term "business" which expressly provides that this term includes professional services or other activities of an independent character.

Observations on the Commentary

78. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 77 — 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.

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(25)-1.

79. [Deleted]

80. [Deleted]

81. [Deleted]

82. *Sweden* wishes to clarify that it does not consider that the different approaches for attributing "free" capital that are included in the Report *Attribution of Profits to Permanent Establishments* will necessarily lead to a result in accordance with the arm's length principle. Consequently, Sweden would, when looking at the facts and circumstances of each case, in many cases not consider that the amount of interest deduction resulting from the application of these approaches conforms to the arm's length principle. When the different views on attributing "free" capital will lead to double taxation, the mutual agreement procedure provided for in Article 25 will have to be used.

83. With reference to paragraphs 27 and 65, the *United States* wishes to clarify how it will relieve double taxation arising due to the application of paragraph 2 of Article 7. Where a taxpayer can demonstrate to the competent authority of the United States that such double taxation has been left unrelieved after the application of mechanisms under the United States' domestic law such as the utilisation of foreign tax credit limitation created by other transactions, the United States will relieve such additional double taxation.

84. *Turkey* does not share the views expressed in paragraph 28 of the Commentary on Article 7.

Reservations on the Article

85. *Australia* reserves the right to include a provision that will permit its domestic law to apply in relation to the taxation of profits from any form of insurance.

86. *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.

87. *Korea* and *Portugal* 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.

88. *Italy*, *Portugal* and *Turkey* 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. In the case of Turkey, the question of whether persons other than individuals should be included in that article shall be determined by bilateral negotiations.

89. 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 10, 11, 12, 13 and 21.

90. *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 branch cases.

91. *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.

92. *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.

93. *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.

94. The *Czech Republic* reserves the right to add to paragraph 3 a provision limiting the potential corresponding adjustments to *bona fide* cases.

95. *New Zealand* reserves the right to use the previous version of Article 7 taking into account its observation and reservations on that version (i.e. the version included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention) because it does not agree with the approach reflected in Part I of the 2010 Report *Attribution of Profits to Permanent Establishments*. It does not, therefore, endorse the changes to the Commentary on the Article made through that update.

96. *Austria*, *Chile*, *Greece*, *Mexico*, the *Slovak Republic* and *Turkey* reserve the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention. They do not, therefore, endorse the changes to the Commentary on the Article made through that update.

97. *Portugal* reserves its right to continue to adopt in its conventions the text of the Article as it read before 2010 until its domestic law is adapted in order to apply the new approach.

98. *Slovenia* reserves the right to specify that a potential adjustment will be made under paragraph 3 only if it is considered justified.

99. *Australia* reserves its right to use the previous version of Article 7 taking into account its observations and reservations on that version (i.e. the version included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention).

100. *Latvia* reserves the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update of the Model Tax Convention, subject to its positions on that version (see the Annex to the Non-OECD Economies' Positions on Article 7).

ANNEX

PREVIOUS VERSION OF ARTICLE 7 AND ITS COMMENTARY

The following is the text of Article 7 and its Commentary as they read before 22 July 2010. That previous version of the Article and Commentary is provided below for historical reference as it will continue to be relevant for the application and interpretation of bilateral tax conventions concluded before that date.

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.

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.

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 by reference to which the profits attributable to the permanent establishment 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 associated are dealt with in Article 9.

2. Articles 7 and 9 are not particularly detailed and were not strikingly novel when they were adopted by the OECD. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between associated enterprises, has had to be dealt with in a large number of double taxation conventions and in various models developed by the League of Nations before the OECD first dealt with it and the solutions adopted have generally conformed to a standard pattern.

3. It is generally recognised that the essential principles on which this standard pattern is based are well founded, and, when the OECD first examined that question, it was 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.

4. It must be acknowledged, however, that there has been considerable variation in the interpretation of the general directives of Article 7 and of the provisions of earlier conventions and models on which the wording of the Article is based. This lack of a common interpretation of Article 7 can lead to problems of double taxation and non-taxation. For that reason, it is 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.

5. Over the years, the Committee on Fiscal Affairs has therefore spent considerable time and effort trying to ensure a more consistent interpretation and application of the rules of the Article. Minor changes to the wording of the Article and a number of changes to the Commentary were made when the 1977 Model Tax Convention was adopted. A report that addressed that question in the specific case of banks was published in 1984.[1] In 1987, noting that the determination of profits attributable to a permanent establishment could give rise to some uncertainty, the Committee undertook a review of the question which led to the adoption, in 1993, of the report entitled "Attribution of Income to Permanent Establishments"[2] and to subsequent changes to the Commentary.

6. Despite that work, the practices of OECD and non-OECD countries regarding the attribution of profits to permanent establishments and these countries' interpretation of Article 7 continued to vary considerably. The Committee acknowledged the need to provide more certainty to taxpayers: in its report *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, adopted in 1995, it indicated that further work would address the application of the arm's length principle to permanent establishments. That work resulted, in 2008, in a report entitled *Attribution of Profits to Permanent Establishments*. The approach developed in that report was not constrained by either the original intent or by the historical practice and interpretation of Article 7. Instead, the focus has been on formulating the most preferable approach to attributing profits to a permanent establishment under Article 7 given modern-day multinational operations and trade.

7. The approach put forward in that Report deals with the attribution of profits both to permanent establishments in general (Part I of the Report) and, in particular, to permanent establishments of businesses operating in the financial sector, where trading through a permanent establishment is widespread (Part II of the Report, which deals with permanent establishments of banks, Part III, which deals with permanent establishments of enterprises carrying on global trading and Part IV, which deals with permanent establishments of enterprises carrying on insurance activities). The Committee considers that the guidance included in the Report represents a better approach to attributing profits to permanent establishments than has previously been available. It does recognise, however, that there are differences between some of the conclusions of the Report and the interpretation of the Article previously given in this Commentary. For that reason, this Commentary has been amended to incorporate a number of conclusions of the Report that did not conflict with the previous version of this Commentary, which prescribed specific approaches in some areas and left considerable leeway in others. The Report therefore represents internationally agreed principles and, to the extent that it does not conflict with this Commentary, provides guidelines for the application of the arm's length principle incorporated in the Article.

8. Before 2000, income from professional services and other activities of an independent character was dealt with 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

1 "The Taxation of Multinational Banking Enterprises", in *Transfer Pricing and Multinational Enterprises Three Taxation Issues*, OECD, Paris, 1984.

2 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(13)-1.

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.

II. Commentary on the provisions of the Article

Paragraph 1

9. 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.

10. The second principle, which is reflected in the second sentence of the paragraph, is that the right to tax of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment. This is a question on which there have historically been differences of view, a few countries having some time ago pursued a principle of general "force of attraction" according to which income such as other business profits, dividends, interest and royalties arising from sources in their territory was fully taxable by them if the beneficiary had a permanent establishment therein even though such income was clearly not attributable to that permanent establishment. Whilst some bilateral tax conventions include a limited anti-avoidance rule based on a restricted force of attraction approach that only applies to business profits derived from activities similar to those carried on by a permanent establishment, the general force of attraction approach described above has now been rejected in international tax treaty practice. The principle that is now generally accepted in double taxation conventions is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the tax 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, subject to the possible application of other Articles of the Convention. This solution allows simpler and more efficient tax administration and compliance, and is more closely adapted to the way in which business is commonly carried on. The organisation of modern business is highly complex. 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. A company may set up a permanent establishment in another country through which it carries on manufacturing activities whilst a different part of the same company sells different goods or manufactures in that other country through independent agents. That company may have perfectly valid commercial reasons for doing so: these may be based, for example, on the historical pattern of its business or on commercial convenience. If the country in which the permanent

establishment is situated wished to go so far as to try to determine, and tax, 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, that approach would interfere seriously with ordinary commercial activities and would be contrary to the aims of the Convention.

11. When referring to the part of the profits of an enterprise that is attributable to a permanent establishment, the second sentence of paragraph 1 refers directly to paragraph 2, which provides the directive for determining what profits should be attributed to a permanent establishment. As paragraph 2 is part of the context in which the sentence must be read, that sentence should not be interpreted in a way that could contradict paragraph 2, e.g. by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole. Thus, whilst paragraph 1 provides that a Contracting State may only tax the profits of an enterprise of the other Contracting State to the extent that they are attributable to a permanent establishment situated in the first State, it is paragraph 2 that determines the meaning of the phrase "profits attributable to a permanent establishment". In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits; conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

12. Clearly, however, the Contracting State of the enterprise has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with Article 23, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

13. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).

Paragraph 2

14. This paragraph contains the central directive on which the attribution of profits to a permanent establishment is intended to be based. The paragraph incorporates the view that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, 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.

15. The paragraph requires that this principle be applied in each Contracting State. Clearly, this does not mean that the amount on which the enterprise will be taxed in the source State will, for a given period of time, be exactly the same as the amount of income with respect to which the other State will have to provide relief pursuant to Article 23 A or 23 B. Variations between the domestic laws of the two States concerning matters such as depreciation rates, the timing of the recognition of income and restrictions on the deductibility of certain expenses that are in accordance with paragraph 3 of this Article will normally result in a different amount of taxable income in each State.

16. 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 to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts (cf. paragraphs 51 to 55 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 profits that are properly attributable to the permanent establishment under the directive contained in paragraph 2. It should perhaps be emphasised that this directive is no justification 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. As noted in paragraph 19 below and as explained in paragraph 39 of Part I of the Report *Attribution of Profits to Permanent Establishments*, however, records and documentation must satisfy certain requirements in order to be considered to reflect the real facts of the situation.

17. In order to determine whether such an adjustment is required by paragraph 2, it will be necessary to determine the profits that would have been realised if the permanent establishment had been a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the rest of the enterprise. Sections D-2 and D-3 of Part I of the Report *Attribution of Profits to Permanent Establishments* describe the two-step approach through which this should be done. This approach will allow the calculation of the profits attributable to all the activities carried on through the permanent establishment, including transactions with other independent enterprises, transactions with associated enterprises and dealings (e.g. the internal transfer of capital or property or the internal provision of services — see for instance paragraphs 31 and 32) with other parts of the enterprise (under the second step referred to above), in accordance with the directive of paragraph 2.

18. The first step of that approach requires the identification of the activities carried on through the permanent establishment. This should be done through a functional and factual analysis (the guidance found in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[1] will be relevant for that purpose). Under that first step, the economically significant activities and responsibilities undertaken through the permanent establishment will be identified. This analysis should, to the extent relevant, consider the activities and responsibilities undertaken

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.

through the permanent establishment in the context of the activities and responsibilities undertaken by the enterprise as a whole, particularly those parts of the enterprise that engage in dealings with the permanent establishment. Under the second step of that approach, the remuneration of any such dealings will be determined by applying by analogy the principles developed for the application of the arm's length principle between associated enterprises (these principles are articulated in the *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*) by reference to the functions performed, assets used and risk assumed by the enterprise through the permanent establishment and through the rest of the enterprise.

19. A question that may arise is to what extent accounting records 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. Accounts should not be regarded as prepared symmetrically, however, 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. Also, as explained in paragraph 16, records and documentation must satisfy certain requirements in order to be considered to reflect the real facts of the situation. For example, 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. One such case would be where 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.

20. It may therefore be concluded that accounting records and contemporaneous documentation that meet the above-mentioned requirements constitute a useful starting point for the purposes of attributing profits to a permanent establishment. Taxpayers are encouraged to prepare such documentation, as it may reduce substantially the potential for controversies. Section D-2 (*vi*)*b)* of Part I of the Report *Attribution of Profits to Permanent Establishments* discusses the conditions under which tax administrations would give effect to such documentation.

21. There may be 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 a State's territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows the former State 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.

22. 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.

23. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing income to them under Article 7.

24. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that income is attributable to a permanent establishment only when it results from activities carried on by the enterprise through that permanent establishment.

25. For example, where such goods are supplied by the other parts of the enterprise, the profits arising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by the parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

26. Where, under paragraph 5 of Article 5, a permanent establishment of an enterprise of a Contracting State is deemed to exist in the other Contracting State by reason of the activities of a so-called dependent agent (see paragraph 32 of the Commentary on Article 5), the same principles used to attribute profits to other types of permanent establishment will apply to attribute profits to that deemed permanent establishment. As a first step, the activities that the dependent agent undertakes for the enterprise will be identified through a functional and factual analysis that will determine the functions undertaken by the dependent agent both on its own account and on behalf of the enterprise. The dependent agent and the enterprise on behalf of which it is acting constitute two separate potential taxpayers. On the one hand, the dependent agent will derive its own income or profits from the activities that it performs on its own account for the enterprise; if the agent is itself a resident of either Contracting State, the provisions of the Convention (including Article 9 if that agent is an enterprise associated to the enterprise on behalf of which it is acting) will be relevant to the taxation of such income or profits. On the other hand, the deemed permanent establishment of the enterprise will be attributed the assets and risks of the enterprise relating to the functions performed by the dependent agent on behalf of that

enterprise (i.e. the activities that the dependent agent undertakes for that enterprise), together with sufficient capital to support those assets and risks. Profits will then be attributed to the deemed permanent establishment on the basis of those assets, risks and capital; these profits will be separate from, and will not include, the income or profits that are properly attributable to the dependent agent itself (see section D-5 of Part I of the Report *Attribution of Profits to Permanent Establishments*).

Paragraph 3

27. 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 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.

28. 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.

29. 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.

30. Also, paragraph 3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3 and 4 of that Article).

31. 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.

32. 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.[1]

33. 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 (subparagraph 4 *d*) of Article 5) so that no question of attribution of profit arises in such circumstances.

34. 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

1 Internal transfers of financial assets, which are primarily relevant for banks and other financial institutions, raise specific issues which have been dealt with in Parts II and III of the Report *Attribution of Profits to Permanent Establishments*.

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 appropriate to allocate between the various parts of the enterprise the actual costs of the creation or acquisition of such intangible rights, as well as the costs subsequently incurred with respect to these intangible rights, 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.

35. 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.

36. 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.

37. 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 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.

38. The treatment of services performed in the course of the general management of an enterprise raises 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 skillful 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 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.

39. 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 38 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.

40. 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.

41. The treatment of interest charges raises particular issues. First, there might be amounts which, under the name of interest, are charged by a head office to its permanent establishment with respect to internal "loans" by the former to the latter. Except for financial enterprises such as banks, it is generally agreed that such internal "interest" need not be recognised. 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. Whilst, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed.

42. For these reasons, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special situation of banks, as mentioned below.

43. A different issue, however, is that of the deduction of interest on debts actually incurred by the enterprise. Such debts may relate in whole or in part to the activities of the permanent establishment; indeed, loans contracted by an enterprise will serve either the head office, the permanent establishment or both. The question that arises in relation to these debts is how to determine the part of the interest that should be deducted in computing the profits attributable to the permanent establishment.

44. The approach suggested in this Commentary before 1994, 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 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, in particular the fact that an independent enterprise would normally be expected to have a certain level of "free" capital.

45. Consequently, the majority of member countries consider 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. This appropriate capital structure will take account of the fact that in order to carry out its activities, the permanent establishment requires a certain amount of funding made up of "free" capital and interest bearing debt. The objective is therefore to attribute an arm's length amount of interest to the permanent establishment after attributing an appropriate amount of "free" capital in order to support the functions, assets and risks of the permanent establishment. Under the arm's length principle a permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. In the financial sector regulations stipulate minimum levels of regulatory capital to provide a cushion in the event that some of the risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors.

46. As explained in section D-2 (*v*)*b*) of Part I of the Report *Attribution of Profits to Permanent Establishments*, there are different acceptable approaches for attributing "free" capital that are capable of giving an arm's length result. Each approach has its own strengths and weaknesses, which become more or less material depending on the facts and circumstances of particular cases. Different methods adopt different starting points for determining the amount of "free" capital attributable to a permanent establishment, which either put more emphasis on the actual structure of the enterprise of which the permanent establishment is a part or alternatively, on the capital structures of comparable independent enterprises. The key to attributing "free" capital is to recognise:

— the existence of strengths and weaknesses in any approach and when these are likely to be present;

— that there is no single arm's length amount of "free" capital, but a range of potential capital attributions within which it is possible to find an amount of "free" capital that can meet the basic principle set out above.

47. It is recognised, however, that the existence of different acceptable approaches for attributing "free" capital to a permanent establishment which are capable of giving an arm's length result can give rise to problems of double taxation. The main concern, which is especially acute for financial institutions, is that if the domestic law rules of the State where the permanent establishment is located and of the State of the enterprise require different acceptable approaches for attributing an arm's length amount of free capital to the permanent establishment, the amount of profits calculated by the State of the permanent establishment may be higher than the amount of profits calculated by the State of the enterprise for purposes of relief of double taxation.

48. Given the importance of that issue, the Committee has looked for a practical solution. OECD member countries have therefore agreed to accept, for the purposes of determining the amount of interest deduction that will be used in computing double taxation relief, the attribution of capital derived from the application of the approach used by the State in which the permanent establishment is located if the following two

conditions are met: first, if the difference in capital attribution between that State and the State of the enterprise results from conflicting domestic law choices of capital attribution methods, and second, if there is agreement that the State in which the permanent establishment is located has used an authorised approach to the attribution of capital and there is also agreement that that approach produces a result consistent with the arm's length principle in the particular case. OECD member countries consider that they are able to achieve that result either under their domestic law, through the interpretation of Articles 7 and 23 or under the mutual agreement procedure of Article 25 and, in particular, the possibility offered by that Article to resolve any issues concerning the application or interpretation of their tax treaties.

49. As already mentioned, special considerations apply to internal interest charges on advances between different parts of a financial enterprise (e.g. a bank), 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 application of Article 7 to the permanent establishments of banks and enterprises carrying on global trading, is discussed in Parts II and III of the Report *Attribution of Profits to Permanent Establishments*.

50. The determination of the investment assets attributable to a permanent establishment through which insurance activities are carried on also raises particular issues, which are discussed in Part IV of the Report.

51. 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 based on other methods.

Paragraph 4

52. 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 emphasised, 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.

53. 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.

54. 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.

55. 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 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.

Paragraph 5

56. 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.

57. 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.

Paragraph 6

58. 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 State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment.

Paragraph 7

59. 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.

60. 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.

61. 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).

62. 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 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 discuss the principles governing whether, in the particular case of computer software, payments should be classified as business profits within Article 7 or as a capital gain 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.

63. 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.

64. 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.

Observations on the Commentary

65. *Italy* and *Portugal* deem as essential to take into consideration that — irrespective of the meaning given to the fourth sentence of paragraph 8 — 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.

66. *Belgium* cannot share the views expressed in paragraph 13 of the Commentary. Belgium considers that the application of controlled foreign companies legislation is contrary to the provisions of paragraph 1 of Article 7. This is especially the case where

a Contracting State taxes one of its residents on income derived by a foreign entity by using a fiction attributing to that resident, in proportion to his participation in the capital of the foreign entity, the income derived by that entity. By doing so, that State increases the tax base of its resident by including in it income which has not been derived by that resident but by a foreign entity which is not taxable in that State in accordance with paragraph 1 of Article 7. That Contracting State thus disregards the legal personality of the foreign entity and acts contrary to paragraph 1 of Article 7.

67. *Luxembourg* does not share the interpretation in paragraph 13 which provides that paragraph 1 of Article 7 does not restrict a Contracting State's right to tax its own residents under controlled foreign companies provisions found in its domestic law as this interpretation challenges the fundamental principle contained in paragraph 1 of Article 7.

68. With reference to paragraph 13, *Ireland* notes its general observation in paragraph 27.5 of the Commentary on Article 1.

69. With regard to paragraph 45, *Greece* notes that the Greek internal law does not foresee any rules or methods for attributing "free" capital to permanent establishments. Concerning loans contracted by an enterprise that relate in whole or in part to the activities of the permanent establishment, Greece allows as deduction the part of the interest which corresponds to the amount of a loan contracted by the head office and actually remitted to the permanent establishment.

70. *Portugal* wishes to reserve its right not to follow the position expressed in paragraph 45 of the Commentary on Article 7 except whenever there are specific domestic provisions foreseeing certain levels of "free" capital for permanent establishments.

71. With regard to paragraph 46, *Sweden* wishes to clarify that it does not consider that the different approaches for attributing "free" capital that the paragraph refers to as being "acceptable" will necessarily lead to a result in accordance with the arm's length principle. Consequently, when looking at the facts and circumstances of each case in order to determine whether the amount of interest deduction resulting from the application of these approaches conforms to the arm's length principle, Sweden in many cases would not consider that the other States' approach conforms to the arm's length principle. Sweden is of the opinion that double taxation will therefore often occur, requiring the use of the mutual agreement procedure.

72. *Portugal* wishes to reserve its right not to follow the "symmetry" approach described in paragraph 48 of the Commentary on Article 7, insofar as the Portuguese internal law does not foresee any rules or methods for attributing "free" capital to permanent establishments. In eliminating double taxation according to Article 23, Portugal, as the home country, determines the amount of profits attributable to a permanent establishment according to the domestic law.

73. *Germany*, *Japan* and the *United States*, whilst agreeing to the practical solution described in paragraph 48, wish to clarify how this agreement will be implemented. Neither Germany, nor Japan, nor the United States can automatically accept for all purposes all calculations by the State in which the permanent establishment is located. In cases involving Germany or Japan, the second condition described in paragraph 48 has to be satisfied through a mutual agreement procedure under Article 25. In the case of Japan and the United States, a taxpayer who seeks to obtain additional foreign tax credit limitation must do so through a mutual agreement procedure in which the taxpayer would have to prove to the Japanese or the United States competent authority, as the case may be, that double taxation of the permanent establishment profits which resulted from the conflicting domestic law choices of capital attribution methods has

been left unrelieved after applying mechanisms under their respective domestic tax law such as utilisation of foreign tax credit limitation created by other transactions.

74. With reference to paragraphs 6 and 7, *New Zealand* notes that it does not agree with the approach put forward on the attribution of profits to permanent establishments in general, as reflected in Part I of the Report *Attribution of Profits to Permanent Establishments*.

Reservations on the Article

75. *Australia*, *Chile*[1] 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.

76. *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.

77. *Korea* and *Portugal* 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.

78. *Chile*,[2] *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.

79. 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.

80. *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.

81. *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.

82. *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.

1 Chile was added to this reservation when it joined the OECD in 2010.
2 Chile was added to this reservation when it joined the OECD in 2010.

83. *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.

COMMENTARY ON ARTICLE 8
CONCERNING THE TAXATION OF PROFITS FROM INTERNATIONAL SHIPPING 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 of the enterprise. The term "international traffic" is defined in subparagraph *e*) of paragraph 1 of Article 3.

2. Until 2017, paragraph 1 provided that the taxing right would be left to the Contracting State in which the place of effective management of the enterprise was situated. A review of the treaty practices of OECD and non-OECD countries revealed, however, that the majority of these States preferred to assign the taxing right to the State of the enterprise and the Article was changed accordingly. Some States, however, prefer to continue to use the previous formulation and to confer the exclusive taxing right on the State in which the place of effective management of the enterprise is situated. Such States are free to substitute a rule on the following lines:

> 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.

3. States wishing to use the alternative formulation in paragraph 2 above may also want to deal with the particular case where the place of effective management of the enterprise is aboard a ship, which could be done by adding the following provision:

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

4. The profits covered consist in the first place of the profits directly obtained by the enterprise from the transportation of passengers or cargo by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise) that it operates in international traffic. However, as international transport has evolved, shipping and air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic operations. The paragraph also covers profits from activities directly connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ships or aircraft in international traffic as long as they are ancillary to such operation.

4.1 Any activity carried on primarily in connection with the transportation, by the enterprise, of passengers or cargo by ships or aircraft that it operates in international traffic should be considered to be directly connected with such transportation.

4.2 Activities that the enterprise does not need to carry on for the purposes of its own operation of ships or aircraft in international traffic but which make a minor contribution relative to such operation and are so closely related to such operation that they should not be regarded as a separate business or source of income of the enterprise should be considered to be ancillary to the operation of ships and aircraft in international traffic.

4.3 In light of these principles, the following paragraphs discuss the extent to which paragraph 1 applies with respect to some particular types of activities that may be carried on by an enterprise engaged in the operation of ships or aircraft in international traffic.

5. Profits obtained by leasing a ship or aircraft on charter fully equipped, crewed 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 ancillary activity of an enterprise engaged in the international operation of ships or aircraft.

6. Profits derived by an enterprise from the transportation of passengers or cargo otherwise than by ships or aircraft that it operates in international traffic are covered by the paragraph to the extent that such transportation is directly connected with the operation, by that enterprise, of ships or aircraft in international traffic or is an ancillary activity. One example would be that of an enterprise engaged in international transport that would have some of its passengers or cargo transported internationally by ships or aircraft operated by other enterprises, e.g. under code-sharing or slot-chartering arrangements or to take advantage of an earlier sailing. Another example would be that of an airline company that operates a bus service connecting a town with its airport primarily to provide access to and from that airport to the passengers of its international flights.

7. A further example would be that of an enterprise that transports passengers or cargo by ships or aircraft operated in international traffic which undertakes to have those passengers or that cargo picked up in the country where the transport originates or transported or delivered in the country of destination by any mode of inland transportation operated by other enterprises. In such a case, any profits derived by the first enterprise from arranging such transportation by other enterprises are covered by the paragraph even though the profits derived by the other enterprises that provide such inland transportation would not be.

8. An enterprise will frequently sell tickets on behalf of other transport enterprises at a location that it maintains primarily for purposes of selling tickets for transportation on ships or aircraft that it operates in international traffic. Such sales of tickets on behalf of other enterprises will either be directly connected with voyages

aboard ships or aircraft that the enterprise operates (e.g. sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the enterprise) or will be ancillary to its own sales. Profits derived by the first enterprise from selling such tickets are therefore covered by the paragraph.

8.1 Advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates or at its business locations (e.g. ticket offices) is ancillary to its operation of these ships or aircraft and profits generated by such advertising fall within the paragraph.

9. Containers are used extensively in 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 are usually either directly connected or ancillary to its operation of ships or aircraft in international traffic and in such cases fall within the scope of the paragraph. The same conclusion would apply with respect to profits derived by such an enterprise from the short-term storage of such containers (e.g. where the enterprise charges a customer for keeping a loaded container in a warehouse pending delivery) or from detention charges for the late return of containers.

10. An enterprise that has assets or personnel in a foreign country for purposes of operating its ships or aircraft in international traffic may 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 and equipment-maintenance staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods or services to other enterprises will fall under the paragraph.

10.1 For example, enterprises engaged in international transport may enter into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees, under an International Airlines Technical Pool agreement, to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic.

11. [Deleted]

12. The paragraph does not apply to a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.

13. [Renumbered]

14. Investment income of shipping 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 so that the investment may be considered to be directly connected with such operation. Thus, the paragraph 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: in such cases, the investment is needed to allow the operation of the ships or aircraft at that location. The paragraph 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.

14.1 Enterprises engaged in the operation of ships or aircraft in international traffic may be required to acquire and use emissions permits and credits for that purpose (the nature of these permits and credits is explained in paragraph 75.1 of the Commentary on Article 7). Paragraph 1 applies to income derived by such enterprises with respect to such permits and credits where such income is an integral part of carrying on the business of operating ships or aircraft in international traffic, e.g. where permits are acquired for the purpose of operating ships or aircraft or where permits acquired for that purpose are subsequently traded when it is realised that they will not be needed.

Operation of boats engaged in inland waterways transport

15. States wishing to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic can do so by including the following provision in their bilateral treaties:

> Profits of an enterprise of a Contracting State from the operation of boats engaged in inland waterways transport shall be taxable only in that State.

16. The above provision would apply not only to inland waterways transport between two or more countries (in which case it would overlap with paragraph 1), but also to inland waterways transport carried on by an enterprise of one State between two points in another State. The alternative formulation set forth in paragraph 2 above according to which the taxing right would be granted to the State in which the place of effective management of the enterprise is situated also applies to the above provision. If this alternative provision is used, it would be appropriate to add a reference to "boats engaged in inland waterways transport" in paragraph 3 of Articles 13 and 22 in order to ensure that such boats are treated in the same way as ships and aircraft operated in international traffic (see also paragraph 9.3 of the Commentary on Article 15). Also, the principles and examples included in paragraphs 4 and 14 above would be applicable, with the necessary adaptations, for purposes of determining which profits may be considered to be derived from the operation of boats engaged in inland waterways

transport. Specific tax problems which may arise in connection with inland waterways transport, in particular between adjacent countries, could also be settled specially by bilateral agreement.

17. Whilst the above alternative provision uses the word "boat" with respect to inland waterways transport, this reflects a traditional distinction that should not be interpreted to restrict in any way the meaning of the word "ship" used throughout the Convention, which is intended to be given a wide meaning that covers any vessel used for water navigation.

18. It may also 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.

Enterprises not exclusively engaged in shipping or air transport

19. It follows from the wording of paragraph 1 that enterprises not exclusively engaged in shipping or air transport nevertheless come within the provisions of that paragraph as regards profits arising to them from the operation of ships or aircraft belonging to them.

20. 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 or air transport.

21. Nor does any difficulty arise in applying the provisions of paragraph 1 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping 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 taxed in the State where the permanent establishment is situated. 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, even though certain functions related to the operation of ships and aircraft in international traffic may be performed by the permanent establishment, the profits attributable to these functions are taxable exclusively in the State to which the enterprise belongs. Any expenses, or part thereof, incurred in performing such functions must be deducted in computing that part of the profit that is not taxable in the State where the permanent establishment is located and will not, therefore, reduce the part of the profits attributable to the permanent establishment which may be taxed in that State pursuant to Article 7.

22. Where ships or aircraft are operated in international traffic, the application of the alternative formulation in paragraph 2 above 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; thus, even if such profits could be attributed to the permanent establishment under Article 7, they will only be taxable in the State in which the place of effective management of the enterprise is situated (a result that is confirmed by paragraph 4 of Article 7).

Paragraph 2

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. [Renumbered and amended]

Observations on the Commentary

26. [Renumbered and amended]

27. [Deleted]

28. *Greece* and *Portugal* reserve their position as to the application of this Article to income from ancillary activities (see paragraphs 4 to 10.1, 14 and 14.1).

29. *Germany*, *Greece*, *Mexico* and *Turkey* reserve their position as to the application of the Article to income from inland transportation of passengers or cargo and from container services (see paragraphs 4, 6, 7 and 9 above).

30. *Greece* will apply Article 12 to payments from leasing a ship or aircraft on a bareboat charter basis.

Reservations on the Article

31. *Canada*, *Hungary*, *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. New Zealand also reserves the right to tax as profits from internal traffic profits from other coastal and continental shelf activities.

32. *Latvia* reserves the right in exceptional cases to apply the permanent establishment rule in relation to profits derived from the operation of ships in international traffic.

33. *Denmark*, *Norway* and *Sweden* reserve the right to insert special provisions regarding profits derived by the air transport consortium Scandinavian Airlines System (SAS).

34. [Deleted]

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.

36. *Mexico* reserves the right to tax at source profits derived from the provision of accommodation.

37. [Deleted]

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.

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.

40. The *Slovak Republic* reserves the right to tax under Article 12 profits from the leasing of ships, aircraft and containers.

41. *Ireland* reserves the right to include within the scope of the Article income from the rental of ships or aircraft 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.

42. *Turkey* reserves the right to broaden the scope of the Article to cover transport by road vehicle and to make a corresponding change to the definition of "international traffic" in Article 3.

43. *Latvia* reserves the right to include a provision that will ensure that profits from the leasing of ships or aircraft on a bare boat basis and 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.

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.

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).

3. As discussed in the Committee on Fiscal Affairs' Report on "Thin Capitalisation",[2] 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;

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.

2 Adopted by the Council of the OECD on 26 November 1986 and reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(4)-1.

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.

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 such situations by means of corresponding adjustments (see below) and under mutual agreement procedures.

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.

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.

6.1 Under the domestic laws of some countries, a taxpayer may be permitted under appropriate circumstances to amend a previously-filed tax return to adjust the price for a transaction between associated enterprises in order to report a price that is, in the taxpayer's opinion, an arm's length price. Where they are made in good faith, such adjustments may facilitate the reporting of taxable income by taxpayers in accordance with the arm's length principle. However, economic double taxation may occur, for example, if such a taxpayer-initiated adjustment increases the profits of an enterprise of one Contracting State but there is no appropriate corresponding adjustment to the profits of the associated enterprise in the other Contracting State. The elimination of such double taxation is within the scope of paragraph 2. Indeed, to the extent that taxes have been levied on the increased profits in the first-mentioned State, that State may be considered to have included in the profits of an enterprise of that State, and to have taxed, profits on which an enterprise of the other State has been charged to tax. In these circumstances, Article 25 enables the competent authorities of the Contracting States to consult together to eliminate the double taxation; the competent authorities may accordingly, if necessary, use the mutual agreement procedure to determine whether the initial adjustment met the conditions of paragraph 1 and, if that is the case, to determine the amount of the appropriate adjustment to the amount of the tax charged in the other State on those profits so as to relieve the double taxation.

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 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.

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.

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.

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 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 39, 40 and 41 of the Commentary on Article 25). Contracting States may also wish to address this issue through a provision limiting the length of time during which a primary adjustment may be made pursuant to paragraph 1; such a solution avoids the economic double taxation that may otherwise result where there is no corresponding adjustment following the primary adjustment. Contracting States that wish to achieve that result may agree bilaterally to add the following paragraph after paragraph 2:

> 3. A Contracting State shall not include in the profits of an enterprise, and tax accordingly, profits that would have accrued to the enterprise but by reason of the conditions referred to in paragraph 1 have not so accrued, after [bilaterally agreed period] from the end of the taxable year in which the profits would have accrued to the enterprise. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default.

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 10, 11, 12, 33, 34, 40 and 41 of the Commentary on Article 25).

12. [Renumbered]

13. [Deleted]

14. [Deleted]

Observation on the Commentary

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 taxing State may defer the deduction for interest paid that otherwise would be allowed in computing the borrower's net income.

Reservations on the Article

16. The *Czech Republic* reserves the right not to insert paragraph 2 in its conventions but 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.

17. [Deleted]

17.1 *Italy* reserves the right to insert in its treaties a provision according to which it will make adjustments under paragraph 2 of Article 9 only in accordance with the procedure provided for by the mutual agreement article of the relevant treaty.

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.

19. *Hungary* and *Slovenia* reserve the right to specify in paragraph 2 that a correlative adjustment will be made only if they consider that the primary adjustment is justified.

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. Many States consider that 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 these States treat the partnership as fiscally transparent and the partners are ordinarily taxed personally on their share of the partnership capital and partnership profits.

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.

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

1 *Sociétés anonymes.*

2 *Sociétés en commandite par actions.*

3 *Sociétés à responsabilité limitée.*

4 *Sociétés de capitaux.*

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 and does not, therefore, apply to dividends paid by a company which is a resident of a third State. 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 may be taxed by the first-mentioned State under paragraph 2 but may also be taxed by the other State under paragraph 1 of Article 7 (see paragraphs 9 and 9.1 of the Commentary on Articles 23 A and 23 B concerning relief of double taxation in such cases).

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. Under subparagraph *b*), the rate of tax is limited to 15 per 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 by subparagraph *a*) in respect of dividends paid by a subsidiary company to its parent company. If a company of one of the States owns directly, throughout a 365 day period that includes the day of the payment of a dividend, a holding of at least 25 per cent in a company of the other State, it is reasonable that the payment of that dividend 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 (see paragraphs 49 to 54 of the Commentary on Articles 23 A and 23 B).

11. Before 2017, subparagraph *a*) of paragraph 2 referred to a company "other than a partnership". That exception was deleted in recognition of the fact that if a partnership is treated as a company for tax purposes by the Contracting State in which it is established, it is appropriate for the other State to grant the benefits of subparagraph *a*) to that partnership. Indeed, an entity or arrangement (e.g. a partnership) that is treated as a company for tax purposes qualifies as a company under the definition in subparagraph *b*) of paragraph 1 of Article 3 and, to the extent that it is a resident of a Contracting State, is therefore entitled to the benefits of subparagraph *a*) of paragraph 2 with respect to dividends paid by a company resident of the other State, as long as it holds directly at least 25 per cent of the capital of that company. This conclusion holds true regardless of the fact that the State of source of the dividends may regard that entity or arrangement as fiscally transparent. That conclusion is confirmed by the provision on fiscally transparent entities in paragraph 2 of Article 1.

11.1 That provision also ensures that the part of the dividend received by a fiscally transparent entity or arrangement that is treated as the income of a member of that entity or arrangement for purposes of taxation by the State of residence of that member will be considered as a dividend paid to that member for the purposes of Article 10 (see paragraph 12 of the Commentary on Article 1). Where, for example, a company resident of State A pays a dividend to a partnership that State B treats as a transparent entity, the part of that dividend that State B treats as the income of a partner resident of State B, will, for the purposes of paragraph 2 of the convention between States A and B, be treated as a dividend paid to a resident of State B. Also, for the purposes of the application of subparagraph *a*) of paragraph 2 in such a case, a member that is a company should be considered to hold directly, in proportion to its interest in the fiscally transparent entity or arrangement, the part of the capital of the company paying the dividend that is held through that entity or arrangement and, in order to determine whether the member holds directly at least 25 per cent of the capital of the company paying the dividends, that part of the capital will be added to other parts of that capital that the member may otherwise hold directly. In that case, for the purposes of the application of the requirement that at least 25 per cent of the capital of the company paying the dividends be held throughout a 365 day period, it will be necessary to take account of both the period during which the member held the relevant interest in the fiscally transparent entity or arrangement and the period during which the part of the capital of the company paying the dividend was held through that entity or arrangement: if either period does not satisfy the 365 day requirement, subparagraph *a*) will not apply and subparagraph b) will therefore apply to the relevant part of the dividend. States are free to clarify the application of subparagraph *a*) in these circumstances by adding a provision drafted along the following lines:

> To the extent that a dividend paid by a company which is a resident of a Contracting State is, under paragraph 2 of Article 1, considered to be income of another company resident of the other Contracting State because that other company is a member of a fiscally transparent entity or arrangement referred to in that paragraph, that other company shall be deemed, for the purposes of the application of subparagraph *a*) of paragraph 2 of Article 10, to hold directly that part of the capital of the company paying the dividend that is held by the transparent entity or arrangement which corresponds to the proportion of the capital of that fiscally transparent entity or arrangement that is held by that other company.

12. The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words "paid ... to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was paid direct to a resident of a State with which the State of source had concluded a convention.

12.1 Since the term "beneficial owner" was added to address potential difficulties arising from the use of the words "paid to … a resident" in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could

have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries[1]), rather, it should be understood in its context, in particular in relation to the words "paid … to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

12.2 Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

12.3 It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[2] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has

1 For example, where the trustees of a discretionary trust do not distribute dividends earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer), could constitute the beneficial owners of such income for the purposes of Article 10 even if they are not the beneficial owners under the relevant trust law.

2 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(6)-1.

as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 22 to 48 of the Commentary on Article 1. Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of that dividend. It should also be noted that Article 10 refers to the beneficial owner of a dividend as opposed to the owner of the shares, which may be different in some cases.

12.5 The fact that the recipient of a dividend is considered to be the beneficial owner of that dividend does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraph 22 below). The provisions of Article 29 and the principles put forward in the section on "Improper use of the Convention" in the Commentary on Article 1 will apply to prevent abuses, including treaty-shopping situations where the recipient is the beneficial owner of the dividends. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

12.6 The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments[1] that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of "beneficial owner" cannot be applied in the context of the Article. Indeed,

1 See, for example, *Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations* (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 110): "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

> In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 *a*), which refers to the situation where a company is the beneficial owner of a dividend. In the context of Article 10, the term "beneficial owner" is intended to address difficulties arising from the use of the words "paid to" in relation to dividends rather than difficulties related to the ownership of the shares of the company paying these dividends. For that reason, it would be inappropriate, in the context of that Article, to consider a meaning developed in order to refer to the individuals who exercise "ultimate effective control over a legal person or arrangement."[1]

12.7 Subject to other conditions imposed by the Article and the other provisions of the Convention, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 and in 2014 to clarify this point, which has been the consistent position of all member countries).

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.

13.1 Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income, including dividends, derived by such an entity resident of the other State shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

13.2 Similarly, some States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 52 and 53 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:

> Notwithstanding the provisions of paragraph 2, dividends paid by a company which is a resident of a Contracting State shall be taxable only in the other Contracting

1 See the Financial Action Task Force's definition quoted in the previous note.

State if the beneficial owner of the dividends is that State or a political subdivision or local authority thereof.

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, 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 subparagraph *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 subparagraph *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 subparagraph *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 subparagraph *a)*.

e) In the case of bodies which do not have a capital within the meaning of company law, capital for the purpose of subparagraph *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 subparagraph *a)* of paragraph 2 and use instead the criterion of "voting power".

16. Before 2017, paragraph 17 of the Commentary on the Article provided that "[t]he reduction envisaged in subparagraph *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." Such abuses were addressed by the final

report on Action 6[1] of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. As a result of that report, subparagraph *a*) was modified in order to restrict its application to situations where the company that receives the dividend holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend. The subparagraph also provides, however, that in computing that period, changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, should not be taken into account. Also, the addition of Article 29 will address other abusive arrangements aimed at obtaining the benefits of subparagraph *a*).

17. Under the domestic law of some States, it is possible to make portfolio investments in shares of companies of that State through certain collective investment vehicles established in that State which do not pay tax on their investment income. In such cases, a non-resident company that would own at least 25 per cent of the capital of such a vehicle could be able to access the lower rate provided by subparagraph *a*) with respect to dividends paid by that vehicle even though the vehicle did not own at least 25 per cent of the capital of any company from which it received dividends. States for which this is an issue could prevent that result by including in paragraph 2 a rule drafted along the following lines (see also paragraph 67.4 below applicable to distributions by a REIT):

> Subparagraph *a*) shall not apply to dividends paid by a company which is a resident of [name of the State] that is a [description of the type of collective investment vehicle to which that rule should apply].

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 (see, however, paragraph 109 of the Commentary on Article 1). Potential abuses arising from situations where dividends paid by a company resident of a Contracting State are attributable to a permanent establishment which an enterprise of the other State has in a third State are dealt with in paragraph 8 of Article 29. Other questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

20. Also, the paragraph 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.

1 OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241695-en.

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. The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, the final report on Action 6[1] produced as part of that project, have addressed a number of abuses related to cases such as the following one: 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). Apart from the fact that Article 29, which was included in the Convention as a result of the final report on Action 6, addresses the treaty-shopping aspects of that case, States wishing to deny the benefits of Article 10 to dividends that enjoy a preferential tax treatment in the State of residence may consider including in their conventions provisions such as those described in paragraphs 82 to 100 of the Commentary on Article 1.

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.

24. The notion of dividends basically concerns distributions by companies within the meaning of subparagraph *b)* of paragraph 1 of Article 3. Therefore the definition relates, in the first instance, to distributions of profits the title to 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

1 OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241695-en.

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 (see paragraph 19 of the Commentary on Article 11); likewise interest on convertible debentures is not a dividend.

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.

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. Likewise, distributions of profits by co-operative societies are generally regarded as dividends.

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.

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

years. Normally, distributions by a company which have the effect of reducing the membership rights, for instance, payments constituting a reimbursement of capital in any form whatever, are not regarded as dividends.

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

— 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.

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.

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.

32. It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that the provisions of Article 29 (and, in particular, paragraph 8 of that Article) and the

principles put forward in the section on "Improper use of the Convention" in the Commentary on Article 1 will typically prevent such abusive transactions, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, as explained below, that the requirement that a shareholding be "effectively connected" to such a location requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes.

32.1 A holding in respect of which dividends are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the "economic" ownership of the holding is allocated to that permanent establishment under the principles developed in the Committee's report entitled *Attribution of Profits to Permanent Establishments*[1] (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of a holding means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the dividends attributable to the ownership of the holding and the potential exposure to gains or losses from the appreciation or depreciation of the holding).

32.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a holding is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that holding is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165 to 170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

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.

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

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

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.

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 Article 21 of that convention, obtain exemption from, or refund of, the withholding tax of the last-mentioned State.

36. Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits.

37. As confirmed by paragraph 3 of Article 1, paragraph 5 cannot be interpreted as preventing the State of residence of a taxpayer from taxing that taxpayer, pursuant to its controlled foreign companies legislation or other rules with similar effect, on profits which have not been distributed by a foreign company. Moreover, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

38. The application of such legislation or rules may, however, complicate the application of Article 23. If the income were 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 of these legislation or rules 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. 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.

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 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 controlled foreign companies legislation or other rules with similar effect. 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 relevant legislation or rules) 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 relevant legislation or rules) 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.

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.

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.

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 subparagraph *b)* of paragraph 2 of Article 10). Consequently, the solution recommended in the Model Convention remains fully applicable in the present case.

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.

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 (see subparagraph *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.

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.

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.

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.

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.

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.

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 constitutes an adjustment of the company's tax. No refund, therefore, is given if the tax credit exceeds that personal tax.

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.

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 provides 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).

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.

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.

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 provides 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.

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.

57. [Deleted]

58. [Deleted]

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. The treatment of dividends paid to collective investment vehicles raises particular issues which are addressed in paragraphs 22 to 48 of the Commentary on Article 1.

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.

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.

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.

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).

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.

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.

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 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.

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 subparagraph *a)* of paragraph 2.

IV. Distributions by Real Estate Investment Trusts

67.1 In many States, a large part of portfolio investment in immovable property is done through Real Estate Investment Trusts (REITs). A REIT may be loosely described as a widely held company, trust or contractual or fiduciary arrangement that derives its income primarily from long-term investment in immovable property, distributes most of that income annually and does not pay income tax on the income related to immovable property that is so distributed. The fact that the REIT vehicle does not pay tax on that income is the result of tax rules that provide for a single-level of taxation in the hands of the investors in the REIT.

67.2 The importance and the globalisation of investments in and through REITs have led the Committee on Fiscal Affairs to examine the tax treaty issues that arise from such investments. The results of that work appear in a report entitled "Tax Treaty Issues Related to REITS."[1]

67.3 One issue discussed in the report is the tax treaty treatment of cross-border distributions by a REIT. In the case of a small investor in a REIT, the investor has no control over the immovable property acquired by the REIT and no connection to that property. Notwithstanding the fact that the REIT itself will not pay tax on its distributed income, it may therefore be appropriate to consider that such an investor

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at R(23)-1.

has not invested in immovable property but, rather, has simply invested in a company and should be treated as receiving a portfolio dividend. Such a treatment would also reflect the blended attributes of a REIT investment, which combines the attributes of both shares and bonds. In contrast, a larger investor in a REIT would have a more particular interest in the immovable property acquired by the REIT; for that investor, the investment in the REIT may be seen as a substitute for an investment in the underlying property of the REIT. In this situation, it would not seem appropriate to restrict the source taxation of the distribution from the REIT since the REIT itself will not pay tax on its income.

67.4 States that wish to achieve that result may agree bilaterally to replace paragraph 2 of the Article by the following:

> 2. However, dividends paid by a company which is a resident of a Contracting State may also be taxed in that State according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), 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 which holds directly at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT) throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);
>
> *b)* 15 per cent of the gross amount of the dividends in all other cases.

According to this provision, a large investor in a REIT is an investor holding, directly or indirectly, capital that represents at least 10 per cent of the value of all the REIT's capital. States may, however, agree bilaterally to use a different threshold. Also, the provision applies to all distributions by a REIT; in the case of distributions of capital gains, however, the domestic law of some countries provides for a different threshold to differentiate between a large investor and a small investor entitled to taxation at the rate applicable to portfolio dividends and these countries may wish to amend the provision to preserve that distinction in their treaties. Finally, because it would be inappropriate to restrict the source taxation of a REIT distribution to a large investor, the drafting of subparagraph *a)* excludes dividends paid by a REIT from its application; thus, the subparagraph can never apply to such dividends, even if a company that did not hold capital representing 10 per cent or more of the value of the capital of a REIT held at least 25 per cent of its capital as computed in accordance with paragraph 15 above. The State of source will therefore be able to tax such distributions to large investors regardless of the restrictions in subparagraphs *a)* and *b)*.

67.5 Where, however, the REITs established in one of the Contracting States do not qualify as companies that are residents of that Contracting State, the provision will need to be amended to ensure that it applies to distributions by such REITs.

67.6 For example, if the REIT is a company that does not qualify as a resident of the State, paragraphs 1 and 2 of the Article will need to be amended as follows to achieve that result:

> 1. Dividends paid by a company which is a resident, or a REIT organised under the laws, of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, dividends may also be taxed in, and according to the laws of, the Contracting State of which the company paying the dividends is a resident or, in the case of a REIT, under the laws of which it has been organised, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), 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 which holds directly at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT) throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);
>
> *b)* 15 per cent of the gross amount of the dividends in all other cases.

67.7 Similarly, in order to achieve that result where the REIT is structured as a trust or as a contractual or fiduciary arrangement and does not qualify as a company, States may agree bilaterally to add to the alternative version of paragraph 2 set forth in paragraph 67.4 above an additional provision drafted along the following lines:

> For the purposes of this Convention, where a REIT organised under the laws of a Contracting State makes a distribution of income to a resident of the other Contracting State who is the beneficial owner of that distribution, the distribution of that income shall be treated as a dividend paid by a company resident of the first-mentioned State.

Under this additional provision, the relevant distribution would be treated as a dividend and not, therefore, as another type of income (e.g. income from immovable property or capital gain) for the purposes of applying Article 10 and the other Articles of the Convention. Clearly, however, that would not change the characterisation of that distribution for purposes of domestic law so that domestic law treatment would not be affected except for the purposes of applying the limitations imposed by the relevant provisions of the Convention.

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.

Reservations on the Article

Paragraph 2

69. *Japan* reserves the right not to apply the direct dividend investment rate to dividends which are deductible in computing the taxable income of the company paying the dividends in the Contracting State of which that company is a resident.

70. The *United States* reserves its right to grant the 5 per cent rate of tax on dividends only when requirements of ownership and residency for prescribed periods of time have been satisfied.

71. The *United States* reserves its right to tax in accordance with its domestic law dividends paid by an "expatriated entity" to a connected person for up to a period of ten years.

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.

73. *Germany* and *Portugal* reserve the right to exclude partnerships from the scope of application of subparagraph *a*) of paragraph 2, as provided in the Model Tax Convention before 2017.

74. In view of its particular taxation system, *Chile* retains its freedom of action with regard to the provisions in the Convention relating to the rate and form of distribution of profits by companies.

75. *Israel*, *Latvia*, *Mexico*, *Portugal* and *Turkey* reserve their positions on the rates of tax in paragraph 2.

76. *Australia*, *Estonia*, *Japan* and *Latvia* reserve the right not to include the requirement for the competent authorities to settle by mutual agreement the mode of application of paragraph 2.

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).

77.1 *Luxembourg* reserves the right not to include the holding period provided in subparagraph *a*) of paragraph 2.

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.

79. *Denmark* reserves the right, in certain cases, to consider as dividends the selling price derived from the sale of shares.

80. *France* and *Mexico* reserve the right to amplify the definition of dividends in paragraph 3 so as to cover all income subjected to the taxation treatment of distributions.

81. *Canada* and *Germany* 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.

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.

81.2 *Chile* and *Luxembourg* reserve the right to expand the definition of dividends in paragraph 3 in order to cover certain payments which are treated as distributions of dividends under their domestic law.

82. *Israel* reserves the right to exclude payments made by a Real Estate Investment Trust which is a resident of Israel from the definition of dividends in paragraph 3 and to tax those payments according to its domestic law.

82.1 *Estonia*, *Japan* and *Latvia* reserve the right to replace, in paragraph 3, the words "income from other corporate rights" by "income from other rights".

82.2 *Australia* reserves the right to expand the definition of dividends in paragraph 3 in order to cover other amounts which are subjected to the same taxation treatment as income from shares under its domestic law.

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. Canada also reserves the right to impose this tax on profits attributable to the alienation of immovable property situated in Canada by a company carrying on a trade in immovable property.

84. [Deleted]

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 the other Contracting State that carries on business through a permanent establishment situated in Turkey that remains after taxation pursuant to Article 7.

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 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 (see 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.

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 does not, therefore, apply to interest arising in a third State. 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 may be taxed by the first-mentioned State under paragraph 2 but may also be taxed by the other State under paragraph 1 of Article 7 (see paragraphs 9 and 9.1 of the Commentary on Articles 23 A and 23 B concerning relief of double taxation in such cases).

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 upon a lower tax or on exclusive taxation in the State of the beneficiary's residence with respect to all interest payments or, as explained below, as regards some specific categories of interest.

7.1 In certain cases, the approach adopted in paragraph 2, which is to allow source taxation of payments of interest, can constitute an obstacle to international trade or may be considered inappropriate for other reasons. For instance, when the beneficiary of the interest has borrowed in order to finance the operation which earns the interest, the profit realised by way of interest will be much smaller than the nominal amount of interest received; if the interest paid is equal to or exceeds the interest received, there will be either no profit at all or even a loss. The problem, in that case, cannot be solved by the State of residence, since little or no tax will be levied in that State where the beneficiary is taxed on the net profit derived from the transaction. That problem arises because the tax in the State of source is typically levied on the gross amount of the interest regardless of expenses incurred in order to earn such interest. In order to avoid that problem, creditors will, in practice, tend to shift to the debtor the burden of the tax levied by the State of source on the interest and therefore increase the rate of interest charged to the debtor, whose financial burden is then increased by an amount corresponding to the tax payable to the State of source.

7.2 The Contracting States may wish to add an additional paragraph to provide for the exclusive taxation in the State of the beneficiary's residence of certain interest. The

preamble of that paragraph, which would be followed by subparagraphs describing the various interest subject to that treatment (see below), might be drafted along the following lines:

> 3. Notwithstanding the provisions of paragraph 2, interest referred to in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident if the beneficial owner of the interest is a resident of that State, and:
>
> *a)* [*description of the relevant category of interest*] ...

7.3 The following are some of the categories of interest that Contracting States may wish to consider for the purposes of paragraph 7.2 above.

Interest paid to a State, its political subdivisions and to central banks

7.4 Some States refrain from levying tax on income derived by other States and some of their wholly-owned entities (e.g. a central bank established as a separate entity), at least to the extent that such income is derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 52 and 53 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. In their bilateral conventions, many States wish to confirm or clarify the scope of these exemptions with respect to interest or to grant such an exemption in cases where it would not otherwise be available. States wishing to do so may therefore agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

a) is that State or the central bank, a political subdivision or local authority thereof;

Interest paid by a State or its political subdivisions

7.5 Where the payer of the interest happens to be the State itself, a political subdivision or a statutory body, the end result may well be that the tax levied at source may actually be borne by that State if the lender increases the interest rate to recoup the tax levied at source. In that case, any benefits for the State taxing the interest at source will be offset by the increase of its borrowing costs. For that reason, many States provide that such interest will be exempt from any tax at source. States wishing to do so may agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

b) if the interest is paid by the State in which the interest arises or by a political subdivision, a local authority or statutory body thereof;

In this suggested provision, the phrase "statutory body" refers to any public sector institution. Depending on their domestic law and terminology, some States may prefer to use phrases such as "agency or instrumentality" or "legal person of public law" [*personne morale de droit public*] to refer to such an institution.

Interest paid pursuant to export financing programmes

7.6 In order to promote international trade, many States have established export financing programmes or agencies which may either provide export loans directly or insure or guarantee export loans granted by commercial lenders. Since that type of financing is supported by public funds, a number of States provide bilaterally that interest arising from loans covered by these programmes shall be exempt from source taxation. States wishing to do so may agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

c) if the interest is paid in respect of a loan, debt-claim or credit that is owed to, or made, provided, guaranteed or insured by, that State or a political subdivision, local authority or export financing agency thereof;

Interest paid to financial institutions

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

d) is a financial institution;

Interest on sales on credit

7.8 The disadvantages described in paragraph 7.1 also arise frequently in the case of sales on credit of equipment and other commercial credit sales. 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. In these cases, the interest is more an element of the selling price than income from invested capital. In fact, in many cases, the interest incorporated in the amounts of instalments to be paid will be difficult to separate from the actual sale price. States may therefore wish to include interest arising from such sales on credit in a paragraph providing for exemption of certain interest from taxation in the State of source, which they can do by adding the following subparagraph:

e) if the interest is paid with respect to indebtedness arising as a consequence of the sale on credit of any equipment, merchandise or services;

7.9 The types of sales on credit referred to in this suggested provision comprise not only sales of complete units, but also sales of separate components thereof. Sales financed through a general line of credit provided by a seller to a customer constitute sales on credit as well for the purposes of the provision. Also, it is immaterial whether the interest is stipulated separately in addition to the sale price or is included from the outset in the price payable by instalments.

Interest paid to some tax-exempt entities (e.g. pension funds)

7.10 Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income, including interest, derived by such an entity resident of the other State shall also be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

7.11 If the Contracting States do not wish to exempt completely any or all of the above categories of interest from taxation in the State of source, they may wish to apply to them a lower rate of tax than that provided for in paragraph 2 (that solution would not, however, seem very practical in the case of interest paid by a State or its political subdivision or statutory body). In that case, paragraph 2 might be drafted along the following lines:

> 2. However, interest arising in a Contracting State may also be taxed in that State 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:
>
> *a)* *[lower rate of tax]* per cent of the gross amount of the interest in the case of interest paid *[description of the relevant category of interest]* ...
>
> *b)* 10 per cent of the gross amount of the interest in all other cases.
>
> The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

If the Contracting States agree to exempt some of the above categories of interest, this alternative provision would be followed by a paragraph 3 as suggested in paragraph 7.2 above.

7.12 Contracting States may add to the categories of interest enumerated in the paragraphs above, other categories in regard to which the imposition of a tax in the State of source might appear to them to be undesirable.

8. The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, the final report on Action 6[1] produced as part of that project, have addressed a number of abuses related to cases such as the following one: the beneficial owner of interest

1 OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241695-en.

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. Whilst Article 29, which was included in the Convention as a result of the final report on Action 6, addresses the treaty-shopping aspects of that case, States wishing to deny the benefits of Article 11 to interest that enjoys a preferential tax treatment in the State of residence may consider including in their conventions provisions such as those described in paragraphs 82 to 100 of the Commentary on Article 1.

9. The requirement of beneficial owner was introduced in paragraph 2 of Article 11 to clarify the meaning of the words "paid to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was paid direct to a resident of a State with which the State of source had concluded a convention.

9.1 Since the term "beneficial owner" was added to address potential difficulties arising from the use of the words "paid to a resident" in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries[1]), rather, it should be understood in its context, in particular in relation to the words "paid to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

10. Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

10.1 It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting

1 For example, where the trustees of a discretionary trust do not distribute interest earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer) could constitute the beneficial owners of such income for the purposes of Article 11 even if they are not the beneficial owners under the relevant trust law.

State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[1] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

10.2 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the interest is not the "beneficial owner" because that recipient's right to use and enjoy the interest is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 22 to 48 of the Commentary on Article 1. Where the recipient of interest does have the right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of that interest. It should also be noted that Article 11 refers to the beneficial owner of interest as opposed to the owner of the debt-claim with respect to which the interest is paid, which may be different in some cases.

10.3 The fact that the recipient of an interest payment is considered to be the beneficial owner of that interest does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse (see also paragraph 8 above). The provisions of Article 29 and the principles put forward in the section on "Improper use of the Convention" in the Commentary on Article 1 will apply to prevent abuses, including treaty-shopping situations where the recipient is the beneficial owner of interest. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the interest to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(6)-1.

10.4 The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments[1] that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of "beneficial owner" cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 *a*) of Article 10, which refers to the situation where a company is the beneficial owner of a dividend. In the context of Articles 10 and 11, the term "beneficial owner" is intended to address difficulties arising from the use of the words "paid to" in relation to dividends and interest rather than difficulties related to the ownership of the shares or debt-claims on which dividends or interest are paid. For that reason, it would be inappropriate, in the context of these Articles, to consider a meaning developed in order to refer to the individuals who exercise "ultimate effective control over a legal person or arrangement".[2]

11. Subject to other conditions imposed by the Article and the other provisions of the Convention, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 and in 2014 to clarify this point, which has been the consistent position of all member countries).

12. 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

1 See, for example, *Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations* (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 110): "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

> In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

2 See the Financial Action Task Force's definition quoted in the previous note.

procedure provided in its own law (see, however, paragraph 109 of the Commentary on Article 1). Potential abuses arising from situations where interest arising in a Contracting State is attributable to a permanent establishment which an enterprise of the other State has in a third State are dealt with in paragraph 8 of Article 29. Other questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

13. 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.

14. 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.

15. [Deleted]

16. [Renumbered and amended]

17. [Renumbered and amended]

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 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.

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.

20. As regards, more particularly, government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest.

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

20.1 The amount that the seller of a bond will receive will typically include the interest that has accrued, but has not yet become payable, at the time of the sale of the bond. In most cases, the State of source will not attempt to tax such accrued interest at the time of the alienation and will only tax the acquirer of the bond or debenture on the full amount of the interest subsequently paid (it is generally assumed that in such a case, the price that the acquirer pays for the bond takes account of the future tax liability of the acquirer on the interest accrued for the benefit of the seller at the time of the alienation). In certain circumstances, however, some States tax the seller of a bond on interest that has accrued at the time of the alienation (e.g. when a bond is sold to a tax-exempt entity). Such accrued interest is covered by the definition of interest and may therefore be taxed by the State of source. In that case, that State should not again tax the same amount in the hands of the acquirer of the bond when the interest subsequently becomes payable.

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.

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.

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 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.

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.

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 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.

25. It has been suggested that the paragraph could give rise to abuses through the transfer of loans to permanent establishments set up solely for that purpose in countries that offer preferential treatment to interest income. Apart from the fact that the provisions of Article 29 (and, in particular, paragraph 8 of that Article) and the principles put forward in the section on "Improper use of the Convention" in the Commentary on Article 1 will typically prevent such abusive transactions, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, as explained below, that the requirement that a debt-claim be "effectively connected" to such a location requires more than merely recording the debt-claim in the books of the permanent establishment for accounting purposes.

25.1 A debt-claim in respect of which interest is paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the "economic" ownership of the debt-claim is allocated to that permanent establishment under the principles developed in the Committee's report entitled *Attribution of Profits to Permanent Establishments*[1] (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of a debt-claim means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the interest attributable to the ownership of the debt-claim and the potential exposure to gains or losses from the appreciation or depreciation of the debt-claim).

25.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a debt-claim is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that debt-claim is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165 to 170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

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.

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:

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)*.

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 taxes the interest on the loan at the source when it is borne by the permanent establishment in its territory.

29. It has been decided not to deal with that case in the Convention. The Contracting State of the payer's residence does not, therefore, have 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. If this were not the case and the third State did not subject the interest borne by the permanent establishment to source taxation, there could be attempts to avoid source taxation in the Contracting State through the use of a permanent establishment situated in such a third State. States for which this is not a concern and that wish to address the issue described in the paragraph above may do so by agreeing to use, in their bilateral convention, the alternative formulation of paragraph 5 suggested in paragraph 30 below. The risk of double taxation just referred to could also be avoided through a multilateral convention. Also, if in the case described in paragraph 28, the State 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 using, where necessary, the mutual agreement procedure (as envisaged in paragraph 3 of Article 25); see paragraphs 38.1 and 55 to 55.2 of the Commentary on Article 25).

30. As mentioned in paragraph 29, any such double taxation could be avoided either through a multilateral convention or if the State of the beneficiary's residence and the State of the payer's residence agreed to word the second sentence of paragraph 5 in the following way, which would have the effect of ensuring that paragraphs 1 and 2 of the Article did not apply to the interest, which would then typically fall under Article 7 or 21:

> 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.

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.

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.

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.

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.

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 as a minimum to remove the limiting phrase "having regard to the debt-claim for which it is paid". If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds". Either of these alternative versions would apply where some or all of an interest payment is excessive because the amount of the loan or the terms relating to it (including the rate of interest) are not what would have been agreed upon in the absence of the special relationship. 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.

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.

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.

Reservations on the Article

Paragraph 2

38. *Chile*, *Hungary*, *Israel*, *Latvia*, *Mexico*, *Portugal*, the *Slovak Republic* and *Turkey* reserve their positions on the rate provided in paragraph 2.

39. The *United States* reserves its right to impose its branch tax on the interest allocable to earnings of a company attributable to a permanent establishment situated in the United States.

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: 1) a form of interest that is "an excess inclusion with respect to residual interest in a real estate mortgage investment conduit"; and 2) interest paid by an "expatriated entity" to a connected person for up to a period of ten years.

40.1 *Estonia*, *Japan* and *Latvia* reserve the right not to include the requirement for the competent authorities to settle by mutual agreement the mode of application of paragraph 2.

Paragraph 3

41. *Mexico* reserves the right to consider as interest other types of income, such as income derived from financial leasing and factoring contracts.

42. *Belgium*, *Canada*, *Estonia*, *Ireland* and *Latvia* 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.

43. *Canada*, *Chile* and *Norway* reserve the right to delete the reference to debt-claims carrying the right to participate in the debtor's profits.

44. *Chile*, *Greece* 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.

45. *Australia* reserves the right to widen the definition of interest to include income which is subjected under its domestic law to the same taxation treatment as income from money lent.

45.1 The *United States* reserves its right to amend the definition of interest to include all income that is subject to the same taxation treatment as income from money lent under the law of the Contracting State in which the income arises, and to specify that income dealt with in Article 10 will not be regarded as interest.

Paragraph 6

46. *Mexico* reserves the right to include a provision regarding the treatment of interest derived from back-to-back loans, as a safeguard against abuse.

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).

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.

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. The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the State of source is not obliged to give up taxing rights over royalty income merely because that income was paid direct to a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries[1]), rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

4.1 Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is paid to a resident of

1 For example, where the trustees of a discretionary trust do not distribute royalties earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer) could constitute the beneficial owners of such income for the purposes of Article 12 even if they are not the beneficial owners under the relevant trust law.

a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

4.2 It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[1] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

4.3 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the royalties is not the "beneficial owner" because that recipient's right to use and enjoy the royalties is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the royalties unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs 22 to 48 of the Commentary on Article 1. Where the recipient of royalties does have the right to use and enjoy the royalties unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of these royalties. It should also be noted that Article 12 refers to the beneficial owner of royalties as opposed to the owner of the right or property in respect of which the royalties are paid, which may be different in some cases.

4.4 The fact that the recipient of royalties is considered to be the beneficial owner of these royalties does not mean, however, that the provisions of paragraph 1 must automatically be applied. The benefit of these provisions should not be granted in

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(6)-1.

cases of abuse (see also paragraph 7 below). The provisions of Article 29 and the principles put forward in the section on "Improper use of the Convention" in the Commentary on Article 1 will apply to prevent abuses, including treaty-shopping situations where the recipient is the beneficial owner of royalties. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on the royalties to someone else), it does not deal with other cases of abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

4.5 The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments[1] that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of "beneficial owner" cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of subparagraph 2 *a*) of Article 10, which refers to the situation where a company is the beneficial owner of a dividend. The term beneficial owner was intended to address difficulties arising from the use of the words "paid to", which are found in paragraph 1 of Articles 10 and 11 and were similarly used in paragraph 1 of Article 12 of the 1977 Model Double Taxation Convention, in relation to dividends, interest and royalties rather than difficulties related to the ownership of the shares, debt-claims, property or rights with respect these dividends, interest or royalties are paid. For that reason, it would be inappropriate, in the context of these articles, to consider a meaning developed in order to refer to the individuals who exercise "ultimate effective control over a legal person or arrangement".[2]

1 See, for example, *Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations* (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 110): "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, *Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes* (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

> In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

2 See the Financial Action Task Force's definition quoted in the previous note.

4.6 Subject to other conditions imposed by the Article and the other provisions of the Convention, the exemption from taxation in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer, in those cases where the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1997 to clarify this point, which has been the consistent position of all member countries).

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 see paragraphs 4 to 6 of the Commentary on Article 21). Potential abuses arising from situations where royalties arising in a Contracting State are attributable to a permanent establishment which an enterprise of the other State has in a third State are dealt with in paragraph 8 of Article 29. Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law. Other questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

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. The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, the final reports on Actions 5, 6 and 8-10[1] produced as part of that project, have addressed a number of abuses related to cases such as the following one: 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. Whilst Article 29, which was included in the Convention as a result of the final report on Action 6, addresses the treaty-shopping aspects of that case, States wishing to deny the benefits of Article 12 to royalties that enjoy a preferential tax treatment in the State of residence may consider including in their conventions provisions such as those described in paragraphs 82 to 100 of the Commentary on Article 1.

1 OECD (2015), *Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report*, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/9789264241190-en; OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*, OECD Publishing, Paris, DOI: http://dx.doi.org/10.1787/9789264241695-en and OECD (2015), *Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports*, OECD Publishing, Paris. DOI: http://dx.doi.org/10.1787/9789264241244-en.

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 license and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.

8.1 The definition does not, however, apply to payments that, whilst based on the number of times a right belonging to someone is used, are made to someone else who does not himself own the right or the right to use it (see, for instance, paragraph 18 below).

8.2 Where a payment is in consideration for the transfer of the full ownership of an element of property referred to in the definition, the payment is not in consideration "for the use of, or the right to use" that property and cannot therefore represent a royalty. As noted in paragraphs 15 and 16 below as regards software, difficulties can arise in the case of a transfer of rights that could be considered to form part of an element of property referred to in the definition where these rights are transferred in a way that is presented as an alienation. For example, this could involve the exclusive granting of all rights to an intellectual property for a limited period or all rights to the property in a limited geographical area in a transaction structured as a sale. Each case will depend on its particular facts and will need to be examined in the light of the national intellectual property law applicable to the relevant type of property and the national law rules as regards what constitutes an alienation but in general, if the payment is in consideration for the alienation of rights that constitute distinct and specific property (which is more likely in the case of geographically-limited than time limited rights), such payments are likely to be business profits within Article 7 or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, 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.

8.3 The word "payment", used in the definition, 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.

8.4 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.

8.5 Where information referred to in paragraph 2 is supplied or where the use or the right to use a type of property referred to in that paragraph is granted, the person who

owns that information or property may agree not to supply or grant to anyone else that information or right. Payments made as consideration for such an agreement constitute payments made to secure the exclusivity of that information or an exclusive right to use that property, as the case may be. These payments being payments "of any kind received as a consideration for ... the right to use" the property "or for information", fall under the definition of royalties.

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.

9.1 Satellite operators and their customers (including broadcasting and telecommunication enterprises) frequently enter into "transponder leasing" agreements under which the satellite operator allows the customer to utilise the capacity of a satellite transponder to transmit over large geographical areas. Payments made by customers under typical "transponder leasing" agreements are made for the use of the transponder transmitting capacity and will not constitute royalties under the definition of paragraph 2: these payments are not made in consideration for the use of, or right to use, property, or for information, that is referred to in the definition (they cannot be viewed, for instance, as payments for information or for the use of, or right to use, a secret process since the satellite technology is not transferred to the customer). As regards treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties, the characterisation of the payment will depend to a large extent on the relevant contractual arrangements. Whilst the relevant contracts often refer to the "lease" of a transponder, in most cases the customer does not acquire the physical possession of the transponder but simply its transmission capacity: the satellite is operated by the lessor and the lessee has no access to the transponder that has been assigned to it. In such cases, the payments made by the customers would therefore be in the nature of payments for services, to which Article 7 applies, rather than payments for the use, or right to use, ICS equipment. A different, but much less frequent, transaction would be where the owner of the satellite leases it to another party so that the latter may operate it and either use it for its own purposes or offer its data transmission capacity to third parties. In such a case, the payment made by the satellite operator to the satellite owner could well be considered as a payment for the leasing of industrial, commercial or scientific equipment. Similar considerations apply to payments made to lease or purchase the capacity of cables for the transmission of electrical power or communications (e.g. through a contract granting an indefeasible right of use of such capacity) or pipelines (e.g. for the transportation of gas or oil).

9.2 Also, payments made by a telecommunications network operator to another network operator under a typical "roaming" agreement (see paragraph 38 of the Commentary on Article 5) will not constitute royalties under the definition of paragraph 2 since these payments are not made in consideration for the use of, or right to use, property, or for information, referred to in the definition (they cannot be viewed, for instance, as payments for the use of, or right to use, a secret process since no secret technology is used or transferred to the operator). This conclusion holds true even in the case of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties since the operator that pays a charge under a roaming agreement is not paying for the use, or the right to use, the visited network, to which it does not have physical access, but rather for the telecommunications services provided by the foreign network operator.

9.3 Payments for the use of, or the right to use, some or all of part of the radio frequency spectrum (e.g. pursuant to a so-called "spectrum license" that allows the holder to transmit media content over designated frequency ranges of the electromagnetic spectrum) do not constitute payments for the use of, or the right to use, property, or for information, that is referred in the definition of royalties in paragraph 2. This conclusion holds true even in the case of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties since the payment is not for the use, or the right to use, any equipment.

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.

10.1 Payments that are solely made in consideration for obtaining the exclusive distribution rights of a product or service in a given territory do not constitute royalties as they are not made in consideration for the use of, or the right to use, an element of property included in the definition. These payments, which are best viewed as being made to increase sales receipts, would rather fall under Article 7. An example of such a payment would be that of a distributor of clothes resident in one Contracting State who pays a certain sum of money to a manufacturer of branded shirts, who is a resident of the other Contracting State, as consideration for the exclusive right to sell in the first State the branded shirts manufactured abroad by that manufacturer. In that example, the resident distributor does not pay for the right to use the trade name or trade mark under which the shirts are sold; he merely obtains the exclusive right to sell in his State of residence shirts that he will buy from the manufacturer.

10.2 A payment cannot be said to be "for the use of, or the right to use" a design, model or plan if the payment is for the development of a design, model or plan that does not already exist. In such a case, the payment is made in consideration for the services that will result in the development of that design, model or plan and would thus fall under Article 7. This will be the case even if the designer of the design, model or plan (e.g. an architect) retains all rights, including the copyright, in that design,

model or plan. Where, however, the owner of the copyright in previously-developed plans merely grants someone the right to modify or reproduce these plans without actually performing any additional work, the payment received by that owner in consideration for granting the right to such use of the plans would constitute royalties.

11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how. The words "payments … for information concerning industrial, commercial or scientific experience" are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.

11.1 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.

11.2 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. Payments made under the latter contracts generally fall under Article 7.

11.3 The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

— Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.

— In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.

— In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve

a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

— payments obtained as consideration for after-sales service,

— payments for services rendered by a seller to the purchaser under a warranty,

— payments for pure technical assistance,

— payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),

— payments for an opinion given by an engineer, an advocate or an accountant, and

— payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.6 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 the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

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.

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.

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.

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 unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.3).

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.

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 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.

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.

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.

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 separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.

14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

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 is a transfer of rights involving:

— exclusive right of use of the copyright 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.

16. Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time limited rights), such payments are likely to be business profits within Article 7 or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, 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.

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 11.6 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.

17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the

customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.

18. The suggestions made above regarding mixed contracts could also be applied in regard to certain performances by artists and, in particular, in regard 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 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, on the basis of his copyright in the sound recording, 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. Where, however, the copyright in a sound recording, because of either the relevant copyright law or the terms of contract, belongs to a person with whom the artist has contractually agreed to provide his services (i.e. a musical performance during the recording), or to a third party, the payments made under such a contract fall under Articles 7 (e.g. if the performance takes place outside the State of source of the payment) or 17 rather than under this Article, even if these payments are contingent on the sale of the recordings.

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.

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.

21. It has been suggested that the paragraph could give rise to abuses through the transfer of rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to royalty income. Apart from the fact that the provisions of Article 29 (and, in particular, paragraph 8 of that Article) and the principles put forward in the section on "Improper use of the Convention" in the Commentary on Article 1 will typically prevent such abusive transactions, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, as explained below, that the requirement that a right or property be "effectively connected" to such a location requires more than merely recording the right or property in the books of the permanent establishment for accounting purposes.

21.1 A right or property in respect of which royalties are paid will be effectively connected with a permanent establishment, and will therefore form part of its business assets, if the "economic" ownership of that right or property is allocated to that permanent establishment under the principles developed in the Committee's report entitled *Attribution of Profits to Permanent Establishments*[1] (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of a right or property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the royalties attributable to the ownership of the right or property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that right or property).

21.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a right or property is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that right or property is taken into account in determining the

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165 to 170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

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. The paragraph permits only the adjustment of the amount of royalties and not the reclassification of the royalties in such a way as to give it a different character, e.g. a contribution to equity capital. For such an adjustment to be possible under paragraph 4 of Article 12 it would be necessary as a minimum to remove the limiting phrase "having regard to the use, right or information for which they are paid". If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds".

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.

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.

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, 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.

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.

Observations on the Commentary

27. *Italy* and *Spain* do not adhere to the interpretation in paragraph 8.2. They hold the view that payments in consideration for the transfer of the ownership of an element referred to in the definition of royalties fall within the scope of this Article where less than the full ownership is transferred. Italy also takes that view with respect to paragraphs 15 and 16.

27.1 As regards paragraph 10.1, *Italy* considers that where contracts grant exclusive distribution rights of a product or a service together with other rights referred to in the definition of royalties, the part of the payment made, under these contracts, in consideration for the exclusive distribution rights of a product or a service may, depending on the circumstances, be covered by the Article.

28. *Mexico*, *Portugal* and *Spain* do not adhere to the interpretation in paragraphs 14, 14.4, 15, 16 and 17.1 to 17.4. Mexico, Portugal and Spain 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 (except payments for the right to distribute standardised software copies, not comprising the right neither to customise nor to reproduce them) or if they relate to software acquired for the business use of the purchaser, when, in this last case, the software is not absolutely standardised but somehow adapted to the purchaser.

29. *Mexico* does not adhere to the interpretation in paragraph 8.2. Mexico holds the view that payments in consideration for the transfer of rights presented as an alienation (e.g. geographically limited or time limited rights) fall within the scope of this Article because less than the full rights inherent to an element of property referred to in the definition are transferred.

30. The *Slovak Republic* does not adhere to the interpretation in paragraphs 14, 15 and 17. The Slovak Republic 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 when, in this last case, the software is not absolutely standardised but somehow adapted to the purchaser.

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.

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.

31.2 *Italy* does not agree that the interpretation in paragraph 14.4 will apply in all cases. It will examine each case taking into account all circumstances, including the rights granted in relation to the acts of distribution.

31.3 Concerning paragraph 9.1, *Germany* reserves its position on whether and under which circumstances payments made for the acquisition of the right of disposal over the transport capacity of pipelines or the capacity of technical installations, lines or cables for the transmission of electrical power or communications (including the distribution of radio and television programs) could be regarded as payments made for the leasing of industrial, commercial or scientific equipment.

31.4 *Greece* does not adhere to the interpretation in the sixth dash of paragraph 11.4 and takes the view that all concerning payments are falling within the scope of the Article.

31.5 *Greece* does not adhere to the interpretation in paragraphs 17.2 and 17.3 because the payments related to downloading of computer software ought to be considered as royalties even if those products are acquired for the personal or business use of the purchaser.

31.6 Concerning paragraph 9.1, *Chile* and *Mexico* reserve their position on whether and under which circumstances payments made for the right of disposal over the transport capacity of pipelines or the capacity of technical installations, satellites, lines or cables for the transmission of electrical power or for communications (including the distribution of radio and television programs) could be regarded as payments made for the leasing of industrial, commercial or scientific equipment.

31.7 *Turkey* reserves its position on whether and under what circumstances the payments referred to in paragraphs 9.1, 9.3, 10.1 and 10.2 constitute royalties.

Reservations on the Article

Paragraph 1

32. The *United States* reserves its right to tax in accordance with its domestic law royalties paid by an "expatriated entity" to a connected person for up to a period of ten years.

32.1 *Latvia* reserves the right to tax royalties at source if the recipient of the income is an individual who is resident of the other Contracting State.

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.

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.

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 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.

36. *Australia*, *Chile*, *Korea*, *Mexico*, *New Zealand*, *Poland*, *Portugal*, the *Slovak Republic*, *Slovenia* and *Turkey* reserve the right to tax royalties at source.

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.

Paragraph 2

38. *Greece* reserves the right to include the payments referred to in paragraphs 9.1, 9.2 and 9.3 in the definition of royalties.

39. *Australia* reserves the right to amend the definition of royalties to include payments or credits which are treated as royalties under its domestic law.

40. *Canada*, *Chile*, the *Czech Republic*, *Latvia* and the *Slovak Republic* reserve the right to add the words "for the use of, or the right to use, industrial, commercial or scientific equipment" to paragraph 2.

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 containers in the definition of "royalties" as provided for in paragraph 2 of Article 12 of the 1977 Model Convention.

41.1 *Poland* reserves the right to include in the definition of "royalties" income derived from the use of, or the right to use, industrial, commercial or scientific equipment and containers.

42. *New Zealand* reserves the right to tax at source payments from the leasing of industrial, commercial or scientific equipment and of containers.

43. [Deleted]

44. [Deleted]

45. [Deleted]

46. *Turkey* reserves the right to tax at source income from the leasing of industrial, commercial or scientific equipment.

46.1 *Mexico* and the *United States* reserve 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.

47. [Deleted]

Other reservations

48. *Australia*, *Belgium*, *Canada*, *Chile*, the *Czech Republic*, *Estonia*, *France*, *Israel*, *Latvia*, *Mexico*, the *Slovak Republic* and *Slovenia* 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.

49. *Mexico* reserves the right to propose a provision considering that royalties will be deemed to arise in a Contracting State where such royalties relate to the use of, or the right to use, in that Contracting State, any property or right described in paragraph 2 of Article 12.

50. The *Slovak Republic* 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.

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.

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

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.

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.

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.

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.

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 establishment 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.

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. Paragraphs 1 to 4 of the Article deal first with gains from the alienation of specific categories of property. For all other capital gains, paragraph 5 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 5 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 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 5 shall apply to such gains (and not, as was mentioned in this Commentary before 2002, those of paragraph 1 of Article 21).

23. The rules of paragraph 1 are supplemented by those of paragraph 4, which applies to gains from the alienation of shares or comparable interests that derive more than 50 per cent of their value from immovable property (see paragraphs 28.3 to 28.12 below).

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, emissions permits 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).

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, see paragraph 10 above.

26. On the other hand, paragraph 2 may not always be applicable to capital gains from the alienation of a participation in an enterprise. Where the enterprise performs its activities in the form of an entity or arrangement that is treated as fiscally transparent under the tax law of a Contracting State, that State will, under paragraph 2 of Article 13, be allowed to tax in the hands of the non-resident partners or members of the entity or arrangement the gains derived from the alienation of the movable property forming part of the business property of a permanent establishment of the enterprise that is situated in that State even where the gains arise from the alienation of the enterprise as a whole (see also paragraph 2 of Article 1 and paragraphs 2 to 16 of the Commentary on Article 1). Where, however, an enterprise performs its activities in the form of an entity or arrangement that a State treats as a separate taxpayer resident of one of the Contracting States, that State should treat the alienation of a participation in such an entity or arrangement in the same way as shares in a company to which paragraphs 4 or 5 of the Article apply. Paragraphs 32.4 to 32.7 of the Commentary on Articles 23 A and 23 B address situations where the domestic laws of the two Contracting States differ in this regard.

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 5. The foregoing explanations accord with those in the Commentary on Article 7.

27.1 For the purposes of the paragraph, property will form part of the business property of a permanent establishment if the "economic" ownership of the property is allocated to that permanent establishment under the principles developed in the Committee's report entitled *Attribution of Profits to Permanent Establishments*[1] (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to any income attributable to the ownership of that property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that property). The mere fact that the property has been recorded, for accounting purposes, on a balance sheet prepared for the permanent establishment will therefore not be sufficient to conclude that it is effectively connected with that permanent establishment.

27.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether property will form part of the business property of the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that property is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165 to 170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that form part of the business property of the permanent establishment.

Paragraph 3

28. An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships and aircraft. Normally, gains from the alienation of such assets are taxable only in the State of the enterprise operating such ships and aircraft. This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 22. Contracting States which would prefer to confer the exclusive taxing right on the State in which the place of effective management of the enterprise is situated are free, in bilateral conventions, to substitute for paragraph 3 a provision corresponding to that proposed in paragraph 2 of the Commentary on Article 8.

28.1 Paragraph 3 applies where the enterprise that alienates the property operates itself the ships or aircraft referred to in the paragraph, whether for its own transportation activities or when leasing the ships or aircraft on charter fully equipped, manned and supplied. It does not apply, however, where the enterprise owning the ships or aircraft does not operate them (for example, where the enterprise leases the

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

property to another person, other than in the case of an occasional bare boat lease as referred to in paragraph 5 of the Commentary on Article 8). In such a case, the gains accruing to the true owner of the property, or connected moveable property, will be covered by paragraph 2 or 5.

28.2 [Deleted]

Paragraph 4

28.3 By providing that gains from the alienation of shares or comparable interests which, at any time during the 365 days preceding the alienation, derived more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State may be taxed in that State, paragraph 4 provides that gains from the alienation of such shares or comparable interests and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in that State.

28.4 Paragraph 4 allows the taxation of the entire gain attributable to the shares or comparable interests to which it applies even where part of the value of these shares or comparable interests is derived from property other than immovable property located in the source State. The determination of whether shares or comparable interests derive, at any time during the 365 days preceding the alienation, more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company, entity or arrangement without taking into account debts or other liabilities (whether or not secured by mortgages on the relevant immovable property).

28.5 Before 2017, paragraph 4 applied only in the case of the alienation of shares but the Commentary provided that States could extend its scope to cover also gains from the alienation of interests in other entities, such as partnerships or trusts, that did not issue shares, as long as the value of these interests was similarly derived principally from immovable property. In 2017, the reference to "comparable interests" was added for that purpose. At the same time, the paragraph was amended in order to cover situations where the shares or comparable interests derive their value primarily from immovable property at any time during the 365 days preceding the alienation as opposed to at the time of the alienation only. This change was made in order to address situations where assets are contributed to an entity shortly before the sale of the shares or other comparable interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in a Contracting State.

28.6 In their bilateral conventions, many States either broaden or narrow the scope of the paragraph. For instance, it is possible for States to increase or reduce the percentage of the value of the shares or comparable interests that must be derived directly or indirectly from immovable property for the provision to apply. This would simply be done by replacing "50 per cent" by the percentage that these States would agree to. Another change that some States may agree to make is to restrict the

application of the provision to cases where the alienator holds a certain level of participation in the entity.

28.7 Also, some States consider that the paragraph should not apply to gains derived from the alienation of shares of companies, or interests in entities or arrangements, that are listed on an approved stock exchange of one of the States, to gains derived from the alienation of shares or comparable interests in the course of a corporate reorganisation or where the immovable property from which the shares or comparable interests derive their value is immovable property (such as a mine or a hotel) in which a business is carried on. States wishing to provide for one or more of these exceptions are free to do so.

28.8 Another possible exception relates to shares or comparable interests held by pension funds and similar entities. Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income derived by such an entity resident of the other State, which would include capital gains on shares or comparable interests referred to in paragraph 4, shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

28.9 Since the paragraph applies in any case where, at any time during the 365 days preceding the alienation of shares or comparable interests, these shares or comparable interests derive more than 50 per cent of their value directly or indirectly from immovable property, the paragraph would apply when shares are alienated within a period of 365 days after the day when immovable property, the value of which is taken into account for the purposes of that paragraph, has itself been alienated by the company or other entity. Some States consider that in such a case, since the alienation of the immovable property is taxable under paragraph 1 in the State where it is situated, it would be inappropriate to take account of the value of that property when determining whether paragraph 4 should apply to the gain on the subsequent alienation of the shares or comparable interests. Assume, for example, that individual X, a resident of State R, owns all the shares of XCO, a company resident of State R. The main asset of XCO is an immovable property situated in State S. In January 00, the property is sold by XCO and State S taxes the gain in accordance with paragraph 1. At the end of 00, X dies, which, under the domestic law of State S, triggers an alienation of the shares of XCO for tax purposes. In that case, some States consider that the value of the immovable property that has been alienated should not be taken into account when applying paragraph 4 to the shares that are alienated as a result of the death of X. These States may agree bilaterally to replace paragraph 4 by a provision drafted along the following lines:

> 4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of

their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State (except immovable property, or part thereof, that was alienated between that time and the time of the alienation of the shares or comparable interests, as long as no part of the value of these shares or comparable interests is derived directly or indirectly from that immovable property, or the part thereof that was alienated, at the time of that subsequent alienation).

States that are concerned that the exception provided in that suggested provision could be abused by arranging sales between related parties may consider restricting its scope to alienations taking place between unrelated parties. Also, States whose domestic tax law does not recognise capital gains upon certain types of alienations are free to exclude such alienations from the scope of the exception included in the suggested provision.

28.10 Finally, a further possible exception relates to shares and comparable interests in a Real Estate Investment Trust (see paragraphs 67.1 to 67.7 of the Commentary on Article 10 for background information on REITs). Whilst it would not seem appropriate to make an exception to paragraph 4 in the case of the alienation of a large investor's interests in a REIT, which could be considered to be the alienation of a substitute for a direct investment in immovable property, an exception to paragraph 4 for the alienation of a small investor's interest in a REIT may be considered to be appropriate.

28.11 As discussed in paragraph 67.3 of the Commentary on Article 10, it may be appropriate to consider a small investor's interest in a REIT as a security rather than as an indirect holding in immovable property. In this regard, in practice it would be very difficult to administer the application of source taxation of gains on small interests in a widely held REIT. Moreover, since REITs, unlike other entities deriving their value primarily from immovable property, are required to distribute most of their profits, it is unlikely that there would be significant residual profits to which the capital gain tax would apply (as compared to other entities). States that share this view may agree bilaterally to add, before the phrase "may be taxed in that other State", words such as "except shares or comparable interests held by a person who holds, directly or indirectly, shares or interests representing less than 10 per cent of all the shares or interests in an entity if that entity is a REIT"

28.12 Some States, however, consider that paragraph 4 was intended to apply to any gain on the alienation of shares or similar interests in an entity that derives its value primarily from immovable property and that there would be no reason to distinguish between a REIT and a publicly held entity with respect to the application of that paragraph, especially since a REIT is not taxed on its income. These States consider that as long as there is no exception for the alienation of shares or similar interests in entities listed on a stock exchange (see paragraph 28.7 above), there should not be a special exception for interests in a REIT.

28.13 Since the domestic laws of some States do not allow them to tax the gains covered by paragraph 4, States that adopt the exemption method should be careful to ensure that the inclusion of the paragraph does not result in a double exemption of these gains. These States may wish to exclude these gains from exemption and apply

the credit method, as suggested by paragraph 35 of the Commentary on Articles 23 A and 23 B.

Paragraph 5

29. As regards gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3 and 4, paragraph 5 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 (other than shares of a company dealt with in paragraph 4) 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 alienated by a shareholder in connection with the liquidation of the issuing company or the redemption of shares or reduction of paid-up capital of that company, the difference between the proceeds obtained by the shareholder and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference is covered by the definition of the term "dividends" contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary relating thereto, to the extent that the domestic law of that State treats that difference as income from shares. As explained in paragraphs 32.1 to 32.7 of the Commentary on Articles 23 A and 23 B, where the State of the issuing company treats the difference as a dividend, the State of residence of the shareholder is required to provide relief of double taxation even though such a difference constitutes a capital gain under its own domestic law. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with Article 11 (see also paragraphs 20 and 21 of the Commentary on Article 11).

32. There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Article 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3 of the Commentary on Article 16.

Observation on the Commentary

32.1 With respect to paragraph 3.1, *Austria* and *Germany* hold the view that when a new tax treaty enters into force, these countries cannot be deprived of the right to tax

the capital appreciation which was generated in these countries before the date when the new tax treaty became applicable.

Reservations on the Article

33. *Spain* reserves its right to tax gains from the alienation of shares or other rights where the ownership of such shares or rights entitles, directly or indirectly, to the enjoyment of immovable property situated in Spain.

34. *Sweden* reserves the right to tax gains from the alienation of property by an individual who was a resident of Sweden at any time during the ten years preceding such alienation.

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.

36. *France* can accept the provisions of paragraph 5, 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.

37. The *United States* reserves its right to include a rule providing for an increase in the basis of property of an individual the value of which was taxed under an exit tax regime.

38. *New Zealand* reserves its position on paragraphs 3 and 5.

39. *Chile* reserves the right to tax gains from the alienation of shares or other corporate rights in its companies.

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.

41. Notwithstanding paragraph 5 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.

42. *Latvia* reserves 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.

43. *Denmark*, *Ireland*, *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.

43.1 *Greece* reserves the right to insert in a special article provisions regarding capital gains relating to offshore exploration and exploitation and related activities.

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).

45. *Korea* reserves 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.

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.

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.

48. *Ireland* reserves the right to tax gains from the alienation of property by an individual who was a resident of Ireland at any time during the five years preceding such alienation.

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 comparable interests in a company that is a resident of Mexico.

50. The *United States* reserves the right to include gains from the alienation of containers within the scope of paragraph 3 of the Article.

51. *Belgium*, *Luxembourg*, the *Netherlands* and *Switzerland* reserve the right not to include paragraph 4 in their conventions.

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 of the full version of the OECD Model Tax Convention 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.]

COMMENTARY ON ARTICLE 15 CONCERNING THE TAXATION OF INCOME FROM EMPLOYMENT[1]

Paragraph 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. The issue of whether or not services are provided in the exercise of an employment may sometimes give rise to difficulties which are discussed in paragraphs 8.1 ff. 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.

2. The general rule is subject to exception only in the case of the remuneration of crews of ships or aircraft operated in international traffic (paragraph 3 of Article 15), 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.

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. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee.

2.3 In some cases, it may be difficult to determine which part of salaries, wages and other similar remuneration paid to an individual is derived from the exercise of employment in a given State. Paragraphs 12.6 to 12.13 below address this issue with respect to the granting of stock-options to an employee who exercises his employment in different States. The issue may also arise in the case of payments made after the termination of employment. Such payments may raise tax treaty

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 in Volume II of the full version of the OECD Model Tax Convention), 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.

issues in different cross-border situations, including cases where such payments are made to cross-border workers, to employees who have worked in a number of different countries during their career or to employees who have been sent to work abroad and are repatriated shortly before their employment is terminated. Regardless of the terminology used to describe these payments, it is essential to identify the real consideration for each such payment on the basis of the facts and circumstances of each case in order to determine whether the payment constitutes "salaries, wages or other similar remuneration" and the extent to which the payment, or part thereof, may be considered to derive from the exercise of employment in a given State. The following paragraphs discuss these questions with respect to different types of payments that are often made following the termination of employment.

2.4 Any remuneration paid after the termination of employment for work done before the employment was terminated (e.g. a salary or bonus for the last period of work or commissions for sales made during that period) will be considered to be derived from the State in which the relevant employment activities were exercised.

2.5 A payment made with respect to unused holidays / sick days that accrued during the last year of employment is part of the remuneration for the period of work that generated the holiday or sick leave entitlement. An employee may also be entitled, at the end of employment, to the payment for holidays and sick days related to a number of previous years that were unused during these years. Absent facts and circumstances showing otherwise, a payment received after termination of employment as compensation for holidays and sick days related to previous years that were unused during these years should be considered to have been a benefit for which the employee was entitled for the last 12 months of employment, allocated on a pro-rated basis to where the employment was exercised during that period. One situation where a different conclusion would be justified would be where it would be established, on the basis of the taxpayer's employment records, that these holidays and sick days clearly relate to specific periods of past employment and that the payment constitutes remuneration for these periods of employment. States should take account, however, of the fact that the former employee may have been previously taxed on these holidays and sick days at the time of their accrual. Assume, for instance, that under a State's domestic tax law, holidays and sick days granted with respect to periods of work performed on the territory of that State are treated as a benefit taxable during the fiscal year during which the relevant work was performed and are taxed accordingly. In such a case, the State of residence of the former employee at the time of the subsequent payment with respect to the holidays / sick days would need to provide relief of double taxation for such tax and any State in which the former employee may have worked during his last year of employment should similarly consider that any payment for previous years' unused holiday / sick days that were already taxed on an accrual basis did not relate to employment activities exercised during the last year.

2.6 In some cases, the employer is required (by law or by contract) to provide an employee with a period of notice before terminating employment. If the employee is told not to work during the notice period and is simply paid the remuneration for that

period, such remuneration is clearly received by virtue of the employment and therefore constitutes remuneration "derived therefrom" for the purposes of paragraph 1. The remuneration received in such a case should be considered to be derived from the State where it is reasonable to assume that the employee would have worked during the period of notice. The determination of where it is reasonable to assume that the employee would have worked during the period of notice should be based on all facts and circumstances. In most cases it will be the last location where the employee worked for a substantial period of time before the employment was terminated; also, it would clearly be inappropriate to take account of a prospective employment period in a State where the employee might have been expected to work but did not, in fact, perform his employment for a substantial period of time.

2.7 A different situation is that of a severance payment (also referred to as a "redundancy payment") which an employer is required (by law or by contract) to make to an employee whose employment has been terminated. Such a payment is often, but not always, calculated by reference to the period of past employment with the employer. Absent facts and circumstances indicating otherwise, such a severance payment should be considered to be remuneration covered by the Article for the last 12 months of employment, allocated on a pro-rated basis to where the employment was exercised during that period; as such it constitutes remuneration derived from that employment for the purposes of the last sentence of paragraph 1.

2.8 An individual whose employment is terminated may have legal grounds to claim that the employment was terminated in violation of the contract of employment, the law or a collective agreement; there may also be other legal grounds for claiming damages depending on the circumstances of the termination. This individual may receive a judicial award or settlement as damages for breach of the relevant contractual or legal obligations. The tax treaty treatment will depend on what the damage award seeks to compensate. For instance, damages granted because an insufficient period of notice was given or because a severance payment required by law or contract was not made should be treated like the remuneration that these damages replace. Punitive damages or damages awarded on grounds such as discriminatory treatment or injury to one's reputation should, however, be treated differently; these payments would typically fall under Article 21.

2.9 Under the provisions of an employment contract or of a settlement following the termination of an employment, a previous employee may receive a payment in consideration for an obligation not to work for a competitor of his ex-employer. This obligation is almost always time-limited and often geographically-limited. Whilst such a payment is directly related to the employment and is therefore "remuneration … derived in respect of an employment", it would not, in most circumstances, constitute remuneration derived from employment activities performed before the termination of the employment. For that reason, it will usually be taxable only in the State where the recipient resides at the time the payment is received. Where, however, such a payment made after the termination of employment is in substance remuneration for activities performed during the employment (which might be the case where, for

example, the obligation not to compete has little or no value for the ex-employer), the payment should be treated in the same way as remuneration received for the work performed during the relevant period of employment. Also, in some States, part of an employee's monthly salary during employment constitutes consideration for an obligation not to work for a competitor during a certain period of time after termination of the employment so that no separate payment for non-competition is made after the termination of the employment; in such a case, the guidance in the first part of this paragraph is not applicable and the part of the remuneration received during the employment that is attributable to that obligation should be treated in the same way as the rest of that remuneration.

2.10 As explained in paragraphs 4 to 6 of the Commentary on Article 18, various payments may be made after the termination of an employment with respect to pension contributions or pension entitlements of the former employee. According to paragraph 6 of that Commentary, "[w]hether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact". The paragraph gives the example of a "[r]eimbursement of pension contributions (e.g. after temporary employment)" as a payment that would not be covered by Article 18. To the extent that such a reimbursement of contributions would constitute additional remuneration for previous employment that results from the termination of the employment, it would covered by Article 15 and should be viewed as deriving from the State where the employment was exercised when the employment was terminated.

2.11 Payments may be made after the termination of employment pursuant to various deferred remuneration arrangements. Such a payment should be treated as remuneration covered by Article 15 and, to the extent that it can be associated to a specific period of past employment in a given State, it should be considered to be derived from the employment activities exercised in that State. Since many States would not allow the deferral of tax on employment remuneration even if the payment of that remuneration is deferred, it will be important for States that will tax deferred remuneration payments received after the termination of employment to ensure that double taxation is relieved.

2.12 Various payments may be made after the termination of an employment on account of incentive compensation in general and stock-options in particular. Whilst the treaty treatment of each such payment will depend on its own characteristics, the principles put forward in paragraphs 12 to 12.15, which deal specifically with stock-options, will assist in dealing with other forms of incentive compensation.

2.13 An employee may be entitled to medical or life insurance coverage for a certain period after termination of his/her employment. He/she may also be entitled to other benefits, such as the services of an employment consultant or agency. Absent facts and circumstances indicating otherwise, such benefits should be considered to be remuneration covered by the Article which is derived from the State where the employment was exercised when the employment was terminated (and when, therefore, the obligation to pay these benefits arose).

2.14 Another type of payment that could be made on or after termination of an employment is a compensation payment for loss of future earnings following injury or disability suffered during the course of employment. The tax treaty treatment of such a payment would depend on the legal context in which it was made. For instance, payments under a social security system such as a worker's compensation fund could fall under Article 18, 19 or 21 (see paragraph 24 of the Commentary on Article 18). A payment that would constitute a pension payment would be covered by Article 18. A payment made because the employee has legal grounds for claiming damages from his employer with respect to a work-related sickness or injury would typically fall under Article 21. A payment made by the employer pursuant to the terms of the employment contract even though the sickness or injury is not work-related or the employer is not responsible for that sickness or injury should be dealt with in the same way as a severance payment: absent facts and circumstances indicating otherwise, such a payment should be considered to be remuneration covered by the Article for the last 12 months of employment, allocated on a pro-rated basis to where the employment was exercised during that period. A short-term disability payment made in the course of employment, however, should be treated in the same way as the payment of sick days during the course of employment; such a payment would be covered by Article 15 (Article 17 in the case of entertainers and sportspersons) and taxable in the State in which the employee normally exercised the employment before becoming sick or being injured.

2.15 After termination of employment, a salesperson may receive a payment in relation to the loss of future commissions. The tax treaty treatment of such a payment will depend on the legal context in which the payment is made. Depending on the circumstances, this payment could constitute deferred remuneration to which the salesperson was entitled in relation to previous sales or could be made pursuant to a provision of the employment contract according to which the salesperson has a right to commissions on any future sales to a client that the salesperson brought to the employer; in both cases, the payment should be dealt with as remuneration for the employment services that gave rise to the entitlement to the commissions. A payment that would constitute a compensation for future commissions that the salesperson would likely have earned if she had continued to work for the same employer may also constitute a compensation for unlawful dismissal or a form of severance payment; where that is the case, the payment should be dealt with accordingly.

2.16 As part of a transitional arrangement leading to the termination of employment, an employee may receive a full or reduced salary for a period during which that employee will not work. Where the salary is paid by the employer for a period during which the employee is not required to work even though the employment has not been terminated, the salary is still received by virtue of the employment and therefore constitutes remuneration "derived therefrom" for the purposes of paragraph 1. The remuneration received in such a case should be considered to be derived from the State where it is reasonable to assume that the employee would have worked during that

period, which will most often be the State where the employment activities were performed before the cessation of work.

Paragraph 2

3. Paragraph 2 contains 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 the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or entertainers and sportsperons.

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 ½ months of one year and the first 5 ½ months of the following year. The present wording of subparagraph 2 *a)* does away with such opportunities for tax avoidance. In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 01 and 31 March 02 but is present there during 210 days between 1 August 01 and 31 July 02, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that first period partly overlaps the second.

4.1 The reference to the "fiscal year concerned" must be interpreted as a reference to a fiscal year of the Contracting State in which a resident of the other Contracting State has exercised his employment and during which the relevant employment services have been rendered. Assume, for example, that the fiscal year of State S runs from 1 January to 31 December and that a resident of State R is present and performs employment services in State S between 1 August 00 and 28 February 01. For the purposes of subparagraph 2 *a*), any twelve month period that begins between 1 January and 31 December 00 or ends between 1 January and 31 December 01 and that includes any part of the period of employment services would be relevant. For instance, the twelve month period of 1 August 00 to 31 July 01, which begins in the fiscal year 00 and during which the person was present in State S for more than 183 days, would include the employment services rendered in that State between 1 August and 31 December 00; similarly, the twelve month period of 1 March 00 to 28 February 01, which ends in the fiscal year 01 and during which the person was present in State S for more than 183 days, would include the employment services rendered in that State between 1 January

and 28 February 01. The taxation of the remuneration for the relevant services need not take place in the fiscal year concerned: as explained in paragraphs 2.2 above and 12.1 below, the Article allows a State to tax the remuneration derived from employment exercised in that State in a particular year even if the remuneration for these employment services is acquired, or the tax is levied, in a different year.

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 a State counts as a day of presence in that State for purposes of computing the 183 day period.

5.1 Days during which the taxpayer is a resident of the source State should not, however, be taken into account in the calculation. Subparagraph *a)* has to be read in the context of the first part of paragraph 2, which refers to "remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State", which does not apply to a person who resides and works in the same State. The words "the recipient is present", found in subparagraph *a)*, refer to the recipient of such remuneration and, during a period of residence in the source State, a person cannot be said to be the recipient of remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State. The following examples illustrate this conclusion:

— Example 1: From January 01 to December 01, X lives in, and is a resident of, State S. On 1 January 02, X is hired by an employer who is a resident of State R and moves to State R where he becomes a resident. X is subsequently sent to State S by his employer from 15 to 31 March 02. In that case, X is present in State S for 292 days between 1 April 01 and 31 March 02 but since he is a resident of State S between 1 April 01 and 31 December 01, this first period is not taken into account for purposes of the calculation of the periods referred to in subparagraph *a)*.

— Example 2: From 15 to 31 October 01, Y, a resident of State R, is present in State S to prepare the expansion in that country of the business of ACO, also a resident

of State R. On 1 May 02, Y moves to State S where she becomes a resident and works as the manager of a newly created subsidiary of ACO resident of State S. In that case, Y is present in State S for 184 days between 15 October 01 and 14 October 02 but since she is a resident of State S between 1 May and 14 October 02, this last period is not taken into account for purposes of the calculation of the periods referred to in subparagraph *a)*.

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 subparagraph 2 *b)*:

b) the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State, and

6.1 The application of the second condition in the case of fiscally transparent partnerships presents difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (see paragraph 8.8 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 *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 it 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 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 *b*) that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent entities or arrangements such as partnerships, that subparagraph applies at the level of the partners or members. Thus, the concepts of "employer" and "resident", as found in subparagraph *b*), are applied at the level of the partners or members rather than at the level of a fiscally transparent entity or arrangement. This approach is consistent with the approach under paragraph 2 of Article 1 under which the benefit of other provisions of tax conventions must be granted with respect to income that is taxed at the partners' or members' level rather than at the level of an entity or arrangement that is treated as fiscally transparent. While this interpretation could create difficulties where the partners or members reside in different States, such difficulties could be

addressed through the mutual agreement procedure by determining, for example, the State in which the partners or members who own the majority of the interests in the entity or arrangement reside (i.e. the State in which the greatest part of the deduction will be claimed).

7. Under the third condition, if the employer has a permanent establishment in the State in which the employment is exercised, the exemption is given on condition that the remuneration is not borne by that permanent establishment. 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 could give rise to a deduction, having regard to the principles of Article 7 and the nature of the remuneration, in computing the profits of a permanent establishment situated in the State in which the employment is exercised.

7.1 The fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether any deduction otherwise available with respect to that remuneration should be taken into account in determining the profits attributable to the permanent establishment. 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. The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment.

7.2 For the purpose of determining the profits attributable to a permanent establishment pursuant to paragraph 2 of Article 7, the remuneration paid to an employee of an enterprise of a Contracting State for employment services rendered in the other State for the benefit of a permanent establishment of the enterprise situated in that other State may, given the circumstances, either give rise to a direct deduction or give rise to the deduction of a notional charge, e.g. for services rendered to the permanent establishment by another part of the enterprise. In the latter case, since the notional charge required by the legal fiction of the separate and independent enterprise that is applicable under paragraph 2 of Article 7 is merely a mechanism provided for by that paragraph for the sole purpose of determining the profits attributable to the permanent establishment, this fiction does not affect the determination of whether or not the remuneration is borne by the permanent establishment.

8. There is a direct relationship between the principles underlying the exception of paragraph 2 and Article 7. Article 7 is based on the principle that an enterprise of a Contracting State should not be subjected to tax in the other State unless its business presence in that other State has reached a level sufficient to constitute a permanent establishment. The exception of paragraph 2 of Article 15 extends that principle to the

taxation of the employees of such an enterprise where the activities of these employees are carried on in the other State for a relatively short period. Subparagraphs *b*) and *c*) make it clear that the exception is not intended to apply where the employment services are rendered to an enterprise the profits of which are subjected to tax in a State either because it is carried on by a resident of that State or because it has a permanent establishment therein to which the services are attributable.

8.1 It may be difficult, in certain cases, to determine whether the services rendered in a State by an individual resident of another State, and provided to an enterprise of the first State (or that has a permanent establishment in that State), constitute employment services, to which Article 15 applies, or services rendered by a separate enterprise, to which Article 7 applies or, more generally, whether the exception applies. While the Commentary previously dealt with cases where arrangements were structured for the main purpose of obtaining the benefits of the exception of paragraph 2 of Article 15, it was found that similar issues could arise in many other cases that did not involve tax-motivated transactions and the Commentary was amended to provide a more comprehensive discussion of these questions.

8.2 In some States, a formal contractual relationship would not be questioned for tax purposes unless there were some evidence of manipulation and these States, as a matter of domestic law, would consider that employment services are only rendered where there is a formal employment relationship.

8.3 If States where this is the case are concerned that such approach could result in granting the benefits of the exception provided for in paragraph 2 in unintended situations (e.g. in so-called "hiring-out of labour" cases), they are free to adopt bilaterally a provision drafted along the following lines:

> Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is not a resident of that other State if:
>
> *a)* the recipient renders services in the course of that employment to a person other than the employer and that person, directly or indirectly, supervises, directs or controls the manner in which those services are performed; and
>
> *b)* those services constitute an integral part of the business activities carried on by that person.

8.4 In many States, however, various legislative or jurisprudential rules and criteria (e.g. substance over form rules) have been developed for the purpose of distinguishing cases where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of service) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services). That distinction keeps its importance when applying the provisions of Article 15, in particular those of subparagraphs 2 *b*) and *c*). Subject to the limit described in paragraph 8.11 and unless

the context of a particular convention requires otherwise, it is a matter of domestic law of the State of source to determine whether services rendered by an individual in that State are provided in an employment relationship and that determination will govern how that State applies the Convention.

8.5 In some cases, services rendered by an individual to an enterprise may be considered to be employment services for purposes of domestic tax law even though these services are provided under a formal contract for services between, on the one hand, the enterprise that acquires the services, and, on the other hand, either the individual himself or another enterprise by which the individual is formally employed or with which the individual has concluded another formal contract for services.

8.6 In such cases, the relevant domestic law may ignore the way in which the services are characterised in the formal contracts. It may prefer to focus primarily on the nature of the services rendered by the individual and their integration into the business carried on by the enterprise that acquires the services to conclude that there is an employment relationship between the individual and that enterprise.

8.7 Since the concept of employment to which Article 15 refers is to be determined according to the domestic law of the State that applies the Convention (subject to the limit described in paragraph 8.11 and unless the context of a particular convention requires otherwise), it follows that a State which considers such services to be employment services will apply Article 15 accordingly. It will, therefore, logically conclude that the enterprise to which the services are rendered is in an employment relationship with the individual so as to constitute his employer for purposes of subparagraphs 2 *b*) and *c*). That conclusion is consistent with the object and purpose of paragraph 2 of Article 15 since, in that case, the employment services may be said to be rendered to a resident of the State where the services are performed.

8.8 As mentioned in paragraph 8.2, even where the domestic law of the State that applies the Convention does not offer the possibility of questioning a formal contractual relationship and therefore does not allow the State to consider that services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise, that State may deny the application of the exception of paragraph 2 in abusive cases, as recognised by paragraph 9 of Article 29 (see also paragraphs 54 to 80 of the Commentary on Article 1).

8.9 [Deleted]

8.10 The approach described in the previous paragraphs therefore allows the State in which the activities are exercised to reject the application of paragraph 2 in abusive cases and in cases where, under that State's domestic law concept of employment, services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise. This approach ensures that relief of double taxation will be provided in the State of residence of the individual even if that State does not, under its own domestic law, consider that there is an employment relationship between the

individual and the enterprise to which the services are provided. Indeed, as long as the State of residence acknowledges that the concept of employment in the domestic tax law of the State of source or the existence of arrangements that constitute an abuse of the Convention allows that State to tax the employment income of an individual in accordance with the Convention, it must grant relief for double taxation pursuant to the obligations incorporated in Articles 23 A and 23 B (see paragraphs 32.1 to 32.7 of the Commentary on these Articles). The mutual agreement procedure provided by paragraph 1 of Article 25 will be available to address cases where the State of residence does not agree that the other State has correctly applied the approach described above and, therefore, does not consider that the other State has taxed the relevant income in accordance with the Convention.

8.11 The conclusion that, under domestic law, a formal contractual relationship should be disregarded must, however, be arrived at on the basis of objective criteria. For instance, a State could not argue that services are deemed, under its domestic law, to constitute employment services where, under the relevant facts and circumstances, it clearly appears that these services are rendered under a contract for the provision of services concluded between two separate enterprises. The relief provided under paragraph 2 of Article 15 would be rendered meaningless if States were allowed to deem services to constitute employment services in cases where there is clearly no employment relationship or to deny the quality of employer to an enterprise carried on by a non-resident where it is clear that that enterprise provides services, through its own personnel, to an enterprise carried on by a resident. Conversely, where services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises, that State should logically also consider that the individual is not carrying on the business of the enterprise that constitutes that individual's formal employer; this could be relevant, for example, for purposes of determining whether that enterprise has a permanent establishment at the place where the individual performs his activities.

8.12 It will not always be clear, however, whether services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises. Any disagreement between States as to whether this is the case should be solved having regard to the following principles and examples (using, where appropriate, the mutual agreement procedure).

8.13 The nature of the services rendered by the individual will be an important factor since it is logical to assume that an employee provides services which are an integral part of the business activities carried on by his employer. It will therefore be important to determine whether the services rendered by the individual constitute an integral part of the business of the enterprise to which these services are provided. For that purpose, a key consideration will be which enterprise bears the responsibility or risk for the results produced by the individual's work. Clearly, however, this analysis will only be relevant if the services of an individual are rendered directly to an enterprise.

Where, for example, an individual provides services to a contract manufacturer or to an enterprise to which business is outsourced, the services of that individual are not rendered to enterprises that will obtain the products or services in question.

8.14 Where a comparison of the nature of the services rendered by the individual with the business activities carried on by his formal employer and by the enterprise to which the services are provided points to an employment relationship that is different from the formal contractual relationship, the following additional factors may be relevant to determine whether this is really the case:

— who has the authority to instruct the individual regarding the manner in which the work has to be performed;

— who controls and has responsibility for the place at which the work is performed;

— the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided (see paragraph 8.15 below);

— who puts the tools and materials necessary for the work at the individual's disposal;

— who determines the number and qualifications of the individuals performing the work;

— who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;

— who has the right to impose disciplinary sanctions related to the work of that individual;

— who determines the holidays and work schedule of that individual.

8.15 Where an individual who is formally an employee of one enterprise provides services to another enterprise, the financial arrangements made between the two enterprises will clearly be relevant, although not necessarily conclusive, for the purposes of determining whether the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided. For instance, if the fees charged by the enterprise that formally employs the individual represent the remuneration, employment benefits and other employment costs of that individual for the services that he provided to the other enterprise, with no profit element or with a profit element that is computed as a percentage of that remuneration, benefits and other employment costs, this would be indicative that the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided. That should not be considered to be the case, however, if the fee charged for the services bears no relationship to the remuneration of the individual or if that remuneration is only one of many factors taken into account in the fee charged for what is really a contract for services (e.g. where a consulting firm charges a client on the basis of an hourly fee for the time spent by one of its employees to perform a particular contract and that fee takes account of the various costs of the enterprise), provided that this is in conformity with the arm's length principle if the two enterprises are associated. It is important to note, however,

that the question of whether the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided is only one of the subsidiary factors that are relevant in determining whether services rendered by that individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises.

8.16 Example 1: Aco, a company resident of State A, concludes a contract with Bco, a company resident of State B, for the provision of training services. Aco is specialised in training people in the use of various computer software and Bco wishes to train its personnel to use recently acquired software. X, an employee of Aco who is a resident of State A, is sent to Bco's offices in State B to provide training courses as part of the contract.

8.17 In that case, State B could not argue that X is in an employment relationship with Bco or that Aco is not the employer of X for purposes of the convention between States A and B. X is formally an employee of Aco whose own services, when viewed in light of the factors in paragraphs 8.13 and 8.14, form an integral part of the business activities of Aco. The services that he renders to Bco are rendered on behalf of Aco under the contract concluded between the two enterprises. Thus, provided that X is not present in State B for more than 183 days during any relevant twelve month period and that Aco does not have in State B a permanent establishment which bears the cost of X's remuneration, the exception of paragraph 2 of Article 15 will apply to X's remuneration.

8.18 Example 2: Cco, a company resident of State C, is the parent company of a group of companies that includes Dco, a company resident of State D. Cco has developed a new worldwide marketing strategy for the products of the group. In order to ensure that the strategy is well understood and followed by Dco, which sells the group's products, Cco sends X, one of its employees who has worked on the development of the strategy, to work in Dco's headquarters for four months in order to advise Dco with respect to its marketing and to ensure that Dco's communications department understands and complies with the worldwide marketing strategy.

8.19 In that case, Cco's business includes the management of the worldwide marketing activities of the group and X's own services are an integral part of that business activity. While it could be argued that an employee could have been easily hired by Dco to perform the function of advising the company with respect to its marketing, it is clear that such function is frequently performed by a consultant, especially where specialised knowledge is required for a relatively short period of time. Also, the function of monitoring the compliance with the group's worldwide marketing strategy belongs to the business of Cco rather than to that of Dco. The exception of paragraph 2 of Article 15 should therefore apply provided that the other conditions for that exception are satisfied.

8.20 Example 3: A multinational owns and operates hotels worldwide through a number of subsidiaries. Eco, one of these subsidiaries, is a resident of State E where it

owns and operates a hotel. X is an employee of Eco who works in this hotel. Fco, another subsidiary of the group, owns and operates a hotel in State F where there is a shortage of employees with foreign language skills. For that reason, X is sent to work for five months at the reception desk of Fco's hotel. Fco pays the travel expenses of X, who remains formally employed and paid by Eco, and pays Eco a management fee based on X's remuneration, social contributions and other employment benefits for the relevant period.

8.21 In that case, working at the reception desk of the hotel in State F, when examined in light of the factors in paragraphs 8.13 and 8.14, may be viewed as forming an integral part of Fco's business of operating that hotel rather than of Eco's business. Under the approach described above, if, under the domestic law of State F, the services of X are considered to have been rendered to Fco in an employment relationship, State F could then logically consider that Fco is the employer of X and the exception of paragraph 2 of Article 15 would not apply.

8.22 Example 4: Gco is a company resident of State G. It carries on the business of filling temporary business needs for highly specialised personnel. Hco is a company resident of State H which provides engineering services on building sites. In order to complete one of its contracts in State H, Hco needs an engineer for a period of five months. It contacts Gco for that purpose. Gco recruits X, an engineer resident of State X, and hires him under a five month employment contract. Under a separate contract between Gco and Hco, Gco agrees to provide the services of X to Hco during that period. Under these contracts, Gco will pay X's remuneration, social contributions, travel expenses and other employment benefits and charges.

8.23 In that case, X provides engineering services while Gco is in the business of filling short-term business needs. By their nature the services rendered by X are not an integral part of the business activities of his formal employer. These services are, however, an integral part of the business activities of Hco, an engineering firm. In light of the factors in paragraphs 8.13 and 8.14, State H could therefore consider that, under the approach described above, the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.

8.24 Example 5: Ico is a company resident of State I specialised in providing engineering services. Ico employs a number of engineers on a full time basis. Jco, a smaller engineering firm resident of State J, needs the temporary services of an engineer to complete a contract on a construction site in State J. Ico agrees with Jco that one of Ico's engineers, who is a resident of State I momentarily not assigned to any contract concluded by Ico, will work for four months on Jco's contract under the direct supervision and control of one of Jco's senior engineers. Jco will pay Ico an amount equal to the remuneration, social contributions, travel expenses and other employment benefits of that engineer for the relevant period, together with a 5 per cent commission. Jco also agrees to indemnify Ico for any eventual claims related to the engineer's work during that period of time.

8.25 In that case, even if Ico is in the business of providing engineering services, it is clear that the work performed by the engineer on the construction site in State J is performed on behalf of Jco rather than Ico. The direct supervision and control exercised by Jco over the work of the engineer, the fact that Jco takes over the responsibility for that work and that it bears the cost of the remuneration of the engineer for the relevant period are factors that could support the conclusion that the engineer is in an employment relationship with Jco. Under the approach described above, State J could therefore consider that the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.

8.26 Example 6: Kco, a company resident of State K, and Lco, a company resident of State L, are part of the same multinational group of companies. A large part of the activities of that group are structured along function lines, which requires employees of different companies of the group to work together under the supervision of managers who are located in different States and employed by other companies of the group. X is a resident of State K employed by Kco; she is a senior manager in charge of supervising human resources functions within the multinational group. Since X is employed by Kco, Kco acts as a cost centre for the human resource costs of the group; periodically, these costs are charged out to each of the companies of the group on the basis of a formula that takes account of various factors such as the number of employees of each company. X is required to travel frequently to other States where other companies of the group have their offices. During the last year, X spent three months in State L in order to deal with human resources issues at Lco.

8.27 In that case, the work performed by X is part of the activities that Kco performs for its multinational group. These activities, like other activities such as corporate communication, strategy, finance and tax, treasury, information management and legal support, are often centralised within a large group of companies. The work that X performs is thus an integral part of the business of Kco. The exception of paragraph 2 of Article 15 should therefore apply to the remuneration derived by X for her work in State L provided that the other conditions for that exception are satisfied.

8.28 Where, in accordance with the above principles and examples, a State properly considers that the services rendered on its territory by an individual have been rendered in an employment relationship rather than under a contract for services concluded between two enterprises, there will be a risk that the enterprises would be required to withhold tax at source in two jurisdictions on the remuneration of that individual even though double taxation should ultimately be avoided (see paragraph 8.10 above). This compliance difficulty may be partly reduced by tax administrations making sure that their domestic rules and practices applicable to employment are clear and well understood by employers and are easily accessible. Also, the problem can be alleviated if the State of residence allows enterprises to quickly adjust the amount of tax to be withheld to take account of any relief for double taxation that will likely be available to the employee.

Paragraph 3

9. Paragraph 3 applies to the remuneration of crews of ships or aircraft operated in international traffic and provides that such remuneration shall be taxable only in the State of residence of the employee. The principle of exclusive taxation in the State of residence of the employee was incorporated in the paragraph through a change made in 2017. The purpose of that amendment was to provide a clearer and administratively simpler rule concerning the taxation of the remuneration of these crews.

9.1 At the same time, the definition of international traffic was modified to ensure that it also applied to a transport by a ship or aircraft operated by an enterprise of a third State. As explained in paragraph 6.1 of the Commentary on Article 3, this last change allows the application of paragraph 3 of Article 15 to a resident of a Contracting State who derives remuneration from employment exercised aboard a ship or aircraft operated by an enterprise of a third State.

9.2 Where, however, the employment is exercised by a resident of a Contracting State aboard a ship or aircraft operated solely within the other State, it would clearly be inappropriate to grant an exclusive right to tax to the State of residence of the employee. The phrase "other than aboard a ship or aircraft operated solely within the other Contracting State" ensures that the paragraph does not apply to such an employee, which means that the taxation of the remuneration of that employee is covered by the provisions of paragraphs 1 and 2 of the Article.

9.3 As indicated in paragraph 9 above, paragraph 3 applies to the crews of ships or aircraft. This is made clear by the reference to employment exercised "as a member of the regular complement of a ship or aircraft". These words are broad enough to cover any employment activities performed in the course of the usual operation of the ship or aircraft, including, for example, the activities of employees of restaurants aboard a cruise ship or the activities of a flight attendant who would only work on a single flight before leaving his employment; they would not cover, however, employment activities that may be performed aboard a ship or aircraft but are unrelated to its operation (e.g. an employee of an insurance company that sells home and auto insurance to the passengers of a cruise ship).

9.4 As explained in paragraph 15 of the Commentary on Article 8, States wishing to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic may extend the scope of Article 8 to cover profits from the operation of boats engaged in inland waterways transport. These States could then wish to apply paragraph 3 of Article 15 to the remuneration of employees working on these boats. In the case of the remuneration derived by an employee working aboard a boat engaged in inland waterways transport, however, paragraph 3 should only apply to the extent that the boat is operated by an enterprise of the State of residence of the employee. It would indeed be inappropriate for one Contracting State to be required to exempt remuneration derived by an employee who is a resident of the other State but is employed by an enterprise of the first-mentioned State (or of a third State with which the first-mentioned State did not agree to exempt profits derived

from the operation of boats engaged in inland waterways transport) where that remuneration relates to activities exercised solely in that first-mentioned State. Contracting States wishing to address this issue could do so by including in their bilateral treaty a separate provision dealing with crews of boats engaged in inland waterways transport that would be drafted as follows:

> Notwithstanding the preceding provisions of this Article and of Article 1, remuneration derived by an individual, whether a resident of a Contracting State or not, in respect of an employment, as a member of the regular complement of a boat, that is exercised aboard a boat engaged in inland waterways transport in a Contracting State and operated by an enterprise of the other State shall be taxable only in that other State. However, such remuneration may also be taxed in the first-mentioned State if it is derived by a resident of that State.

9.5 As indicated in paragraph 2 of the Commentary on Article 8, some States may prefer to attribute the exclusive right to tax profits from shipping and air transport to the State in which the place of effective management of the enterprise is situated rather than the State of residence. Where the Contracting States follow that approach, a similar change should be made to the alternative provisions included in paragraphs 9.4 above and 9.6 below if these provisions are used.

9.6 Some States prefer to allow taxation of the remuneration of an employee who works aboard a ship or aircraft operated in international traffic both by the State of the enterprise that operates such ship or aircraft and the State of residence of the employee. States wishing to do so may draft paragraph 3 along the following lines:

> 3. Notwithstanding the preceding provisions of this Article and Article 1, remuneration derived by an individual, whether a resident of a Contracting State or not, in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State shall be taxable only in that Contracting State. Where, however, such remuneration is derived by a resident of the other Contracting State, it may also be taxed in that other State.

9.7 Some States wishing to apply that approach may also wish to restrict the application of paragraph 3 to employees who are residents of one of the Contracting States, which could be done by using the following wording:

> 3. Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic shall be taxable only in that State. Where, however, the ship or aircraft is operated by an enterprise of the other Contracting State, such remuneration may also be taxed in the other State.

9.8 According to the alternative provision in paragraph 9.6 above, the Contracting State of the enterprise has the primary right to tax the remuneration of the employee. Where the employee is a resident of the other Contracting State, the remuneration may

also be taxed in that other State, subject to the obligation of that State to provide relief of double taxation under the provisions of Article 23 A or 23 B.

9.9 Since that alternative provision allows taxation in the State of the enterprise that operates the ship or aircraft, it may help to address the situation of employees who work extensively aboard ships or aircraft operated in international traffic and who may find it advantageous to establish their residence in States that levy no or little tax on the employment income derived from such work performed outside their territory. The provision assumes, however, that the Contracting States have the possibility, under their domestic law, to tax the remuneration of employees working aboard ships or aircraft operated in international traffic solely because the enterprises that operate these ships or aircraft are enterprises of these States. Where this is not the case, the use of that provision in combination with the exemption method for the elimination of double taxation would create a risk of non-taxation. Assume, for instance, that the above provision has been included in a treaty between States R and S, that State R follows the exemption method and that an employee who is a resident of State R works on flights between State R and third States operated by an airline that is an enterprise of State S. In that case, if the domestic law of State S does not allow State S to tax the remuneration of employees of the airline who are not residents of, and do not work in, State S, State S will be unable to exercise the taxing right that has been allocated to it but State R will be required to exempt such remuneration because, under the provisions of the Convention, State S has the right to tax that remuneration.

9.10 As explained in paragraph 3 of the Commentary on Article 8, it may be provided that the reference to the "place of effective management" in the alternative provision in paragraph 2 of that Commentary is applicable if the place of effective management of a shipping enterprise is aboard a ship. According to the domestic laws of some 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 a non-taxation situation similar to the one described in the preceding paragraph. 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.

10. It should be noted that no special rules regarding the taxation of income of frontier workers or of employees working on trucks and trains travelling between States are included as it would be more suitable for the problems created by local conditions to be solved directly between the States concerned.

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.

The treatment of employee stock-options

12. The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is largely due to the fact that stock-options are often taxed at a time (e.g. when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.

12.1 As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State.

12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realised and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is

attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).

12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterised for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, e.g. as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

12.5 The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar remuneration, even if the option is exercised after termination of the employment or retirement.

12.6 Paragraph 1 allows the State of source to tax salaries, wages and other similar remuneration derived from employment exercised in that State. The determination of whether and to what extent an employee stock-option is derived from employment exercised in a particular State must be done in each case on the basis of all the relevant facts and circumstances, including the contractual conditions associated with that option (e.g. the conditions under which the option granted may be exercised or disposed of). The following general principles should be followed for that purpose.

12.7 The first principle is that, as a general rule, an employee stock-option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise that option. Thus, where a stock-option is granted to an employee on the condition that he provides employment services to the same employer (or an associated enterprise) for a period of three years, the employment benefit derived from that option should generally not be attributed to services performed after that three year period.

12.8 In applying the above principle, however, it is important to distinguish between a period of employment that is required to obtain the right to exercise an employee stock-option and a period of time that is merely a delay before such option may be exercised (a blocking period). Thus, for example, an option that is granted to an employee on the condition that he remains employed by the same employer (or an associated enterprise) during a period of three years can be considered to be derived from the services performed during these three years while an option that is granted,

without any condition of subsequent employment, to an employee on a given date but which, under its terms and conditions, can only be exercised after a delay of three years, should not be considered to relate to the employment performed during these years as the benefit of such an option would accrue to its recipient even if he were to leave his employment immediately after receiving it and waited the required three years before exercising it.

12.9 It is also important to distinguish between a situation where a period of employment is required as a condition for the acquisition of the right to exercise an option, i.e. the vesting of the option, and a situation where an option that has already vested may be forfeited if it is not exercised before employment is terminated (or within a short period after). In the latter situation, the benefit of the option should not be considered to relate to services rendered after vesting since the employee has already obtained the benefit and could in fact realise it at any time. A condition under which the vested option may be forfeited if employment is terminated is not a condition for the acquisition of the benefit but, rather, one under which the benefit already acquired may subsequently be lost. The following examples illustrate this distinction:

— Example 1: On 1 January of year 1, a stock-option is granted to an employee. The acquisition of the option is conditional on the employee continuing to be employed by the same employer until 1 January of year 3. The option, once this condition is met, will be exercisable from 1 January of year 3 until 1 January of year 10 (a so-called "American" option[1]). It is further provided, however, that any option not previously exercised will be lost upon cessation of employment. In that example, the right to exercise that option has been acquired on 1 January of year 3 (i.e. the date of vesting) since no further period of employment is then required for the employee to obtain the right to exercise the option.

— Example 2: On 1 January of year 1, a stock-option is granted to an employee. The option is exercisable on 1 January of year 5 (a so-called "European" option). The option has been granted subject to the condition that it can only be exercised on 1 January of year 5 if employment is not terminated before that date. In that example, the right to exercise that option is not acquired until 1 January of year 5, which is the date of exercise, since employment until that date is required to acquire the right to exercise the option (i.e. for the option to vest).

12.10 There are cases where that first principle might not apply. One such case could be where the stock-option is granted without any condition to an employee at the time he either takes up an employment, is transferred to a new country or is given significant new responsibilities and, in each case, the option clearly relates to the new functions to be performed by the employee during a specific future period. In that case, it may be appropriate to consider that the option relates to these new functions even if

1 Under an "American" stock-option, the right to acquire a share may be exercised during a certain period (typically a number of years) whilst under a European stock-option, that right may only be exercised at a given moment (i.e. on a particular date).

the right to exercise the option is acquired before these are performed. There are also cases where an option vested technically but where that option entitles the employee to acquire shares which will not vest until the end of a period of required employment. In such cases, it may be appropriate to consider that the benefit of the option relates to the services rendered in the whole period between the grant of the option and the vesting of the shares.

12.11 The second principle is that an employee stock-option should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is intended to reward the provision of such services by the recipient for a specific period. This would be the case, for example, where the remuneration is demonstrably based on the employee's past performance during a certain period or is based on the employer's past financial results and is conditional on the employee having been employed by the employer or an associated enterprise during a certain period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a period of past employment, there was a well-founded expectation among participants to an employee stock-option plan that part of their remuneration for that period would be provided through the plan by having stock-options granted at a later date. This evidence might include, for example, the consistent practice of an employer that has granted similar levels of stock-options over a number of years, as long as there was no indication that this practice might be discontinued. Depending on other factors, such evidence may be highly relevant for purposes of determining if and to what extent the stock-option relates to such a period of past employment.

12.12 Where a period of employment is required to obtain the right to exercise an employee's stock-option but such requirement is not applied in certain circumstances, e.g. where the employment is terminated by the employer or where the employee reaches retirement age, the stock-option benefit should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.

12.13 Finally, there may be situations in which some factors may suggest that an employee stock-option is rewarding past services but other factors seem to indicate that it relates to future services. In cases of doubt, it should be recognised that employee stock-options are generally provided as an incentive to future performance or as a way to retain valuable employees. Thus, employee stock-options are primarily related to future services. However, all relevant facts and circumstances will need to be taken into account before such a determination can be made and there may be cases where it can be shown that a stock-option is related to combined specific periods of previous and future services (e.g. options are granted on the basis of the employee having achieved specific performance targets for the previous year, but they become exercisable only if the employee remains employed for another three years).

12.14 Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment

exercised in each State for purposes of the application of the Article and of Articles 23 A and 23 B. In such a case, the employment benefit attributable to the stock-option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock-option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, e.g. those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option.

12.15 It is possible for member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, member countries should be careful in adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach.

Observations on the Commentary

13. *France* considers that paragraph 8.13 should not be interpreted as being sufficient in itself to question a formal contractual relationship. If, with respect to paragraph 8.13, the services rendered by an individual constitute an integral part of the business of the enterprise to which these services are provided, the situation should then be analysed in accordance with the provisions of paragraph 8.14.

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 of Article 4.

Reservations on the Article

14. *Slovenia* reserves the right to add an article which addresses the situation of teachers, professors and researchers, subject to various conditions, and to make a corresponding modification to paragraph 1 of Article 15.

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).

16. *Norway* reserves 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" (see paragraph 8 above).

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.

18. *Latvia* reserves 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.

19. *Switzerland* 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".

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.

21. *Greece* reserves the right to insert special provisions regarding income from employment relating to offshore activities.

22. *Turkey*, with regard to paragraph 3, reserves the right to tax exclusively the remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic by an enterprise resident in Turkey.

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. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

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.

3.1 Many of the issues discussed under paragraphs 12 to 12.15 of the Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies. To the extent that stock-options are granted to a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment (see paragraph 1.1 above) even if the tax is levied at a later time when the person is no longer a member of that board. While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (e.g. upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realised and any subsequent gain on the acquired shares (i.e. the value of the shares that accrues after exercise) will be derived by the member of the board of directors in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is

what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so).

Reservations on the Article

4. *Estonia* and *Latvia* 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.

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.

6. *Belgium* reserves the right to state that remuneration that a person dealt with in Article 16 receives in respect of daily activities as well as remuneration that a partner of a company, other than a company with share capital, receives in respect of his personal activities for the company shall be taxable in accordance with the provisions of Article 15.

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.

COMMENTARY ON ARTICLE 17
CONCERNING THE TAXATION OF ENTERTAINERS AND SPORTSPERSONS

Paragraph 1

1. Paragraph 1 provides that entertainers and sportspersons 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 (over which it prevails by virtue of paragraph 4 of that Article) 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 sportspersons 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 replace the words "notwithstanding the provisions of Article 15" by "subject to the provisions of Article 15" in paragraphs 1 and 2. In such a case, entertainers and sportspersons 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.

3. Paragraph 1 refers to entertainers and sportspersons. It is not possible to give a precise definition of "entertainer", 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 "entertainer" clearly includes the stage performer, film actor or actor (including for instance a former sportsperson) 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 (e.g. a former politician who receives a fee for a speaking engagement), to a model performing as such (e.g. a model presenting clothes during a fashion show or photo session) rather than as an entertainer 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.

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.

5. Whilst no precise definition is given of the term "sportspersons" 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.

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.

7. Income received by impresarios, etc. for arranging the appearance of an entertainer or sportsperson is outside the scope of the Article, but any income they receive on behalf of the entertainer or sportsperson is of course covered by it.

8. Paragraph 1 applies to income derived directly and indirectly from a performance by an individual entertainer or sportsperson. In some cases the income will not be paid to the individual, or his impresario or agent, directly with respect to a specific performance. 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 entertainer or sportsperson 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 a State's domestic laws "look through" such entities and treat the income as accruing directly to the individual, paragraph 1 enables that State to tax income derived from performances 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.

8.1 The paragraph applies regardless of who pays the income. For example, it covers prizes and awards paid by a national federation, association or league which a team or an individual may receive in relation to a particular sports event.

9. Besides fees for their actual performances, entertainers and sportspersons often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there is no close connection between the income and the performance of activities in the country concerned. Such a close connection will generally be found to exist where it cannot reasonably be considered that the income would have been derived in the absence of the performance of these activities. This connection may be related to the timing of the income-generating event (e.g. a payment received by a professional golfer for an interview given during a tournament in which she participates) or to the nature of the consideration for the payment of the income (e.g. a payment made to a star tennis player for the use of his picture on posters advertising a tournament in which he will participate). Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (see 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 has a close connection with a performance in a given State (e.g. payments made to a tennis player for wearing a sponsor's logo, trade mark or trade name on his tennis shirt during a match). Such a close connection may be evident from contractual arrangements which relate to participation in named events or a number of unspecified events; in the latter case, a Contracting State in which one or more of these events take place may tax a proportion of the relevant advertising or sponsorship income (as it would do, for example, in the case of remuneration covering a number of unspecified performances; see paragraphs 9.2 and 9.3). Similar income which could not be attributed to such performances 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 Article 7 or 15, as the case may be. Various payments may be made as regards merchandising; whilst the payment to an entertainer or sportsperson of a share of the merchandising income closely connected with a public performance but not constituting royalties would normally fall under Article 17, merchandising payments derived from sales in a country that are not closely connected with performances in that country and that do not constitute royalties would normally be covered by Article 7 (or Article 15, in the case of an employee receiving such income).

9.1 Apart from the above examples, there are a number of cases where it may be difficult to determine whether a particular item of income is derived by a person as an entertainer or sportsperson from that person's personal activities as such. The following principles may be useful to deal with such cases:

— The reference to an "entertainer or sportsperson" includes anyone who acts as such, even for a single event. Thus, Article 17 can apply to an amateur who wins a monetary sports prize or a person who is not an actor but who gets a fee for a once-in-a-lifetime appearance in a television commercial or movie.

— As noted in the previous paragraphs, the activities of an entertainer or sportsperson do not include only the appearance in an entertainment or sports event in a given State but also, for example, advertising or interviews in that State that are closely connected with such an appearance.

— Merely reporting or commenting on an entertainment or sports event in which the reporter does not himself participate is not an activity of an entertainer or sportsperson acting as such. Thus, for instance, the fee that a former or injured sportsperson would earn for offering comments during the broadcast of a sports event in which that person does not participate would not be covered by Article 17.

— Preparation, such as rehearsal and training, is part of the normal activities of entertainers and sportspersons. If an entertainer or sportsperson is remunerated for time spent on rehearsal, training or similar preparation in a State (which would be fairly common for employed entertainers and sportspersons but could also happen for a self-employed individual, such as an opera singer whose

contract would require participation in a certain number of rehearsals), the relevant remuneration, as well as remuneration for time spent travelling in that State for the purposes of performances, rehearsal and training (or similar preparation), would be covered by the Article. This would apply regardless of whether or not such rehearsal, training or similar preparation is related to specific public performances taking place in that State (e.g. remuneration that would be paid with respect to the participation in a pre-season training camp would be covered).

9.2 Entertainers and sportspersons often perform their activities in different States making it necessary to determine which part of their income is derived from activities exercised in each State. Whilst such determination must be based on the facts and circumstances of each case, the following general principles will be relevant for that purpose:

— An element of income that is closely connected with specific activities exercised by the entertainer or sportsperson in a State (e.g. a prize paid to the winner of a sports competition taking place in that State; a daily allowance paid with respect to participation in a tournament or training stage taking place in that State; a payment made to a musician for a concert given in a State) will be considered to be derived from the activities exercised in that State.

— As indicated in paragraph 1 of the Commentary on Article 15, employment is exercised where the employee is physically present when performing the activities for which the employment remuneration is paid. Where the remuneration received by an entertainer or sportsperson employed by a team, troupe or orchestra covers various activities to be performed during a period of time (e.g. an annual salary covering various activities such as training or rehearsing; travelling with the team, troupe or orchestra; participating in a match or public performance, etc.), it will therefore be appropriate, absent any indication that the remuneration or part thereof should be allocated differently, to allocate that salary or remuneration on the basis of the working days spent in each State in which the entertainer or sportsperson has been required, under his or her employment contract, to perform these activities.

9.3 The following examples illustrate these principles:

— Example 1: A self-employed singer is paid a fixed amount for a number of concerts to be performed in different states plus 5 per cent of the ticket sales for each concert. In that case, it would be appropriate to allocate the fixed amount on the basis of the number of concerts performed in each State but to allocate the payments based on ticket sales on the basis of where the concerts that generated each such payment took place.

— Example 2: A cyclist is employed by a team. Under his employment contract, he is required to travel with the team, appear in some public press conferences organised by the team and participate in training activities and races that take place in different countries. He is paid a fixed annual salary plus bonuses based on his results in particular races. In that case, it would be reasonable to allocate

the salary on the basis of the number of working days during which he is present in each State where his employment-related activities (e.g. travel, training, races, public appearances) are performed and to allocate the bonuses to where the relevant races took place.

9.4 Payments for the simultaneous broadcasting of a performance by an entertainer or sportsperson made directly to the performer or for his or her benefit (e.g. a payment made to the star-company of the performer) fall within the scope of Article 17 (see paragraph 18 of the Commentary on Article 12, which also deals with payments for the subsequent sales or public playing of recordings of the performance). Where, however, the payment is made to a third party (e.g. the owner of the broadcasting rights) and that payment does not benefit the performer, the payment is not related to the personal activities of the performer and therefore does not constitute income derived by a person as an entertainer or sportsperson from that person's personal activities as such. For example, where the organiser of a football tournament holds all intellectual property rights in the event and, as such, receives payments for broadcasting rights related to the event, Article 17 does not apply to these payments; similarly, Article 17 will not apply to any share of these payments that will be distributed to the participating teams and will not be re-distributed to the players and that is not otherwise paid for the benefit of the players. Whether such payments will constitute royalties covered by Article 12 will depend, among other things, on the legal nature of such broadcasting rights, in particular under the relevant copyright law.

9.5 It is frequent for entertainers and sportspersons to derive, directly or indirectly (e.g. through a payment made to the star-company of the entertainer or sportsperson), a substantial part of their income in the form of payments for the use of, or the right to use, their "image rights", e.g. the use of their name, signature or personal image. Where such uses of the entertainer's or sportsperson's image rights are not closely connected with the entertainer's or sportsperson's performance in a given State, the relevant payments would generally not be covered by Article 17 (see paragraph 9 above). There are cases, however, where payments made to an entertainer or sportsperson who is a resident of a Contracting State, or to another person, for the use of, or right to use, that entertainer's or sportsperson's image rights constitute in substance remuneration for activities of the entertainer or sportsperson that are covered by Article 17 and that take place in the other Contracting State. In such cases, the provisions of paragraph 1 or 2, depending on the circumstances, will be applicable.

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 entertainers and sportspersons. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc. Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines:

> Where a resident of a Contracting State derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting State on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions.

10.1 Some States may also consider that it would be inappropriate to apply Article 17 to a non-resident entertainer or sportsperson who would not otherwise be taxable in a Contracting State (e.g. under the provisions of Article 7 or 15) and who, during a given taxation year, derives only low amounts of income from activities performed in that State. States wishing to exclude such situations from the application of Article 17 may do so by using an alternative version of paragraph 1 drafted along the following lines:

> Notwithstanding the provisions of Article 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 sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State, except where the gross amount of such income derived by that resident from these activities exercised during a taxation year of the other Contracting State does not exceed an amount equivalent to [15 000 IMF Special Drawing Rights] expressed in the currency of that other State at the beginning of that taxation year or any other amount agreed to by the competent authorities before, and with respect to, that taxation year.

10.2 The amount referred to in the above provision is purely illustrative. The reference to "IMF Special Drawing Rights" avoids the reference to the currency of one of the two Contracting States and is intended to provide an amount that remains relatively constant in value regardless of currency fluctuations in each State (the IMF Special Drawing Rights (SDRs) are based on a basket of currencies revised periodically and are easily expressed in most convertible currencies). Also, for ease of administration, the proposed provision provides that the limit applicable in a State for a given taxation year is the amount converted in the currency of that State at the beginning of that year. The proposed provision also allows competent authorities to modify the amount when they consider it appropriate; instead of adopting a static amount, however, some States may prefer to adopt an objective mechanism that would allow periodic changes (this could be done, for example, by replacing the amount by a formula such as "50 per cent of the average GDP per capita for OECD countries, as determined by the OECD").

10.3 The proposed provision would not prevent Contracting States from collecting tax at the time the relevant income is earned and refunding it after the end of the year once it is established that the minimum amount has not been exceeded.

10.4 The proposed provision only applies with respect to paragraph 1 (applying the rule with respect to other persons covered by paragraph 2 could encourage a fragmentation of contracts among many related entities in order to multiply the benefit of the exception). Also, the provision only restricts the additional taxing right recognised by Article 17 and does not affect the source taxing rights otherwise available under Articles 7 and 15. It would therefore not prevent taxation to the extent that the entertainer has a permanent establishment in the State of source or is present in that State for more than 183 days (or is employed by an employer who is a resident of that State or has permanent establishment in that State).

Paragraph 2

11. Paragraph 1 of the Article deals with income derived by individual entertainers and sportspersons 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 sportsperson 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 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 sportspersons (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 they perform their activities as entertainers or sportspersons, on any remuneration (or income accruing for their benefit) derived from the performance of these activities (see, however, paragraph 14.1 below). 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 entertainer or sportsperson is not paid to the entertainer or sportsperson himself but to another person, e.g. a so-called star-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 sportsperson 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 entertainer or sportsperson; 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 entertainer or sportsperson 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.

11.1 The application of paragraph 2 is not restricted to situations where both the entertainer or sportsperson 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 sportsperson 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 sportsperson 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.

11.2 Paragraph 2 does not apply, however, to prize money that the owner of a horse or the team to which a race car belongs derives from the results of the horse or car during a race or during races taking place during a certain period. In such a case, the prize money is not paid in consideration for the personal activities of the jockey or race car driver but in consideration for the activities related to the ownership and training of the horse or the design, construction, ownership and maintenance of the car. Such prize money is not derived from the personal activities of the jockey or race car driver and is not covered by Article 17. Clearly, however, if the owner or team receives a payment in consideration for the personal activities of the jockey or race car driver, that income may be taxed in the hands of the jockey or race car driver under paragraph 1 (see paragraph 7 above).

11.3 As a general rule it should be noted, however, that, regardless of Article 7, 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/sportsperson or the star-company in abusive cases, as is recognised in paragraphs 76 to 79 of the Commentary on Article 1. Also, paragraph 9 of Article 29 will prevent the benefits of provisions such as those of Articles 7 and 15 from being granted in these abusive cases.

11.4 Paragraph 2 covers income that may be considered to be derived in respect of the personal activities of an entertainer or sportsperson. Whilst that covers income that is received by an enterprise that is paid for performing such activities (such as a sports team or orchestra), it clearly does not cover the income of all enterprises that are involved in the production of entertainment or sports events. For example, the income

derived by the independent promoter of a concert from the sale of tickets and allocation of advertising space is not covered by paragraph 2.

11.5 Whilst the Article does not provide how the income covered by paragraphs 1 and 2 is to be computed and leaves it to the domestic law of a Contracting State to determine the extent of any deductions (see paragraph 10 above), the income derived in respect of the personal activities of a sportsperson or entertainer should not be taxed twice through the application of these two paragraphs. This will be an important consideration where, for example, paragraph 2 allows a Contracting State to tax the star-company of an entertainer on a payment received by that company with respect to activities performed by the entertainer in that State and paragraph 1 also allows that State to tax the part of the remuneration paid by that company to the entertainer that can reasonably be attributed to these activities. In that case, the Contracting State may, depending on its domestic law, either tax only the company or the entertainer on the whole income attributable to these activities or tax each of them on part of the income, e.g. by taxing the income received by the company but allowing a deduction for the relevant part of the remuneration paid to the entertainer and taxing that part in the hands of the entertainer.

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.

13. Article 17 will ordinarily apply when the entertainer or sportsperson 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 entertainers or sportspersons employed in organisations which are subsidised out of public funds from the application of Article 17.

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 entertainers or sportspersons 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 entertainer or the sportsperson is a resident.

14.1 Also, given the administrative difficulties involved in allocating to specific activities taking place in a State the overall employment remuneration of individual members of a foreign team, troupe or orchestra, and in taxing the relevant part of that remuneration, some States may consider it appropriate not to tax such remuneration. Whilst a State could unilaterally decide to exempt such remuneration, such a unilateral solution would not be reciprocal and would give rise to the problem described in paragraph 12 above where the exemption method is used by the State of residence of the person deriving such income. These States may therefore consider it appropriate to exclude such remuneration from the scope of the Article. Whilst paragraph 2 above indicates that one solution would be to amend the text of the Article so that it does not apply with respect to income from employment, some States may prefer a narrower exception dealing with cases that they frequently encounter in practice. The following is an example of a provision applicable to members of a sports team that could be used for that purpose:

The provisions of Article 17 shall not apply to income derived by a resident of a Contracting State in respect of personal activities of an individual exercised in the other Contracting State as a sportsperson member of a team of the first-mentioned State that takes part in a match organised in the other State by a league to which that team belongs.

Observations on the Commentary

15. With respect to the examples given in paragraph 3, *Turkey* considers that the activity of a model performing as such (e.g. a model presenting clothes during a fashion show or photo session) falls within the scope of this Article regarding the performance and appearance nature of this activity.

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 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.

15.2 *Switzerland* does not share the view expressed in paragraph 9 of the Commentary which provides that Article 17 will apply to advertising or sponsorship income, which has a close connection with a performance in a given State. Switzerland considers that advertising or sponsorship income falls under the standard rules of Article 7 or Article 15, as appropriate, even if such income has a close connection with a

performance in a given State. Additionally, Switzerland takes the view that merchandising income and income in the form of payments for the use of, or the right to use, image rights (paragraph 9.5 of the Commentary) are not covered by Article 17.

15.3 *Chile* and *Mexico* consider that it needs to be clarified that in the case of the third example in paragraph 9.1 with respect to fees earned by a former sportsperson, such fees may be covered by Article 17 even if the former sportsperson does not participate in a sports event when those fees are paid for an entertainment activity and the former sportsperson acts as an entertainer.

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 subparagraph 11 *c*) above and these countries reserve the right to propose an amendment to that effect.

17. *Germany* reserves its right to insert a provision according to which income derived by a person for the transfer of live broadcasting rights or other commercial exploitations of personal activities of entertainers or sportspersons may be taxed in the State where the entertainer or sportsperson exercises the personal activities.

18. According to *France's* doctrine and treaty practice, income that a sportsperson or entertainer derives from the use of that person's image is inseparable from that person's professional activities and must therefore be taxed in the State in which such income arises. France therefore reserves the right to include in its bilateral conventions an additional paragraph allowing the source taxation of income from activities that cannot be disassociated from professional notoriety.

19. [Deleted]

20. The *United States* reserves the right to limit paragraph 1 to situations where the entertainer or sportsperson earns a specified amount.

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. Various policy and administrative considerations support the principle that the taxing right with respect to this type of pension, and other similar remuneration, should be left to the State of residence. For instance, the State of residence of the recipient of a pension is in a better position than any other State to take into account the recipient's overall ability to pay tax, which mostly depends on worldwide income and personal circumstances such as family responsibilities. This solution also avoids imposing on the recipient of this type of pension the administrative burden of having to comply with tax obligations in States other than that recipient's State of residence.

2. Some States, however, are reluctant to adopt the principle of exclusive residence taxation of pensions and propose alternatives to the Article. Some of these alternatives and the issues that they raise are discussed in paragraphs 12 to 21 below, which deal with the various considerations related to the allocation of taxing rights with respect to pension benefits and the reasons supporting the Article as drafted.

Scope of the Article

3. The types of payment that are covered by the Article include not only pensions directly paid to former employees but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees) and other similar payments, such as annuities, paid in respect of past employment. The Article 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. The Article only applies, however, to payments that are in consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. The Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a "pension or other similar remuneration" (the tax mismatch that could arise in such a situation is discussed below). Similarly, the Article applies regardless of whether or not the relevant payments are made from a "recognised pension fund" as defined in subparagraph i) of paragraph 1 of Article 3.

4. Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following two

paragraphs (see also paragraphs 2.3 to 2.16 of the Commentary on Article 15, which deal with the application of the Convention to a number of these payments).

5. While the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration" are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may fall within the Article.

6. Whether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact. For example, if it is shown that the consideration for the payment is the commutation of the pension or the compensation for a reduced pension then the payment may be characterised as "other similar remuneration" falling under the Article. This would be the case where a person was entitled to elect upon retirement between the payment of a pension or a lump-sum computed either by reference to the total amount of the contributions or to the amount of pension to which that person would otherwise be entitled under the rules in force for the pension scheme. The source of the payment is an important factor; payments made from a pension scheme would normally be covered by the Article. Other factors which could assist in determining whether a payment or series of payments fall under the Article include: whether a payment is made on or after the cessation of the employment giving rise to the payment, whether the recipient continues working, whether the recipient has reached the normal age of retirement with respect to that particular type of employment, the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits. Reimbursement of pension contributions (e.g. after temporary employment) does not constitute "other similar remuneration" under Article 18. Where cases of difficulty arise in the taxation of such payments, the Contracting States should solve the matter by recourse to the provisions of Article 25.

7. Since the Article applies only to pensions and other similar remuneration that are paid in consideration for past employment, it does not cover other pensions such as those that are paid with respect to previous independent personal services. Some States, however, extend the scope of the Article to cover all types of pensions, including Government pensions; States wishing to do so are free to agree bilaterally to include provisions to that effect.

Cross-border issues related to pensions

8. The globalisation of the economy and the development of international communications and transportation have considerably increased the international mobility of individuals, both for work-related and personal reasons. This has significantly increased the importance of cross-border issues arising from the interaction of the different pension arrangements which exist in various States and which were primarily designed on the basis of purely domestic policy considerations. As these issues often affect large numbers of individuals, it is desirable to address

them in tax conventions so as to remove obstacles to the international movement of persons, and employees in particular.

9. Many such issues relate to mismatches resulting from differences in the general tax policy that States adopt with respect to retirement savings. In many States, tax incentives are provided for pension contributions. Such incentives frequently take the form of a tax deferral so that the part of the income of an individual that is contributed to a pension arrangement as well as the income earned in the scheme or any pension rights that accrue to the individual are exempt from tax. Conversely, the pension benefits from these arrangements are taxable upon receipt. Other States, however, treat pension contributions like other forms of savings and neither exempt these contributions nor the return thereon; logically, therefore, they do not tax pension benefits. Between these two approaches exist a variety of systems where contributions, the return thereon, the accrual of pension rights or pension benefits are partially taxed or exempt.

10. Other issues arise from the existence of very different arrangements to provide retirement benefits. These arrangements are often classified under the following three broad categories:

— statutory social security schemes;

— occupational pension schemes;

— individual retirement schemes.

The interaction between these three categories of arrangements presents particular difficulties. These difficulties are compounded by the fact that each State may have different tax rules for the arrangements falling in each of these categories as well as by the fact that there are considerable differences in the extent to which States rely on each of these categories to ensure retirement benefits to individuals (e.g. some States provide retirement benefits almost exclusively through their social security system while others rely primarily on occupational pension schemes or individual retirement schemes).

11. The issues arising from all these differences need to be fully considered in the course of bilateral negotiations, in particular to avoid double taxation or non-taxation, and, where appropriate, addressed through specific provisions. The following sections examine some of these cross-border issues.

Allocation of taxing rights with respect to pension benefits

12. As explained in paragraph 9 above, many States have adopted the approach under which, subject to various restrictions, tax is totally or partially deferred on contributions to, and earnings in, pension schemes or on the accrual of pension rights, but is recovered when pension benefits are paid.

13. Some of these States consider that because a deduction for pension contributions is a deferral of tax on the part of the employment income that is saved towards retirement, they should be able to recover the tax so deferred where the

individual has ceased to be a resident before the payment of all or part of the pension benefits. This view is particularly prevalent where the benefits are paid through a lump-sum amount or over a short period of time as this increases risks of double non-taxation.

14. If the other State of which that individual then becomes a resident has adopted a similar approach and therefore taxes these pension benefits when received, the issue is primarily one of allocation of taxing rights between the two States. If, however, the individual becomes a resident of a State which adopts a different approach so as not to tax pension benefits, the mismatch in the approaches adopted by the two States will result in a situation where no tax will ever be payable on the relevant income.

15. For these reasons, some States seek to include in their tax conventions alternative provisions designed to secure either exclusive or limited source taxation rights with respect to pensions in consideration of past employment. The following are examples of provisions that some members have adopted in consequence of these policy and administrative considerations; States are free to agree bilaterally to include such provisions:

a) Provisions allowing exclusive source taxation of pension payments

Under such a provision, the Article is drafted along the following lines:

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

b) Provisions allowing non-exclusive source taxation of pension payments

Under such a provision, the State of source is given the right to tax pension payments and the rules of Article 23 A or 23 B results in that right being either exclusive or merely prior to that of the State of residence. The Article is then drafted along the following lines:

> 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. However such pensions and other similar remuneration may also be taxed in the other Contracting State if they arise in that State.

c) Provisions allowing limited source taxation of pension

Under such a provision, the State of source is given the right to tax pension payments but that right is subjected to a limit, usually expressed as a percentage of the payment. The Article is then drafted along the following lines:

> 1. 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 may be taxed in that State.
>
> 2. However such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise and according to the laws of

that State but the tax so charged shall not exceed [percentage] of the gross amount of the payment.

Where such a provision is used, a reference to paragraph 2 of Article 18 is added to paragraph 2 of Article 23 A to ensure that the residence State, if it applies the exemption method, is allowed to tax the pension payments but needs to provide a credit for the tax levied by the source State.

d) Provisions allowing source taxation of pension payments only where the State of residence does not tax these payments

Such a provision is used by States that are primarily concerned with the structural mismatch described in paragraph 14 above. A paragraph 2 is then added along the following lines:

2. However such pensions and other similar remuneration may also be taxed in the Contracting State in which they arise if these payments are not subject to tax in the other Contracting State under the ordinary rules of its tax law.

16. Apart from the reasons presented in paragraphs 13 and 14 above, various policy and administrative considerations should be taken into account when considering such provisions.

17. First, the State of residence is in a better position to provide for adequate taxation of pension payments as it is easier for that State to take into account the worldwide income, and therefore the overall ability to pay tax, of the recipient so as to apply appropriate rates and personal allowances. By contrast, the source taxation of pensions may well result in excessive taxation where the source State imposes a final withholding tax on the gross amount paid. If little or no tax is levied in the residence State (e.g. because of available allowances), the pensioner may not be able to claim a credit in the residence State for the tax paid. However, some States have sought to relieve that problem by extending their personal allowances to non-residents who derive almost all their income from these States. Also, some States have allowed the pension payments made to non-resident recipients to be taxed at the marginal rate that would be applicable if that recipient were taxed on worldwide income (that system, however, involves administrative difficulties as it requires a determination of the worldwide income of the non-resident only for the purpose of determining the applicable rate of tax).

18. Second, equity considerations could be relevant since the level of pensions paid in the source State will generally have been set factoring local rates of tax. In this situation, an individual who has emigrated to another State with different tax rates will either be advantaged or disadvantaged by receiving an after-tax pension that will be different from that envisaged under the pension scheme.

19. Third, alternative provisions under which there is either exclusive or limited source taxation rights with respect to pensions require a determination of the State of source of pensions. Since a mere reference to a pension "arising in" a Contracting State could be construed as meaning either a pension paid by a fund established in that State

or a pension derived from work performed in a State, States using such wording should clarify how it should be interpreted and applied.

19.1 Conceptually, the State of source might be considered to be the State in which the fund is established, the State where the relevant work has been performed or the State where deductions have been claimed. Each of these approaches would raise difficulties in the case of individuals who work in more than one State, change residence during their career or derive pensions from funds established in a State other than that in which they have worked. For example, many individuals now spend significant parts of their careers outside the State in which their pension funds are established and from which their pension benefits are ultimately paid. In such a case, treating the State in which the fund is established as the State of source would seem difficult to justify. The alternative of considering as the State of source the State where the work has been performed or deductions claimed would address that issue but would raise administrative difficulties for both taxpayers and tax authorities, particularly in the case of individuals who have worked in many States during their career, since it would create the possibility of different parts of the same pension having different States of source.

19.2 States that wish to use provisions under which there is either exclusive or limited source taxation rights with respect to pensions should take account of these issues related to the determination of the State of source of pensions. They should then address the administrative difficulties that will arise from the rule that they adopt for that purpose, for example to avoid situations where two States would claim to have source taxation rights on the same pension.

20. Fourth, another argument against these alternative provisions is that exclusive taxation by the State of residence means that pensioners only need to comply with the tax rules of their State of residence as regards payments covered by Article 18. Where, however, limited or exclusive source taxation of pensions is allowed, the pensioner will need to comply with the tax rules of both Contracting States.

21. Exclusive residence taxation may, however, give rise to concerns about the non-reporting of foreign pension income. Exchange of information coupled with adequate taxpayer compliance systems will, however, reduce the incidence of non-reporting of foreign pension payments.

Exempt pensions

22. As mentioned in paragraph 9 above, some States do not tax pension payments generally or otherwise exempt particular categories or parts of pension payments. In these cases, the provisions of the Article, which provides for taxation of pensions in the State of residence, may result in the taxation by that State of pensions which were designed not to be taxed and the amount of which may well have been determined having regard to that exemption. This may result in undue financial hardship for the recipient of the pension.

23. To avoid the problems resulting from this type of mismatch, some States include in their tax treaties provisions to preserve the exempt treatment of pensions when the recipient is a resident of the other Contracting State. These provisions may be restricted to specific categories of pensions or may address the issue in a more comprehensive way. An example of that latter approach would be a provision drafted along the following lines:

> Notwithstanding any provision of this Convention, any pension or other similar remuneration paid to a resident of a Contracting State in respect of past employment exercised in the other Contracting State shall be exempt from tax in the first-mentioned State if that pension or other remuneration would be exempt from tax in the other State if the recipient were a resident of that other State.

Issues related to statutory social security schemes

24. Depending on the circumstances, social security payments can fall under this Article as "pensions and other similar remuneration in consideration of past employment", under Article 19 as "pension[s] paid by, or out of funds created by, a Contracting State ... in respect of services rendered to that State..." or under Article 21 as "items of income ... not dealt with in the foregoing Articles". Social security pensions fall under this Article when they are paid in consideration of past employment, unless paragraph 2 of Article 19 applies (see below). A social security pension may be said to be "in consideration of past employment" if employment is a condition for that pension. For instance, this will be the case where, under the relevant social security scheme:

— the amount of the pension is determined on the basis of either or both the period of employment and the employment income so that years when the individual was not employed do not give rise to pension benefits,

— the amount of the pension is determined on the basis of contributions to the scheme that are made under the condition of employment and in relation to the period of employment, or

— the amount of the pension is determined on the basis of the period of employment and either or both the contributions to the scheme and the investment income of the scheme.

25. Paragraph 2 of Article 19 will apply to a social security pension that would fall within Article 18 except for the fact that the past employment in consideration of which it is paid constituted services rendered to a State or a political subdivision or a local authority thereof, other than services referred to in paragraph 3 of Article 19.

26. Social security payments that do not fall within Article 18 or 19 fall within Article 21. This would be the case, for instance, for payments made to self-employed persons as well as a pension purely based on resources, on age or disability which would be paid regardless of past employment or factors related to past employment (such as years of employment or contributions made during employment).

27. Some States, however, 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 all 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. 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.

28. Although the above draft provision refers to the social security legislation of each Contracting State, there are limits to what it covers. "Social security" generally refers to a system of mandatory protection that a State puts in place in order to provide its population with a minimum level of income or retirement benefits or to mitigate the financial impact of events such as unemployment, employment-related injuries, sickness or death. A common feature of social security systems is that the level of benefits is determined by the State. Payments that may be covered by the provision include retirement pensions available to the general public under a public pension scheme, old age pension payments as well as unemployment, disability, maternity, survivorship, sickness, social assistance, and family protection payments that are made by the State or by public entities constituted to administer the funds to be distributed. As there may be substantial differences in the social security systems of the Contracting States, it is important for the States that intend to use the draft provision to verify, during the course of bilateral negotiations, that they have a common understanding of what will be covered by the provision.

Issues related to individual retirement schemes

29. In many States, preferential tax treatment (usually in the form of the tax deferral described in paragraph 9 above) is available to certain individual private saving schemes established to provide retirement benefits. These individual retirement schemes are usually available to individuals who do not have access to occupational pension schemes; they may also, however, be available to employees who wish to supplement the retirement benefits that they will derive from their social security and occupational pension schemes. These schemes take various legal forms. For example,

they may be bank savings accounts, individual investment funds or individually subscribed full life insurance policies. Their common feature is a preferential tax treatment which is subject to certain contribution limits.

30. These schemes raise many of the cross-border issues that arise in the case of occupational schemes, such as the tax treatment, in one Contracting State, of contributions to such a scheme established in the other State (see paragraphs 31 to 65 below). There may be, however, issues that are specific to individual retirement schemes and which may need to be addressed separately during the negotiation of a bilateral convention. One such issue is the tax treatment, in each State, of income accruing in such a scheme established in the other State. Many States have rules (such as foreign investment funds (FIF) rules, rules that attribute the income of a trust to a settlor or beneficiary in certain circumstances or rules that provide for the accrual taxation of income with respect to certain types of investment, including full life insurance policies) that may, in certain circumstances, result in the taxation of income accruing in an individual retirement scheme established abroad. States which consider that result inappropriate in light of their approach to the taxation of retirement savings may wish to prevent such taxation. A provision dealing with the issue and restricted to those schemes which are recognised as individual retirement schemes could be drafted along the following lines:

> For purposes of computing the tax payable in a Contracting State by an individual who is a resident of that State and who was previously a resident of the other Contracting State, any income accruing under an arrangement
>
> *a)* entered into with a person established outside the first-mentioned State in order to secure retirement benefits for that individual,
>
> *b)* in which the individual participates and had participated when the individual was a resident of the other State,
>
> *c)* that is accepted by the competent authority of the first-mentioned State as generally corresponding to an individual retirement scheme recognised as such for tax purposes by that State,
>
> shall be treated as income accruing in an individual retirement scheme established in that State. This paragraph shall not restrict in any manner the taxation of any benefit distributed under the arrangement.

The tax treatment of contributions to foreign pension schemes

A. *General comments*

31. 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. Similarly, individuals who move to other countries to provide independent services are often confronted with

cross-border tax issues related to the pension arrangements that they have established in their home country.

32. Individuals working abroad will often wish to continue contributing to a pension scheme (including a social security scheme that provides pension benefits) 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.

33. The tax treatment accorded to pension contributions made by or for individuals working 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 or contract, pension contributions made by or for these individuals commonly qualify for tax relief in the home country. When the individual works abroad, the contributions in some cases continue to qualify for relief. Where the 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 working 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 or contract. Paragraph 37 below suggests a provision which member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions made by or for individuals working outside their home country.

34. 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 below in treaties where domestic legislation allows relief only with respect to contributions paid to residents. In such cases it may be inappropriate to include the suggested provision in a bilateral treaty.

35. The suggested provision covers contributions made to all forms of pension schemes, including individual retirement schemes as well as social security schemes. Many member countries have entered into bilateral social security totalisation agreements which may help to partially avoid the problem with respect to contributions to social security schemes; these agreements, however, usually do not deal with the tax treatment of cross-border contributions. In the case of an occupational scheme to which both the employer and the employees contribute, the provision covers both these contributions. Also, the provision is not restricted to the issue of the deductibility of the contributions as it deals with all aspects of the tax treatment of the contributions as regards the individual who derive benefits from a pension scheme. Thus the provision deals with issues such as whether or not the employee should be taxed on the employment benefit that an employer's contribution constitutes and whether or not the investment income derived from the contributions should be taxed in the hands of the individual. It does not, however, deal with the

taxation of the pension fund on its income (this issue is dealt with in paragraph 69 below). Contracting States wishing to modify the scope of the provision with respect to any of these issues may do so in their bilateral negotiations.

B. *Aim of the provision*

36. The aim of the provision is to ensure that, as far as possible, individuals are not discouraged from taking up overseas work by the tax treatment of their contributions to a home country pension scheme. The provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the contributions to which the tax relief applies based on the limits in the laws of both countries.

C. *Suggested provision*

37. The following is the suggested text of the provision that could be included in bilateral conventions to deal with the problem identified above:

1. Contributions to a pension scheme established in and recognised for tax purposes in a Contracting State that are made by or on behalf of an individual who renders services in the other Contracting State shall, for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that State, be 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 State, provided that:
   a) the individual was not a resident of that State, and was participating in the pension scheme, immediately before beginning to provide services in that State, and
   b) 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.
2. For the purposes of paragraph 1:
   a) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1, and
   b) 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.

38. The above provision is restricted to pension schemes established in one of the two Contracting States. As it is not unusual for individuals to work in a number of different countries in succession, some States may wish to extend the scope of the provision to cover situations where an individual moves from one Contracting State to another while continuing to make contributions to a pension scheme established in a third State. Such an extension may, however, create administrative difficulties if the host State cannot have access to information concerning the pension scheme (e.g. through the exchange of information provisions of a tax convention concluded

with the third State); it may also create a situation where relief would be given on a non-reciprocal basis because the third State would not grant similar relief to an individual contributing to a pension scheme established in the host State. States which, notwithstanding these difficulties, want to extend the suggested provision to funds established in third States can do so by adopting an alternative version of the suggested provision drafted along the following lines:

1. Contributions made by or on behalf of an individual who renders services in a Contracting State to a pension scheme

a) recognised for tax purposes in the other Contracting State,

b) in which the individual participated immediately before beginning to provide services in the first-mentioned State,

c) in which the individual participated at a time when that individual was providing services in, or was a resident of, the other State, and

d) that is accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State,

shall, for the purposes of

e) determining the individual's tax payable in the first-mentioned State, and

f) determining the profits of an enterprise which may be taxed in the first-mentioned State,

be 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.

2. For the purposes of paragraph 1:

a) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1; and

b) 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.

D. Characteristics of the suggested provision

39. The following paragraphs discuss the main characteristics of the suggested provision found in paragraph 37 above.

40. Paragraph 1 of the suggested provision lays down the characteristics of both the individual and the contributions in respect of which the provision applies. It also provides the principle that contributions made by or on behalf of an individual rendering services in one Contracting State (the host State) to a defined pension scheme in the other Contracting State (the home State) are to be treated for tax purposes in the host State in the same way and subject to the same conditions and limitations as contributions to domestic pension schemes of the host State.

41. Tax relief with respect to 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.

42. A solution in which relief would be given by the home country might not be effective, since the individual 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.

43. In looking at the characteristics of the individual, paragraph 1 makes it clear that, in order to get the relief from taxation in the host State, the individual must not have been resident in the host State immediately prior to working there.

44. Paragraph 1 does not, however, limit the application of the provision to individuals who become resident in the host State. In many cases, individuals 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 individuals 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.

45. 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.

46. As already noted, it is not unusual for individuals to work in a number of different countries in succession; for that reason, the suggested provision is not limited to individuals who are residents of the home State immediately prior to providing services in the host State. The provision covers an individual coming to the host State from a third country as it is only limited to individuals who were not resident in the host country before starting to work there. However, Article 1 restricts the scope of the Convention to residents of one or both Contracting States. An individual 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.

47. The suggested provision places no limits on the length of time for which an individual can work in a host State. It could be argued that, if an individual 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 pension schemes to cases where the individuals are present on a temporary basis.

48. In addition, the inclusion of a time limit may be helpful in preventing the possibility of abuse outlined in paragraph 45 above. In bilateral negotiations, individual countries may find it appropriate to include a limit on the length of time for which an individual may provide services in the host State after which reliefs granted by the suggested provision would no longer apply.

49. In looking at the characteristics of the contributions, paragraph 1 provides a number of tests. It makes it clear that the provision applies only to contributions made by or on behalf of 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 subparagraph 2 *b*) of the suggested provision; that phrase is unrelated to the definition of the term "recognised pension fund" in subparagraph *i*) of paragraph 1 of Article 3 and therefore applies whether or not the pension scheme constitutes a "recognised pension fund". The phrase "made by or on behalf of" is intended to apply to contributions that are made directly by the individual as well as to those that are made for that individual's benefit by an employer or another party (e.g. a spouse). Whilst paragraph 4 of Article 24 ensures that the employer's contributions to a pension fund resident of the other Contracting State (whether or not because it constitutes a "recognised pension fund") are deductible under the same conditions as contributions to a resident pension fund, that provision may not be sufficient to ensure the similar treatment of employer's contributions to domestic and foreign pension funds. This will be the case, for example, where the employer's contributions to the foreign fund are treated as a taxable benefit in the hands of the employee or where the deduction of the employer's contributions is not dependent on the fund being a resident but, rather, on other conditions (e.g. registration with tax authorities or the presence of offices) which have the effect of generally excluding foreign pension funds. For these reasons, employer's contributions are covered by the suggested provision even though paragraph 4 of Article 24 may already ensure a similar relief in some cases.

50. 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 individual 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 individual 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.

51. However, it would not be in accordance with the stated aim of securing, as far as possible, equivalent tax treatment of contributions to foreign schemes 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 individuals 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.

52. 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 specify expressly to which existing schemes the provision will apply or 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.

53. The contributions covered by the provision are limited to payments to schemes in which the individual was participating before beginning to provide services in the host State. This means that contributions to new pension schemes which an individual joins while in the host State are excluded from the suggested provision.

54. 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; this could be done by adding the following subparagraph to paragraph 2 of the suggested provision:

c) a pension scheme that is substituted for, but is substantially similar to, a pension scheme accepted by the competent authority of a Contracting State under subparagraph *b)* of paragraph 1 shall be deemed to be the pension scheme that was so accepted.

55. Paragraph 1 also sets out the relief to be given by the host State if the characteristics of the individual and the contributions fall within the terms of the provision. In brief, the contributions must be treated for tax purposes in a way which corresponds to the manner in which they would be treated if these contributions were to a scheme established in the host State. Thus, the contributions will qualify for the same tax relief (e.g. be deductible), for both the individual and the employer (where the individual is employed and contributions are made by the employer) as if these contributions had been made to a scheme in the host State. Also, the same treatment has to be given as regards the taxation of an employee on the employment benefit derived from an employer's contribution to either a foreign or a local scheme (see paragraph 58 below).

56. This measure of relief does not, of course, necessarily secure equivalent tax treatment given to contributions paid when an individual is working abroad and contributions paid when he is working in the home country. Similar considerations apply here to those discussed in paragraphs 50 and 51 above. The measure does,

however, ensure equivalent treatment of the contributions of co-workers. The following example is considered. The home country allows relief for pension contributions subject to a limit of 18 per cent of income. The host country allows relief subject to a limit of 20 per cent. The suggested provision in paragraph 37 would require the host country to allow relief up to its domestic limit of 20 per cent. Countries wishing to adopt the limit in the home country would need to amend the wording of the provision appropriately.

57. 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. in the case of an individual, only employment or business income or all income) or as a tax credit.

58. For an individual who participates in an occupational pension scheme, being assigned to work abroad may not only mean that this 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. Since it applies to both employees' and employers' contributions, the suggested provision ensures that employers' contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.

59. Subparagraph 2 *a)* defines a pension scheme for the purposes of paragraph 1. 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 services provided in the host State. All the above conditions must apply to the pension scheme before it can qualify for relief under the suggested provision.

60. Subparagraph 2 *a)* 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.

61. 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 (whether social security, occupational or individual retirement schemes) may take in different member countries.

62. Although subparagraph 2 *a*) sets out that participation in this scheme has to be by the individual who provides services referred to in paragraph 1 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

pension for other beneficiaries (e.g. surviving spouses, companions or children) may be eligible for relief under the suggested provision.

63. 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. Social security schemes are therefore covered by the provision to the extent that contributions to such schemes can be considered to be with respect to the services provided in the host State by an individual, whether as an employee or in an independent capacity.

64. Subparagraph 2 *b)* 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 individual were resident in his home State, it is right to limit the scope of the provision to contributions which would have qualified for relief if the individual 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. As already explained in paragraph 49 above, whether or not a pension scheme is recognised for tax purposes is unrelated to the question of whether the pension scheme constitutes a "recognised pension fund" under the definition of that term in subparagraph *i*) of paragraph 1 of Article 3.

65. 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. They may also wish to define other terms used in the provision, such as "renders services" and "provides services".

Tax obstacles to the portability of pension rights

66. Another issue, which also relates to international labour mobility, is that of the tax consequences that may arise from the transfer of pension rights from a pension scheme established in one Contracting State to another scheme located in the other Contracting State. When an individual moves from one employer to another, it is frequent for the pension rights that this individual accumulated in the pension scheme covering the first employment to be transferred to a different scheme covering the second employment. Similar arrangements may exist to allow for the portability of pension rights to or from an individual retirement scheme.

67. Such transfers usually give rise to a payment representing the actuarial value, at the time of the transfer, of the pension rights of the individual or representing the value of the contributions and earnings that have accumulated in the scheme with respect to the individual. These payments may be made directly from the first scheme to the second one; alternatively, they may be made by requiring the individual to

contribute to the new pension scheme all or part of the amount received upon withdrawing from the previous scheme. In both cases, it is frequent for tax systems to allow such transfers, when they are purely domestic, to take place on a tax-free basis.

68. Problems may arise, however, where the transfer is made from a pension scheme located in one Contracting State to a scheme located in the other State. In such a case, the Contracting State where the individual resides may consider that the payment arising upon the transfer is a taxable benefit. A similar problem arises when the payment is made from a scheme established in a State to which the relevant tax convention gives source taxing rights on pension payments arising therefrom as that State may want to apply that taxing right to any benefit derived from the scheme. Contracting States that wish to address that issue are free to include a provision drafted along the following lines:

> Where pension rights or amounts have accumulated in a pension scheme established in and recognised for tax purposes in one Contracting State for the benefit of an individual who is a resident of the other Contracting State, any transfer of these rights or amounts to a pension scheme established in and recognised for tax purposes in that other State shall, in each State, be treated for tax purposes in the same way and subject to the same conditions and limitations as if it had been made from one pension scheme established in and recognised for tax purposes in that State to another pension scheme established in and recognised for tax purposes in the same State.

The above provision could be modified to also cover transfers to or from pensions funds established and recognised in third States (this, however, could raise similar concerns as those described in the preamble of paragraph 38 above).

Exemption of the income of a pension fund

69. Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:

> Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall be exempt from tax in that State.

As explained in paragraphs 10.7 and 10.8 of the Commentary on Article 3, States may prefer to simply refer to the income of a "recognised pension fund" when drafting such a provision.

Observations on the Commentary

70. With regard to paragraphs 24 and 26, the *Netherlands* is of the opinion that social security payments can in some circumstances fall within Article 15 if they are paid whilst the employment still continues.

71. Regarding paragraph 24, *Germany* considers that where the amount of a social security pension is determined on the basis of contributions to the scheme by the employee, that pension cannot be viewed as being covered by Article 18.

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.

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, subparagraph *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 subparagraph *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 (see Article 28) but deals with cases not covered by such rules.

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.

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).

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 subparagraph *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 subparagraph *b)* of paragraph 1 is incorporated also in subparagraph *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 only prerequisite for the receiving State's power to tax the pension is that the pensioner must be one of its own residents and nationals.

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.

5.1 Whilst the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration", which were added to paragraph 2 in 2005, are broad enough to cover non-periodic payments. For example, a lump-sum payment in lieu of periodic pension payments that is made to a former State employee after cessation of employment may fall within paragraph 2 of the Article. Whether a particular lump-sum payment made in these circumstances is to be considered as other remuneration similar to a pension falling under paragraph 2 or as final remuneration for work performed falling under paragraph 1 is a question of fact which can be resolved in light of the factors presented in paragraph 5 of the Commentary on Article 18.

5.2 It should be noted that the expression "out of funds created by" in subparagraph *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 a government body. In addition, the original capital of the fund would not need to be provided by the State, a political subdivision or a local authority. The phrase would cover payments from a privately administered fund established for the government body.

5.3 An issue arises where pensions are paid for combined private and government services. This issue may frequently arise where a person has been employed in both the private and public sector and receives one pension in respect of both periods of employment. This may occur either because the person participated in the same scheme throughout the employment or because the person's pension rights were portable. A trend towards greater mobility between private and public sectors may increase the significance of this issue.

5.4 Where a civil servant having rendered services to a State has transferred a right to a pension from a public scheme to a private scheme the pension payments would be taxed only under Article 18 because such payment would not meet the technical requirement of subparagraph 2 *a)*.

5.5 Where the transfer is made in the opposite direction and the pension rights are transferred from a private scheme to a public scheme, some States tax the whole pension payments under Article 19. Other States, however, apportion the pension payments based on the relative source of the pension entitlement so that part is taxed under Article 18 and another part under Article 18. In so doing, some States consider that if one source has provided by far the principal amount of the pension, then the pension should be treated as having been paid exclusively from that source. Nevertheless, it is recognised that apportionment often raises significant administrative difficulties.

5.6 Contracting States may be concerned about the revenue loss or the possibility of double non-taxation if the treatment of pensions could be changed by transferring the fund between public and private schemes. Apportionment may counter this; however, to enable apportionment to be applied to pensions rights that are transferred from a public scheme to a private scheme, Contracting States may, in bilateral negotiations, consider extending subparagraph 2 *a)* to cover the part of any pension or other similar remuneration that it is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof. Such a provision could be drafted as follows:

2. *a)* Notwithstanding the provisions of paragraph 1, the part of any pension or other similar remuneration that is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that Contracting State.

Alternatively Contracting States may address the concern by subjecting all pensions to a common treatment.

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, pensions or other similar remuneration. 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 entertainers and sportspersons, 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, pensions, and other similar remuneration paid by such bodies, even if they could be said to be performing business activities.

Observation on the Commentary

7. The *Netherlands* does not adhere to the interpretation in paragraphs 5.4 and 5.6. Apportionment of pension payments on the base of the relative source of the pension entitlements, private or government employment, is in the Netherlands view also possible if pension rights are transferred from a public pension scheme to a private scheme.

Reservations on the Article

8. *Germany* reserves the right to include a provision that covers services rendered to special private law institutions serving public purposes and financed from public budgets, e.g. the Goethe Institute or the German Academic Exchange Service, as well as remuneration paid to a specialist or volunteer seconded to the other Contracting State under a development assistance program, as government services under Article 19.

9. The *United States* reserves the right to modify the text to indicate that its application is not limited by Article 1.

10. [Deleted]

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.

12. [Deleted]

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 entertainers and sportspersons 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.

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.

3. The Article covers only payments received for the purpose of the recipient's maintenance, education or training. It does not, therefore, apply to a payment, or any part thereof, that is remuneration for services rendered by the recipient and which is covered by Article 15 (or by Article 7 in the case of independent services). Where the recipient's training involves work experience, however, there is a need to distinguish between a payment for services and a payment for the recipient's maintenance, education or training. The fact that the amount paid is similar to that paid to persons who provide similar services and are not students or business apprentices would generally indicate that the payment is a remuneration for services. Also, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient's maintenance, education or training.

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

Reservations on the Article

5. *Estonia* and *Latvia* reserve the right to amend the Article to refer to any apprentice or trainee.

6. *Japan* reserves the right to limit the exemption for a business apprentice under the Article to a period of one year.

7. The *United States* reserves its right to provide a limited exemption from tax for income from personal services earned by students and business trainees, and a definition of "business trainee".

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. Where, for instance, a person who would be a resident of two Contracting States under the provisions of paragraph 1 of Article 4 is deemed to be a resident of only one of these States pursuant to the provisions of paragraph 2 or 3 of that Article, this Article will prevent the other State from taxing the person on income arising in third states even if the person is resident of this other State for domestic law purposes (see also paragraph 8.2 of the Commentary on Article 4 as regards the effect of paragraphs 2 and 3 of Article 4 for purposes of the conventions concluded between this other State and 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. 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 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 (see 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 cases not dealt with in the previous Articles of the Convention 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 (see paragraph 9 of the Commentary on these Articles). Articles 23 A and 23 B.

5.1 For the purposes of the paragraph, a right or property in respect of which income is paid will be effectively connected with a permanent establishment if the "economic" ownership of that right or property is allocated to that permanent establishment under the principles developed in the Committee's report entitled *Attribution of Profits to Permanent Establishments*[1] (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of a right or property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to the income attributable to the ownership of the right or property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that right or property).

5.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether a right or property is effectively connected with the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that right or property is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165 to 170 of Part IV). That guidance being general in nature, tax authorities should consider applying a flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that are effectively connected with the permanent establishment.

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

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. Apart from the fact that paragraph 9 of Article 29 would deny the benefits of Article 23 A in the case of arrangements undertaken for that purpose, it is important to note that the requirement that such assets be "effectively connected" with such a permanent establishment requires more than merely recording these assets in the books of the permanent establishment for accounting purposes (see paragraphs 5.1 and 5.2 above).

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.

The inclusion of this additional paragraph should carry no implication about the treatment of innovative financial transactions between independent persons or under other provisions of the Convention.

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 to 34 of the Commentary on Article 11 apply to this paragraph as well.

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 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 on Article 11).

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 to 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.

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).

12. [Deleted]

Reservations on the Article

13. *Australia*, *Canada*, *Chile*, *Mexico*, *New Zealand* and the *Slovak Republic* reserve their positions on this Article and would wish to maintain the right to tax income arising from sources in their own country.

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.

15. The *United Kingdom* wishes to maintain the right to tax income paid by its residents to non-residents in the form of income from a trust or from estates of deceased persons in the course of administration.

16. *Japan* reserves the right to tax income from a certain contract arrangement, which gives rise to a deduction for the purpose of determining the taxable income of the payer in the Contracting State of which the payer is a resident.

17. The *United States* reserves the right to provide for exemption in both States of child support payments.

18. The *United States* reserves its right to tax in accordance with its domestic law guarantee fees characterised as other income paid by an "expatriated entity" to a connected person for up to a period of ten years.

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).

3.1 For the purposes of paragraph 2, property will form part of the business property of a permanent establishment if the "economic" ownership of the property is allocated to that permanent establishment under the principles developed in the Committee's report entitled *Attribution of Profits to Permanent Establishments*[1] (see in particular paragraphs 72 to 97 of Part I of the report) for the purposes of the application of paragraph 2 of Article 7. In the context of that paragraph, the "economic" ownership of property means the equivalent of ownership for income tax purposes by a separate enterprise, with the attendant benefits and burdens (e.g. the right to any income attributable to the ownership of that property, the right to any available depreciation and the potential exposure to gains or losses from the appreciation or depreciation of that property). The mere fact that the property has been recorded, for accounting purposes, on a balance sheet prepared for the permanent establishment will therefore not be sufficient to conclude that it is effectively connected with that permanent establishment.

3.2 In the case of the permanent establishment of an enterprise carrying on insurance activities, the determination of whether property will form part of the business property of the permanent establishment shall be made by giving due regard to the guidance set forth in Part IV of the Committee's report with respect to whether the income on or gain from that property is taken into account in determining the permanent establishment's yield on the amount of investment assets attributed to it (see in particular paragraphs 165 to 170 of Part IV). That guidance being general in nature, tax authorities should consider applying a

1 *Attribution of Profits to Permanent Establishments*, OECD, Paris, 2010.

flexible and pragmatic approach which would take into account an enterprise's reasonable and consistent application of that guidance for purposes of identifying the specific assets that form part of the business property of the permanent establishment.

4. Normally, ships and aircraft operated in international traffic and movable property pertaining to the operation of such ships or aircraft shall be taxable only in the State of residence (paragraph 3). This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 13. Contracting States which would prefer to confer the exclusive taxing right on the State in which the place of effective management of the enterprise is situated are free in bilateral conventions to substitute for paragraph 3 a provision corresponding to that proposed in paragraph 2 of the Commentary on Article 8. Immovable property pertaining to the operation of ships or aircraft may be taxed in the State in which they are situated in accordance with the rule laid down in paragraph 1.

4.1 Paragraph 3 applies where the enterprise that owns the property operates itself the ships or aircraft referred to in the paragraph, whether for its own transportation activities or when leasing the ships or aircraft on charter fully equipped, manned and supplied. It does not apply, however, where the enterprise owning the ships or aircraft does not operate them (for example, where the enterprise leases the property to another person, other than in the case of an occasional bare boat lease as referred to in paragraph 5 of the Commentary on Article 8). In such a case, the capital will be covered by paragraph 2 or 4.

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.

8. [Renumbered and amended]

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.

10. *New Zealand*, *Portugal* and *Turkey* reserve their positions on this Article if and when they impose taxes on capital.

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 resident of France, or of shares or rights of companies the assets of which consist mainly of immovable property situated in France.

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).

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.

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.

COMMENTARY ON ARTICLES 23 A AND 23 B CONCERNING THE METHODS FOR ELIMINATION OF DOUBLE TAXATION

I. 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, see 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 (see 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, see paragraph 11 below).

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 providing special rules 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).

4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case *a)* may therefore not be solved if the same item of income is subject

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.

to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.

4.2 The conflict in that situation will be reduced to that of case *b)* and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that that State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).

4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation and, as confirmed by the phrase "except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State" found in paragraph 1 of Articles 23 A and 23 B, any resulting double taxation will be outside the scope of these Articles. The mutual agreement procedure provided for in paragraph 3 of Article 25 could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States.

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.

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 Article 19[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.

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 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 1 of Article 7 and 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 (see also paragraph 5 of the Commentary on Article 21). However, where the Contracting States agree to give to State R a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of Article 10 or 11, 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.

9.1 Where, however, State R applies the exemption method, 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, State R, being the State of source of the dividends or interest, could tax such dividends or interest at the

1 See the first sentence of paragraph 1 of Article 7, paragraph 1 of Article 8, paragraph 1 of Article 12, paragraphs 3 and 5 of Article 13, the first sentence of paragraph 1 as well as paragraphs 2 and 3 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 See subparagraph *a)* of paragraphs 1 and 2 of Article 19.

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 notwithstanding the fact that it applies the exemption method. The State where the permanent establishment is situated would give a credit for such tax along the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit would 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.

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 1 of Article 7 and 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 3 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 (see paragraphs 67 to 72 of the Commentary on Article 24).

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 (see also paragraph 10 above).

11.1 In some cases, the same income or capital may be taxed by each Contracting State as income or capital of one of its residents. This may happen where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income. The phrase "(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State)" clarifies that in such cases, both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer and that each State is therefore only obliged to provide relief of double taxation to the extent that taxation by the other State is in accordance with provisions of the Convention that allow taxation of the relevant income or capital as the State of source or as a State where there is a permanent establishment to which that income or capital is attributable, thereby excluding taxation that would solely be the result of the residence of a person in that other State. Whilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect.

11.2 The principles put forward in the preceding paragraph are illustrated by the following examples:

— Example A: An entity established in State R constitutes a resident of State R and is therefore taxed on its worldwide income in that State. State S treats that entity as fiscally transparent and taxes the members of the entity on their respective share of the income derived through the entity. All the members of the entity are residents of State S. All the income of the entity constitutes business profits attributable to a permanent establishment situated in State R. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S, on the other hand, will be required to provide relief under Article 23 A or 23 B with respect to the entire income of the entity as that income may be taxed in State R in accordance with the provisions of Article 7 regardless of the fact that State R considers that the income is derived by an entity resident of State R. In determining the amount of income tax paid in State R for the purposes of providing relief from double taxation to the members of the entity under Article 23 B, State S will need to take account of the tax paid by the entity in State R.

— Example B: Same facts as in example A except that 30 per cent of the income derived through the entity is interest arising in State S that is attributable to a permanent establishment in State R, the rest of the income being business profits attributable to the same permanent establishment. In that case, relief of double taxation with respect to the business profits other than the interest will be provided as described in example A. In the case of the interest, however, State R will be required to provide a credit to the entity under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State S by all the members of the entity without exceeding the lower of 10 per cent the gross amount of interest (which is the maximum amount of tax that may be paid in State S in accordance with paragraph 2 of Article 11) or the tax payable in State R on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, on the other hand, will also be required to provide relief under Article 23 A or 23 B to the members of the entity that are residents in State S because that income may be taxed by State R in accordance with the provisions of paragraph 1 of Article 7. If State S applies the exemption method of Article 23 A, that suggests that State S will need to exempt the share of the interest attributable to the members that are residents of State S (see paragraph 5 of the Commentary on Article 21 and paragraph 9 of the Commentary on Articles 23 A and 23 B). If State S applies the credit method of Article 23 B, the credit should only be applicable against the part of the tax payable in State S that exceeds the amount of tax that State S would be entitled to levy under paragraph 2 of Article 11 and that credit should be given for the

amount of tax paid in State R after deduction of the credit that State R itself must grant for the tax payable in State S under paragraph 2 of Article 11.

— Example C: Same facts as in example A except that all the income of the entity is derived from immovable property situated in State S. In that case, in determining the tax payable by the entity, State R will be required to provide relief under Article 23 A or 23 B with respect to the entire income of the entity as that income may be taxed in State S in accordance with the provisions of Article 6 regardless of the fact that State S considers that the income is derived by the members who are residents of State S. State S, on the other hand, is not required to provide relief under Articles 23 A and 23 B because the only reason why State R may tax the income in accordance with the provisions of the Convention is because of the residence of the entity (the result would be the same even if the income were attributable to a permanent establishment situated in State R: see the first sentence of paragraph 9 of the Commentary on Articles 23 A and 23 B).

— Example D: Same facts as in example A except that all the income of the entity is interest arising in State S which is not attributable to a permanent establishment. In that case, in determining the tax payable by the entity, State R will be required to provide a credit to the entity under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State S by all the members of the entity without exceeding the lower of 10 per cent of the gross amount of the interest (which is the maximum amount of tax that may be paid in State S in accordance with paragraph 2 of Article 11) or the tax payable in State R on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, on the other hand, will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity since that income does not arise in State R and is not attributable to a permanent establishment in State R and the only reason why State R may tax the income is because the income is also income derived by a resident of State R. Paragraph 1 of Article 11 confirms State R's taxing right in respect of the interest as income derived by an entity resident of State R.

— Example E: Same facts as in example D except that all the income of the entity is interest arising in State R. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S, on the other hand, will be required to provide a credit to the members under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State R by the entity without exceeding the lower of 10 per cent of the gross amount of the interest (which is the maximum amount of tax that may be paid in State R in accordance with paragraph 2 of Article 11) or the tax payable in State S on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, however, will not be obliged to provide relief under Article 23 A or 23 B with respect to tax paid in State R in excess of the maximum amount of tax that

may be paid in accordance with paragraph 2 of Article 11 since the interest is not attributable to a permanent establishment in State R and the only reason why State R may levy such additional tax is because the income is also income derived by a resident of State R. Paragraph 1 of Article 21 confirms State R's right to tax the interest as income derived by an entity resident of State R.

— Example F: Same facts as in example D except that all the income of the entity is interest arising in a third State. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S will also not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity since that income does not arise in State R and is not attributable to a permanent establishment in State R and the only reason why State R may tax the income is because the income is also income derived by a resident of State R. Paragraph 1 of Article 21 confirms State R's right to tax the interest as income derived by an entity resident of State R. Paragraph 1 of Article 21 also confirms State S' taxing right in respect of the interest as income derived by the entity's members who are residents of State S.

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; see 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".

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; see 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 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 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 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.

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)[a]	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

a 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*)[a]	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

a Numbers in brackets refer to paragraphs in this Commentary.

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 (adjustments to paragraphs 1 and 2 of Article 23 A may, however, be required in the case of distributions from Real Estate Investment Trusts (REITs) where provisions similar to those referred to in paragraphs 67.1 to 67.7 of the Commentary on Article 10 have been adopted by the Contracting States). 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.

31.1 One example where paragraph 2 could be so amended is where a State that generally adopts the exemption method considers that that method should not apply to items of income that benefit from a preferential tax treatment in the other State by reason of a tax measure that has been introduced in that State after the date of signature of the Convention. In order to include these items of income, paragraph 2 could be amended as follows:

2. Where a resident of a Contracting State derives an item of income which

a) may be taxed in the other Contracting State in accordance with the provisions of Articles 10 and 11, (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State), or

b) may be taxed in the other Contracting State in accordance with the provisions of this Convention (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State) but which benefits from a preferential tax treatment in that other State by reason of a tax measure

(i) that has been introduced in the other Contracting State after the date of signature of the Convention, and

(ii) in respect of which that State has notified the competent authorities of the other Contracting State, before the item of income is so derived and after consultation with that other State, that this paragraph shall apply,

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 item of income derived from that other State.

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.

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.

32.2 The interpretation of the phrase "may be taxed in the other Contracting State in accordance with the provisions of this Convention", 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 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 5 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 business but State R considers that paragraph 5 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 had the right to tax, 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 have the right 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 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 5 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 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 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.

F. Timing mismatch

32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23 A or 23 B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year.

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.

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 (see 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 (see 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 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 (see 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, see 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 (see paragraph 31 above).

36. It should also be noted that, as explained in paragraphs 11.1 and 11.2 above, Article 23 A does not oblige a Contracting State to exempt income or capital where the only reason why the other Contracting State may tax that income or capital in accordance with the provisions of the Convention is because that other State attributes that income or capital to a resident of that other State.

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 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. (see, however, 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 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. 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 (see 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 (see 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).

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 (see 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 (see 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 undistributed 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 (see 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.

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 (see 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.

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.

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 or 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 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 subparagraph *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 23 A).

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 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 (see 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 paragraph 3 of the said Article, and reference was made to exemption "in accordance with any provision of the Convention".

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.

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 (see 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 applies 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.

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 (see 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 (see also paragraph 63 below).

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 which according to subparagraph *a*) of paragraphs 1 and 2 of Article 19 "shall be taxable only" in the other State are from the outset exempt from tax in State R (see paragraph 6 above), and the Commentary on Article 23 A applies to such exempted income. As regards progression, reference is made to paragraph 2 of the Article (and paragraph 79 below).

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 (excluding the amount of tax paid in that other State solely because the income or capital is also income derived by a resident of that State or capital owned by a resident of that 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 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 (see 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 (see paragraph 40 above). For such reason, the maximum deduction in many cases may be lower than the tax effectively paid in State E (or S). This may especially be true in the case where, for instance, a resident of State R deriving interest from State S has borrowed funds from a third person to finance the interest-producing loan. As the interest due on such borrowed money may be offset against the interest derived from State S, the amount of net income subject to tax in State R may be very small, or there may even be no net income at all. As explained in

paragraph 7.1 of the Commentary on Article 11, the problem, in that case, cannot be solved by State R, since little or no tax will be levied in that State. One solution would be to exempt such interest from tax in State S, as is proposed in paragraphs 7 to 7.12 of the Commentary on Article 11.

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 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);

— the inclusion of such "interest" in the taxable profits of the lender company.

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.

69. As regards dividends from a substantial holding by a company, reference is made to paragraphs 49 to 54 above.

69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State where a partnership is established treats that partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of the partnership 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 of the partner, however, will only tax the partner on his share of the partnership's income when that income is realised by the partnership.

69.2 The first issue that arises in this case is whether the State of residence of the partner, 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 on the partnership in the State of 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 income may be taxed by the State of the partnership in accordance with the provisions of the

Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable (see also paragraphs 11.1 and 11.2 above). To the extent that the State of residence of the partner flows through the income of the partnership to the partner for the purpose of taxing that partner, it must adopt a coherent approach and flow through to the partner the tax paid by the partnership (but only to the extent that such tax is paid in accordance with the provisions of the Convention that allow source taxation) 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 of the partner must provide credit for the tax levied by the State of the partnership 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 of the partner, there is simply no tax in that State against which to credit the tax levied by the State of the partnership 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 of the partner should not be expected to credit the tax levied by the State of the partnership upon the distribution against its own tax levied upon generation (see the first sentence of paragraph 64 above).

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.

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.

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 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.

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.

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 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 State of source.

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

— general concerns with the way in which tax sparing may encourage States to use tax incentives.

1 Reproduced in Volume II of the full version of the OECD Model Tax Convention at page R(14)-1.

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.

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.

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.

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.

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.

Observations on the Commentary

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 Netherland's 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 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.

81. *Switzerland* reserves its right not to apply the rules laid down in paragraph 32.3 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.

82. The *United States* does not agree with the final sentence of paragraph 11.1 of the Commentary.

Reservations on the Article

83. Consistent with its reservations on paragraphs 2 and 3 of Article 1, *France* reserves the right not to include in paragraph 1 of Articles 23 A and 23 B the modifications provided by the 2017 update of the Model Tax Convention relative to the elimination of double taxation in the presence of a fiscally transparent entity.

84. *Luxembourg* reserves the right not to include in paragraph 1 the modifications provided by the 2017 update of the Model Tax Convention.

85. The *United States* reserves its right not to include in paragraph 1 the parenthetical phrase "(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State)". Furthermore, the United

States wishes to express the opinion that paragraph 1, which has been added to address so-called "economic double taxation" is inconsistent with paragraphs 1 and 2 of the Commentary, which explain that Article 23 deals only with so called "juridical double taxation".

COMMENTARY ON ARTICLE 24
CONCERNING NON-DISCRIMINATION

General remarks

1. This Article deals with the elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay. The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called "indirect" discrimination. For example, whilst paragraph 1, which deals with discrimination on the basis of nationality, would prevent a different treatment that is really a disguised form of discrimination based on nationality such as a different treatment of individuals based on whether or not they hold, or are entitled to, a passport issued by the State, it could not be argued that non-residents of a given State include primarily persons who are not nationals of that State to conclude that a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph.

2. Likewise, the provisions of the Article cannot be interpreted as to require most-favoured-nation treatment. Where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State(s) party to that agreement, nationals or residents of a third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention between the third State and the first-mentioned State. As tax conventions are based on the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of the specific economic relationship between those Contracting States may not be extended to a resident or national of a third State under the non-discrimination provision of the tax convention between the first State and the third State.

3. The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. "in the same circumstances" in paragraphs 1 and 2; "carrying on the same activities" in paragraph 3; "similar enterprises" in paragraph 5). Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents (see, for example, paragraph 34 below).

4. Finally, as illustrated by paragraph 79 below, the provisions of the Article must be read in the context of the other Articles of the Convention so that measures that are mandated or expressly authorised by the provisions of these Articles cannot be considered to violate the provisions of the Article even if they only apply, for example, as regards payments to non-residents. Conversely, however, the fact that a particular measure does not constitute a violation of the provisions of the Article does not mean that it is authorised by the Convention since that measure could violate other Articles of the Convention.

Paragraph 1

5. 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.

6. 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.

7. 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 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.

8. 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.

9. The expression "in the same circumstances" can in some cases refer to a person's tax situation. This would be the case, for example, where a country would subject its nationals, or some of them, to a more comprehensive tax liability than non-nationals (this, for example, is a feature of the United States tax system). As long as such treatment is not itself a violation of paragraph 1, it could not be argued that persons who are not nationals of that State are in the same circumstances as its nationals for the purposes of the application of the other provisions of the domestic tax law of that State with respect to which the comprehensive or limited liability to tax of a taxpayer would be relevant (e.g. the granting of personal allowances).

10. 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.

11. 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.

12. 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.

13. 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.

14. 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 in accordance with Article 7, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

15. 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 formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.

16. 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 subparagraph *g)* of paragraph 1 of Article 3.

17. By virtue of that definition, in the case of a legal person such as a company, "national of a Contracting State" means a legal person "deriving its status as such from the laws in force in that Contracting State". A company will usually derive its status as such from the laws in force in the State in which it has been incorporated or registered. Under the domestic law of many countries, however, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for the purposes of Article 4. Since paragraph 1 of Article 24 prevents different treatment based on nationality but only with respect to persons or entities "in the same circumstances, in particular with respect to residence", it is therefore important to distinguish, for purposes of that paragraph, a different treatment that is solely based on nationality from a different treatment that relates to other circumstances and, in particular, residence. As explained in paragraphs 7 and 8 above,

paragraph 1 only prohibits discrimination based on a different nationality and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of domestic tax systems and of tax treaties; when Article 24 is read in the context of the other Articles of the Convention, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same State for purposes of the Convention (under the rules of Article 4) are usually not in the same circumstances for purposes of paragraph 1.

18. Whilst residents and non-residents are usually not in the same circumstances for the purposes of paragraph 1, it is clear, however, that this is not the case where residence has no relevance whatsoever with respect to the different treatment under consideration.

19. The following examples illustrate these principles.

20. Example 1: Under the domestic income tax law of State A, companies incorporated in that State or having their place of effective management in that State are residents thereof. Under the domestic income tax law of State B, only companies that have their place of effective management in that State are residents thereof. The State A - State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Since a company incorporated in State B that would have its place of effective management in State A would be a resident of State A for purposes of the State A - State B Convention, the fact that dividends paid to such a company by a company incorporated in State A would not be eligible for this exemption, even though the recipient company is in the same circumstances as a company incorporated in State A with respect to its residence, would constitute a breach of paragraph 1 absent other relevant different circumstances.

21. Example 2: Under the domestic income tax law of State A, companies incorporated in that State are residents thereof and companies incorporated abroad are non-residents. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Paragraph 1 does not extend that treatment to dividends paid to a company incorporated in State B. Even if a company incorporated in State A and a company incorporated in State B that receive such dividends are treated differently, these companies are not in the same circumstances with regards to their residence and residence is a relevant factor in this case (as can be concluded, for example, from paragraph 5 of Article 10, which would prevent the subsequent taxation of dividends paid by a non-resident company but not those paid by a resident company).

22. Example 3: Under the domestic income tax law of State A, companies that are incorporated in that State are residents thereof. Under the domestic tax law of State B, companies that have their place of effective management in that State are residents thereof. The State A - State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that a non-resident company that is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information is subject to an annual tax equal to 3 per cent of the value of its immovable property instead of a tax on the net income derived from that property. A company incorporated in State B but which is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information cannot claim that paragraph 1 prevents the application of the 3 per cent tax levied by State A because it is treated differently from a company incorporated in State A. In that case, such a company would not be in the same circumstances, with respect to its residence, as a company incorporated in State A and the residence of the company would be relevant (e.g. for purposes of accessing the information necessary to verify the net income from immovable property derived by a non-resident taxpayer).

23. Example 4: Under the domestic income tax law of State A, companies incorporated in that State are residents of State A and companies incorporated abroad are non-residents. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. Under State A's payroll tax law, all companies that employ resident employees are subject to a payroll tax that does not make any distinction based on the residence of the employer but that provides that only companies incorporated in State A shall benefit from a lower rate of payroll tax. In that case, the fact that a company incorporated in State B will not have the same residence as a company incorporated in State A for the purposes of the A-B convention has no relevance at all with respect to the different tax treatment under the payroll tax and that different treatment would therefore be in violation of paragraph 1 absent other relevant different circumstances.

24. Example 5: Under the domestic income tax law of State A, companies incorporated in that State or which have their place of effective management in that State are residents of the State and companies that do not meet one of these two conditions are non-residents. Under the domestic income tax law of State B, companies incorporated in that State are residents of that State. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident only of the State in which it has been incorporated. The domestic tax law of State A further provides that companies that have been incorporated and that have their place of effective management in that State are entitled to consolidate their income for tax purposes if they are part of a group of companies that have common shareholders. Company X, which was incorporated in State B, belongs to the same group as two companies

incorporated in State A and all these companies are effectively managed in State A. Since it was not incorporated in State A, company X is not allowed to consolidate its income with that of the two other companies.

25. In that case, even if company X is a resident of State A under the domestic law of that State, it is not a resident of State A for purposes of the Convention by virtue of paragraph 3 of Article 4. It will therefore not be in the same circumstances as the other companies of the group as regards residence and paragraph 1 will not allow it to obtain the benefits of consolidation even if the different treatment results from the fact that company X has not been incorporated in State A. The residence of company X is clearly relevant with respect to the benefits of consolidation since certain provisions of the Convention, such as Articles 7 and 10, would prevent State A from taxing certain types of income derived by company X.

Paragraph 2

26. 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.

27. 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.

28. 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.

29. 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.

30. 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.

31. Some States may consider that the provisions of paragraph 2 are too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. States wishing to avoid this latter consequence are free to modify paragraph 2 as follows:

Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected.

32. 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 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".

Paragraph 3

33. 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.

34. 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. For example, paragraph 3 does not prevent the application of specific mechanisms that apply only for the purposes of determining the profits that are attributable to a permanent establishment. The paragraph must be read in the context of the Convention and, in particular, of paragraph 2 of Article 7 which provides that the profits attributable to the permanent establishment are those that a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions would have been expected to make. Clearly, rules or administrative practices that seek to determine the profits that are attributable to a permanent establishment on the basis required by paragraph 2 of Article 7 cannot be considered to violate paragraph 3, which is based on the same principle since it requires that the

taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities.

35. 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.

36. 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 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.

37. It is also clear that, for purposes of paragraph 3, the tax treatment in one Contracting State of the permanent establishment of an enterprise of the other Contracting State should be compared to that of an enterprise of the first-mentioned State that has a legal structure that is similar to that of the enterprise to which the permanent establishment belongs. Thus, for example, paragraph 3 does not require a State to apply to the profits of the permanent establishment of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.

38. Similarly, regulated and unregulated activities would generally not constitute the "same activities" for the purposes of paragraph 3. Thus, for instance, paragraph 3 would not require that the taxation on a permanent establishment whose activities include the borrowing and lending of money but which is not registered as a bank be not less favourably levied than that of domestic banks since the permanent establishment does not carry on the same activities. Another example would be that of activities carried on by a State or its public bodies, which, since they are controlled by the State, could not be considered, for the purposes of paragraph 3, to be similar to activities that an enterprise of the other State performs through a permanent establishment.

39. 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.

A. Assessment of tax

40. 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. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises (see also paragraphs 33 and 34 of the Commentary on Article 7).

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 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 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 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.

41. As clearly stated in subparagraph *c*) above, the equal treatment principle of paragraph 3 only applies to the taxation of the permanent establishment's own activities. That principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment's own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises. Such rules will often operate to ensure or facilitate tax compliance and administration within a domestic group. It therefore follows that the equal treatment principle has no application. For the same reasons, rules related to the distribution of the profits of a resident enterprise cannot be extended to a permanent establishment under paragraph 3 as they do not relate to the business activities of the permanent establishment (see paragraph 59 below).

42. Also, it is clear that the application of transfer pricing rules based on the arm's length standard in the case of transfers from a permanent establishment to its head office (or vice versa) cannot be considered to be a violation of paragraph 3 even if such rules do not apply to transfers within an enterprise of the Contracting State where the permanent establishment is located. Indeed, the application of the arm's length standard to the determination of the profits attributable to a permanent establishment is mandated by paragraph 2 of Article 7 and that paragraph forms part of the context in which paragraph 3 of Article 24 must be read; also, since Article 9 would authorise the application of the arm's length standard to a transfer between a domestic enterprise and a foreign related enterprise, one cannot consider that its application in the case of a permanent establishment results in less favourable taxation than that levied on an enterprise of the Contracting State where the permanent establishment is located.

43. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, they do not constitute an exhaustive list of the possible consequences of that principle with respect to the determination of the tax base. The application of that principle may be less clear in the case of 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 problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

44. 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.

45. 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.

46. Also, 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.

47. Finally, the provisions of paragraph 3 should not be construed as obliging a State which accords special taxation privileges to non-profit institutions whose activities are performed for purposes of public benefit that are specific to that State, to extend the same privileges to permanent establishments of similar institutions of the other State whose activities are not exclusively for the first-mentioned State's public benefit.

B. *Special treatment of dividends received in respect of holdings owned by permanent establishments*

48. 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 permanent establishments in respect of dividends on holdings forming part of their assets.

49. 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.

50. 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 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.

51. 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.

52. 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 change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

53. 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.

54. 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.

C. Structure and rate of tax

55. 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, some specific issues related to 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.

56. 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 (see paragraphs 55, 56 and 79 of the Commentary on Articles 23 A and 23 B). States that tax their own companies in this

way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

57. 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.

58. However, even if the profits of the whole enterprise to which the permanent establishment belongs are taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the separate and independent 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 establishment is situated is, therefore, the amount which would be due if it were a separate and independent 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.

59. Since a permanent establishment, by its very nature, does not distribute dividends, the tax treatment of distributions made by the enterprise to which the permanent establishment belongs is therefore outside the scope of paragraph 3. Paragraph 3 is restricted to the taxation of the profits from the activities of the permanent establishment itself and does not extend to the taxation of the enterprise as a whole. This is confirmed by the second sentence of the paragraph, which confirms that tax aspects related to the taxpayer that owns the permanent establishment, such as personal allowances and deductions, are outside the scope of the paragraph. Thus, issues related to various systems for the integration of the corporate and shareholder's taxes (e.g. advance corporate tax, *précompte mobilier*, computation of franked income and related dividend tax credits) are outside the scope of the paragraph.

60. In some States, the profits of a permanent establishment of an enterprise of another Contracting State are taxed at a higher rate than the profits of enterprises of that State. This additional tax, sometimes referred to as a "branch tax", may be explained by the fact that if a subsidiary of the foreign enterprise earned the same profits as the permanent establishment and subsequently distributed these profits as a dividend, an additional tax would be levied on these dividends in accordance with paragraph 2 of Article 10. Where such tax is simply expressed as an additional tax

payable on the profits of the permanent establishment, it must be considered as a tax levied on the profits of the activities of the permanent establishment itself and not as a tax on the enterprise in its capacity as owner of the permanent establishment. Such a tax would therefore be contrary to paragraph 3.

61. That situation must, however, be distinguished from that of a tax that would be imposed on amounts deducted, for instance as interest, in computing the profits of a permanent establishment (e.g. "branch level interest tax"); in that case, the tax would not be levied on the permanent establishment itself but, rather, on the enterprise to which the interest is considered to be paid and would therefore be outside the scope of paragraph 3 (depending on the circumstances, however, other provisions, such as those of Articles 7 and 11, may be relevant in determining whether such a tax is allowed by the Convention; see the last sentence of paragraph 4).

D. Withholding tax on dividends, interest and royalties received by a permanent establishment

62. 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 53 above as regards dividends received on holdings of permanent establishment — falls to be included in the taxable profits of such permanent establishments (see paragraph 74 of the Commentary on Article 7).

63. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 (see 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.

64. 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.

65. 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 Article 12 — permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

66. 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.

E. Credit for foreign tax

67. In a related context, when foreign income is included in the profits attributable to a permanent establishment, 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.

68. 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 credit provisions included in tax conventions concluded with third States. Whilst the permanent establishment is not itself a person and is therefore not entitled to the benefits of these tax conventions, this issue is relevant to the taxation on the permanent establishment. This question is examined below in the particular case of dividends and interest.

F. Extension to permanent establishments of the benefit of the credit provisions of double taxation conventions concluded with third States

69. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends or interest 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.

70. 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 or interest from a third State and the holding or debt-claim in respect of which the dividends or interest 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 or interest, 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.

If the convention also provides for other categories of income that may be taxed in the State in which they arise and for which credit should be given (e.g. royalties, in some conventions), the above provision should be amended to also cover these.

71. 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 question that arises with triangular cases is that of abuses. For example, if a Contracting State applies the exemption method of Article 23 A to the profits attributable to a permanent establishment situated in a third State which does not tax passive income that arises in the other Contracting State but that is attributable to such permanent establishment, there is risk that such income might not be taxed in any of the three States. Paragraph 8 of Article 29 addresses this issue.

72. In addition to the typical triangular case considered here, other triangular cases arise, particularly that in which the State of the enterprise is also the State from which the income attributed to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21 and paragraphs 9 and 9.1 of the Commentary on Articles 23 A and 23 B). States can settle these matters in bilateral negotiations.

Paragraph 4

73. 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 non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.

74. Paragraph 4 does not prohibit the country of the borrower from applying 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.

75. Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.

Paragraph 5

76. 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.

77. Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership). For example, if the domestic tax law of one State allows a resident company to consolidate its income with that of a resident parent company, paragraph 5 cannot have the effect to force the State to allow such consolidation between a resident company and a non-resident parent company. This would require comparing the combined treatment of a resident enterprise and the non-resident that owns its capital with that of a resident enterprise of the same State and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone.

78. Also, because paragraph 5 is aimed at ensuring that all resident companies are treated equally regardless of who owns or controls their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way (see paragraph 76 above), it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but

not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently. A similar example would be that of a State that levies a tax on resident companies that make distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. The fact that the latter exemption would not apply to distributions to non-resident companies should not be considered to violate paragraph 5. In that case, it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is restricted to cases where distributions are made in circumstances where the distribution tax could be avoided.

79. Since the paragraph prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise, it would not *prima facie* be relevant with respect to rules that provide for a different treatment of an enterprise based on whether it pays interest to resident or non-resident creditors. The paragraph is not concerned with rules based on a debtor-creditor relationship as long as the different treatment resulting from the rules is not based on whether or not non-residents own or control, wholly or partly, directly or indirectly, the capital of the enterprise. For example, if under a State's domestic thin capitalisation rules, a resident enterprise is not allowed to deduct interest paid to a non-resident associated enterprise, that rule would not be in violation of paragraph 5 even where it would be applied to payments of interest made to a creditor that would own or control the capital of the enterprise, provided that the treatment would be the same if the interest had been paid to a non-resident associated enterprise that did not itself own or control any of the capital of the payer. Clearly, however, such a domestic law rule could be in violation of paragraph 4 to the extent that different conditions would apply for the deduction of interest paid to residents and non-residents and it will therefore be important to determine, for purposes of that paragraph, whether the application of the rule is compatible with the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 (see paragraph 74 above). This would also be important for purposes of paragraph 5 in the case of thin capitalisation rules that would apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents. Indeed, since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the *Vienna Convention on the Law of Treaties*), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.

80. 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.

Paragraph 6

81. 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.

Observation on the Commentary

82. [Deleted]

83. 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.

84. [Deleted]

Reservations on the Article

85. *Canada* and *New Zealand* reserve their positions on this Article.

86. *Australia* reserves the right to propose amendments to ensure that Australia can continue to apply certain provisions of its domestic law relating to withholding tax collection.

87. The *United States* reserves its right to apply its branch tax.

Paragraph 1

88. *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.

89. *Chile* and the *United Kingdom* reserve their position on the second sentence of paragraph 1.

Paragraph 2

90. *Chile*, *Estonia*, *Japan*, *Switzerland* and the *United Sates* reserve the right not to insert paragraph 2 in their conventions.

Paragraph 3

90.1 In view of its particular taxation system, *Chile* retains its freedom of action with regard to the provisions in the Convention relating to the rate and form of distribution of profits by permanent establishments.

Paragraph 4

91. *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 an associated or related company.

Paragraph 6

92. *Chile*, *Greece* and the *United Kingdom* reserve the right to restrict the application of the Article to the taxes covered by the Convention.

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. 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. Article 26 applies to the exchange of information for the purposes of the provisions of this Article. The confidentiality of information exchanged for the purposes of a mutual agreement procedure is thus ensured.

5. Finally, paragraph 5 provides a mechanism that allows a taxpayer to request the arbitration of unresolved issues that have prevented competent authorities from reaching a mutual agreement within two years. Whilst the mutual agreement procedure provides a generally effective and efficient method of resolving disputes arising under the Convention, there may be cases where the competent authorities are unable to agree that the taxation by both States is in accordance with the Convention. The arbitration process provided for under paragraph 5 allows such cases to be resolved by allowing an independent decision of the unresolved issues, thereby allowing a mutual agreement to be reached. This process is an integral part of the mutual agreement procedure and does not constitute an alternative route to solving disputes concerning the application of the Convention.

5.1 The undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith. In particular, the requirement in paragraph 2 that the competent authority "shall endeavour" to resolve the case by mutual agreement with the competent authority of the other Contracting State means that the competent authorities are obliged to seek to resolve the case in a fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law on the interpretation of treaties.

6. Since the Article merely lays down general rules concerning the mutual agreement procedure, the comments below are intended to clarify the purpose of such rules, and also to amplify them, if necessary, by referring, in particular, to the rules and practices 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. In particular, since paragraph 5 expressly requires the competent authorities to agree on the mode of application of the arbitration process that it provides, the comments below discuss in detail various procedural aspects of that process. An Annex to this Commentary contains a sample form of agreement that the competent authorities may use as a basis for settling the mode of application of the arbitration process; that Annex addresses various structural and procedural issues, discusses the various provisions of the sample agreement and, in some cases, puts forward alternatives.

6.1 Through Article 25, the Contracting States have delegated to the competent authorities broad powers concerning the application and interpretation of the provisions of the Convention. Paragraph 2 authorises the competent authorities to resolve by mutual agreement cases presented by taxpayers in order to avoid taxation which could otherwise result from domestic laws but would not be in accordance with the Convention. Paragraph 3 similarly authorises the competent authorities to resolve by mutual agreement difficulties or doubts concerning the interpretation or application of the Convention, both in individual cases (e.g. with respect to a single taxpayer's case) and more generally (e.g. through the joint interpretation of a provision of the treaty applicable to a large number of taxpayers). Under paragraph 3, the competent authorities can, in particular, enter into a mutual agreement to define a term not defined in the Convention, or to complete or clarify the definition of a defined term, where such an agreement would resolve difficulties or doubts arising as to the interpretation or application of the Convention. Such circumstances could arise, for example, where a conflict in meaning under the domestic laws of the two States creates difficulties or leads to an unintended or absurd result. As expressly recognised in paragraph 2 of Article 3, an agreement reached under paragraph 3 concerning the meaning of a term used in the Convention prevails over each State's domestic law meaning of that term.

6.2 More generally, whilst the status under domestic law of a mutual agreement reached pursuant to Article 25 may vary between States, it is clear that the principles of international law for the interpretation of treaties, as embodied in Articles 31 and 32 of the *Vienna Convention on the Law of Treaties*, allow domestic courts to take account of such an agreement. The object of Article 25 is to promote, through consultation and mutual agreement between the competent authorities, the consistent treatment of individual cases and the same interpretation and/or application of the provisions of the Convention in both States. Article 25 also authorises the competent authorities to resolve, by mutual agreement, difficulties or doubts as to the interpretation or application of the Convention; such a mutual agreement, reached pursuant to the express mandate contained in paragraph 3 of the Article, represents objective evidence

of the competent authorities' mutual understanding of the meaning of the Convention and its terms. For these reasons, an agreement reached by the competent authorities under Article 25 must be taken into account for purposes of the interpretation of the Convention.

6.3 In addition, there are some cases where the application of certain treaty provisions has been expressly delegated by the Contracting States to the competent authorities and the agreements reached by the competent authorities in these matters legally govern the application of these provisions. Subparagraph *d*) of paragraph 2 of Article 4, for example, provides that the competent authorities shall resolve by mutual agreement certain cases where an individual is a resident of both Contracting States under paragraph 1 of that Article. Some treaties similarly delegate to the competent authorities the power to determine jointly the status of various entities or arrangements for the purposes of certain treaty provisions (see, for example, subdivision (*i*) of subparagraph *b*) of the suggested provision in paragraph 35 of the Commentary on Article 1) or the power to supplement or modify lists of entities, arrangements or domestic law provisions referred to in these treaties.

II. Commentary on the provisions of the Article

Paragraphs 1 and 2

7. 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 agreed basis, i.e. by agreement between competent authorities, the first stage being conducted exclusively in one of the Contracting States from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter.

8. 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.

9. 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:

— questions relating to the attribution of profits to a permanent establishment under paragraph 2 of Article 7;

— 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).

10. 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.

11. 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.

12. Whilst the mutual agreement procedure has a clear role in dealing with issues arising as to the sorts of adjustments referred to in paragraph 2 of Article 9, it follows that even in the absence of such a provision, States should be seeking to avoid double taxation, including by giving corresponding adjustments in cases of the type contemplated in paragraph 2. Whilst there may be some difference of view, States would therefore generally regard a taxpayer initiated mutual agreement procedure

based upon economic double taxation contrary to the terms of Article 9 as encompassing issues of whether a corresponding adjustment should have been provided, even in the absence of a provision similar to paragraph 2 of Article 9. 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.

13. 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.

14. 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. Thus, for example, if a change to a Contracting State's tax law would result in a person deriving a particular type of income being subjected to taxation not in accordance with the Convention, that person could set the mutual agreement procedure in motion as soon as the law has been amended and that person has derived the relevant income or it becomes probable that the person will derive that income. Other examples include filing a return in a self assessment system or the active examination of a specific taxpayer reporting position in the course of an audit, to the extent that either event creates the probability of taxation not in accordance with the Convention (e.g. where the self assessment reporting position the taxpayer is required to take under a Contracting State's domestic law would, if proposed by that State as an assessment in a non-self assessment regime, give rise to the probability of taxation not in accordance with the Convention, or where circumstances such as a Contracting State's published positions or its audit practice create a significant likelihood that the active examination of a specific reporting position such as the taxpayer's will lead to proposed assessments that would give rise to the probability of taxation not in accordance with the Convention). Another example might be a case where a Contracting State's transfer pricing law requires a taxpayer to report taxable income in an amount greater than would result from the actual prices used by the taxpayer in its

transactions with a related party, in order to comply with the arm's length principle, and where there is substantial doubt whether the taxpayer's related party will be able to obtain a corresponding adjustment in the other Contracting State in the absence of a mutual agreement procedure. procedure. Such actions may also be understood to include the bona fide taxpayer-initiated adjustments which are authorised under the domestic laws of some countries and which permit a taxpayer, under appropriate circumstances, to amend a previously-filed tax return in order to report a price in a controlled transaction, or an attribution of profits to a permanent establishment, that is, in the taxpayer's opinion, in accordance with the arm's length principle (see paragraph 6.1 of the Commentary on Article 9 and paragraph 59.1 of the Commentary on Article 7). As indicated by the opening words of paragraph 1, whether or not the actions of one or both of the Contracting States will result in taxation not in accordance with the Convention must be determined from the perspective of the taxpayer. Whilst the taxpayer's belief that there will be such taxation must be reasonable and must be based on facts that can be established, the tax authorities should not refuse to consider a request under paragraph 1 merely because they consider that it has not been proven (for example to domestic law standards of proof on the "balance of probabilities") that such taxation will occur.

15. Since the first steps in a mutual agreement procedure may be set in motion at a very early stage based upon the mere probability of taxation not in accordance with the Convention, the initiation of the procedure in this manner would not be considered the start date for the purposes of determining the beginning of the two year period referred to in paragraph 5 of the Article. Paragraph 75 below explains when that two year period commences.

16. To be admissible objections presented under paragraph 1 must first meet a twofold requirement expressly formulated in that paragraph: they must be presented to the competent authority of either Contracting State, 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 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.

17. The option provided to the taxpayer to present his case to the competent authority of either Contracting State is intended to reinforce the general principle that access to the mutual agreement procedure should be as widely available as possible and to provide flexibility. This option is also intended to ensure that the decision as to whether a case should proceed to the second stage of the mutual agreement procedure (i.e. be discussed by the competent authorities of both Contracting States) is open to consideration by both competent authorities. Paragraph 1 permits a person to present his case to the competent authority of either Contracting State; it does not preclude a person from presenting his case to the competent authorities of both Contracting States at the same time (see paragraph 75 below). Where a person presents his case to

the competent authorities of both Contracting States, he should appropriately inform both competent authorities, in order to facilitate a co-ordinated approach to the case.

18. On the other hand, Contracting States may consider that taxpayers should not have the option of presenting their cases to the competent authority of either State, but should, in the first instance, be required to present their cases to the competent authority of the State of which they are resident. However, 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 taxation (or any requirement connected therewith) 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 alternative rule which obliges the taxpayer to present his case to the competent authority of his State of residence, to present his objection to the competent authority of the Contracting State of which he is a national. Similarly, it appears more appropriate that it would be to the same competent authority that an objection should 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. To accommodate the alternative rule and the exception for cases coming under paragraph 1 of Article 24, 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 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.

Contracting States that prefer this alternative rule should take appropriate measures to ensure broad access to the mutual agreement procedure and that the decision as to whether a case should proceed to the second stage of the mutual agreement procedure is appropriately considered by both competent authorities.

19. If the taxpayer becomes a resident of a State subsequently to the taxation he considers not in accordance with the Convention, he must, under the alternative rule in paragraph 18 above, nevertheless still present his objection to the competent authority of the other State of which he was a resident during the period in respect of which such taxation has been or will be charged.

20. 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.

21. 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. Since a taxpayer has the right to present a case as soon as the taxpayer considers that taxation will result in taxation not in accordance with the provisions of the Convention, whilst the three year limit only begins when that result has materialised, there will be cases where the taxpayer will have the right to initiate the mutual agreement procedure before the three year time limit begins (see the examples of such a situation given in paragraph 14 above).

22. In most cases it will be clear what constitutes the relevant notice of assessment, official demand or other instrument for the collection or levy of tax, and there will usually be domestic law rules governing when that notice is regarded as "given". Such domestic law will usually look to the time when the notice is sent (time of sending), a specific number of days after it is sent, the time when it would be expected to arrive at the address it is sent to (both of which are times of presumptive physical receipt), or the time when it is in fact physically received (time of actual physical receipt). Where there are no such rules, either the time of actual physical receipt or, where this is not sufficiently evidenced, the time when the notice would normally be expected to have arrived at the relevant address should usually be treated as the time of notification, bearing in mind that this provision should be interpreted in the way most favourable to the taxpayer.

23. In self assessment cases, there will usually be some notification effecting that assessment (such as a notice of a liability or of denial or adjustment of a claim for refund), and generally the time of notification, rather than the time when the taxpayer lodges the self-assessed return, would be a starting point for the three year period to run. Where a taxpayer pays additional tax in connection with the filing of an amended return reflecting a bona fide taxpayer-initiated adjustment (as described in paragraph 14 above), the starting point of the three year time limit would generally be the notice of assessment or liability resulting from the amended return, rather than the time when the additional tax was paid. There may, however, be cases where there is no notice of a liability or the like. In such cases, the relevant time of "notification" would be the time when the taxpayer would, in the normal course of events, be regarded as having been made aware of the taxation that is in fact not in accordance with the Convention. This could, for example, be when information recording the transfer of funds is first made available to a taxpayer, such as in a bank balance or statement. The time begins to run whether or not the taxpayer actually regards the

taxation, at that stage, as contrary to the Convention, provided that a reasonably prudent person in the taxpayer's position would have been able to conclude at that stage that the taxation was not in accordance with the Convention. In such cases, notification of the fact of taxation to the taxpayer is enough. Where, however, it is only the combination of the self assessment with some other circumstance that would cause a reasonably prudent person in the taxpayer's position to conclude that the taxation was contrary to the Convention (such as a judicial decision determining the imposition of tax in a case similar to the taxpayer's to be contrary to the provisions of the Convention), the time begins to run only when the latter circumstance materialises.

24. 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. Where it is the combination of decisions or actions taken in both Contracting States that results in taxation not in accordance with the Convention, the time limit begins to run only from the first notification of the most recent decision or action. This means that where, for example, a Contracting State levies a tax that is not in accordance with the Convention but the other State provides relief for such tax pursuant to Article 23 A or Article 23 B so that there is no double taxation, a taxpayer will in practice often not initiate the mutual agreement procedure in relation to the action of the first State. If, however, the other State subsequently notifies the taxpayer that the relief is denied so that double taxation now arises, a new time limit begins from that notification, since the combined actions of both States then result in the taxpayer's being subjected to double taxation contrary to the provisions of the Convention. In some cases, especially of this type, the records held by taxing authorities may have been routinely destroyed before the period of the time limit ends, in accordance with the normal practice of one or both of the States. The Convention obligations do not prevent such destruction, or require a competent authority to accept the taxpayer's arguments without proof, but in such cases the taxpayer should be given the opportunity to supply the evidential deficiency, as the mutual agreement procedure continues, to the extent domestic law allows. In some cases, the other Contracting State may be able to provide sufficient evidence, in accordance with Article 26 of the Model Tax Convention. It is, of course, preferable that such records be retained by tax authorities for the full period during which a taxpayer is able to seek to initiate the mutual agreement procedure in relation to a particular matter.

25. The three year period continues to run during any domestic law (including administrative) proceedings (e.g. a domestic appeal process). This could create difficulties by in effect requiring a taxpayer to choose between domestic law and mutual agreement procedure remedies. Some taxpayers may rely solely on the mutual agreement procedure, but many taxpayers will attempt to address these difficulties by initiating a mutual agreement procedure whilst simultaneously initiating domestic law action, even though the domestic law process is initially not actively pursued. This could result in mutual agreement procedure resources being inefficiently applied.

Where domestic law allows, some States may wish to specifically deal with this issue by allowing for the three year (or longer) period to be suspended during the course of domestic law proceedings. Two approaches, each of which is consistent with Article 25 are, on one hand, requiring the taxpayer to initiate the mutual agreement procedure, with no suspension during domestic proceedings, but with the competent authorities not entering into talks in earnest until the domestic law action is finally determined, or else, on the other hand, having the competent authorities enter into talks, but without finally settling an agreement unless and until the taxpayer agrees to withdraw domestic law actions. This second possibility is discussed at paragraph 42 of this Commentary. In either of these cases, the taxpayer should be made aware that the relevant approach is being taken. Whether or not a taxpayer considers that there is a need to lodge a "protective" appeal under domestic law (because, for example, of domestic limitation requirements for instituting domestic law actions) the preferred approach for all parties is often that the mutual agreement procedure should be the initial focus for resolving the taxpayer's issues, and for doing so on a bilateral basis.

26. Some States may deny the taxpayer the ability to initiate the mutual agreement procedure under paragraph 1 of Article 25 in cases where the transactions to which the request relates are regarded as abusive. This issue is closely related to the issue of "improper use of the Convention" discussed in paragraph 54 and the following paragraphs of the Commentary on Article 1. In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement. However, where serious violations of domestic laws resulting in significant penalties are involved, some States may wish to deny access to the mutual agreement procedure. The circumstances in which a State would deny access to the mutual agreement procedure must be made clear in the Convention.

27. Some States regard certain issues as not susceptible to resolution by the mutual agreement procedure generally, or at least by taxpayer initiated mutual agreement procedure, because of constitutional or other domestic law provisions or decisions. An example would be a case where granting the taxpayer relief would be contrary to a final court decision that the tax authority is required to adhere to under that State's constitution. The recognised general principle for tax and other treaties is that domestic law, even domestic constitutional law, does not justify a failure to meet treaty obligations, however. Article 27 of the *Vienna Convention on the Law of Treaties* reflects this general principle of treaty law. It follows that any justification for what would otherwise be a breach of the Convention needs to be found in the terms of the Convention itself, as interpreted in accordance with accepted tax treaty interpretation principles. Such a justification would be rare, because it would not merely govern how a matter will be dealt with by the two States once the matter is within the mutual agreement procedure, but would instead prevent the matter from even reaching the stage when it is considered by both States. Since such a determination might in practice be reached by one of the States without consultation with the other, and since

there might be a bilateral solution that therefore remains unconsidered, the view that a matter is not susceptible of taxpayer initiated mutual agreement procedure should not be lightly made, and needs to be supported by the terms of the Convention as negotiated. A competent authority relying upon a domestic law impediment as the reason for not allowing the mutual agreement procedure to be initiated by a taxpayer should inform the other competent authority of this and duly explain the legal basis of its position. More usually, genuine domestic law impediments will not prevent a matter from entering into the mutual agreement procedure, but if they will clearly and unequivocally prevent a competent authority from resolving the issue in a way that avoids taxation of the taxpayer which is not in accordance with the Convention, and there is no realistic chance of the other State resolving the issue for the taxpayer, then that situation should be made public to taxpayers, so that taxpayers do not have false expectations as to the likely outcomes of the procedure.

28. In other cases, initiation of the mutual agreement procedure may have been allowed but domestic law issues that have arisen since the negotiation of the treaty may prevent a competent authority from resolving, even in part, the issue raised by the taxpayer. Where such developments have a legally constraining effect on the competent authority, so that bilateral discussions can clearly not resolve the matter, most States would accept that this change of circumstances is of such significance as to allow that competent authority to withdraw from the procedure. In some cases, the difficulty may be only temporary however; such as whilst rectifying legislation is enacted, and in that case, the procedure should be suspended rather than terminated. The two competent authorities will need to discuss the difficulty and its possible effect on the mutual agreement procedure. There will also be situations where a decision wholly or partially in the taxpayer's favour is binding and must be followed by one of the competent authorities but where there is still scope for mutual agreement discussions, such as for example in one competent authority's demonstrating to the other that the latter should provide relief.

29. There is less justification for relying on domestic law for not implementing an agreement reached as part of the mutual agreement procedure. The obligation of implementing such agreements is unequivocally stated in the last sentence of paragraph 2, and impediments to implementation that were already existing should generally be built into the terms of the agreement itself. As tax conventions are negotiated against a background of a changing body of domestic law that is sometimes difficult to predict, and as both parties are aware of this in negotiating the original Convention and in reaching mutual agreements, subsequent unexpected changes that alter the fundamental basis of a mutual agreement would generally be considered as requiring revision of the agreement to the extent necessary. Obviously where there is a domestic law development of this type, something that should only rarely occur, good faith obligations require that it be notified as soon as possible, and there should be a good faith effort to seek a revised or new mutual agreement, to the extent the domestic law development allows. In these cases, the taxpayer's request should be regarded as still operative, rather than a new application's being required from that person.

30. As regards the procedure itself, it is necessary to consider briefly the two distinct stages into which it is divided (see paragraph 7 above).

31. 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 the taxpayer and the competent authorities of the State to which the case was presented. The provisions of paragraph 1 give the taxpayer concerned the right to apply to the competent authority of either State, whether or not all the remedies available under the domestic law of each of the two States have been exhausted. On the other hand, the 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.

31.1 The determination whether the objection "appears … to be justified" requires the competent authority to which the case was presented to make a preliminary assessment of the taxpayer's objection in order to determine whether the taxation in both Contracting States is consistent with the terms of the Convention. It is appropriate to consider that the objection is justified where there is, or it is reasonable to believe that there will be, in either of the Contracting States, taxation not in accordance with the Convention.

32. 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 that State, 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 moving beyond the first (unilateral) stage of 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.

33. 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 second (bilateral) stage of the mutual agreement procedure. It is important that the competent 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.

34. A taxpayer is entitled to present his case under paragraph 1 to the competent authority of either State whether or not he may also have made a claim or commenced litigation under the domestic law of one (or both) of the States. If litigation is pending in the State to which the claim is presented, the competent authority of that State 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.

35. If a claim has been finally adjudicated by a court in either State, 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 (i.e. it is obliged, as a matter of law, to follow the court decision) or will not depart from the court decision as a matter of administrative policy or practice. 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.

36. 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 whilst 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 (based on the existence of the arbitration process provided for in paragraph 5 to address unresolved issues or on the assumption that the procedure 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.

37. 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. Paragraph 5, however, provides a mechanism that will allow an agreement to be reached even if there are issues on which the competent authorities have been unable to reach agreement through negotiations.

38. 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.

38.1 The combination of bilateral tax conventions concluded among several States may allow the competent authorities of these States to resolve multilateral cases by

mutual agreement under paragraphs 1 and 2 of Article 25 of these conventions. A multilateral mutual agreement may be achieved either through the negotiation of a single agreement between all the competent authorities of the States concerned or through the negotiation of separate, but consistent, bilateral mutual agreements.

38.2 This may, for instance, be the case to determine an appropriate allocation of profits between the permanent establishments that an enterprise has in two different States with which the State of the enterprise has tax conventions. In such case an adjustment made with respect to dealings between the two permanent establishments may affect the taxation of the enterprise in the State of residence. Based on paragraphs 1 and 2 of Article 25 of the tax conventions between the State of the enterprise and the States in which the permanent establishments are situated, the competent authority of the State of the enterprise clearly has the authority to endeavour to resolve the case by mutual agreement with the competent authorities of the States in which the permanent establishments are situated and to determine the appropriate attribution of profits to the permanent establishments of its resident in accordance with both tax conventions. Where the tax conventions between the State of the enterprise and the States in which the permanent establishments are situated contain different versions of Article 7 (e.g. the version included in the OECD Model in 2010 in one convention and the previous version of Article 7 in the other convention), the competent authorities may have regard to considerations of equity as mentioned under paragraph 38 above in order to find an appropriate solution with a view to ensuring taxation in accordance with the provisions of the applicable conventions.

38.3 This may, for instance, also be the case where a number of associated enterprises of different States are involved in a series of integrated controlled transactions and there are bilateral tax conventions among the States of all the enterprises. Such a series of integrated controlled transactions could exist, for example, where intellectual property is licensed in a controlled transaction between two members of a multinational enterprise (MNE) group and is then used by the licensee to manufacture goods sold by the licensee to other members of the MNE group. Based on paragraphs 1 and 2 of Article 25 of these tax conventions, the competent authorities of the States of these enterprises clearly have the authority to endeavour to determine the appropriate arm's length transfer prices for the controlled transactions in accordance with the arm's length principle of Article 9.

38.4 As recognised in paragraph 55 below, in the multilateral case described in paragraph 38.2, paragraph 3 of Article 25 of the tax convention between the States in which the permanent establishments are situated enables those two States to consult together to ensure that the convention operates effectively and that the double taxation that can occur in such a situation is appropriately eliminated.

38.5 The desire for certainty may result in taxpayers seeking multilateral advance pricing arrangements ("APAs") to determine, in advance, the transfer pricing of controlled transactions between associated enterprises of several States. Where there exist bilateral tax conventions among all these States and it appears that the actions of at least one of these States are likely to result for the taxpayer in taxation not in

accordance with the provisions of a convention, Article 25 of these conventions allows the competent authorities of these States to negotiate on a multilateral basis an appropriate set of criteria for the determination of the transfer pricing for the controlled transactions. A multilateral APA may be achieved either through the negotiation of a single agreement between all the competent authorities of the States concerned or through the negotiation of separate, but consistent, bilateral mutual agreements.

39. 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 (see also paragraph 62 of the Commentary on Article 7 and paragraph 10 of the Commentary on Article 9 which offer an alternative approach which addresses this issue in the Convention). 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 (subject to the possible application of paragraph 5 where such a course of action would prevent a mutual agreement case from being resolved). 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.

40. 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.

41. 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.

c) Competent authorities should, where appropriate, formulate and publicise domestic rules, guidelines and procedures concerning use of the mutual agreement procedure.

42. 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 that suit. Also, a view that competent authorities might reasonably take is that where the taxpayer's suit is ongoing as to the particular issue upon which mutual agreement is sought by that same taxpayer, discussions of any depth at the competent authority level should await a court decision. If the taxpayer's request for a mutual agreement procedure applied to different tax years than the court action, but to essentially the same factual and legal issues, so that the court outcome would in practice be expected to affect the treatment of the taxpayer in years not specifically the subject of litigation, the position might be the same, in practice, as for the cases just mentioned. In either case, awaiting a court decision or otherwise holding a mutual agreement procedure in abeyance whilst formalised domestic recourse proceedings are underway will not infringe upon, or cause time to expire from, the two year period referred to in paragraph 5 of the Article. Of course, if competent authorities consider, in either case, that the matter might be resolved notwithstanding the domestic law proceedings (because, for example, the competent authority where the court action is taken will not be legally bound or constrained by the court decision) then the mutual agreement procedure may proceed as normal. A competent authority may be precluded as a matter of law from maintaining taxation where a court has decided that such taxation is not in accordance with the provisions of a tax treaty. In contrast, in some countries a competent authority would not be legally precluded from granting relief from taxation notwithstanding a court decision that such taxation was in accordance with the provisions of a tax treaty. In such a case, nothing (e.g. administrative policy or practice) should prevent the competent authorities from

reaching a mutual agreement pursuant to which a Contracting State will relieve taxation considered by the competent authorities as not in accordance with the provisions of the tax treaty, and thus depart from a decision rendered by a court of that State.

43. The situation is also different if there is a suit ongoing on an issue, but the suit has been taken by another taxpayer than the one who is seeking to initiate the mutual agreement procedure. In principle, if the case of the taxpayer seeking the mutual agreement procedure supports action by one or both competent authorities to prevent taxation not in accordance with the Convention, that should not be unduly delayed pending a general clarification of the law at the instance of another taxpayer, although the taxpayer seeking mutual agreement might agree to this if the clarification is likely to favour that taxpayer's case. In other cases, delaying competent authority discussions as part of a mutual agreement procedure may be justified in all the circumstances, but the competent authorities should be mindful of the time constraints imposed by paragraph 5 and should as far as possible seek to prevent disadvantage to the taxpayer seeking mutual agreement in such a case. This could be done, where domestic law allows, by deferring payment of the amount outstanding during the course of the delay, or at least during that part of the delay which is beyond the taxpayer's control.

44. Depending upon domestic procedures, the choice of redress is normally that of the taxpayer and in most cases it is the domestic recourse provisions such as appeals or court proceedings that are held in abeyance in favour of the less formal and bilateral nature of mutual agreement procedure.

45. As noted above, there may be a pending suit by the taxpayer on an issue, or else the taxpayer may have preserved the right to take such domestic law action, yet the competent authorities might still consider that an agreement can be reached. In such cases, it is, however, necessary to take into account the concern of a particular competent authority to avoid any divergences or contradictions between the decision of the court and the mutual agreement that is being sought, with the difficulties or risks of abuse that these could entail. In short, therefore, the implementation of such a mutual agreement should normally be made subject:

— to the acceptance of such mutual agreement by the taxpayer, and

— to the taxpayer's withdrawal of the suit at law concerning those points settled in the mutual agreement.

45.1 In some States, audit settlements may be used as a mechanism to promote the closing of audit files. As the word "settlement" implies, there are usually concessions made by both the taxpayer and the tax administration involved, which may create difficult issues where an audit involves questions related to the interpretation or application of a tax treaty which could potentially be resolved through the mutual agreement procedure. One concession tax administrations sometimes seek is a limit on further recourse by the taxpayer, which in some cases may include an agreement by the taxpayer not to initiate the mutual agreement procedure with respect to issues

covered by the audit settlement. Double taxation can often be a consequence of such arrangements, which preclude the competent authorities from reaching a bilateral resolution through the mutual agreement procedure, and may indeed cause the other Contracting State to deny relief under its domestic law for the tax paid to the first Contracting State upon settlement of the audit. A taxpayer should thus not be required, as part of an audit settlement, to give up the right provided by paragraph 1 of Article 25 to present its case to a competent authority since this may impede the proper application of a tax treaty. For the purposes of this paragraph, however, an "audit settlement" does not include the settlement of a treaty dispute that is the result of an administrative or statutory dispute settlement/resolution process that is independent from the audit and examination functions and that can only be accessed through a request by the taxpayer. Countries should inform their treaty partners of such administrative or statutory processes and should expressly address the effects of those processes with respect to the MAP in their public guidance on such processes and in their public MAP programme guidance.

46. Some States take the view that a mutual agreement procedure may not be initiated by a taxpayer unless and until payment of all or a specified portion of the tax amount in dispute has been made. They consider that the requirement for payment of outstanding taxes, subject to repayment in whole or in part depending on the outcome of the procedure, is an essentially procedural matter not governed by Article 25, and is therefore consistent with it. A contrary view, held by many States, is that Article 25 indicates all that a taxpayer must do before the procedure is initiated, and that it imposes no such requirement. Those States find support for their view in the fact that the procedure may be implemented even before the taxpayer has been charged to tax or notified of a liability (as noted at paragraph 14 above) and in the acceptance that there is clearly no such requirement for a procedure initiated by a competent authority under paragraph 3.

47. Article 25 gives no absolutely clear answer as to whether a taxpayer initiated mutual agreement procedure may be denied on the basis that there has not been the necessary payment of all or part of the tax in dispute. However, whatever view is taken on this point, in the implementation of the Article it should be recognised that the mutual agreement procedure supports the substantive provisions of the Convention and that the text of Article 25 should therefore be understood in its context and in the light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

47.1 Unlike disputes that involve solely the application of a Contracting State's domestic law, the disputes that are addressed through the mutual agreement procedure will in most cases involve double taxation. States therefore should as far as possible take into account cash flow issues in requiring advance payment of an amount that the taxpayer contends was at least in part levied contrary to the terms of the relevant Convention. Even if a mutual agreement procedure ultimately eliminates any double taxation or other taxation not in accordance with the Convention, the requirement to pay tax prior to the conclusion of the mutual agreement procedure may

permanently cost the taxpayer the time value of the money represented by the amount inappropriately imposed for the period prior to the mutual agreement procedure resolution, at least in the fairly common case where the respective interest policies of the relevant Contracting States do not fully compensate the taxpayer for that cost. Thus, this means that in such cases the mutual agreement procedure would not achieve the goal of fully eliminating, as an economic matter, the burden of the double taxation or other taxation not in accordance with the Convention. Moreover, even if that economic burden is ultimately removed, a requirement that the taxpayer pay taxes on the same income to two Contracting States can impose cash flow burdens that are inconsistent with the Convention's goals of eliminating barriers to cross border trade and investment. As a minimum, payment of outstanding tax should not be a requirement to initiate the mutual agreement procedure if it is not a requirement before initiating domestic law review. States may wish to provide so expressly in the Convention by adding the following text to the end of paragraph 2:

> The suspension of assessment and collection procedures during the period that any mutual agreement proceeding is pending shall be available under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy.

It also appears, as a minimum, that if the mutual agreement procedure is initiated prior to the taxpayer's being charged to tax (such as by an assessment), a payment should only be required once that charge to tax has occurred.

48. For the reasons described in the preceding paragraph, suspension of the collection of tax pending resolution of a mutual agreement procedure can be a desirable policy. Moreover, any requirement to pay a tax assessment specifically as a condition of obtaining access to the mutual agreement procedure in order to get relief from that very tax would generally be inconsistent with the policy of making the mutual agreement procedure broadly available to resolve such disputes. Another unfortunate complication of such a requirement may be delays in the resolution of cases if a country is less willing to enter into good faith mutual agreement procedure discussions when a probable result could be the refunding of taxes already collected. In many States, the suspension of the assessment and/or collection of tax pending the resolution of a mutual agreement procedure may require legislative changes for the purpose of its implementation. States may also wish to provide expressly in the Convention for the suspension of assessment and collection procedures by adding the following text to the end of paragraph 2:

> Assessment and collection procedures shall be suspended during the period that any mutual agreement proceeding is pending.

In connection with any suspension of collection of tax pending the resolution of a mutual agreement procedure, it is important to recall the availability of measures of conservancy pursuant to paragraph 4 of Article 27.

48.1 As there may be substantial differences in the domestic law assessment and collection procedures of the Contracting States, it may be important to verify, during the course of bilateral negotiations, how those procedures will operate in each State

pending the resolution of a mutual agreement procedure, in order to address any obstacles such procedures may present to the effective implementation of the Article. For example, where a State takes the view that payment of outstanding tax is a precondition to the taxpayer initiated mutual agreement procedure, this should be notified to the treaty partner during negotiations on the terms of a Convention. Where both Contracting States take this view, there is a common understanding, but also the particular risk of the taxpayer's being required to pay an amount twice. Where domestic law (or a treaty provision such as that in the preceding paragraph) allows it, one possibility which States might consider to deal with this would be for the higher of the two amounts to be held in trust, escrow or similar, pending the outcome of the mutual agreement procedure. Alternatively, a bank guarantee provided by the taxpayer's bank could be sufficient to meet the requirements of the competent authorities. As another approach, one State or the other (decided by time of assessment, for example, or by residence State status under the treaty) could agree to seek a payment of no more than the difference between the amount paid to the other State, and that which it claims, if any. Which of these possibilities is open will ultimately depend on the domestic law (including administrative requirements) of a particular State and the provisions of the applicable treaty, but they are the sorts of options that should as far as possible be considered in seeking to have the mutual agreement procedure operate as effectively as possible. Where States require some payment of outstanding tax as a precondition to the taxpayer initiated mutual agreement procedure, or to the active consideration of an issue within that procedure, they should have a system in place for refunding an amount of interest on any underlying amount to be returned to the taxpayer as the result of a mutual agreement reached by the competent authorities. Any such interest payment should sufficiently reflect the value of the underlying amount and the period of time during which that amount has been unavailable to the taxpayer.

49. Paragraph 4 of the Commentary on Article 2 clarifies that whilst most States do not consider interest and administrative penalties accessory to the taxes covered under Article 2 to themselves be covered by Article 2, where such interest and administrative penalties are directly connected to taxes covered under Article 2, they should be appropriately reduced or withdrawn to the same extent as the underlying covered tax is reduced or withdrawn pursuant to the mutual agreement procedure. Consequently, a Contracting State that has applied interest or an administrative penalty that is computed with reference to an underlying tax liability (or with reference to some other amount relevant to the determination of tax, such as the amount of an adjustment or an amount of taxable income) and that has subsequently agreed pursuant to a mutual agreement procedure under paragraphs 1 and 2 of Article 25 to reduce or withdraw that underlying tax liability should proportionally reduce the amount of or withdraw such interest or administrative penalty.

49.1 In contrast, other administrative penalties (for example, a penalty for failure to maintain proper transfer pricing documentation) may concern domestic law compliance issues that are not directly connected to a tax liability that is the object of

a mutual agreement procedure request. Such administrative penalties would generally not fall within the scope of the mutual agreement procedure under paragraphs 1 and 2 of the Article. Under paragraph 3 of Article 25, however, the competent authorities may consult together and agree, in a specific case, that a penalty not directly connected with taxation not in accordance with the Convention was not or is no longer justified. For instance, where an administrative penalty for negligence, wilful conduct or fraud has been levied at a fixed amount and it is subsequently agreed in the mutual agreement procedure that there was no fraudulent intent, wilful conduct or negligence, the competent authorities may agree that the Contracting State that applied such penalty will withdraw it. Under paragraph 3 of the Article, the competent authorities may also enter into a general mutual agreement pursuant to which they will endeavour through the mutual agreement procedure to resolve under paragraphs 1 and 2 issues related to interest and administrative penalties that give rise to difficulties or doubts as to the application of the Convention. Contracting States may, if they consider it preferable, expressly provide in paragraph 2 of Article 25 for the application of that paragraph to interest and administrative penalties in mutual agreement procedure cases presented in accordance with paragraph 1 by adding the following as a second sentence:

> The competent authorities shall also endeavour to agree on the application of domestic law provisions regarding interest and administrative penalties related to the case.

49.2 Criminal penalties imposed by a public prosecutor or a court would generally not fall within the scope of the mutual agreement procedure. In many States, competent authorities would have no legal authority to reduce or withdraw those penalties.

49.3 A mutual agreement will often result in a tax liability being maintained in one Contracting State whilst the other Contracting State has to refund all or part of the tax it has levied. In such cases, the taxpayer may suffer a significant economic burden if there are asymmetries with respect to how interest accrues on tax liabilities and refunds in the two Contracting States. This will, for instance, be the case where the first Contracting State has charged late payment interest on the tax that was the object of the mutual agreement procedure request and the second Contracting State does not grant overpayment interest on the amount it has to refund to the taxpayer. Therefore, Contracting States should seek to adopt flexible approaches to provide relief from interest accessory to the tax liability that is the object of a mutual agreement procedure request. Relief from interest would be especially appropriate for the period during which the taxpayer is in the mutual agreement process, given that the amount of time it takes to resolve a case through the mutual agreement procedure is, for the most part, outside the taxpayer's control. Changes to the domestic law of a Contracting State may be required to permit the competent authority to provide interest relief agreed upon under the mutual agreement procedure.

49.4 The object of the Convention in avoiding double taxation, and the requirement for States to implement conventions in good faith, suggest that interest and penalty payments should not be imposed in a way that effectively discourages taxpayers from

initiating a mutual agreement procedure, because of the cost and the cash flow impact that this would involve. Interest and administrative penalties should not be applied in a way that severely discourages or nullifies taxpayer reliance upon the benefits of the Convention, including the right to initiate the mutual agreement procedure as provided by Article 25. For example, a State's requirements as to payment of outstanding penalties and interest should not be more onerous to taxpayers in the context of the mutual agreement procedure than they would be in the context of taxpayer initiated domestic law review.

Paragraph 3

50. 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.

51. 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 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.

52. 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).

— Conclude bilateral advance pricing arrangements (APAs) as well as conclude multilateral APAs with competent authorities of third States with which each of the Contracting States has concluded a bilateral tax convention in cases where difficulties or doubts exist as to the interpretation or application of the conventions (especially in cases where no actions of the Contracting States are likely to result in taxation not in accordance with the provisions of a convention). A multilateral APA may be concluded either through the negotiation of a single

agreement between all the competent authorities of the concerned States or through the negotiation of separate, but consistent, bilateral mutual agreements.

— Determine appropriate procedures, conditions and modalities for the application of paragraphs 1 and 2 as well as the second sentence of this paragraph to multilateral cases (see paragraphs 38.1 to 38.5 above and paragraphs 55 to 55.2 below) and for the involvement of third States in the mutual agreement procedure where the resolution of the case may affect or be affected by taxation in third States.

53. 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.

54. 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.

55. 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. The second sentence of paragraph 3 allows the competent authorities of the Contracting States to consult with each other in order to eliminate double taxation that may occur with respect to dealings between the permanent establishments. This could for instance be the case where one or both of the Contracting States have no bilateral tax convention with the third State. Where both Contracting States have a convention with the third State, the combination of these two conventions may, however, allow the competent authorities of all three States to resolve the case by mutual agreement under paragraphs 1, 2 and 3 of Article 25 of these conventions (see paragraphs 38.2 and 38.4 above). A multilateral agreement between the competent authorities of all involved States is the best way of ensuring that any double taxation can be eliminated.

55.1 There will be Contracting States whose domestic law prevents the Convention from being complemented on points which are not explicitly or at least implicitly dealt with in the Convention. In these situations the Convention could be complemented by a protocol dealing with this issue. The second sentence of paragraph 3 does not, however, allow the Contracting States to eliminate double taxation where the provision of such relief would contravene their respective domestic laws or is not authorised by the provisions of other applicable tax treaties. That sentence only allows the Contracting States, in cases not provided for in the Convention, to consult each other in order to eliminate double taxation in accordance with their respective domestic laws

or in accordance with a tax treaty one of the Contracting States has concluded with a third State. Thus, for instance, in the case of an enterprise of a third State having permanent establishments in both Contracting States, the second sentence of paragraph 3 allows the competent authorities of the Contracting States to agree on the facts and circumstances of a case in order to apply their respective domestic tax laws in a coherent manner, in particular with respect to any dealings between those permanent establishments; the Contracting States could provide relief from any double taxation of the profits of such permanent establishments, however, only to the extent allowed by their respective domestic laws or by the provisions of a tax treaty concluded between a Contracting State and that third State (i.e. applying the provisions of Article 7 and Article 23 of a tax treaty between a Contracting State and the third State). As shown by these examples, paragraph 3 therefore plays a crucial role to allow competent authority consultation to ensure that tax treaties operate in a co-ordinated and effective manner.

55.2 Under the first sentence of paragraph 3, the competent authorities may agree on a general basis that they shall endeavour to resolve a case presented under paragraph 1 with the competent authority of any third State in circumstances where taxation on income or on capital in that third State is likely to affect or be affected by the resolution of the case. Contracting States that wish to make express provision for multilateral mutual agreement procedures may agree to use the following alternative formulation of paragraph 2:

> 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. Where the resolution of the case may affect or be affected by taxation on income or on capital in any third State, the competent authorities shall endeavour to resolve the case by mutual agreement with the competent authority of any such third State provided there is a tax convention in force between each of the Contracting States and that third State and the competent authority of that third State agrees within the three-year period provided in paragraph 1 to consult with the competent authorities of the Contracting States to resolve the case by mutual agreement. In order to resolve the case, the competent authorities shall take into consideration the relevant provisions of this Convention together with the relevant provisions of the tax conventions between the Contracting States and any third State involved in the procedure. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

Paragraph 4

56. 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.

57. It provides first that the competent authorities may communicate with each other directly. It would therefore not be necessary to go through diplomatic channels.

58. 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.

59. 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.

60. However, whilst 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.

61. 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.

62. 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.

Paragraph 5

63. This paragraph provides that, in a case where the competent authorities are unable to reach an agreement under paragraph 2 within two years, the unresolved issues will, at the written request of the person who presented the case, be solved through an arbitration process. This process is not dependent on a prior authorisation by the competent authorities: once the requisite procedural requirements have been met, the unresolved issues that prevent the conclusion of a mutual agreement must be submitted to arbitration.

64. The arbitration process provided for by the paragraph is not an alternative or additional recourse: where the competent authorities have reached an agreement that does not leave any unresolved issues as regards the application of the Convention, there are no unresolved issues that can be brought to arbitration even if the person who made the mutual agreement request does not consider that the agreement reached by the competent authorities provides a correct solution to the case. The paragraph is, therefore, an extension of the mutual agreement procedure that serves to

enhance the effectiveness of that procedure by ensuring that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Thus, under the paragraph, the resolution of the case continues to be reached through the mutual agreement procedure, whilst the resolution of a particular issue which is preventing agreement in the case is handled through an arbitration process. This distinguishes the process established in paragraph 5 from other forms of commercial or government-private party arbitration where the jurisdiction of the arbitration panel extends to resolving the whole case.

65. Before 2017, a footnote to paragraph 5 indicated that in some States, national law, policy or administrative considerations may not allow or justify the type of arbitration process provided for in the paragraph and gave the example of constitutional barriers preventing arbitrators from deciding tax issues. The footnote was deleted, however, in recognition of the importance of including an arbitration mechanism that ensures the resolution of disputes between the competent authorities where these disputes would otherwise prevent the mutual agreement procedure from playing its role.

65.1 Paragraph 5 includes the essential conditions of the arbitration process. The last sentence of the paragraph expressly requires the competent authorities to agree on the mode of application of that process and it is therefore expected that most of the procedural aspects of the process will be determined in an agreement between the competent authorities (see paragraph 85 below and the sample "mutual agreement on arbitration" included in the Annex). Some States, however, may prefer to incorporate into the Convention itself certain of these procedural aspects. Whilst this increases the complexity of the arbitration provision, a State may consider that the importance of some of these aspects (such as the rules concerning the appointment of the arbitrators and the confidentiality of information communicated to them) is such that these issues should be addressed in the Convention itself. Part VI of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the "Multilateral Instrument"), which was opened for signature on 31 December 2016, provides a good example of a convention that includes many of the procedural aspects of the arbitration process.

66. Some States may wish to include paragraph 5 but limit its application to a more restricted range of cases. For example, access to arbitration could be restricted to cases involving issues which are primarily factual in nature. It could also be possible to provide that arbitration would always be available for issues arising in certain classes of cases, for example, highly factual cases such as those related to transfer pricing or the question of the existence of a permanent establishment, whilst extending arbitration to other issues on a case-by-case basis. States wishing to limit the application of paragraph 5 should be mindful that any significant restriction in the scope of an arbitration provision may limit its effectiveness in ensuring the resolution of unresolved issues arising in a mutual agreement procedure case.

66.1 Where paragraph 5 is included in a new convention that replaces provisions of a previous convention that included an arbitration provision or to which Part VI of the

Multilateral Instrument applied, the Contracting States should clarify whether paragraph 5 of the new convention applies to cases related to the provisions of that previous convention. If that is not the case, the Contracting States should ensure that the arbitration provision of the previous convention or of Part VI of the Multilateral Instrument, as the case may be, continues to apply in order to ensure the arbitration of unresolved issues arising under the provisions of that previous convention.

67. Also, States which are members of the European Union may want to co-ordinate the scope of paragraph 5 with their obligations under legal instruments applicable to these members. Such co-ordination should ensure that arbitration under such a legal instrument is possible even if paragraph 5 has a narrower scope. This could be done, for example, by including in Article 25 an additional paragraph drafted along the following lines:

> Paragraph 5 shall not affect the fulfilment of wider obligations that result from any other legal instrument applicable to the Contracting States and that relate to the arbitration of unresolved issues referred to in that paragraph.

The co-ordination should also ensure that unresolved issues within the scope of application of paragraph 5 are not subject to arbitration procedures under both that paragraph and under any other legal instrument.

68. The taxpayer should be able to request arbitration of unresolved issues in all cases dealt with under the mutual agreement procedure that have been presented under paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for a person in taxation not in accordance with the provisions of this Convention. Where the mutual agreement procedure is not available, for example because of the existence of serious violations involving significant penalties (see paragraph 26), it is clear that paragraph 5 is not applicable.

69. Where two Contracting States that have not included the paragraph in their Convention wish to implement an arbitration process for general application or to deal with a specific case, it is still possible for them to do so by mutual agreement. In that case, the competent authorities can conclude a mutual agreement along the lines of the sample wording presented in the Annex, to which they would add the following first paragraph:

> 1. Where,
>
> *a)* under paragraph 1 of Article 25 of the Convention, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
>
> *b)* the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 of the Article within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities,
>
> any unresolved issues arising from the case shall be submitted to arbitration in accordance with the following paragraphs if the person so requests in writing.

> These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, the competent authorities hereby agree to consider themselves bound by the arbitration decision and to resolve the case pursuant to paragraph 2 of Article 25 on the basis of that decision.

This agreement would go on to address the various structural and procedural issues discussed in the Annex . Whilst the competent authorities would thus be bound by such process, such agreement would be given as part of the mutual agreement procedure and would therefore only be effective as long as the competent authorities continue to agree to follow that process to solve cases that they have been unable to resolve through the traditional mutual agreement procedure.

70. Paragraph 5 provides that a person who has presented a case to the competent authority of a Contracting State pursuant to paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention may request in writing that any unresolved issues arising from the case be submitted to arbitration. This request may be made at any time after a period of two years that begins on the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities. Recourse to arbitration is therefore not automatic; the person who presented the case may prefer to wait beyond the end of the two year period (for example, to allow the competent authorities more time to resolve the case under paragraph 2) or simply not to pursue the case.

70.1 States that consider that the two year period is too short may amend the provision to allow an arbitration request to be made only after three years. Also, States are free to provide that, in certain circumstances, a longer period of time will be required before the request can be made in a specific case. This could be done, for example, by allowing the competent authorities to agree, on a case-by-case basis, to a different time period before the expiration of the two years; this could be done by drafting subparagraph *b*) as follows:

> *b*) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities (unless, prior to the expiration of that period, the competent authorities of the Contracting States have agreed to a different time period with respect to that case and have notified the person who presented the case of such agreement).

70.2 States may also wish to provide that the two year period will be suspended in circumstances in which the mutual agreement procedure itself is suspended. This may be the case, for example, where the mutual agreement procedure case concerns one or more issues that are also pending before a court or administrative tribunal and a Contracting State will not allow a taxpayer to pursue simultaneously both a mutual

agreement procedure and proceedings before a court or administrative tribunal (see paragraph 76). It may also be the case where one competent authority agrees with the person who presented the case to suspend the mutual agreement procedure (e.g. because of serious illness or some other personal hardship). The following provision could be added to paragraph 5 to deal with such cases:

> Where a competent authority has suspended the mutual agreement procedure referred to in paragraph 1 because a case with respect to one or more of the same issues is pending before a court or administrative tribunal, the period provided in subparagraph *b*) shall stop running until the case pending before a court or administrative tribunal has been suspended or withdrawn. Also, where a person who presented a case and a competent authority have agreed to suspend the mutual agreement procedure, the period provided in subparagraph *b*) will stop running until the suspension has been lifted.

70.3 In some cases, after a taxpayer has provided the initial information needed to undertake substantive consideration of the case, the competent authorities may need to request additional information from the taxpayer. For example, after the period provided in subparagraph *b*) has begun and after further analysis of the case, a competent authority may determine that it needs additional information in order to reach agreement on how to resolve a remaining issue. In such cases, a failure by a person directly affected by the case to provide such additional information in a timely manner may delay or prevent the competent authorities from being able to resolve the case. This issue may be dealt with by using the alternative formulation of subparagraph *b*) suggested in paragraph 70.1 above, which allows the competent authorities to agree to a different period of time on a case-by-case basis. Alternatively, it could be dealt with in the mutual agreement that will settle the mode of application of the arbitration provision, e.g. by providing that the two year period will be extended where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start of the period provided in subparagraph *b*) (see Article 7 of the sample mutual agreement in the Annex; a similar provision could instead be added to the Convention itself if the alternative provision in paragraph 70.1 is not used).

71. Under paragraph 2 of Article 25, the competent authorities must endeavour to resolve a case presented under paragraph 1 with a view to the avoidance of taxation not in accordance with the Convention. For the purposes of paragraph 5, a case should therefore not be considered to have been resolved as long as there is at least one issue on which the competent authorities disagree and which, according to one of the competent authorities, indicates that there has been taxation not in accordance with the Convention. One of the competent authorities could not, therefore, unilaterally decide that such a case is closed and that the person involved cannot request the arbitration of unresolved issues; similarly, the two competent authorities could not consider that the case has been resolved and deny the request for arbitration if there are still unresolved issues that prevent them from agreeing that there has not been

taxation not in accordance with the Convention. Where, however, the two competent authorities agree that taxation by both States has been in accordance with the Convention, there are no unresolved issues and the case may be considered to have been resolved, even in the case where there might be double taxation that is not addressed by the provisions of the Convention.

72. The arbitration process is only available in cases where the person considers that taxation not in accordance with the provisions of the Convention has actually resulted from the actions of one or both of the Contracting States; it is not available, however, in cases where it is argued that such taxation will eventually result from such actions even if the latter cases may be presented to the competent authorities under paragraph 1 of the Article (see paragraph 70 above). For that purpose, taxation should be considered to have resulted from the actions of one or both of the Contracting States as soon as, for example, tax has been paid, assessed or otherwise determined or even in cases where the taxpayer is officially notified by the tax authorities that they intend to tax him on a certain element of income.

73. As drafted, paragraph 5 only provides for arbitration of unresolved issues arising from a request made under paragraph 1 of the Article. States wishing to extend the scope of the paragraph to also cover mutual agreement cases arising under paragraph 3 of the Article are free to do so. In some cases, a mutual agreement case may arise from other specific treaty provisions, such as subparagraph 2 *d*) of Article 4. Under that subparagraph, the competent authorities are, in certain cases, required to settle by mutual agreement the question of the status of an individual who is a resident of both Contracting States. As indicated in paragraph 20 of the Commentary on Article 4, such cases must be resolved according to the procedure established in Article 25. If the competent authorities fail to reach an agreement on such a case and this results in taxation not in accordance with the Convention (according to which the individual should be a resident of only one State for purposes of the Convention), the taxpayer's case comes under paragraph 1 of Article 25 and, therefore, paragraph 5 is applicable.

74. In some States, it may be possible for the competent authorities to deviate from a court decision on a particular issue arising from the case presented to the competent authorities. Those States should therefore be able to omit the second sentence of the paragraph and, if they wish to use the alternative provision in paragraph 70.2 above, should amend it to read:

> Where a competent authority has suspended the mutual agreement procedure referred to in paragraph 1 because a case with respect to one or more of the same issues is pending before a court or administrative tribunal, the period provided in subparagraph *b*) will stop running until either a final decision has been rendered by the court or administrative tribunal or the case has been suspended or withdrawn. Also, where a person who presented a case and a competent authority have agreed to suspend the mutual agreement procedure, the period provided in subparagraph *b*) will stop running until the suspension has been lifted.

75. For the purpose of determining the start of the two year period, it will be considered that all the information required by the competent authorities in order to address the case has been provided to both competent authorities only if sufficient information has been presented to both competent authorities to allow them to decide whether the objection underlying the case appears to be justified. The mutual agreement providing for the mode of application of paragraph 5 should clarify the process that will be used to determine that start date and should specify which type of information will normally be sufficient for that purpose. The sample mutual agreement included in the Annex suggests a process that is similar to the one used in Part VI of the Multilateral Instrument. States that consider that rules for the determination of the start date for the two year period should be included directly in the Convention are free to do so, e.g. by including provisions similar to those of paragraphs 5 to 9 of Article 19 of the Multilateral Instrument.

76. The paragraph also deals with the relationship between the arbitration process and rights to domestic remedies. For the arbitration process to be effective and to avoid the risk of conflicting decisions, a person should not be allowed to pursue the arbitration process if the issues submitted to arbitration have already been resolved through the domestic litigation process of either State (which means that any court or administrative tribunal of one of the Contracting States has already rendered a decision that deals with these issues and that applies to that person). This is consistent with the approach adopted by most countries as regards the mutual agreement procedure and according to which:

a) A person cannot pursue simultaneously the mutual agreement procedure and domestic legal remedies. Where domestic legal remedies are still available, the competent authorities will generally either require that the taxpayer agree to the suspension of these remedies or, if the taxpayer does not agree, will delay the mutual agreement procedure until these remedies are exhausted.

b) Where the mutual agreement procedure is first pursued and a mutual agreement has been reached, the taxpayer and other persons directly affected by the case are offered the possibility to reject the agreement and pursue the domestic remedies that had been suspended; conversely, if these persons prefer to have the agreement apply, they will have to renounce the exercise of domestic legal remedies as regards the issues covered by the agreement.

c) Where the domestic legal remedies are first pursued and are exhausted in a State, a person may only pursue the mutual agreement procedure in order to obtain relief of double taxation in the other State. Indeed, once a legal decision has been rendered in a particular case, most countries consider that it is impossible to override that decision through the mutual agreement procedure and would therefore restrict the subsequent application of the mutual agreement procedure to trying to obtain relief in the other State.

The same general principles should be applicable in the case of a mutual agreement procedure that would involve one or more issues submitted to arbitration. It would not be helpful to submit an issue to arbitration if it is known in advance that one of the countries is limited in the response that it could make to the arbitration decision. This,

however, would not be the case if the country could, in a mutual agreement procedure, deviate from a court decision (see paragraph 74) and in that case paragraph 5 could be adjusted accordingly.

77. A second issue involves the relationship between existing domestic legal remedies and arbitration where these legal remedies have not been exhausted. In that case, the approach that would be the most consistent with the basic structure of the mutual agreement procedure would be to apply the same general principles when arbitration is involved. Thus, the legal remedies would be suspended pending the outcome of the mutual agreement procedure involving the arbitration of the issues that the competent authorities are unable to resolve and a tentative mutual agreement would be reached on the basis of that decision. As in other mutual agreement procedure cases, that agreement would then be presented to the taxpayer who would have to choose to accept the agreement, which would require abandoning any remaining domestic legal remedies, or reject the agreement to pursue these remedies.

78. This approach is in line with the nature of the arbitration process set out in paragraph 5. The purpose of that process is to allow the competent authorities to reach a conclusion on the unresolved issues that prevent an agreement from being reached. When that agreement is achieved though the aid of arbitration, the essential character of the mutual agreement remains the same.

79. In some cases, this approach will mean that the parties will have to expend time and resources in an arbitration process that will lead to a mutual agreement that will not be accepted by the taxpayer. As a practical matter, however, experience shows that there are very few cases where the taxpayer rejects a mutual agreement to resort to domestic legal remedies. Also, in these rare cases, one would expect the domestic courts or administrative tribunals to take note of the fact that the taxpayer had been offered an administrative solution to his case that would have bound both States.

79.1 As noted in paragraph 76 *a*) above, most States will not allow a person to pursue simultaneously the mutual agreement procedure and domestic legal remedies. Some States, however, may permit a person simultaneously to pursue both the mutual agreement procedure and proceedings before a court or administrative tribunal with respect to the same issues; in these States, the possibility exists that a decision concerning an issue or issues submitted to arbitration may be rendered by a court or administrative tribunal after a request for arbitration has been made and before the arbitration panel has delivered its decision. Such States may wish to provide expressly that the arbitration process will terminate in such a circumstance, in order to avoid the difficulties that may then arise with the application of the mutual agreement implementing a subsequent arbitration decision (see paragraph 76 above). The following language could be added to paragraph 5 for this purpose:

> If, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities of the Contracting States, a decision concerning the issue is rendered by a court or administrative tribunal of one of the Contracting States, the arbitration process shall terminate.

80. In some States, unresolved issues between competent authorities may only be submitted to arbitration if domestic legal remedies are no longer available. In order to implement an arbitration approach, these States could consider the alternative approach of requiring a person to waive the right to pursue domestic legal remedies before arbitration can take place. This could be done by replacing the second sentence of the paragraph by "these unresolved issues shall not, however, be submitted to arbitration if any person directly affected by the case is still entitled, under the domestic law of either State, to have courts or administrative tribunals of that State decide these issues or if a decision on these issues has already been rendered by such a court or administrative tribunal." To avoid a situation where a taxpayer would be required to waive domestic legal remedies without any assurance as to the outcome of the case, it would then be important to also modify the paragraph to include a mechanism that would guarantee, for example, that double taxation would in fact be relieved. Also, since the taxpayer would then renounce the right to be heard by domestic courts, the paragraph should also be modified to ensure that sufficient legal safeguards are granted to the taxpayer as regards his participation in the arbitration process to meet the requirements that may exist under domestic law for such a renunciation to be acceptable under the applicable legal system (e.g. in some countries, such renunciation might not be effective if the person were not guaranteed the right to be heard orally during the arbitration).

80.1 Some States consider that taxpayers and their advisors should not disclose any information received in the course of arbitration proceedings. States that share that view are free to include the following provision, which is based on paragraph 5 of Article 23 of the Multilateral Instrument:

> Prior to the beginning of arbitration proceedings, the competent authorities of the Contracting States shall ensure that each person that presented the case and their advisors agree in writing not to disclose to any other person any information received during the course of the arbitration proceedings from either competent authority or the arbitration panel. The mutual agreement procedure and the arbitration proceedings related to the case shall terminate if, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities, a person that presented the case or one of that person's advisors materially breaches that agreement.

81. Paragraph 5 provides that, unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both States. Thus, the taxation of any person directly affected by the case will have to conform with the decision reached on the issues submitted to arbitration and the decisions reached in the arbitration process will be reflected in the mutual agreement that will be presented to these persons. Where, however, an arbitration decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or of any procedural rule, that arbitration decision will not be binding on either State (see also Article 11 of the sample mutual agreement, which deals with this issue).

82. As noted in subparagraph 76 *b*) above, where a mutual agreement is reached before domestic legal remedies have been exhausted, it is normal for the competent authorities to require, as a condition for the application of the agreement, that the persons affected renounce the exercise of domestic legal remedies that may still exist as regards the issues covered by the agreement. Without such renunciation, a subsequent court decision could indeed prevent the competent authorities from applying the agreement. Thus, for the purpose of paragraph 5, if a person to whom the mutual agreement that implements the arbitration decision has been presented does not agree to renounce the exercise of domestic legal remedies, that person must be considered not to have accepted that agreement. Where the mutual agreement is not accepted, or is considered not to have been accepted, the case shall not be eligible for any further consideration by the competent authorities.

82.1 For greater certainty, some States may wish to reflect the conclusions of paragraphs 81 and 82 above into the text of their conventions, which could be done by adding an additional paragraph drafted along the following lines:

For the purposes of paragraph 5

a) the mutual agreement that implements the arbitration decision on the case shall be considered not to be accepted by a person directly affected by the case if any person directly affected by the case does not, within 60 days after the date on which notification of the mutual agreement is sent to the person, withdraw all issues resolved in the mutual agreement implementing the arbitration decision from consideration by any court or administrative tribunal or otherwise terminate any pending court or administrative proceedings with respect to such issues in a manner consistent with that mutual agreement; and

b) the decision shall not be binding on the Contracting States if:

(i) a final decision of the courts of one of the Contracting States holds that the arbitration decision is invalid. In such a case, the request for arbitration under paragraph 5 shall be considered not to have been made, and the arbitration process shall be considered not to have taken place (except with respect to any applicable provisions dealing with confidentiality of information and payment of the costs related to the arbitration). In such a case, a new request for arbitration may be made unless the competent authorities agree that such a new request should not be permitted; or

(ii) a person directly affected by the case pursues litigation in any court or administrative tribunal concerning the issues that were resolved in the mutual agreement implementing the arbitration decision.

83. The arbitration decision is only binding with respect to the specific issues submitted to arbitration. Whilst nothing would prevent the competent authorities from solving other similar cases (including cases involving the same persons but different taxable periods) on the basis of the decision, there is no obligation to do so and each State therefore has the right to adopt a different approach to deal with these other cases.

84. Some States may wish to allow the competent authorities to depart from the arbitration decision, provided that they can agree on a different solution that would settle all outstanding issues that prevented the resolution of the mutual agreement procedure case (this, for example, is allowed under Article 12 of the EU Arbitration Convention). States wishing to do so are free to amend the third sentence of the paragraph as follows:

> ... Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision or the competent authorities agree on a different resolution of all unresolved issues arising from the case within three months after the decision has been communicated to them, the arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States.

85. The last sentence of the paragraph leaves the mode of application of the arbitration process to be settled by mutual agreement. As indicated in paragraph 65.1 above, some States may prefer to incorporate into the Convention itself certain of the procedural aspects of the arbitration process; other States may want to deal with them through a protocol or through an exchange of diplomatic notes. It should be noted, however, that addressing these issues through a mutual agreement allows more flexibility with respect to subsequent changes that could become necessary as the Contracting States gain experience in applying the arbitration provisions. Whatever form the agreement takes, it should set out the structural and procedural rules to be followed in applying the paragraph, taking into account the paragraph's requirement that the arbitration decision be binding on both States. Ideally, that agreement should be drafted at the same time as the Convention so as to be signed, and to apply, immediately after the paragraph becomes effective. Also, since the agreement will provide the details of the process to be followed to bring unresolved issues to arbitration, it would be important that this agreement be made public. A sample form of such a procedural mutual agreement is provided in the Annex together with comments on the procedural rules that it puts forward.

Use of other supplementary dispute resolution mechanisms

86. Regardless of whether or not paragraph 5 is included in a Convention or an arbitration process is otherwise implemented using the procedure described in paragraph 69 above, it is clear that supplementary dispute resolution mechanisms other than arbitration can be implemented on an ad hoc basis as part of the mutual agreement procedure. Where there is disagreement about the relative merits of the positions of the two competent authorities, the case may be helped if the issues are clarified by a mediator. In such situations the mediator listens to the positions of each party and then communicates a view of the strengths and weaknesses of each side. This helps each party to better understand its own position and that of the other party. Some tax administrations are now successfully using mediation to resolve internal disputes and the extension of such techniques to mutual agreement procedures could be useful.

87. If the issue is a purely factual one, the case could be referred to an expert whose mandate would simply be to make the required factual determinations. This is often done in judicial procedures where factual matters are referred to an independent party who makes factual findings which are then submitted to the court. Unlike the dispute resolution mechanism which is established in paragraph 5, these procedures are not binding on the parties but nonetheless can be helpful in allowing them to reach a decision before an issue would have to be submitted to arbitration under that paragraph.

III. Interaction of the mutual agreement procedure with the dispute resolution mechanism provided by the General Agreement on Trade in Services

88. 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.

89. 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 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.

90. That paragraph raises two particular problems with respect to tax treaties.

91. 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.

92. 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. Whilst it seems clear that a country could not argue in good faith[1] that a measure relating to a tax to which no

1 The obligation of applying and interpreting treaties in good faith is expressly recognised 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.

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.

93. 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.

94. 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.

Observations on the Commentary

95. *Hungary* does not fully share the interpretation in paragraph 27 of the Commentary on Article 25 and is not in a position to pursue a mutual agreement procedure where a Hungarian court has already rendered a decision on the merits of the case.

95.1 Regarding paragraphs 21 to 24, *Chile* wishes to clarify that the starting point of the three-year time limit, the date of the "first notification", is the time when the tax administration first notifies the taxpayer of a proposed adjustment, unless an earlier date as discussed in paragraphs 21 to 24 is applicable.

95.2 *Chile* reserves its position in connection with cases discussed in paragraph 23, and takes the view that the three-year time period starts from the filing of the amended return.

95.3 Regarding paragraph 26, *France* does not adhere to the interpretation according to which the circumstances in which a Contracting State would deny access to the mutual agreement procedure, in particular where they concern cases of double taxation involving serious penalties that have become definitive, must necessarily be specified in the Convention.

95.4 *Portugal* does not adhere to the interpretation in paragraph 49 of the Commentary on Article 25. Portugal holds the view that interest and penalties are not taxes covered by the Convention and, therefore, cannot be dealt with in the mutual agreement procedure.

Reservations on the Article

96. *Switzerland* reserves its position on the second sentence of paragraph 2. It considers that the implementation of reliefs and refunds following a mutual agreement ought to remain linked to time limits prescribed by its domestic laws. Switzerland is willing to accept alternative treaty provisions that limit the time during which a Contracting State may make an adjustment pursuant to paragraph 1 of Article 9 or paragraph 2 of Article 7, in order to avoid late adjustments with respect to which MAP relief will not be available.

97. *Denmark*, *Israel*, *Korea*, *Mexico* and *Turkey* reserve the right not to include paragraph 5 in their conventions.

98. *Mexico* and *Poland* 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.

99. With respect to paragraph 2, *Turkey*, for the purpose of regulating tax refund claims, reserves the right to require its taxpayers to make an application to the competent tax office within one year to claim the tax refund resulting from a mutual agreement reached, beginning from the notification date of the result of such agreement.

100. *Canada* reserves the right to include a provision similar to those referred to in paragraph 62 of the Commentary on Article 7 and paragraph 10 of the Commentary on Article 9, which effectively sets a time limit within which a Contracting State can make an adjustment to the income of an enterprise.

101. *Hungary* reserves its position on the last sentence of paragraph 1 as it could not agree to pursue a mutual agreement procedure in the case of a request that would be presented to its competent authority outside the prescription period provided for under its domestic legislation.

102. Due to policy and administrative considerations, *Chile* and *Hungary* reserve the right not to include paragraph 5 in their conventions.

103. *Australia* reserves the right to exclude a case presented under the mutual agreement procedure article from the scope of paragraph 5 to the extent that any unresolved issue involves the application of Australia's general anti-avoidance rules contained in Part IVA of the Income Tax Assessment Act 1936 and section 67 of the Fringe Benefits Tax Assessment Act 1986.

ANNEX

SAMPLE MUTUAL AGREEMENT ON ARBITRATION

1. The following is a sample form of agreement that the competent authorities may use as a basis for a mutual agreement to implement the arbitration process provided for in paragraph 5 of the Article (see paragraph 85 above). Paragraphs 2 to 48 below discuss the various provisions of the agreement and, in some cases, put forward alternatives. Competent authorities are of course free to modify, add or delete any provisions of this sample agreement when concluding their bilateral agreement.

Mutual agreement on the implementation of paragraph 5 of Article 25

The competent authorities of [State A] and [State B] have entered into the following mutual agreement to establish the mode of application of the arbitration process provided for in paragraph 5 of Article 25 of the [title of the Convention], which entered into force on [date of entry into force]. The competent authorities may modify or supplement this agreement by an exchange of letters between them.

1. *Request for submission of case to arbitration*

A request that unresolved issues arising from a mutual agreement case be submitted to arbitration pursuant to paragraph 5 of Article 25 of the Convention (the "request for arbitration") shall be made in writing and sent to one or both of the competent authorities. The request shall contain sufficient information to identify the case. The request shall also be accompanied by a written statement by each of the persons who either made the request or is directly affected by the case that no decision on the same issues has already been rendered by a court or administrative tribunal of the States. Within 10 days after the receipt of the request, a competent authority who received it without any indication that it was also sent to the other competent authority shall send a copy of that request and the accompanying statements to the other competent authority.

2. *Start date of the two-year period*

1. A request for arbitration may only be made after two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities (hereinafter referred to as the "start date"). For this purpose, the information required by the competent authorities in order to address the case shall include: [the necessary information and documents will be specified in the agreement].

2. The following rules shall apply in order to determine the start date:

a) The competent authority that received the initial request for a mutual agreement procedure under paragraph 1 of Article 25 of the Convention shall, within 60 days after receiving the request:

(i) send a notification to the person who presented the case that it has received the request; and

(ii) send a notification of that request, along with a copy of the request, to the competent authority of the other Contracting State.

b) Within 90 days after receiving the request for a mutual agreement procedure (or a copy thereof from the competent authority of the other Contracting State), each competent authority shall either:

(i) notify the person who has presented the case and the other competent authority that it has received the information necessary to undertake substantive consideration of the case; or

(ii) request additional information from that person for that purpose.

c) Where, pursuant to subdivision (ii) of subparagraph *b*) above, one or both of the competent authorities have requested from the person who presented the case additional information necessary to undertake substantive consideration of the case, the competent authority that requested the additional information shall, within 90 days after receiving the additional information from that person, notify that person and the other competent authority either:

(i) that it has received the requested information; or

(ii) that some of the requested information is still missing.

d) Where neither competent authority has requested additional information pursuant to subdivision (ii) of subparagraph *b*) above, the start date shall be the earlier of:

(i) the date on which both competent authorities have notified the person who presented the case pursuant to subdivision (i) of subparagraph *b*) above; and

(ii) the date that is 90 days after the notification to the competent authority of the other Contracting State pursuant to subdivision (ii) of subparagraph *a*) above.

e) Where additional information has been requested pursuant to subdivision (ii) of subparagraph *b*) above, the start date shall be the earlier of:

(i) the latest date on which the competent authorities that requested additional information have notified the person who presented the case and the other competent authority pursuant to subdivision (i) of subparagraph *c*) above; and

(ii) the date that is 90 days after both competent authorities have received all information requested by either competent authority from the person who presented the case.

If, however, one or both of the competent authorities send the notification referred to in subdivision (ii) of subparagraph *c*) above, such notification shall be treated as a request for additional information under subdivision (ii) of subparagraph *b*).

[Terms of Reference: as explained in paragraphs 15.1 to 15.5 of the explanations that follow this sample agreement, the agreement could also provide for the adoption of "terms of reference"]

3. *Selection and appointment of arbitrators*

1. The arbitration panel shall consist of three individual arbitrators with expertise or experience in international tax matters. Each arbitrator appointed to the arbitration panel must be impartial and independent of the competent authorities, tax administrations, and ministries of finance of the Contracting States and of all persons directly affected by the case (as well as their advisors) at the time of accepting an appointment, maintain his or her impartiality and independence throughout the proceedings, and avoid any conduct for a reasonable period of time thereafter which may damage the appearance of impartiality and independence of the arbitrators with respect to the proceedings.

2. Within 60 days after the request for arbitration (or a copy thereof) has been received by both competent authorities, the competent authorities shall each appoint one arbitrator. Within 60 days after the latter appointment, the arbitrators so appointed will appoint a third arbitrator who will function as Chair. The Chair shall not be a national or resident of either Contracting State.

3. If any appointment is not made within the required time period, the arbitrator(s) not yet appointed shall be appointed by the highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development who is not a national of either Contracting State within 10 days after receiving a request to that effect from the person who made the request for arbitration. The same procedure shall apply with the necessary adaptations if for any reason it is necessary to replace an arbitrator after the arbitration process has begun.

4. An arbitrator will be considered to have been appointed when a letter confirming that appointment and signed by both the arbitrator and the person or persons who have the power to appoint that arbitrator has been communicated to both competent authorities.

4. *Arbitration process*

1. Within 60 days after the appointment of the Chair of the arbitration panel (unless, before the end of that period, the competent authorities agree on a different period or agree to use the approach described in Article 5 with respect to the relevant case), the competent authority of each Contracting State shall submit to each arbitrator and to the other competent authority a proposed resolution which addresses all unresolved issue(s) in the case (taking into account all agreements previously reached in that case between the competent authorities). The proposed resolution shall be limited to a disposition of specific monetary amounts (for example, of income) or, where specified, the maximum amount of tax that may be charged pursuant to the provisions of the Convention, for each adjustment or similar issue in the case. In a case in which the competent authorities of the Contracting States have been unable to reach agreement on an issue regarding the conditions for application of a provision of the Convention (hereinafter referred to as a "threshold question"), such as whether an individual is a resident or whether a permanent establishment exists, the competent authorities may submit alternative proposed resolutions with respect to issues the determination of which is contingent on resolution of such threshold questions.

2. The competent authority of each Contracting State may also submit to the arbitrators and to the other competent authority, within the period of time provided for in paragraph 1, a supporting position paper for consideration by the arbitrators.

3. Each competent authority may also submit to the arbitrators and to the other competent authority, within 120 days after the appointment of the Chair of the arbitration panel, a reply submission with respect to the proposed resolution and supporting position paper submitted by the other competent authority.

4. As far as possible, the arbitrators will use tele- and videoconferencing to communicate between themselves and with both competent authorities. If a face-to-face meeting involving additional costs is necessary, the Chair will contact the competent authorities who will decide when and where the meeting should be held and will communicate that information to the arbitrators.

5. The arbitration panel shall select as its decision one of the proposed resolutions for the case submitted by the competent authorities with respect to each issue and any threshold questions, and shall not include a rationale or any other explanation of the decision. The arbitration decision will be adopted by a simple majority of the arbitrators. Unless the competent authorities agree otherwise, the arbitration decision shall be delivered to the competent authorities of the Contracting States in writing within 60 days after the

reception by the arbitrators of the last reply submission or, if no reply submission has been submitted, within 150 days after the appointment of the Chair of the arbitration panel. The arbitration decision shall have no precedential value.

5. *Optional arbitration process*

1. If, within 60 days after the appointment of the Chair of the arbitration panel, the competent authorities agree to use the approach described in this Article with respect to a given case, each competent authority must provide to the arbitration panel and to the other competent authority, within 120 days after that election, any information that it considers necessary for the panel to reach its decision. That information should include a description of the facts and of the unresolved issues to be decided together with the position of the competent authority concerning these issues and the arguments supporting that position. Unless the competent authorities agree otherwise, the arbitration panel may not take into account any information that was not available to both competent authorities before both competent authorities received the request for arbitration (or a copy thereof).

2. The person who made the request for arbitration may, either directly or through his representatives, present his position to the arbitrators in writing to the same extent that he can do so during the mutual agreement procedure. In addition, if the competent authorities and arbitrators all agree, the person may present his position orally during the arbitration proceedings.

3. Within 30 days after the Chair has informed the competent authorities that a meeting of the arbitration panel should be held, the competent authorities will decide when and where the meeting will be held and will communicate that information to the arbitrators.

4. The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the Convention and, subject to these provisions, of those of the domestic laws of the Contracting States. The arbitrators shall also consider any other sources which the competent authorities of the Contracting States may by mutual agreement expressly identify.

5. Subject to the provisions of the Convention and of this agreement, the arbitrators shall adopt those procedural and evidentiary rules that they deem necessary to provide a decision concerning the unresolved issues submitted to arbitration.

6. Unless the competent authorities agree otherwise, the arbitration decision shall be delivered to the competent authorities of the Contracting States in writing within 365 days after the date of the appointment of the Chair and shall indicate the sources of law relied upon and the reasoning which led

to its result. The arbitration decision shall be adopted by a simple majority of the arbitrators. The arbitration decision shall have no precedential value. With the permission of the person who made the request for arbitration and both competent authorities, the decision of the arbitration panel will be made public in redacted form without mentioning the names of the parties involved or any details that might disclose their identity and with the mention that the decision has no formal precedential value.

6. *Communication of information and confidentiality*

1. For the sole purposes of the application of the provisions of Articles 25 and 26 and of the domestic laws of the Contracting States, concerning the communication and the confidentiality of the information related to the case that results in the arbitration process, each arbitrator and a maximum of three staff per arbitrator (and prospective arbitrators solely to the extent necessary to verify their ability to fulfil the requirements of arbitrators) shall be designated as authorised representatives of the competent authority that has appointed that arbitrator or, if that arbitrator has not been appointed by a competent authority, of both competent authorities.

2. In designating a person as its authorised representative pursuant to paragraph 1, the competent authority of a Contracting State shall ensure that the person agrees in writing to treat any information relating to the arbitration proceeding consistently with the confidentiality requirements of the Convention and of the applicable laws of that Contracting State.

7. *Suspension of time in the case of failure to provide information in a timely manner*

Where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start date of the two-year period referred to in paragraph 1 of Article 2, the period provided in that paragraph shall be extended for an amount of time equal to the period beginning on the date by which the information was requested and ending on the date on which that information was provided.

8. *Costs*

Unless agreed otherwise by the competent authorities:

a) each competent authority and the person who requested the arbitration will bear the costs related to his own participation in the arbitration proceedings (including travel costs and costs related to the preparation and presentation of his views);

b) each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority, or appointed by the highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development that is not a national of either Contracting State because of the failure of that competent authority to appoint that arbitrator, together with that arbitrator's travel, telecommunication and secretariat costs;

c) the remuneration of the Chair of the arbitration panel and that Chair's travel, telecommunication and secretariat costs will be borne in equal shares by the two competent authorities;

d) other costs related to any meeting of the arbitration panel will be borne by the competent authority that hosts that meeting; and

e) other costs related to expenses that both competent authorities have agreed to incur will be borne in equal shares by the two competent authorities.

9. *Failure to communicate the decision within the required period*

In the event that the decision has not been communicated to the competent authorities within the period provided for in paragraph 5 of Article 4 or paragraph 6 of Article 5, as the case may be, or within any other period agreed to by the competent authorities, the competent authorities may agree to appoint new arbitrators in accordance with Article 3. The date of such agreement shall, for the purposes of the subsequent application of Article 3, be deemed to be the date when the request for arbitration has been received by both competent authorities.

10. *Where no arbitration decision will be provided*

Where, at any time after a request for arbitration has been made and before the arbitrators have delivered a decision to the competent authorities, the competent authorities notify in writing the arbitrators

a) that they have solved all the unresolved issues that were subject to arbitration, or

b) that the person who presented the case has withdrawn the request for arbitration or the request for a mutual agreement procedure

no arbitration decision shall be provided and the mutual agreement procedure shall be considered to have been completed.

11. *Final decision*

The arbitration decision shall be final, unless that decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or for any other reasons. If a decision is

found to be unenforceable, the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place (except for the purposes of Articles 6 "Communication of information and confidentiality" and 8 "Costs").

12. Implementing the arbitration decision

The competent authorities will implement the arbitration decision within 180 days after the communication of the decision to them by reaching a mutual agreement on the case that led to the arbitration.

This agreement applies to any request for arbitration made pursuant to paragraph 5 of Article 25 of the Convention after that provision has become effective.

[Date of signature of the agreement]

[Signature of the competent authority of each Contracting State]

General approach of the sample agreement

2. There are two main approaches that can be followed when designing the arbitration process that will be used to supplement the mutual agreement procedure. Under one approach, the so-called "last best offer" or "final offer" approach, each competent authority would be required to give to the arbitration panel a proposed resolution of the issue involved and the arbitration panel would choose between the two proposals which were presented to it. Alternatively, under what might be referred to as the "independent opinion" approach, the arbitrators would be presented with the facts and arguments by the parties based on the applicable law, and would then reach their own independent decision which would be based on a written, reasoned analysis of the facts involved and applicable legal sources.

3. Each of the two approaches has advantages and disadvantages and the choice of the approach depends on a number of policy considerations that are often specific to each State. In addition, there are obviously a number of variations of these two approaches. For example, the arbitrators could reach an independent decision but would not be required to submit a written decision but simply their conclusions. To some extent, the appropriate method may also depend on the type of issue to be decided.

4. The above sample agreement takes as its starting point the "last best offer" approach which is thus the generally applicable process but, in recognition of the fact that in some cases, especially those which involve complex legal questions, the competent authorities may prefer to receive a more elaborate decision, it also provides for an alternative "independent opinion" process. Competent authorities can therefore agree to use that independent opinion process on a case-by-case basis. Competent authorities may of course adopt this combined approach, adopt the independent

opinion approach as the generally applicable process with the last best offer approach as an option or limit themselves to only one of the two approaches.

The request for arbitration

5. Article 1 of the sample agreement provides the manner in which a request for arbitration should be made. Such request should be presented in writing to one of the competent authorities involved in the case. That competent authority should then inform the other competent authority within 10 days after the receipt of the request.

6. In order to determine that the conditions of paragraph 5 of Article 25 have been met (see paragraph 76 of the Commentary on this Article) the request should be accompanied by statements indicating that no decision on these issues has already been rendered by domestic courts or administrative tribunals in either Contracting State.

7. Since the arbitration process is an extension of the mutual agreement procedure that is intended to deal with cases that cannot be solved under that procedure, it would seem inappropriate to ask the person who makes the request to pay in order to make such request or to reimburse the expenses incurred by the competent authorities in the course of the arbitration proceedings. Unlike taxpayers' requests for rulings or other types of advance agreements, where a charge is sometimes made, providing a solution to disputes between the Contracting States is the responsibility of these States for which they in general should bear the costs.

Start date of the two-year period

8. A request for arbitration may not be made before two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities. Paragraph 1 of Article 2 of the sample agreement refers to the information that is required for that purpose. That paragraph should include a list of the information required by the competent authorities; in general, that information will correspond to the information and documents that were required to begin the consideration of the case. Ordinarily, a Contracting State's published guidance would indicate the information that would be required for that purpose. In such cases, it is assumed that the competent authorities would generally mutually agree to list or otherwise identify the information included in that guidance as the information that would be required by each Contracting State.

9. Paragraph 2 of Article 2 describes the process to be followed in order to determine the precise date on which the two-year period begins.

10. Subparagraph *a*) provides that the competent authority that received the initial request for a mutual agreement procedure must, within 60 days after receiving that request, notify the person who presented the case that the request has been received, and send a notification of the request, along with a copy of the request, to the other competent authority.

11. Under subparagraph *b*), a competent authority must notify the person that presented the case and the other competent authority that it has received all information necessary to undertake substantive consideration of the case, or request additional information for that purpose from the person that presented the case, within 90 days after the date on which it received the initial request or was notified of the request, as the case may be.

12. Where one or both competent authorities request additional information, subparagraph *c*) provides that after receiving such information, the competent authority requesting the information would have 90 days to notify the person presenting the case and the other competent authority that it has received all necessary information, or that requested information is still missing.

13. The start date of the two-year period depends on whether such additional information has been requested. Where no request for additional information has been made, subparagraph *d*) provides that the start date is the earlier of: i) the date on which both competent authorities have notified the person who presented the case that all necessary information was received (i.e. the date on which the second of the two competent authorities has made that notification), and ii) 90 days after the date on which the competent authority to which the request for a mutual agreement procedure was initially made notified the other competent authority of the request.

14. Where additional information was requested, subparagraph *e*) provides that, in general, the start date is the earlier of: i) the latest date on which the competent authorities that requested additional information have notified the taxpayer and the other competent authority that the information has been received; and ii) the date that is 90 days after both competent authorities have received the additional information from the person who presented the case. If either competent authority notifies the taxpayer and the other competent authority that some of the requested information is still missing, such notification shall be treated as a request for additional information.

15. In some cases, after a taxpayer has provided the initial information needed to undertake substantive consideration of the case, the competent authorities may need to request additional information from the taxpayer. In such cases, a failure by a person directly affected by the case (i.e. the person who made the initial request for a mutual agreement procedure or a person whose tax liability is directly affected by the case) to provide such additional information in a timely manner may delay or prevent the competent authorities from being able to resolve the case. To address such cases, Article 7 of the sample agreement provides that the two-year period shall be extended where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start of that period. In that case the period will be extended for an amount of time equal to the period beginning on the date by which the information was requested and ending on the date on which that information was ultimately provided.

Terms of reference

15.1 Although the sample agreement does not expressly include provisions on the adoption of "terms of reference" as the first step of the arbitration process, the competent authorities may find it useful to include such provisions in the mutual agreement implementing the arbitration process. These provisions could be drafted as follows:

Terms of reference

1. Within 60 days after the request for arbitration (or a copy thereof) has been received by both competent authorities, the competent authorities shall agree on the questions to be resolved by the arbitration panel and communicate them in writing to the person who made the request for arbitration. This will constitute the "Terms of Reference" for the case. Notwithstanding the following paragraphs of this agreement, the competent authorities may also, in the Terms of Reference, provide procedural rules that are additional to, or different from, those included in these paragraphs and deal with such other matters as are deemed appropriate.

2. If the Terms of Reference have not been communicated to the person who made the request for arbitration within the period referred to in paragraph 1 above, that person and each competent authority may, within 30 days after the end of that period, communicate in writing to each other a list of issues to be resolved by the arbitration. All the lists so communicated during that period shall constitute the tentative Terms of Reference. Within 30 days after all the arbitrators have been appointed as provided in the following paragraphs of this agreement, the Chair shall communicate to the competent authorities and the person who made the request for arbitration a revised version of the tentative Terms of Reference based on the lists so communicated. Within 30 days after the revised version has been received by both of them, the competent authorities will have the possibility to agree on different Terms of Reference and to communicate them in writing to the arbitrators and the person who made the request for arbitration. If they do so within that period, these different Terms of Reference shall constitute the Terms of Reference for the case. If no different Terms of Reference have been agreed to between the competent authorities and communicated in writing within that period, the revised version of the tentative Terms of Reference prepared by the arbitrators shall constitute the Terms of Reference for the case.

15.2 If such provisions are included in the agreement, it would be necessary to extend the period of time within which, under Article 3 of the sample mutual agreement, each competent authority shall appoint an arbitrator. That period could, for example, be extended to 90 days, which would allow the competent authorities the possibility of taking into account the agreed Terms of Reference in selecting their respective arbitrators.

15.3 The "Terms of Reference" would be the document that would set forth the questions to be resolved by the arbitrators. It would establish the jurisdictional basis for the issues which are to be decided by the arbitration panel. It would be established

by the competent authorities who might wish in that connection to consult with the person who made the request for arbitration. If the competent authorities cannot agree on the Terms of Reference within the period provided for in the suggested paragraph 1 above, some mechanism would be necessary to ensure that the procedure goes forward. The suggested paragraph 2 above provides for that eventuality.

15.4 Whilst the Terms of Reference would generally be limited to a particular issue or set of issues, it would be possible for the competent authorities, given the nature of the case and the interrelated nature of the issues, to draft the Terms of Reference so that the whole case (and not only certain specific issues) be submitted to arbitration.

15.5 As indicated in the suggested paragraph 1 above, the procedural rules provided for in the sample agreement would apply unless the competent authorities provide otherwise in the Terms of Reference. It would therefore be possible for the competent authorities, through the Terms of Reference, to depart from any of these rules (including, for example, the rules for the nomination and remuneration of the arbitrators) or to provide for additional rules in a particular case.

Selection and appointment of arbitrators

16. Article 3 of the sample agreement describes how arbitrators will be selected. Normally, the two competent authorities will each appoint one arbitrator. These appointments must be made within 60 days after the request for arbitration has been received by both competent authorities. The arbitrators thus appointed will select a Chair who must be appointed within 60 days after the date on which the last of the initial appointments was made. If the competent authorities do not appoint an arbitrator during the required period, or if the arbitrators so appointed do not appoint the third arbitrator within the required period, the paragraph provides that the appointment will be made by the highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development who is not a national of either Contracting State. The competent authorities may, of course, provide for other ways to address these rare situations but it seems important to provide for an independent appointing authority to solve any deadlock in the selection of the arbitrators.

17. Paragraph 1 of Article 3 provides the requirements that each arbitrator must satisfy. The arbitrators must have expertise or experience in international tax matters, though, unless the competent authorities agree otherwise, there is no requirement that each arbitrator have experience as a judge or an arbitrator. In addition, each arbitrator must, at the time of accepting his or her appointment, be impartial and independent of the competent authorities, tax administrations, and ministries of finance (or relevant equivalent ministries or departments, regardless of their name) of the Contracting States, as well as all persons directly affected by the case and their advisors. Each arbitrator must also maintain his or her impartiality and independence throughout the proceedings, and must, for a reasonable period of time thereafter, avoid conduct that may damage the appearance of impartiality and independence of the

arbitrators with respect to the proceedings. Such conduct would include, for example, accepting employment with one of the persons directly affected by the case soon after delivering the arbitration decision with respect to the case. The competent authorities are free to agree on additional details with respect to the applicable standards for impartiality and independence. For example, the competent authorities may wish to require that any prospective arbitrator disclose to the competent authorities any fact or circumstance likely to call into question that prospective arbitrator's impartiality or independence. The competent authorities may also wish to agree to rules addressing the situation in which an arbitrator is unable to perform his or her duties, as a result of illness or incapacity, failing to meet standards for impartiality and independence, or any other reason.

18. Paragraph 4 of Article 3 clarifies when an arbitrator shall be considered to have been appointed, which is relevant for the purposes of other provisions that make reference to the date of appointment of one or more arbitrators. The appointment shall be considered to have been made when a letter confirming that appointment and signed both by the arbitrator and by the person or persons who have the power to appoint that arbitrator pursuant to paragraphs 2 and 3 of the Article has been communicated to both competent authorities.

The arbitration process

19. Article 4 provides the rules that will apply to the arbitration process unless, within 60 days after the appointment of the Chair of the arbitration panel, the competent authorities agree to use the optional approach of Article 5 with respect to the relevant case.

20. As indicated in paragraph 4 above, the arbitration process proposed in the sample agreement follows the "last best offer" approach. Paragraph 1 of the Article provides that the first step of that process is for the competent authority of each Contracting State to submit to each arbitrator, within 60 days after the appointment of the Chair (or any different period agreed to by the competent authorities before the end of that 60-day period), a proposed resolution which addresses all the unresolved issues of the case in a manner that is consistent with any previous agreements that have been reached in that case by the competent authorities. For each adjustment or similar issue in the case, the proposed resolution will include only the disposition of specific monetary amounts (for example, of income) or the maximum amount of tax that may be charged pursuant to the provisions of the Convention. In some cases, however, unresolved issues will include questions regarding whether the conditions for applying a provision of the Convention have been met. Where the unresolved issues in a case include such a "threshold question", such as whether a person is a resident of a Contracting State or whether an enterprise of a Contracting State has a permanent establishment in the other Contracting State, the competent authorities may submit their proposed answers to the threshold question (i.e. yes or no). If there are other unresolved issues the disposition of which is contingent on the answer reached with

respect to the threshold question, it is expected that the competent authorities would also submit alternative proposed resolutions of those remaining issues.

21. As explained in paragraph 2 of the Article, the proposed resolutions submitted by the competent authorities of each Contracting State may be supported by a position paper to be provided within the same period of time.

22. Paragraph 3 provides that each competent authority may also submit, within 120 days after the appointment of the Chair, a reply submission with respect to the proposed resolution and supporting position paper submitted by the other competent authority. The reply submission and its supporting position paper are meant to address only the positions and arguments of the other competent authority, and are not intended as an opportunity for a competent authority to advance additional arguments in favour of its own position.

23. Given the nature of the "last best offer" process, a face-to-face meeting of the arbitrators will typically not be necessary and the arbitrators will be able to liaise between themselves and with both competent authorities by telephone or video conference. This is provided in paragraph 4 which adds that if a face-to-face meeting involving additional costs is necessary, the Chair will first contact the competent authorities who will then decide when and where the meeting should be held.

24. Paragraph 5 provides that the arbitration panel will select as its decision one of the proposed resolutions submitted by the competent authorities. In a case involving one or more threshold questions, the arbitration panel will decide the threshold questions, and then adopt one of the alternative proposed resolutions submitted by the competent authorities. The decision will be adopted by a simple majority of the arbitrators, and will not include any rationale or explanation. In light of the purpose of arbitration to act as a streamlined method for resolving disputes between the competent authorities, the decision will be delivered in writing to the competent authorities and may not be used as precedent with respect to any other cases. Unless the competent authorities agree otherwise, the arbitration decision will be delivered within 60 days after the reception by the arbitrators of the last reply submission or, if no reply submission has been submitted, within 150 days after the appointment of the Chair.

The optional arbitration process

25. Article 5 provides the rules for the "independent opinion" process which, under the sample agreement, the competent authorities may elect to use on a case-by-case basis. That election must be exercised within 60 days after the appointment of the Chair of the arbitration panel.

26. Paragraph 1 of the Article provides that if the competent authorities have made that election, each competent authority must provide to the arbitration panel and to the other competent authority, within 120 days after that election, any information that it considers necessary for the panel to reach its decision. It is assumed that this information will include a description of the facts and of the issues to be decided, the

position of the competent authority on these issues and the arguments supporting that position. Unless the competent authorities agree otherwise, the arbitration panel may not take into account any information that was not available to both competent authorities before both competent authorities received the request for arbitration.

27. It is expected that one or more meetings of the arbitration panel and both competent authorities will be necessary to discuss the case. Paragraph 3 provides that the competent authorities will decide when and where each such meeting will be held within 30 days after the Chair of the arbitration panel has informed them of the need for such a meeting.

28. Paragraph 2 provides that the person requesting arbitration, either directly or through its representatives, is entitled to present a written submission of its position to the arbitrators to the same extent that the person can present such a submission during the mutual agreement procedure and, if the competent authorities and arbitrators all agree, to make an oral presentation during a meeting of the arbitrators. The involvement in the arbitration process of the person who made the request for arbitration is, therefore, conditional on what the competent authorities agree as part of the mutual agreement procedure and during the arbitration process.

29. The simplest way to establish the procedural rules that will govern the "independent opinion" arbitration process and that have not already been agreed to between the competent authorities is to leave it to the arbitrators to develop these rules on an ad hoc basis. In doing so, the arbitrators are free to refer to existing arbitration procedures. It should be made clear in the procedural rules that, unless agreed otherwise by the competent authorities, the factual material on which the arbitration panel will base its decision will be that developed in the mutual agreement procedure (see the last sentence of paragraph 1 of the Article). Paragraph 5 of the Article follows that approach. Thus, decisions as regards the format of arbitration meetings will be made by the arbitrators unless otherwise agreed to by the competent authorities.

30. According to paragraph 4 of the Article, the arbitrators will decide the issues which have been submitted to arbitration in accordance with the applicable provisions of the Convention and, subject to those provisions, those of the domestic laws of the Contracting States. In this regard, the arbitration panel would review the application of domestic law only to the extent necessary to determine whether a Contracting State correctly applied the provisions of the Convention.

31. As indicated in paragraph 4, the competent authorities may also, by mutual agreement, identify other sources of law or authority that will be considered by the arbitration panel. Issues on which competent authorities have difficulties reaching agreement often include matters of treaty interpretation or matters related to the application of the arm's length principle underlying Article 9 and paragraph 2 of Article 7. Competent authorities may therefore wish to provide that matters of treaty interpretation should be decided by the arbitrators in the light of the principles of interpretation incorporated in Articles 31 to 33 of the *Vienna Convention on the Law of*

Treaties, having regard to the Commentaries of the OECD Model Tax Convention as periodically amended, as explained in paragraphs 28 to 36.1 of the Introduction. They could also provide that issues related to the application of the arm's length principle should similarly be decided in the light of the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Since Article 32 of the *Vienna Convention on the Law of Treaties* permits a wide access to supplementary means of interpretation, arbitrators will, in practice, have considerable latitude in determining relevant sources for the interpretation of treaty provisions. Also, there may be cases where the competent authorities agree that the interpretation or application of a provision of a tax treaty depends on a particular document (e.g. a memorandum of understanding or mutual agreement concluded after the entry into force of a treaty) but may disagree about the interpretation of that document. In such a case, the competent authorities may wish to make express reference to that document.

32. Paragraph 6 of the Article provides that unless the competent authorities agree otherwise, the decision of the arbitration panel will be delivered to the competent authorities in writing within 365 days after the date of the appointment of the Chair. The decision will indicate the sources of law relied upon and the reasoning which led to its result. It would also normally include a description of the relevant facts and circumstances of the case, a clear statement of the positions of both competent authorities, and a short summary of the proceedings. The adoption of the arbitration decision will be by a simple majority of the arbitrators. As with the "last best offer" approach, the decision will have no precedential value but paragraph 6 provides for the possibility to publish the decision. Such publication, however, should only be made if both competent authorities and the person who made the arbitration request so agree. Also, in order to maintain the confidentiality of information communicated to the competent authorities, the publication should be made in a form that would not disclose the names of the parties nor any element that would help to identify them. Decisions on individual cases reached under the mutual agreement procedure are generally not made public but, in the case of reasoned arbitration decisions, publishing the decisions would lend additional transparency to the process. Also, whilst the decision would not be in any sense a formal precedent, having the material in the public domain could influence the course of other cases so as to avoid subsequent disputes and lead to a more uniform approach to the same issue.

Communication of information and confidentiality

33. It is important that arbitrators be allowed full access to the information needed to resolve the issues submitted to arbitration but, at the same time, be subjected to the same strict confidentiality requirements as regards that information as apply to the competent authorities themselves. The proposed approach to ensure that result, which is incorporated in Article 6 of the sample agreement, is to make the arbitrators authorised representatives of the competent authorities. This, however, will only be for the purposes of the application of the relevant provisions of the Convention (i.e. Articles 25, and 26) and of the provisions of the domestic laws of the Contracting

States, which would normally include the sanctions applicable in case of a breach of confidentiality.

Suspension of time in the case of failure to provide information in a timely manner

34. As indicated in paragraph 15 above, Article 7 of the sample agreement provides that the two-year period referred to in paragraph 1 of Article 2 may be extended where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start of that two-year period. In that case, the approach taken by the sample agreement is to extend that two-year period by an amount of time equal to the period beginning on the date by which the information was requested and ending on the date on which that information was provided. Where, however, the competent authorities are not provided with the information necessary to solve a particular case, there is nothing that prevents them from resolving the case on the basis of the limited information that is at their disposal, thereby preventing any access to arbitration. Also, it would be possible to provide in the agreement that if within an additional period (e.g. one year), the taxpayer still had not provided additional material information requested by either competent authority, the issue would no longer be required to be submitted to arbitration.

Costs

35. Different costs may arise in relation to the arbitration process and it should be clear who should bear these costs. Article 8 of the sample agreement, which deals with this issue, is based on the principle that where a competent authority or a person involved in the case can control the amount of a particular cost, this cost should be borne by that party and that other costs should be borne in equal shares by the two competent authorities.

36. Thus, it seems logical to provide that each competent authority, as well as the person who requested the arbitration, should pay for its own participation in the arbitration proceedings. This would include costs of being represented at the meetings and of preparing and presenting a position and arguments, whether in writing or orally. This is provided in subparagraph *a*).

37. The fees to be paid to the arbitrators are likely to be one of the major costs of the arbitration process. As indicated in subparagraph *b*), each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority (or appointed by the highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development because of the failure of that competent authority to appoint that arbitrator), together with that arbitrator's travel, telecommunication and secretariat costs.

38. Subparagraph *c*) provides, however, that the fees and the travel, telecommunication and secretariat costs of the Chair of the arbitration panel will be

borne in equal shares by the competent authorities. The competent authorities will normally agree to incur these costs at the time that the arbitrators are appointed and this would typically be confirmed in the letter of appointment. The fees should be large enough to ensure that appropriately qualified experts could be recruited.

39. The competent authorities may also wish to include in the agreement a scale for the fees to be paid to the arbitrators. They are free to agree to set such fees in a way that reflects the particular circumstances of the Contracting States, their particular relationship, and the type of arbitration process. Competent authorities have used a variety of schedules of fees as resources for this purpose, including the schedule of fees set by the International Centre for Settlement of Investment Disputes and the schedule of fees provided in the Revised Code of Conduct for the EU Arbitration Convention. The agreement may also limit the amount of travel and the number of days for which the arbitrators will be compensated.

40. The costs related to any meeting of the arbitration panel, including those of the administrative personnel necessary for the preparation and conduct of that meeting and costs associated to the use of meeting facilities, will be borne by the competent authority that will host that meeting. In most cases, that competent authority will use meeting facilities and personnel that it already has at its disposal and it would seem inappropriate to try to allocate part of the costs thereof to the other competent authority. Clearly, the reference to "costs related to the meetings" does not include the travel and accommodation costs incurred by the participants; these are dealt with above.

41. The other costs (not including any costs resulting from the taxpayers' participation in the process) should be borne in equal shares by the two competent authorities as long as they have agreed to incur the relevant expenses. This would include, for example, costs related to translation and recording that both competent authorities have agreed to provide. It would also include the costs of a meeting of the arbitration panel agreed to by both competent authorities but not hosted by either of them. In the absence of an agreement between the competent authorities, the party that has requested that particular costs be incurred should pay for these.

42. As indicated at the beginning of Article 8, the competent authorities may, however, depart from these rules and agree to a different allocation of costs with respect to a specific case or a specific expense.

Failure to communicate the decision within the required period

43. In order to deal with the unusual circumstances in which the arbitrators may be unable or unwilling to present an arbitration decision, Article 9 provides that if the decision is not communicated within the period provided for in paragraph 5 of Article 4 or paragraph 6 of Article 5, or within any other period agreed to by the competent authorities, the competent authorities may agree to appoint new arbitrators to deal with the case. In such a case, the date of such an agreement between the competent

authorities will, for the purposes of the process described in Articles 4 and 5, be treated as the date of the request for arbitration.

Where no arbitration decision will be provided

44. Article 10 of the sample agreement first deals with the case where the competent authorities are able to solve the unresolved issues that led to arbitration before the decision is rendered. Since the arbitration process is an exceptional mechanism to deal with issues that cannot be solved under the usual mutual agreement procedure, it is appropriate to put an end to that exceptional mechanism if the competent authorities are able to resolve these issues by themselves. The competent authorities may agree on a resolution of these issues as long as the arbitration decision has not been rendered. Article 10 also provides that the arbitration process and the mutual agreement procedure will terminate automatically if, before a decision has been rendered, the person that presented the case withdraws either its request for arbitration or its request for a mutual agreement procedure.

Final decision

45. Article 11 deals with the case where the arbitration decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or for any other reason. In such a case, the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place except for the purposes of the provisions of the sample agreement dealing with "Communication of information and confidentiality" and "Costs". In that case, the taxpayer can immediately make a new request for arbitration since the two-year period for making such a request will have already passed. The competent authorities may also provide, however, that such a request should not be permitted in certain cases, e.g. where the actions of the taxpayer were the main reason for the invalidation of the arbitration decision.

46. Article 11 is not intended to provide independent grounds for the invalidation of an arbitration decision where such grounds do not exist under the domestic laws of the Contracting States. Instead, it is meant to ensure that where a court of one of the Contracting States invalidates an arbitration decision based on such existing rules, the other Contracting State is not bound to implement the decision. This may occur under the domestic laws of some States, for example, where there has been a procedural failure (e.g. a violation of the impartiality or independence requirements applicable to arbitrators) that has materially affected the outcome of the arbitration process. Since the arbitration decision is final, however, it is not expected that a court would invalidate an arbitration decision merely because it disagrees with the outcome of the arbitration process.

Implementing the decision

47. Once the arbitration process has provided a binding solution to the issues that the competent authorities have been unable to resolve, the competent authorities will proceed to conclude a mutual agreement that reflects that decision and that will be presented to the persons directly affected by the case. In order to avoid further delays, it is suggested that the mutual agreement that incorporates the solution arrived at should be completed and presented to the taxpayer within 180 days after the date of the communication of the decision. This is provided in Article 12 of the sample agreement.

48. Paragraph 2 of Article 25 provides that the competent authorities have the obligation to implement the agreement reached notwithstanding any time limit in their domestic law. Paragraph 5 of the Article also provides that the arbitration decision is binding on both Contracting States. Failure to assess taxpayers in accordance with the agreement or to implement the arbitration decision through the conclusion of a mutual agreement would therefore result in taxation not in accordance with the Convention and, as such, would allow the person whose taxation is affected to seek relief through domestic legal remedies or by making a new request pursuant to paragraph 1 of the Article.

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 tax laws of the Contracting States 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 Articles 1 and 2, so that the information may include particulars about non-residents and may relate to the administration or enforcement of taxes not referred to in Article 2.

3. The matter of administrative assistance for the purpose of tax collection is dealt with in Article 27, but exchanges of information for the purpose of tax collection are governed by Article 26 (see paragraph 5 of the Commentary on Article 27). Similarly, mutual agreement procedures are dealt with in Article 25, but exchanges of information for the purposes of a mutual agreement procedure are governed by Article 26 (see paragraph 4 of the Commentary on Article 25).

4. In 2002, the Committee on Fiscal Affairs undertook a comprehensive review of Article 26 to ensure that it reflects current country practices. That review also took into account recent developments such as the *Model Agreement on Exchange of Information on Tax Matters* developed by the OECD Global Forum Working Group on Effective Exchange of Information and the ideal standard of access to bank information as described in the report *Improving Access to Bank Information for Tax Purposes*.[1] As a result, several changes to both the text of the Article and the Commentary were made in 2005.

4.1 Many of the changes that were then made to the Article were not intended to alter its substance, but instead were made to remove doubts as to its proper interpretation. For instance, the change from "necessary" to "foreseeably relevant" and the insertion of the words "to the administration or enforcement" in paragraph 1 were made to achieve consistency with the *Model Agreement on Exchange of Information on Tax Matters* and were not intended to alter the effect of the

1 OECD, Paris, 2000.

provision. Paragraph 4 was added to incorporate into the text of the Article the general understanding previously expressed in the Commentary (see paragraph 19.6). Paragraph 5 was added to reflect practices among the vast majority of OECD member countries (see paragraph 19.10). The insertion of the words "or the oversight of the above" into paragraph 2, on the other hand, constituted a reversal of the previous rule.

4.2 The Commentary was also expanded considerably. This expansion in part reflected the addition of paragraphs 4 and 5 to the Article. Other changes were made to the Commentary to take into account developments and country practices and more generally to remove doubts as to the proper interpretation of the Article.

4.3 The Article and the Commentary were further modified in 2012 to take into account recent developments and to further elaborate on the interpretation of certain provisions of this Article. Paragraph 2 of the Article was amended to allow the competent authorities to use information received for other purposes provided such use is allowed under the laws of both States and the competent authority of the supplying State authorises such use. This was previously included as an optional provision in paragraph 12.3 of the Commentary.

4.4 The Commentary was expanded to develop the interpretation of the standard of "foreseeable relevance" and the term "fishing expeditions" through the addition of: general clarifications (see paragraph 5), language in respect of the identification of the taxpayer under examination or investigation (see paragraph 5.1), language in respect of requests in relation to a group of taxpayers (see paragraph 5.2) and new examples (see subparagraphs *e*) to *h*) of paragraph 8 and paragraph 8.1). The Commentary further provides for an optional default standard of time limits within which the information is required to be provided unless a different agreement has been made by the competent authorities (see paragraphs 10.4 to 10.6) and that in accordance with the principle of reciprocity, if a Contracting State applies under paragraph 5 measures not normally foreseen in its domestic law or practice, such as to access and exchange bank information, that State is equally entitled to request similar information from the other Contracting State (see paragraph 15). Other clarifications were added in paragraphs 3, 5.3, 6, 11, 12, 12.3, 12.4, 16, 16.1 and 19.7.

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 foreseeably relevant 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. The standard of "foreseeable relevance" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to engage in "fishing expeditions" or to request information

that is unlikely to be relevant to the tax affairs of a given taxpayer. In the context of information exchange upon request, the standard requires that at the time a request is made there is a reasonable possibility that the requested information will be relevant; whether the information, once provided, actually proves to be relevant is immaterial. A request may therefore not be declined in cases where a definite assessment of the pertinence of the information to an ongoing investigation can only be made following the receipt of the information. The competent authorities should consult in situations in which the content of the request, the circumstances that led to the request, or the foreseeable relevance of requested information are not clear to the requested State. However, once the requesting State has provided an explanation as to the foreseeable relevance of the requested information, the requested State may not decline a request or withhold requested information because it believes that the information lacks relevance to the underlying investigation or examination. Where the requested State becomes aware of facts that call into question whether part of the information requested is foreseeably relevant, the competent authorities should consult and the requested State may ask the requesting State to clarify foreseeable relevance in the light of those facts. At the same time, paragraph 1 does not obligate the requested State to provide information in response to requests that are "fishing expeditions", i.e. speculative requests that have no apparent nexus to an open inquiry or investigation.

5.1 As is the case under the *Model Agreement on Exchange of Information on Tax Matters*[1] a request for information does not constitute a fishing expedition solely because it does not provide the name or address (or both) of the taxpayer under examination or investigation. The same holds true where names are spelt differently or information on names and addresses is presented using a different format. However, in cases in which the requesting State does not provide the name or address (or both) of the taxpayer under examination or investigation, the requesting State must include other information sufficient to identify the taxpayer. Similarly, paragraph 1 does not necessarily require the request to include the name and/or address of the person believed to be in possession of the information. In fact, the question of how specific a request has to be with respect to such person is typically an issue falling within the scope of subparagraphs *a*) and *b*) of paragraph 3 of Article 26.

5.2 The standard of "foreseeable relevance" can be met both in cases dealing with one taxpayer (whether identified by name or otherwise) or several taxpayers (whether identified by name or otherwise). Where a Contracting State undertakes an investigation into a particular group of taxpayers in accordance with its laws, any request related to the investigation will typically serve "the administration or enforcement" of its domestic tax laws and thus comply with the requirements of paragraph 1, provided it meets the standard of "foreseeable relevance". However, where the request relates to a group of taxpayers not individually identified, it will often be more difficult to establish that the request is not a fishing expedition, as the

1 See paragraph 58 of its Commentary.

requesting State cannot point to an ongoing investigation into the affairs of a particular taxpayer which in most cases would by itself dispel the notion of the request being random or speculative. In such cases it is therefore necessary that the requesting State provide a detailed description of the group and the specific facts and circumstances that have led to the request, an explanation of the applicable law and why there is reason to believe that the taxpayers in the group for whom information is requested have been non-compliant with that law supported by a clear factual basis. It further requires a showing that the requested information would assist in determining compliance by the taxpayers in the group. As illustrated in the example in subparagraph *h*) of paragraph 8, in the case of a group request a third party will usually, although not necessarily, have actively contributed to the non-compliance of the taxpayers in the group, in which case such circumstance should also be described in the request. Furthermore, and as illustrated in the example in subparagraph *a*) of paragraph 8.1, a group request that merely describes the provision of financial services to non-residents and mentions the possibility of non-compliance by the non-resident customers does not meet the standard of foreseeable relevance.

5.3 Contracting States may agree to an alternative formulation of the standard of foreseeable relevance that is consistent with the scope of the Article and is therefore understood to require an effective exchange of information (e.g. by replacing, "is foreseeably relevant" with "is necessary", "is relevant" or "may be relevant"). The scope of exchange of information covers all tax matters without prejudice to the general rules and legal provisions governing the rights of defendants and witnesses in judicial proceedings. Exchange of information for criminal tax matters can also be based on bilateral or multilateral treaties on mutual legal assistance (to the extent they also apply to tax crimes). 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.

5.4 The information covered by paragraph 1 is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement, for example risk analysis techniques or tax avoidance or evasion schemes.

5.5 The possibilities of assistance provided by the Article do not limit, nor are they limited by, those contained in existing international agreements or other arrangements between the Contracting States which relate to co-operation in tax matters. Since the exchange of information concerning the application of custom duties has a legal basis in other international instruments, the provisions of these more specialised instruments will generally prevail and the exchange of information concerning custom duties will not, in practice, be governed by the Article.

6. The following examples seek to clarify the principles dealt with in paragraphs 5, 5.1 and 5.2 above. In the examples mentioned in paragraphs 7 and 8 information can be exchanged under paragraph 1 of Article 26. In the examples mentioned in paragraph 8.1, and assuming no further information is provided, the Contracting

States are not obligated to provide information in response to a request for information. The examples are for illustrative purposes only. They should be read in the light of the overarching purpose of Article 26 not to restrict the scope of exchange of information but to allow information exchange "to the widest possible extent".

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.

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).

d) Information may be needed for the purposes of applying Article 25.

e) When applying Articles 15 and 23 A, State A, where the employee is resident, informs State B, where the employment is exercised for more than 183 days, of the amount exempted from taxation in State A.

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 subparagraph *c)* of paragraph 3 relating to business and other secrets.

d) State A, for the purpose of verifying VAT input tax credits claimed by a company situated in its territory for services performed by a company resident in State B, requests confirmation that the cost of services was properly entered into the books and records of the company in State B.

e) The tax authorities of State A conduct a tax investigation into the affairs of Mr. X. Based on this investigation the tax authorities have indications that Mr. X holds one or several undeclared bank accounts with Bank B in State B. However, State A has experienced that, in order to avoid detection, it is not unlikely that the bank accounts may be held in the name of relatives of the beneficial owner. State A therefore requests information on all accounts with Bank B of which Mr. X is the beneficial owner and all accounts held in the names of his spouse E and his children K and L.

f) State A has obtained information on all transactions involving foreign credit cards carried out in its territory in a certain year. State A has processed the data and launched an investigation that identified all credit card numbers where the frequency and pattern of transactions and the type of use over the course of that year suggest that the cardholders were tax residents of State A. State A cannot obtain the names by using regular sources of information available under its internal taxation procedure, as the pertinent information is not in the possession or control of persons within its jurisdiction. The credit card numbers identify an issuer of such cards to be Bank B in State B. Based on an open inquiry or investigation, State A sends a request for information to State B, asking for the name, address and date of birth of the holders of the particular cards identified during its investigation and any other person that has signatory authority over those cards. State A supplies the relevant individual credit card numbers and further provides the above information to demonstrate the foreseeable relevance of the requested information to its investigation and more generally to the administration and enforcement of its tax law.

g) Company A, resident of State A, is owned by foreign unlisted Company B, resident of State B. The tax authorities of State A suspect that managers X, Y and Z of Company A directly or indirectly own Company B. If that were the case, the dividends received by Company B from Company A would be taxable in their hands as resident shareholders under State A's controlled foreign company rules. The suspicion is based on information provided to State A's tax authorities by a former employee of Company A. When confronted with the allegations, the three managers of Company A deny having any ownership interest in Company B. The State A tax authorities have exhausted all domestic means of obtaining ownership information on Company B. State A now requests from State B information on whether X, Y and Z are shareholders of Company B. Furthermore, considering that ownership in such cases is often held through, for example, shell companies and nominee shareholders it requests information from State B on whether X, Y and Z indirectly hold an ownership interest in Company B. If State B is unable to determine whether X,

Y or Z holds such an indirect interest, information is requested on the shareholder(s) so that it can continue its investigations.[1]

h) Financial service provider B is established in State B. The tax authorities of State A have discovered that B is marketing a financial product to State A residents using misleading information suggesting that the product eliminates the State A income tax liability on the income accumulated within the product. The product requires that an account be opened with B through which the investment is made. State A's tax authorities have issued a taxpayer alert, warning all taxpayers about the product and clarifying that it does not achieve the suggested tax effect and that income generated by the product must be reported. Nevertheless, B continues to market the product on its website, and State A has evidence that it also markets the product through a network of advisors. State A has already discovered several resident taxpayers that have invested in the product, all of whom had failed to report the income generated by their investments. State A has exhausted its domestic means of obtaining information on the identity of its residents that have invested in the product. State A requests information from the competent authority of State B on all State A residents that (*i*) have an account with B and (*ii*) have invested in the financial product. In the request, State A provides the above information, including details of the financial product and the status of its investigation.

8.1 Situations where Contracting States are not obligated to provide information in response to a request for information, assuming no further information is provided

a) Bank B is a bank established in State B. State A taxes its residents on the basis of their worldwide income. The competent authority of State A requests that the competent authority of State B provide the names, date and place of birth, and account balances (including information on any financial assets held in such accounts) of residents of State A that have an account with, hold signatory authority over, or a beneficial interest in an account with Bank B in State B. The request states that Bank B is known to have a large group of foreign account holders but does not contain any additional information.

b) Company B is a company established in State B. State A requests the names of all shareholders in Company B resident of State A and information on all dividend payments made to such shareholders. The requesting State A points out that Company B has significant business activity in State A and is therefore likely to have shareholders resident of State A. The request further states that it is well known that taxpayers often fail to disclose foreign source income or assets.

1 For cases where State B becomes aware of facts that call into question whether part of the shareholder information is foreseeably relevant, the competent authorities should consult and State B may ask State A to clarify foreseeable relevance in light of those facts, as discussed in paragraph 5.

9. The rule laid down in paragraph 1 allows information to be exchanged in three different ways:

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 a 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; see the Recommendations of the OECD Council C(97)29/FINAL, dated 13 March 1997 (*Recommendation on the use of Tax Identification Numbers in an international context*) and C(2001)28/FINAL, dated 22 March 2001 (*Recommendation on the use of the OECD Model Memorandum of Understanding on Automatic Exchange of Information for Tax Purposes*);

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.

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*[1] 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 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 State. To the extent allowed by its domestic law, a Contracting State may permit authorised representatives of the other Contracting State to enter the first Contracting State to interview individuals or examine a person's books and records, — or to be present at such interviews or examinations carried out by the tax authorities of the first Contracting State — in accordance with procedures mutually agreed upon by the competent authorities. Such a request might arise, for example, where the taxpayer in a Contracting State is permitted to keep

1 OECD, Paris, 1994.

records in the other Contracting State. 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. The Joint Council of Europe/OECD Convention on Mutual Administrative Assistance in Tax Matters specifically addresses tax examinations abroad in its Article 9;

— 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.

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. For example, Contracting States may wish to use electronic or other communication and information technologies, including appropriate security systems, to improve the timeliness and quality of exchanges of information. Contracting States which are required, according to their law, to observe data protection laws, may wish to include provisions in their bilateral conventions concerning the protection of personal data exchanged. Data protection concerns the rights and fundamental freedoms of an individual, and in particular, the right to privacy, with regard to automatic processing of personal data. See, for example, the *Council of Europe Convention for the Protection of Individuals with regard to Automatic Processing of Personal Data* of 28 January 1981.

10.1 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 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 the Article to the taxes covered by the Convention.

10.2 In some cases, a Contracting State may need to receive information in a particular form to satisfy its evidentiary or other legal requirements. Such forms may include depositions of witnesses and authenticated copies of original records. Contracting States should endeavour as far as possible to accommodate such requests. Under paragraph 3, the requested State may decline to provide the information in the specific form requested if, for instance, the requested form is not known or permitted

under its law or administrative practice. A refusal to provide the information in the form requested does not affect the obligation to provide the information.

10.3 Nothing in the Convention prevents the application of the provisions of the Article to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such information, in particular when the provisions of that convention will have effect with respect to taxes arising or levied from a certain time.

10.4 Contracting States may wish to improve the speediness and timeliness of exchange of information under this Article by agreeing on time limits for the provision of information. Contracting States may do so by adding the following language to the Article:

> 6. The competent authorities of the Contracting States may agree on time limits for the provision of information under this Article. In the absence of such an agreement, the information shall be supplied as quickly as possible and, except where the delay is due to legal impediments, within the following time limits:
>
> *a)* Where the tax authorities of the requested Contracting State are already in possession of the requested information, such information shall be supplied to the competent authority of the other Contracting State within two months of the receipt of the information request;
>
> *b)* Where the tax authorities of the requested Contracting State are not already in the possession of the requested information, such information shall be supplied to the competent authority of the other Contracting State within six months of the receipt of the information request.
>
> Provided that the other conditions of this Article are met, information shall be considered to have been exchanged in accordance with the provisions of this Article even if it is supplied after these time limits.

10.5 The provisions in subparagraphs *a*) and *b*) of optional paragraph 6, referenced in paragraph 10.4, set a default standard for time limits that would apply where the competent authorities have not made a different agreement on longer or shorter time limits. The default standard time limits are two months from the receipt of the information request if the requested information is already in the possession of the tax authorities of the requested Contracting State and six months in all other cases. Notwithstanding the default standard time limits or time limits otherwise agreed, competent authorities may come to different agreements on a case-by-case basis, for example, when they both agree more time is appropriate. This may arise where the request is complex in nature. In such a case, the competent authority of a requesting Contracting State should not unreasonably deny a request by the competent authority of a requested Contracting State for more time. If a requested Contracting State is unable to supply the requested information within the prescribed time limit because of

legal impediments (for example, because of ongoing litigation regarding a taxpayer's challenge to the validity of the request or ongoing litigation regarding a domestic notification procedure of the type described in paragraph 14.1), it would not be in violation of the time limits.

10.6 The last sentence in optional paragraph 6, referenced in paragraph 10.4, which provides "provided that the other conditions of this Article are met, information shall be considered to have been exchanged in accordance with the provisions of this Article even if it is supplied after these time limits" makes it clear that no objection to the use or admissibility of information exchanged under this Article can be based on the fact that the information was exchanged after the time limits agreed to by the competent authorities or the default time limits provided for in the paragraph.

Paragraph 2

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. The confidentiality rules of paragraph 2 apply to all types of information received under paragraph 1, including both information provided in a request and information transmitted in response to a request. Hence, the confidentiality rules cover, for instance, competent authority letters, including the letter requesting information. At the same time, it is understood that the requested State can disclose the minimum information contained in a competent authority letter (but not the letter itself) necessary for the requested State to be able to obtain or provide the requested information to the requesting State, without frustrating the efforts of the requesting State. If, however, court proceedings or the like under the domestic laws of the requested State necessitate the disclosure of the competent authority letter itself, the competent authority of the requested State may disclose such a letter unless the requesting State otherwise specifies. The maintenance of secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph 2 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. In situations in which the requested State determines that the requesting State does not comply with its duties regarding the confidentiality of the information exchanged under this Article, the requested State may suspend assistance under this Article until such time as proper assurance is given by the requesting State that those duties will indeed be respected. If necessary, the competent authorities may enter into specific arrangements or memoranda of understanding regarding the confidentiality of the information exchanged under this Article.

12. Subject to paragraphs 12.3 and 12.4, 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, the determination of appeals in relation to

the taxes with respect to which information may be exchanged according to the first sentence of paragraph 1, or the oversight of the above. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses. This also means that information can be disclosed to governmental or judicial authorities charged with deciding whether such information should be released 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 2 Furthermore, information covered by paragraph 1, whether taxpayer-specific or not, should not be disclosed to persons or authorities not mentioned in paragraph 2, regardless of domestic information disclosure laws such as freedom of information or other legislation that allows greater access to governmental documents.

12.1 Information can also be disclosed to oversight bodies. Such oversight bodies include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State. In their bilateral negotiations, however, Contracting States may depart from this principle and agree to exclude the disclosure of information to such supervisory bodies.

12.2 The information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.

12.3 Information exchanged for tax purposes may be of value to the receiving State for purposes in addition to those referred to in the first and second sentences of paragraph 2 of Article 26. The last sentence of paragraph 2 therefore allows the Contracting States to share information received for tax purposes provided two conditions are met: first, the information may be used for other purposes under the laws of both States and, second, the competent authority of the supplying State authorises such use. It allows the sharing of tax information by the tax authorities of the receiving State with other law enforcement agencies and judicial authorities in that State on certain high priority matters (e.g. to combat money laundering, corruption, terrorism financing). When a receiving State desires to use the information for an additional purpose (i.e. non-tax purpose), the receiving State should specify to the supplying State the other purpose for which it wishes to use the information and confirm that the receiving State can use the information for such other purpose under its laws. Where the supplying State is in a position to do so, having regard to, amongst others, international agreements or other arrangements between the Contracting States relating to mutual assistance between other law enforcement agencies and judicial authorities, the competent authority of the supplying State would generally be expected to authorise such use for other purposes if the information can be used for similar purposes in the supplying State. Law enforcement agencies and judicial authorities receiving information under the last sentence of paragraph 2 must treat that information as confidential consistent with the principles of paragraph 2.

12.4 It is recognised that Contracting States may wish to achieve the overall objective inherent in the last sentence of paragraph 2 in other ways and they may do so by replacing the last sentence of paragraph 2 with the following text:

> The competent authority of the Contracting State that receives information under the provisions of this Article may, with the written consent of the Contracting State that provided the information, also make available that information to be used for other purposes allowed under the provisions of a mutual legal assistance treaty in force between the Contracting States that allows for the exchange of tax information.

13. As stated in paragraph 12, the information obtained can be communicated to the persons and authorities mentioned and on the basis of the third sentence of paragraph 2 of the Article can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. 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 2 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 3

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, 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.

14.1 Some countries' laws include procedures for notifying the person who provided the information and/or the taxpayer that is subject to the enquiry prior to the supply of information. Such notification procedures may be an important aspect of the rights provided under domestic law. They can help prevent mistakes (e.g. in cases of mistaken identity) and facilitate exchange (by allowing taxpayers who are notified to co-operate voluntarily with the tax authorities in the requesting State). Notification procedures should not, however, be applied in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State. In other words, they should not prevent or unduly delay effective exchange of information. For instance, notification procedures should permit exceptions from prior notification, e.g. in cases in which the information request is of a very urgent nature or

the notification is likely to undermine the chance of success of the investigation conducted by the requesting State. A Contracting State that under its domestic law is required to notify the person who provided the information and/or 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. Such information should be provided to the other Contracting State when a convention is concluded and thereafter whenever the relevant rules are modified.

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. Thus, a State may refuse to provide information where the requesting State would be precluded by law from obtaining or providing the information or where the requesting State's administrative practices (e.g. failure to provide sufficient administrative resources) result in a lack of reciprocity. However, it is recognised that too rigorous an application of the principle of reciprocity could frustrate effective exchange of information and that reciprocity should be interpreted in a broad and pragmatic manner. Different countries will necessarily have different mechanisms for obtaining and providing information. Variations in practices and procedures should not be used as a basis for denying a request unless the effect of these variations would be to limit in a significant way the requesting State's overall ability to obtain and provide the information if the requesting State itself received a legitimate request from the requested State. It is worth noting that if a Contracting State applies, under paragraph 5, measures not normally foreseen in its domestic law or practice, such as to access and exchange bank information, that State is equally entitled to request similar information from the other Contracting State. This would be fully in line with the principle of reciprocity which underlies subparagraphs *a*) and *b*) of paragraph 3.

15.1 The principle of reciprocity has no application where the legal system or administrative practice of only one country provides for a specific procedure. For instance, a country requested to provide information could not point to the absence of a ruling regime in the country requesting information and decline to provide information on a ruling it has granted, based on a reciprocity argument. Of course, where the requested information itself is not obtainable under the laws or in the normal course of the administrative practice of the requesting State, a requested State may decline such a request.

15.2 Most countries recognise under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State may, therefore, decline to provide information if the requesting State would have been precluded by its own self-incrimination rules from obtaining the information under similar circumstances. In practice, however, the

privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. The overwhelming majority of information requests seek to obtain information from third parties such as banks, intermediaries or the other party to a contract and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

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 examinations for their own purposes. The paragraph assumes, of course, that tax authorities have the powers and resources necessary to facilitate effective information exchange. For instance, assume that a Contracting State requests information in connection with an investigation into the tax affairs of a particular taxpayer and specifies in the request that the information might be held by one of a few service providers identified in the request and established in the other Contracting State. In this case, the requested State would be expected to be able to obtain and provide such information to the extent that such information is held by one of the service providers identified in the request. In responding to a request the requested State should be guided by the overarching purpose of Article 26 which is to permit information exchange "to the widest possible extent" and may consider the importance of the requested information to the requesting State in relation to the administrative burden for the requested State.

16.1 Subparagraphs *a*) and *b*) of paragraph 3 do not permit the requested State to decline a request where paragraph 4 or 5 applies. Paragraph 5 would apply, for instance, in situations in which the requested State's inability to obtain the information was specifically related to the fact that the requested information was believed to be held by a bank or other financial institution. Thus, the application of paragraph 5 includes situations in which the tax authorities' information gathering powers with respect to information held by banks and other financial institutions are subject to different requirements than those that are generally applicable with respect to information held by persons other than banks or other financial institutions. This would, for example, be the case where the tax authorities can only exercise their information gathering powers with respect to information held by banks and other financial institutions in instances where specific information on the taxpayer under examination or investigation is available. This would also be the case where, for example, the use of information gathering measures with respect to information held by banks and other financial institutions requires a higher probability that the information requested is held by the person believed to be in possession of the requested information than the degree of probability required for the use of

information gathering measures with respect to information believed to be held by persons other than banks or financial institutions.

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 subparagraphs *a)* and *b)* of paragraph 3 will 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.

18.1 Unless otherwise agreed to by the Contracting States, it can be assumed that the requested information could be obtained by the requesting State in a similar situation if that State has not indicated to the contrary.

19. In addition to the limitations referred to above, subparagraph *c)* of paragraph 3 contains a reservation concerning the disclosure of certain secret information. Secrets mentioned in this subparagraph 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.

19.1 In its deliberations regarding the application of secrecy rules, the Contracting State should also take into account the confidentiality rules of paragraph 2 of the Article. The domestic laws and practices of the requesting State together with the obligations imposed under paragraph 2, may ensure that the information cannot be used for the types of unauthorised purposes against which the trade or other secrecy rules are intended to protect. Thus, a Contracting State may decide to supply the information where it finds that there is no reasonable basis for assuming that a taxpayer involved may suffer any adverse consequences incompatible with information exchange.

19.2 In most cases of information exchange no issue of trade, business or other secret will arise. A trade or business secret is generally understood to mean facts and circumstances that are of considerable economic importance and that can be exploited practically and the unauthorised use of which may lead to serious damage (e.g. may lead to severe financial hardship). The determination, assessment or collection of taxes as such could not be considered to result in serious damage. Financial information, including books and records, does not by its nature constitute a trade,

business or other secret. In certain limited cases, however, the disclosure of financial information might reveal a trade, business or other secret. For instance, a request for information on certain purchase records may raise such an issue if the disclosure of such information revealed the proprietary formula used in the manufacture of a product. The protection of such information may also extend to information in the possession of third persons. For instance, a bank might hold a pending patent application for safe keeping or a secret trade process or formula might be described in a loan application or in a contract held by a bank. In such circumstances, details of the trade, business or other secret should be excised from the documents and the remaining financial information exchanged accordingly.

19.3 A requested State may decline to disclose information relating to confidential communications between attorneys, solicitors or other admitted legal representatives in their role as such and their clients to the extent that the communications are protected from disclosure under domestic law. However, the scope of protection afforded to such confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficial owner of a company is typically not protected as a confidential communication. Whilst the scope of protection afforded to confidential communications might differ among states, it should not be overly broad so as to hamper effective exchange of information. Communications between attorneys, solicitors or other admitted legal representatives and their clients are only confidential if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors or under a power of attorney to represent a company in its business affairs. An assertion that information is protected as a confidential communication between an attorney, solicitor or other admitted legal representative and its client should be adjudicated exclusively in the Contracting State under the laws of which it arises. Thus, it is not intended that the courts of the requested State should adjudicate claims based on the laws of the requesting State.

19.4 Contracting States wishing to refer expressly to the protection afforded to confidential communications between a client and an attorney, solicitor or other admitted legal representative may do so by adding the following text at the end of paragraph 3:

d) to obtain or provide information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are:

(i) produced for the purposes of seeking or providing legal advice or

(ii) produced for the purposes of use in existing or contemplated legal proceedings.

19.5 Paragraph 3 also includes 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). However, this limitation should only become relevant in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial, or religious persecution. The limitation may also be invoked where the information constitutes a state secret, for instance sensitive information held by secret services the disclosure of which would be contrary to the vital interests of the requested State. Thus, issues of public policy (ordre public) rarely arise in the context of information exchange between treaty partners.

Paragraph 4

19.6 Paragraph 4 was added in 2005 to deal explicitly with the obligation to exchange information in situations where the requested information is not needed by the requested State for domestic tax purposes. Prior to the addition of paragraph 4 this obligation was not expressly stated in the Article, but was clearly evidenced by the practices followed by member countries which showed that, when collecting information requested by a treaty partner, Contracting States often use the special examining or investigative powers provided by their laws for purposes of levying their domestic taxes even though they do not themselves need the information for these purposes. This principle is also stated in the report Improving Access to Bank Information for Tax Purposes.[1]

19.7 According to paragraph 4, Contracting States must use their information gathering measures, even though invoked solely to provide information to the other Contracting State and irrespective of whether the information could still be gathered or used for domestic tax purposes in the requested Contracting State. Thus, for instance, any restrictions on the ability of a requested Contracting State to obtain information from a person for domestic tax purposes at the time of a request (for example, because of the expiration of a statute of limitations under the requested State's domestic law or the prior completion of an audit) must not restrict its ability to use its information gathering measures for information exchange purposes. The term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information. Paragraph 4 does not oblige a requested Contracting State to provide information in circumstances where it has attempted to obtain the requested information but finds that the information no longer exists following the expiration of a domestic record retention period. However, where the requested information is still available notwithstanding the expiration of such retention period, the requested State cannot decline to exchange the information available. Contracting States should ensure that reliable accounting records are kept for five years or more.

1 OECD, Paris, 2000 (at paragraph 21 *b*).

19.8 The second sentence of paragraph 4 makes clear that the obligation contained in paragraph 4 is subject to the limitations of paragraph 3 but also provides that such limitations cannot be construed to form the basis for declining to supply information where a country's laws or practices include a domestic tax interest requirement. Thus, whilst a requested State cannot invoke paragraph 3 and argue that under its domestic laws or practices it only supplies information in which it has an interest for its own tax purposes, it may, for instance, decline to supply the information to the extent that the provision of the information would disclose a trade secret.

19.9 For many countries the combination of paragraph 4 and their domestic law provide a sufficient basis for using their information gathering measures to obtain the requested information even in the absence of a domestic tax interest in the information. Other countries, however, may wish to clarify expressly in the convention that Contracting States must ensure that their competent authorities have the necessary powers to do so. Contracting States wishing to clarify this point may replace paragraph 4 with the following text:

> 4. In order to effectuate the exchange of information as provided in paragraph 1, each Contracting State shall take the necessary measures, including legislation, rule-making, or administrative arrangements, to ensure that its competent authority has sufficient powers under its domestic law to obtain information for the exchange of information regardless of whether that Contracting State may need such information for its own tax purposes.

Paragraph 5

19.10 Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitations of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries as well as ownership information. Whilst paragraph 5, which was added in 2005, represents a change in the structure of the Article, it should not be interpreted as suggesting that the previous version of the Article did not authorise the exchange of such information. The vast majority of OECD member countries already exchanged such information under the previous version of the Article and the addition of paragraph 5 merely reflects current practice.

19.11 Paragraph 5 stipulates that a Contracting State shall not decline to supply information to a treaty partner solely because the information is held by a bank or other financial institution. Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of bank secrecy. The addition of this paragraph to the Article reflects the international trend in this area as reflected in the Model Agreement on Exchange of Information on Tax Matters and as described in the report, Improving Access to Bank Information for Tax Purposes.[1] In accordance with that report, access to

1 OECD, Paris, 2000.

information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

19.12 Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State had a law under which all information held by a fiduciary was treated as a "professional secret" merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information to the other Contracting State. A person is generally said to act in a "fiduciary capacity" when the business which the person transacts, or the money or property which the person handles, is not its own or for its own benefit, but for the benefit of another person as to whom the fiduciary stands in a relation implying and necessitating confidence and trust on the one part and good faith on the other part, such as a trustee. The term "agency" is very broad and includes all forms of corporate service providers (e.g. company formation agents, trust companies, registered agents, lawyers).

19.13 Finally, paragraph 5 states that a Contracting State shall not decline to supply information solely because it relates to an ownership interest in a person, including companies and partnerships, foundations or similar organisational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

19.14 Paragraph 5 does not preclude a Contracting State from invoking paragraph 3 to refuse to supply information held by a bank, financial institution, a person acting in an agency or fiduciary capacity or information relating to ownership interests. However, such refusal must be based on reasons unrelated to the person's status as a bank, financial institution, agent, fiduciary or nominee, or the fact that the information relates to ownership interests. For instance, a legal representative acting for a client may be acting in an agency capacity but for any information protected as a confidential communication between attorneys, solicitors or other admitted legal representatives and their clients, paragraph 3 continues to provide a possible basis for declining to supply the information.

19.15 The following examples illustrate the application of paragraph 5:

a) Company X owns a majority of the stock in a subsidiary company Y, and both companies are incorporated under the laws of State A. State B is conducting a tax examination of business operations of company Y in State B. In the course of this examination the question of both direct and indirect ownership in company Y becomes relevant and State B makes a request to State A for ownership information of any person in company Y's chain of ownership. In its reply State A should provide to State B ownership information for both company X and Y.

b) An individual subject to tax in State A maintains a bank account with Bank B in State B. State A is examining the income tax return of the individual and makes a request to State B for all bank account income and asset information held by Bank B in order to determine whether there were deposits of untaxed earned income. State B should provide the requested bank information to State A.

Observation on the Commentary

20. [Deleted]

21. In connection with paragraph 15.1 *Greece* wishes to clarify that according to Article 28 of the Greek Constitution international tax treaties are applied under the terms of reciprocity.

COMMENTARY ON ARTICLE 27
CONCERNING THE ASSISTANCE IN THE COLLECTION OF TAXES

1. This Article provides the rules under which Contracting States[1] may agree to provide each other assistance in the collection of taxes. In some States, national law or policy may prevent this form of assistance or set limitations to it. Also, in some cases, administrative considerations may not justify providing assistance in the collection of taxes to another State or may similarly limit it. During the negotiations, each Contracting State will therefore need to decide whether and to what extent assistance should be given to the other State based on various factors, including

- the stance taken in national law to providing assistance in the collection of other States' taxes;
- whether and to what extent the tax systems, tax administrations and legal standards of the two States are similar, particularly as concerns the protection of fundamental taxpayers' rights (e.g. timely and adequate notice of claims against the taxpayer, the right to confidentiality of taxpayer information, the right to appeal, the right to be heard and present argument and evidence, the right to be assisted by a counsel of the taxpayer's choice, the right to a fair trial, etc.);
- whether assistance in the collection of taxes will provide balanced and reciprocal benefits to both States;
- whether each State's tax administration will be able to effectively provide such assistance;
- whether trade and investment flows between the two States are sufficient to justify this form of assistance;
- whether for constitutional or other reasons the taxes to which the Article applies should be limited.

The Article should only be included in the Convention where each State concludes that, based on these factors, they can agree to provide assistance in the collection of taxes levied by the other State.

2. The Article provides for comprehensive collection assistance. Some States may prefer to provide a more limited type of collection assistance. This may be the only form of collection assistance that they are generally able to provide or that they may agree to in a particular convention. For instance, a State may want to limit assistance to cases where the benefits of the Convention (e.g. a reduction of taxes in the State where income such as interest arises) have been claimed by persons

1 Throughout this Commentary on Article 27, the State making a request for assistance is referred to as the "requesting State" whilst the State from which assistance is requested is referred to as the "requested State".

not entitled to them. States wishing to provide such limited collection assistance are free to adopt bilaterally an alternative Article drafted along the following lines:

Article 27
Assistance in the collection of taxes

1. The Contracting States shall lend assistance to each other in the collection of tax to the extent needed to ensure that any exemption or reduced rate of tax granted under this Convention shall not be enjoyed by persons not entitled to such benefits. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

2. In no case shall the provisions of this Article 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 carry out measures which would be contrary to public policy (*ordre public*).

Paragraph 1

3. This paragraph contains the principle that a Contracting State is obliged to assist the other State in the collection of taxes owed to it, provided that the conditions of the Article are met. Paragraphs 3 and 4 provide the two forms that this assistance will take.

4. The paragraph also provides that assistance under the Article is not restricted by Articles 1 and 2. Assistance must therefore be provided as regards a revenue claim owed to a Contracting State by any person, whether or not a resident of a Contracting State. Some Contracting States may, however, wish to limit assistance to taxes owed by residents of either Contracting State. Such States are free to restrict the scope of the Article by omitting the reference to Article 1 from the paragraph.

5. Article 26 applies to the exchange of information for purposes of the provisions of this Article. The confidentiality of information exchanged for purposes of assistance in collection is thus ensured.

6. The paragraph finally provides that the competent authorities of the Contracting States may, by mutual agreement, decide the details of the practical application of the provisions of the Article.

7. Such agreement should, in particular, deal with the documentation that should accompany a request made pursuant to paragraph 3 or 4. It is common practice to agree that a request for assistance will be accompanied by such documentation as is required by the law of the requested State, or has been agreed to by the competent authorities of the Contracting States, and that is necessary to undertake, as the case may be, collection of the revenue claim or measures of conservancy. Such documentation may include, for example, a declaration that the revenue claim is enforceable and is owed by a person who cannot, under the law of the requesting State, prevent its collection or an official copy of the instrument permitting enforcement in the requesting State. An official translation of the documentation in the language of

the requested State should also be provided. It could also be agreed, where appropriate, that the instrument permitting enforcement in the requesting State shall, where appropriate and in accordance with the provisions in force in the requested State, be accepted, recognised, supplemented or replaced, as soon as possible after the date of the receipt of the request for assistance, by an instrument permitting enforcement in the latter State.

8. The agreement should also deal with the issue of the costs that will be incurred by the requested State in satisfying a request made under paragraph 3 or 4. In general, the costs of collecting a revenue claim are charged to the debtor but it is necessary to determine which State will bear costs that cannot be recovered from that person. The usual practice, in this respect, is to provide that in the absence of an agreement specific to a particular case, ordinary costs incurred by a State in providing assistance to the other State will not be reimbursed by that other State. Ordinary costs are those directly and normally related to the collection, i.e. those expected in normal domestic collection proceedings. In the case of extraordinary costs, however, the practice is to provide that these will be borne by the requesting State, unless otherwise agreed bilaterally. Such costs would cover, for instance, costs incurred when a particular type of procedure has been used at the request of the other State, or supplementary costs of experts, interpreters, or translators. Most States also consider as extraordinary costs the costs of judicial and bankruptcy proceedings. The agreement should provide a definition of extraordinary costs and consultation between the Contracting States should take place in any particular case where extraordinary costs are likely to be involved. It should also be agreed that, as soon as a Contracting State anticipates that extraordinary costs may be incurred, it will inform the other Contracting State and indicate the estimated amount of such costs so that the other State may decide whether such costs should be incurred. It is, of course, also possible for the Contracting States to provide that costs will be allocated on a basis different from what is described above; this may be necessary, for instance, where a request for assistance in collection is suspended or withdrawn under paragraph 7 or where the issue of costs incurred in providing assistance in collection is already dealt with in another legal instrument applicable to these States.

9. In the agreement, the competent authorities may also deal with other practical issues such as:

— whether there should be a limit of time after which a request for assistance could no longer be made as regards a particular revenue claim;

— what should be the applicable exchange rate when a revenue claim is collected in a currency that differs from the one which is used in the requesting State;

— how should any amount collected pursuant to a request under paragraph 3 be remitted to the requesting State.

Paragraph 2

10. Paragraph 2 defines the term “revenue claim” for purposes of the Article. The definition applies to any amount owed in respect of all taxes that are imposed on

behalf of the Contracting States, or of their political subdivisions or local authorities, but only insofar as the imposition of such taxes is not contrary to the Convention or other instrument in force between the Contracting States. It also applies to the interest, administrative penalties and costs of collection or conservancy that are related to such an amount. Assistance is therefore not restricted to taxes to which the Convention generally applies pursuant to Article 2, as is confirmed in paragraph 1.

11. Some Contracting States may prefer to limit the application of the Article to taxes that are covered by the Convention under the general rules of Article 2. States wishing to do so should replace paragraphs 1 and 2 by the following:

> 1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Article 1. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.
>
> 2. The term "revenue claim" as used in this Article means any amount owed in respect of taxes covered by the Convention together with interest, administrative penalties and costs of collection or conservancy related to such amount.

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

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

13. In order to make sure that the competent authorities can freely communicate information for purposes of the Article, Contracting States should ensure that the Article 26 is drafted in a way that allows exchanges of information with respect to any tax to which this Article applies.

14. Nothing in the Convention prevents the application of the provisions of the Article to revenue claims that arise before the Convention enters into force, as long as assistance with respect to these claims is provided after the treaty has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such revenue claims, in particular when the provisions concerning the entry into force of their convention provide that the provisions of that convention will have effect with respect to taxes arising or levied from a certain time. States wishing to restrict the application of the Article to claims arising after the Convention enters into force are also free to do so in the course of bilateral negotiations.

Paragraph 3

15. This paragraph stipulates the conditions under which a request for assistance in collection can be made. The revenue claim has to be enforceable under the law of the requesting State and be owed by a person who, at that time, cannot, under the law of that State, prevent its collection. This will be the case where the requesting State has the right, under its internal law, to collect the revenue claim and the person owing the amount has no administrative or judicial rights to prevent such collection.

16. In many States, a revenue claim can be collected even though there is still a right to appeal to an administrative body or a court as regards the validity or the amount of the claim. If, however, the internal law of the requested State does not allow it to collect its own revenue claims when appeals are still pending, the paragraph does not authorise it to do so in the case of revenue claims of the other State in respect of which such appeal rights still exist even if this does not prevent collection in that other State. Indeed, the phrase "collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State" has the effect of making that requested State's internal law restriction applicable to the collection of the revenue claim of the other State. Many States, however, may wish to allow collection assistance where a revenue claim may be collected in the requesting State notwithstanding the existence of appeal rights even though the requested State's own law prevents collection in that case. States wishing to do so are free to modify paragraph 3 to read as follows:

> When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State that met the conditions allowing that other State to make a request under this paragraph.

17. Paragraph 3 also regulates the way in which the revenue claim of the requesting State is to be collected by the requested State. Except with respect to time limits and priority (see the Commentary on paragraph 5), the requested State is obliged to collect the revenue claim of the requesting State as though it were the requested State's own revenue claim even if, at the time, it has no need to undertake collection actions related to that taxpayer for its own purposes. As already mentioned, the phrase "in accordance with the provisions of its law applicable to the enforcement and collection of its own taxes" has the effect of limiting collection assistance to claims with respect to which no further appeal rights exist if, under the requested State's internal law, collection of that State's own revenue claims are not permitted as long as such rights still exist.

18. It is possible that the request may concern a tax that does not exist in the requested State. The requesting State shall indicate where appropriate the nature of

the revenue claim, the components of the revenue claim, the date of expiry of the claim and the assets from which the revenue claim may be recovered. The requested State will then follow the procedure applicable to a claim for a tax of its own which is similar to that of the requesting State or any other appropriate procedure if no similar tax exists.

Paragraph 4

19. In order to safeguard the collection rights of a Contracting State, this paragraph enables it to request the other State to take measures of conservancy even where it cannot yet ask for assistance in collection, e.g. when the revenue claim is not yet enforceable or when the debtor still has the right to prevent its collection. This paragraph should only be included in conventions between States that are able to take measures of conservancy under their own laws. Also, States that consider that it is not appropriate to take measures of conservancy in respect of taxes owed to another State may decide not to include the paragraph in their conventions or to restrict its scope. In some States, measures of conservancy are referred to as "interim measures" and such States are free to add these words to the paragraph to clarify its scope in relation to their own terminology.

20. One example of measures to which the paragraph applies is the seizure or the freezing of assets before final judgement to guarantee that these assets will still be available when collection can subsequently take place. The conditions required for the taking of measures of conservancy may vary from one State to another but in all cases the amount of the revenue claim should be determined beforehand, if only provisionally or partially. A request for measures of conservancy as regards a particular revenue claim cannot be made unless the requesting State can itself take such measures with respect to that claim (see the Commentary on paragraph 8).

21. In making a request for measures of conservancy the requesting State should indicate in each case what stage in the process of assessment or collection has been reached. The requested State will then have to consider whether in such a case its own laws and administrative practice permit it to take measures of conservancy.

Paragraph 5

22. Paragraph 5 first provides that the time limits of the requested State, i.e. time limitations beyond which a revenue claim cannot be enforced or collected, shall not apply to a revenue claim in respect of which the other State has made a request under paragraph 3 or 4. Since paragraph 3 refers to revenue claims that are enforceable in the requesting State and paragraph 4 to revenue claims in respect of which the requesting State can take measures of conservancy, it follows that it is the time limits of the requesting State that are solely applicable.

23. Thus, as long as a revenue claim can still be enforced or collected (paragraph 3) or give rise to measures of conservancy (paragraph 4) in the requesting State, no objection based on the time limits provided under the laws of the requested State may be made to the application of paragraph 3 or 4 to that revenue claim. States which

cannot agree to disregard their own domestic time limits should amend paragraph 5 accordingly.

24. The Contracting States may agree that after a certain period of time the obligation to assist in the collection of the revenue claim no longer exists. The period should run from the date of the original instrument permitting enforcement. Legislation in some States requires renewal of the enforcement instrument, in which case the first instrument is the one that counts for purposes of calculating the time period after which the obligation to provide assistance ends.

25. Paragraph 5 also provides that the rules of both the requested (first sentence) and requesting (second sentence) States giving their own revenue claims priority over the claims of other creditors shall not apply to a revenue claim in respect of which a request has been made under paragraph 3 or 4. Such rules are often included in domestic laws to ensure that tax authorities can collect taxes to the fullest possible extent.

26. The rule according to which the priority rules of the requested State do not apply to a revenue claim of the other State in respect of which a request for assistance has been made applies even if the requested State must generally treat that claim as its own revenue claim pursuant to paragraphs 3 and 4. States wishing to provide that revenue claims of the other State should have the same priority as is applicable to their own revenue claims are free to amend the paragraph by deleting the words "or accorded any priority" in the first sentence.

27. The words "by reason of their nature as such", which are found at the end of the first sentence, indicate that the time limits and priority rules of the requested State to which the paragraph applies are only those that are specific to unpaid taxes. Thus, the paragraph does not prevent the application of general rules concerning time limits or priority which would apply to all debts (e.g. rules giving priority to a claim by reason of that claim having arisen or having been registered before another one).

Paragraph 6

28. This paragraph ensures that any legal or administrative objection concerning the existence, validity or the amount of a revenue claim of the requesting State shall not be dealt with by the requested State's courts and administrative bodies. Thus, no legal or administrative proceedings, such as a request for judicial review, shall be undertaken in the requested State with respect to these matters. The main purpose of this rule is to prevent administrative or judicial bodies of the requested State from being asked to decide matters which concern whether an amount, or part thereof, is owed under the internal law of the other State. States in which the paragraph may raise constitutional or legal difficulties may amend or omit it in the course of bilateral negotiations.

Paragraph 7

29. This paragraph provides that if, after a request has been made under paragraph 3 or 4, the conditions that applied when such request was made cease to apply (e.g. a

revenue claim ceases to be enforceable in the requesting State), the State that made the request must promptly notify the other State of this change of situation. Following the receipt of such a notice, the requested State has the option to ask the requesting State to either suspend or withdraw the request. If the request is suspended, the suspension should apply until such time as the State that made the request informs the other State that the conditions necessary for making a request as regards the relevant revenue claim are again satisfied or that it withdraws its request.

Paragraph 8

30. This paragraph contains certain limitations to the obligations imposed on the State which receives a request for assistance.

31. The requested State is at liberty to refuse to provide assistance in the cases referred to in the paragraph. However if it does provide assistance in these cases, it remains within the framework of the Article and it cannot be objected that this State has failed to observe the provisions of the Article.

32. 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 or those of the other State in fulfilling its obligations under the Article. Thus, if the requesting State has no domestic power to take measures of conservancy, the requested State could decline to take such measures on behalf of the requesting State. Similarly, if the seizure of assets to satisfy a revenue claim is not permitted in the requested State, that State is not obliged to seize assets when providing assistance in collection under the provisions of the Article. However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide assistance in the collection of taxes owed to the requesting State.

33. Paragraph 5 of the Article provides that a Contracting State's time limits will not apply to a revenue claim in respect of which the other State has requested assistance. Subparagraph *a*) is not intended to defeat that principle. Providing assistance with respect to a revenue claim after the requested State's time limits have expired will not, therefore, be considered to be at variance with the laws and administrative practice of that or of the other Contracting State in cases where the time limits applicable to that claim have not expired in the requesting State.

34. Subparagraph *b)* includes a limitation to carrying out measures contrary to public policy (*ordre public*). As is the case under Article 26 (see paragraph 19 of the Commentary on Article 26), it has been felt necessary to prescribe a limitation with regard to assistance which may affect the vital interests of the State itself.

35. Under subparagraph *c)*, a Contracting State is not obliged to satisfy the request if the other State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice.

36. Finally, under subparagraph *d*), the requested State may also reject the request for practical considerations, for instance if the costs that it would incur in collecting a revenue claim of the requesting State would exceed the amount of the revenue claim.

37. Some States may wish to add to the paragraph a further limitation, already found in the joint Council of Europe-OECD multilateral Convention on Mutual Administrative Assistance in Tax Matters, which would allow a State not to provide assistance if it considers that the taxes with respect to which assistance is requested are imposed contrary to generally accepted taxation principles.

COMMENTARY ON ARTICLE 28
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.

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.

3. In many OECD member countries, the domestic laws contain provisions to the effect that members of diplomatic missions and consular posts whilst 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 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.

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 (see 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.

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 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.

COMMENTARY ON ARTICLE 29
CONCERNING THE ENTITLEMENT TO BENEFITS

I. Preliminary Remarks

1. As explained in the footnote to the Article, Article 29 reflects the intention of the Contracting States, incorporated in the preamble of the Convention, to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. This intention and the wording of the Article correspond to the minimum standard that was agreed to as part of the OECD/G20 Base Erosion and Profit Shifting Project and that is described in paragraph 22 of the report *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report*. As indicated in that report, the drafting of the Article will depend on how the Contracting States decide to implement that minimum standard. Depending on their own circumstances, States may wish to adopt only the general anti-abuse rule of paragraph 9 of the Article, may prefer instead to adopt the detailed version of paragraphs 1 to 7 that is described below, which they would supplement by a mechanism that would address conduit arrangements not otherwise dealt with by the provisions of the Convention, or may prefer to include in their treaty the general anti-abuse rule of paragraph 9 together with any variation of paragraphs 1 to 7 described below.

2. A State may prefer the last approach described above because it combines the flexibility of a general rule that can prevent a large number of abusive transactions with the certainty of a more "automatic" rule that prevents transactions that are known to cause treaty-shopping concerns and that can be easily described by reference to certain features (such as the foreign ownership of an entity). That last approach is reflected in the "simplified version" of paragraphs 1 to 7 reproduced below, which should only be used in combination with the general rule of paragraph 9. Such a combination should not be construed in any way as restricting the scope of the general anti-abuse rule of paragraph 9: a transaction or arrangement should not be considered to be outside the scope of paragraph 9 simply because the specific anti-abuse rules of paragraphs 1 to 7, which only deal with certain cases of treaty shopping that can be easily identified by certain of their features, are not applicable.

3. A State may, however, prefer to deal with treaty shopping without the general anti-abuse rule of paragraph 9, relying instead on the specific anti-abuse rules of paragraphs 1 to 7, together with a mechanism that will address conduit arrangements that would escape the application of these paragraphs. This may be the case of a State whose domestic law includes strong anti-abuse rules that are sufficient to deal with other forms of treaty abuses. States that adopt that approach will need to ensure that the version of paragraphs 1 to 7 that they include in their bilateral conventions is sufficiently robust to prevent most forms of treaty shopping. For this reason, the paragraphs below provide different versions of the

provisions of paragraphs 1 to 7, the more robust version of these paragraphs mentioned above being referred to as the "detailed version". States that do not wish to include paragraph 9 for the reasons explained in this paragraph should adopt the detailed version, as opposed to the "simplified" version, subject to any adaptations referred to in the Commentary below.

4. This Article contains provisions that prevent various forms of treaty shopping through which persons who are not residents of a Contracting State might establish an entity that would be a resident of that State in order to reduce or eliminate taxation in the other Contracting State through the benefits of the tax treaty concluded between these two States. Allowing persons who are not directly entitled to treaty benefits (such as the reduction or elimination of withholding taxes on dividends, interest or royalties) to obtain these benefits indirectly through treaty shopping would frustrate the bilateral and reciprocal nature of tax treaties. If, for instance, a State knows that its residents can indirectly access the benefits of treaties concluded by another State, it may have little interest in granting reciprocal benefits to residents of that other State through the conclusion of a tax treaty. Also, in such a case, the benefits that would be indirectly obtained may not be appropriate given the nature of the tax system of the former State; if, for instance, that State does not levy an income tax on a certain type of income, it would be inappropriate for its residents to benefit from the provisions of a tax treaty concluded between two other States that grant a reduction or elimination of source taxation for that type of income and that were designed on the assumption that the two Contracting States would tax such income.

5. The provisions of paragraphs 1 to 7 seek to deny treaty benefits in the case of structures that typically result in the indirect granting of treaty benefits to persons that are not directly entitled to these benefits whilst recognising that in some cases, persons who are not residents of a Contracting State may establish an entity in that State for legitimate business reasons. Although these provisions apply regardless of whether or not a particular structure was adopted for treaty-shopping purposes, the Article allows the competent authority of a Contracting State to grant treaty benefits where the other provisions of the Article would otherwise deny these benefits but the competent authority determines that the structure did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. The Article restricts the general scope of the other provisions of the Convention, including those of Article 1 according to which the Convention applies to persons who are residents of a Contracting State. Paragraph 1 of the Article provides that a resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a "qualified person" under paragraph 2 or unless benefits are granted under the provisions of paragraphs 3, 4, 5 or 6. Paragraph 2 determines who constitutes a "qualified person" by reference to the nature or attributes of various categories of persons; any person to which that paragraph applies is entitled to all the benefits of the Convention. Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a "qualified person" under paragraph 2 as long as that item of income emanates from, or is incidental to,

the active conduct of a business in that person's State of residence (subject to certain exceptions). Paragraph 4 is a "derivative benefits" provision that allows certain entities owned by residents of third States to obtain treaty benefits provided that these residents would have been entitled to equivalent benefits if they had invested directly. Paragraph 5 is a "headquarters company" provision under which a company that is not eligible for benefits under paragraph 2 may nevertheless qualify for benefits with respect to particular items of income. Paragraph 6 includes the provisions that allow the competent authority of a Contracting State to grant treaty benefits where the other provisions of the Article would otherwise deny these benefits. Paragraph 7 includes a number of definitions that apply for the purposes of the Article.

Paragraph 1: provision restricting treaty benefits to a resident of a Contracting State who is a "qualified person"

Simplified and detailed versions

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25) unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded.

Commentary on paragraph 1 of the simplified and detailed versions

7. Paragraph 1 of both the simplified and detailed versions provides that a resident of a Contracting State, as defined under Article 4, will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only if it constitutes a "qualified person" under paragraph 2 or unless benefits are otherwise granted under paragraphs 3, 4, 5 or 6. The benefits otherwise accorded to a resident of a Contracting State under the Convention include all limitations to the Contracting States' taxing rights under Articles 6 through 22, the elimination of double taxation provided by Article 23 and the protection afforded to residents of a Contracting State under Article 24. The Article does not, however, restrict the availability of treaty benefits under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25 or under the few provisions of the Convention that do not require that a person be a resident of a Contracting State in order to enjoy the benefits of those provisions (e.g. the provisions of paragraph 1 of Article 24, to the extent that they apply to nationals who are not residents of either Contracting State). Whilst the provisions of paragraph 3 of Article 7 share the main features of paragraph 2 of Article 9, the availability of the benefits of paragraph 3 of Article 7 is restricted by paragraph 1 of Article 29 because relief of double taxation under Article 7 depends largely on the provisions of paragraph 2 of that Article (see paragraphs 40 to 57 of the Commentary on Article 7) and it would be inconsistent to be more generous with respect to the relief provided under paragraph 3 of Article 7 than with respect to the relief provided under paragraph 2 of that Article.

8. Paragraph 1 does not extend in any way the scope of the benefits granted by the other provisions of the Convention. Thus, a resident of a Contracting State who constitutes a "qualified person" under paragraph 2 must still meet the conditions of the other provisions of the Convention in order to obtain these benefits (e.g. that resident must be the beneficial owner of dividends in order to benefit from the provisions of paragraph 2 of Article 10) and these benefits may be denied or restricted under applicable anti-abuse rules such as the rules in paragraphs 8 and 9.

9. Paragraph 1 applies at any time when the Convention would otherwise provide a benefit to a resident of a Contracting State. Thus, for example, it applies at the time when income to which Article 6 applies is derived by a resident of a Contracting State, at the time that dividends to which Article 10 applies are paid to a resident of a Contracting State or at any time when profits to which Article 7 applies are made. The paragraph requires that, in order to be entitled to the benefit provided by the relevant provision of the Convention, the resident of the Contracting State must be a "qualified person", within the meaning of paragraph 2, at the relevant time. In some cases, however, the definition of "qualified person" requires that a resident of a Contracting State must satisfy certain conditions over a period of time in order to constitute a "qualified person" at a given time.

10. Since the definition of "equivalent beneficiary" that would be used for the purpose of paragraph 4 of the detailed version dealing with derivative benefits would exclude persons who, under another convention, are entitled to relief from taxation by the State of source that is not as favourable as the relief provided under the Convention, that definition would have the so-called "cliff" effect of denying all treaty benefits even if the difference in the relief provided by the two conventions is relatively minor. In that case, some States consider that it is appropriate to provide relief from taxation by the State of source that is similar to the relief that would be provided under the other convention. This treatment may be achieved through the alternative provisions included in paragraph 147 below that relate to the taxation of dividends, interest and royalties, which are provisions that alleviate the so-called "cliff effect" when a potential equivalent beneficiary is, under another convention, entitled to restrictions on taxation by the State of source that are not as favourable as those provided by the Convention. Instead of denying all treaty benefits with respect to such income, these provisions grant limited benefits that broadly correspond to those that would have been available under the other convention. In order to ensure that paragraph 1 does not deny the benefits granted under these alternative provisions, which would be contrary to the purpose of these provisions, these States should adopt a different version of paragraph 1 that would be drafted as follows:

> Except as otherwise provided in this Article and in [reference to the paragraphs of Articles 10, 11 and 12 that relate to the so-called "cliff effect"], a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a "qualified person", as defined in paragraph 2, at the time that the benefit would be accorded.

Paragraph 2: situations where a resident is a qualified person

Simplified and detailed versions

2. A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:

Commentary on the preamble of paragraph 2 of the simplified and detailed versions

11. Each of the subparagraphs of paragraph 2 of the simplified and detailed versions describes a category of residents that are qualified persons at the time when the relevant treaty benefits are claimed.

12. It is intended that the provisions of paragraph 2 will be self-executing. Unlike the provisions of paragraph 5 (simplified version) / 6 (detailed version), discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Subparagraph a): individuals

Simplified and detailed versions

a) an individual;

Commentary on subparagraph a) of paragraph 2 of the simplified and detailed versions

13. Subparagraph *a*) of both the simplified and detailed versions provides that any individual who is a resident of a Contracting State will be a qualified person. As explained in paragraph 61 below, under some treaty provisions, a collective investment vehicle must be treated as an individual for the purposes of applying the relevant treaty; where that is the case, such a collective investment vehicle will therefore constitute a qualified person by virtue of subparagraph *a*).

Subparagraph b): Contracting States, political subdivisions and their agencies and instrumentalities

Simplified and detailed versions

b) that Contracting State, or a political subdivision or local authority thereof, or an agency or instrumentality of that State, political subdivision or local authority;

Commentary on subparagraph b) of paragraph 2 of the simplified and detailed versions

14. Subparagraph *b*) of both the simplified and detailed versions provides that the Contracting States and any political subdivision or local authority thereof constitute qualified persons. These words apply to any part of a State, such as a separate fund established by the State that does not constitute, and is not owned by, a separate person. Under the last part of the subparagraph, a separate legal person which is a resident of a Contracting State and is an agency or instrumentality of a Contracting State, or a political subdivision or local authority thereof, will also be a qualified person and, therefore, will be entitled to all the benefits of the Convention whilst it qualifies as such. The concept of "agency or instrumentality" is restricted to entities set up by a State (or a political subdivision or local authority thereof) to perform exclusively functions of a governmental nature; it does not apply, for example, to a company that acts as an agent of the State for certain purposes but that was not set up by the State to perform functions of a governmental nature. The wording of the subparagraph may need to be adapted to reflect the different legal nature that State-owned entities, such as sovereign wealth funds, may have in the Contracting States as well as the different views that these States may have concerning the application of Article 4 to these entities (see paragraphs 50 to 53 of the Commentary on Article 1 and paragraphs 8.5 and 8.11 of the Commentary on Article 4).

Subparagraph c): publicly-traded companies and entities

Simplified version

c) a company or other entity, if the principal class of its shares is regularly traded on one or more recognised stock exchanges;

Detailed version

c) a company or other entity, if, throughout the taxable period that includes that time, the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:

(i) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or

(ii) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident;

Commentary on subparagraph c) of paragraph 2 of the simplified version

15. Subparagraph *c*) of the simplified version recognises that because the shares of publicly-traded companies and of some entities are generally widely-held, these companies and entities are unlikely to be established for treaty-shopping purposes.

The terms "shares", "principal class of shares" and "recognised stock exchange" are defined in paragraph 6; as indicated in the definition of "shares", that term covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, publicly-traded units of a trust.

Commentary on subparagraph c) of paragraph 2 of the detailed version

16. Subparagraph *c*) recognises that, as a general rule, because the shares of publicly-traded companies and of some entities are generally widely-held, these companies and entities are unlikely to be established for treaty-shopping purposes.

17. Subparagraph *c*) provides that a company or entity resident in a Contracting State constitutes a qualified person at a time when a benefit is provided by the Convention if, throughout the taxable period that includes that time, the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognised stock exchanges, provided that the company or entity also satisfies at least one of the following additional requirements: first, the company's or entity's principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident or, second, the company's or entity's primary place of management and control is in its State of residence. These additional requirements take account of the fact that whilst a publicly-traded company or entity may be technically resident in a given State, it may not have a sufficient relationship with that State to justify allowing such a company or entity to obtain the benefits of treaties concluded by that State. Such a sufficient relationship may be established by the fact that the shares of the publicly-traded company or entity are primarily traded in recognised stock exchanges situated in the State of residence of the company or entity; given the fact that the globalisation of financial markets means that shares of publicly-listed companies that are residents of some States are often traded on foreign stock exchanges, the alternative test provides that this sufficient relationship may also be established by the fact that the company or entity is primarily managed and controlled in its State of residence.

18. A company or entity whose principal class of shares is regularly traded on a recognised stock exchange will nevertheless not qualify for benefits under subparagraph *c*) of paragraph 2 if it has a disproportionate class of shares that is not regularly traded on a recognised stock exchange.

19. The terms "recognised stock exchange", "shares", "principal class of shares" and "disproportionate class of shares" are defined in paragraph 7. As indicated in these definitions, the term "shares" covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, publicly-traded units of a trust.

20. The regular trading requirement can be met by the trading of issued shares on any recognised exchange or exchanges located in either State. Trading on one or more recognised stock exchanges may be aggregated for purposes of this requirement; a company or entity could therefore satisfy this requirement if its shares are regularly

traded, in whole or in part, on a recognised stock exchange located in the other Contracting State.

21. Subdivision (i) includes the additional requirement that the shares of the company or entity be primarily traded on one or more recognised stock exchanges located in the State of residence of the company or entity. In general, the principal class of shares of a company or entity is "primarily traded" on one or more recognised stock exchanges located in the State of residence of that company or entity if, during the relevant taxation year, the number of shares in the company's or entity's principal class of shares that are traded on these stock exchanges exceeds the number of shares in the company's or entity's principal class of shares that are traded on established securities markets in any other State. Some States, however, consider that the fact that shares of a company or entity resident in a Contracting State are primarily traded on recognised stock exchanges situated in other States (e.g. in a State that is part of the European Economic Area within which rules relating to stock exchanges and securities create a single market for securities trading) constitutes a sufficient safeguard against the use of that company or entity for treaty-shopping purposes; States that share that view may modify subdivision (i) accordingly.

22. Subdivision (ii) provides the alternative requirement applicable to a company or entity whose principal class of shares is regularly traded on recognised stock exchanges but not primarily traded on recognised stock exchanges situated in the State of residence of the company or entity. Such a company or entity may claim treaty benefits if its "primary place of management and control" (as defined in paragraph 7) is in its State of residence.

23. The conditions of subparagraph c) must be satisfied throughout the taxable period of the company or entity. This does not require that the shares of the company or entity be traded on the relevant stock exchanges each day of the relevant period. For shares to be considered as regularly traded on one or more stock exchanges throughout the taxable period, it is necessary that more than a very small percentage of the shares be actively traded during a sufficiently large number of days included in that period. The test would be met, for example, if 10 per cent of the average number of outstanding shares of a given class of shares of a company were traded during 60 days of trading taking place in the taxable period of the company. The phrase "taxable period" in subparagraphs c) and f) refers to the period for which an annual tax return must be filed in the State of residence of the company or entity. If the Contracting States have a concept corresponding to "taxable period" in their domestic law, such as "taxable year", they are free to replace the reference to taxable period by that other concept.

Subparagraph d) (detailed version): affiliates of publicly-traded companies and entities

Detailed version only

d) a company, if:

(i) throughout the taxable period that includes that time, at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subparagraph *c*) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; and

(ii) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*);

Commentary on subparagraph d) of paragraph 2 of the detailed version

24. Subparagraph *d*) extends the principle underlying subparagraph *c*) (i.e. that publicly-traded companies and entities are unlikely to be established for treaty-shopping purposes) to some companies in which five or fewer publicly-traded companies and entities own a majority interest, subject to additional conditions.

25. In order for a company resident of a Contracting State to be entitled to all the benefits of the Convention under subparagraph *d*) at a given time, that company must satisfy two conditions applicable to the taxable period that includes that time.

26. First, under subdivision (*i*), the company must satisfy an ownership test. Under that test, five or fewer publicly-traded companies or entities described in subparagraph *c*) must be, throughout that taxable period, the direct or indirect owners of at least 50 per cent of the aggregate vote and value of the company's shares (and at least 50 per cent of any disproportionate class of shares). If the publicly-traded companies or entities are indirect owners, however, each of the intermediate companies or entities must either be a resident of the Contracting State from which a benefit under this Convention is being sought or be a "qualifying intermediate owner". The term

"qualifying intermediate owner" is defined in paragraph 7; under that definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company claiming benefits under subparagraph *d*).

27. Thus, for example, a company resident of a Contracting State satisfies the requirements of subdivision (i) if it is wholly owned by a company that is a resident of the same State and that satisfies the requirements of subparagraph *c*). Furthermore, if a publicly-traded parent company in the other Contracting State indirectly owns the company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the Contracting State from which a benefit under this Convention is being sought or a qualifying intermediate owner in order for the company to meet the ownership test in subdivision (*i*).

28. The phrase "50 per cent of the aggregate vote and value of the shares", which is used in subparagraphs *d*) and *f*) and in other parts of paragraphs 1 to 7, refers to a participation that represents both at least 50 per cent of all the voting rights in the relevant company or entity and at least 50 per cent of the value of all the shares in that company or entity. That test would therefore not be satisfied in the case of a participation that would satisfy the vote condition without satisfying the value condition (or *vice versa*).

29. Under the second condition, included in subdivision (ii), the company must also satisfy a base erosion test with respect to any treaty benefits that it claims (other than a benefit with respect to dividends under Article 10). That base erosion test is satisfied if.

— less than 50 per cent of the company's gross income (and less than 50 per cent of the tested group's gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and

— less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

30. The term "ineligible persons" used in the previous paragraph refers to any persons other than the residents of each Contracting State who are entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2. Entities that are residents of the Contracting States and that are entitled to the benefits of this Convention under this subparagraph or under subparagraph *f*) of paragraph 2 are, therefore, ineligible persons; this ensures that these entities are not used in arrangements that could allow third country investors to accumulate indirectly a significant amount of the base eroding payments made by a company seeking benefits

under this subparagraph. Paragraph 7 includes the definition of the terms "tested group" and "gross income" which are used in subdivision (*ii*).

31. For the purpose of the base erosion test, deductible payments do not include arm's-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. Depreciation and amortisation deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Finally, payments of interest are not arm's-length amounts paid or accrued in the ordinary course of business for services or tangible property, and would therefore be taken into account if made to an ineligible person.

32. The following examples illustrate the application of the base erosion test of subdivision (*ii*) of subparagraph *d*) by a Contracting State (referred to in the examples as the "first-mentioned State"), taking into account the definitions of "tested group" and "gross income" in paragraph 7:

— Example A: Assume that at all relevant times, R3 is a company wholly owned by another company, R2, which in turn is wholly owned by R1, a publicly-traded company that satisfies the requirements of subparagraph *c*). R3, R2 and R1 are all residents of the other Contracting State under Article 4 and are all members of the same tax consolidation group. The ownership test in subdivision (*i*) of subparagraph *d*) is satisfied because R1, a company satisfying the requirements of subparagraph *c*), indirectly owns at least 50 per cent of the aggregate vote and value of R3 (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares of R3), and R2, which is an intermediate owner, is a resident of the other Contracting State and is therefore a qualifying intermediate owner.

  During the taxable period that includes the time when the benefit would otherwise be accorded by the first-mentioned State, R3 derives: first, 200 of dividends from a company resident in a third State that are excluded from gross income of R3 in the other Contracting State; and, second, 100 of interest arising in the first-mentioned State, for which R3 is seeking the benefits of Article 11 of the Convention. R3 makes a base eroding payment of 49 to an ineligible person and pays a dividend of 51 to R2. In addition to the 51 dividend that it receives from R3, R2 receives additional gross receipts of 100 from persons outside the tested group. R2 makes a base eroding payment of 51 to an ineligible person.

  In this example, the tested group, as defined in paragraph 7, consists of R3, R2 and R1, because the three companies participate in a tax consolidation regime. In order to be eligible for benefits with respect to the interest arising in the first-mentioned State, R3 and the tested group must each meet the base erosion test of subdivision (*ii*).

  R3's gross income, as defined in paragraph 7, is 100 (the interest arising in the first-mentioned State), since the 200 dividend paid to R3 from a third-State company is excluded. Thus, for the taxable period for which R3 seeks benefits,

less than 50 of R3's gross income is in the form of base eroding payments to ineligible persons. R3 has made only 49 in base eroding payments and would therefore satisfy the part of the base erosion test that applies to it.

The tested group's gross income computed under the tax law of the other Contracting State excludes the 200 dividend paid to R3 from a third-State company as well as intragroup transactions (i.e. the 51 dividend from R3 to R2). The tested group's gross income is, therefore, 200 (the 100 interest arising in the first-mentioned State plus the 100 R2 received from persons outside the tested group). Thus, during the taxable period in question, the tested group must make less than 100 in base eroding payments to ineligible persons in order to satisfy the base erosion test of subdivision (*ii*).

In this example, R3 does not satisfy the requirements of subparagraph *d*). Although R3's 49 of base eroding payments to ineligible persons does not exceed the allowable limit of less than 50, the tested group's total base eroding payments to ineligible persons of 100 (49 + 51), exceeds the tested group's allowable limit of base eroding payments to ineligible persons, which was less than 100.

— Example B: Assume the same facts as in Example A, except that R3 derives 100 of dividends paid by a company resident of the first-mentioned State rather than interest arising in that State, and has no other gross income in the taxable period. Since the only treaty benefit that R3 is seeking is under Article 10 with respect to the dividends, R3 is not required to apply the base erosion test under subdivision (*ii*). Accordingly, R3 will be a qualified person with respect to the dividend under subparagraph *d*) because it satisfies the ownership requirement of subdivision (*i*).

— Example C: Assume that at all relevant times, P2 (the relevant company) is a company that is wholly owned by P1, a publicly-traded company that satisfies the requirements of subparagraph *c*). P2 and P1 are residents of the other Contracting State.

During the taxable period in question, P2's only items of income are interest of 100 arising in the first-mentioned State for which P2 seeks to claim the benefits of Article 11. P2 makes a deductible interest payment of 100 to P1, a person that satisfies subparagraph *c*). P1 makes a deductible payment during the same taxable period of 100 to ThirdCo, a company resident in State Y. P2, through P1, has indirectly made a base eroding payment of 100 to an ineligible person. In this example, the base erosion test under subdivision (*ii*) is not satisfied and P2 will not be a qualified person.

33. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons (as defined in paragraph 7) that benefit from regimes that constitute "special tax regimes" (see paragraphs 85 to 100 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see

paragraph 107 of the Commentary on Article 1). These States may want to modify the base erosion test of subdivision (ii) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subdivision (ii) as follows:

(ii) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), c) or *e*);

B) to persons that are connected to the person described in this subparagraph and that benefit from a special tax regime, as defined in [reference to the paragraph of the convention that includes the definition of "special tax regime"] of this Convention, with respect to the deductible payment; or

C) with respect to a payment of interest, to persons that are connected to the person described in this subparagraph and that benefit from notional deductions described in [reference to the paragraph of Article 11 that relates to notional deductions for equity].

34. The following example illustrates the application of the alternative formulation of the base erosion test included in the previous paragraph:

— Example: Assume the same facts as in Example B in paragraph 32 above, except that R3's only items of income are 100 of royalties arising in the State from which the treaty benefits are sought, for which R3 seeks to claim the benefits of Article 12. R3 makes a deductible royalty payment of 100 to R1. At all relevant times, R1 benefits from a special tax regime (as defined in that Convention) with respect to royalties.

The ownership condition of subdivision (*i*) of subparagraph *d*) is satisfied because R1, a company satisfying the requirements of subparagraph c), indirectly owns at least 50 per cent of the aggregate vote and value of R3 and R2 is a qualifying intermediate owner. However, even though R1 is a person that satisfies subparagraph c), the deductible royalty payment made to R1 by R3 is a base eroding payment because R1 is an ineligible person. R1 is a connected person with respect to R3 and benefits from a special tax regime with respect to the royalty income. In this example, R3 does not satisfy the base erosion test under subdivision (ii) because R3 has made 100 of base eroding payments to a person who benefits from a special tax regime and the amount, 100, exceeds R3's

allowable limit of base eroding payments to ineligible persons (that limit being exceeded if the total of these payments is not lower than 50).

35. Some other States, however, may consider that there is no need to impose the base-erosion condition of subdivision (*ii*) in the case of companies that are primarily owned by publicly-traded companies or entities. These States may therefore wish to omit subparagraph *d*) and use the following version of subparagraph *c*) which would deal both with publicly-traded companies or entities and with companies in which five or fewer publicly-traded companies and entities own a majority interest (States following this approach should also renumber the subsequent subparagraphs of paragraph 2 and replace the references to "subparagraph *c*)" by references to "subdivision (*i*) of subparagraph *c*)" in the wording of the "ownership/base erosion", "derivative benefits" and headquarters company rules in order to avoid the problem described in paragraph 30 above):

c) a company or other entity, if, throughout the taxable period that includes that time

(i) the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:

A) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or

B) the company's or entity's primary place of management and control is in the Contracting State of which it is a resident; or

(ii) at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision (*i*) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner;

Subparagraph d) (simplified version) / e) (detailed version): non-profit organisations and recognised pension funds

Simplified version

d) a person, other than an individual, that:

(i) is a [agreed description of the relevant non-profit organisations found in each Contracting State],

(ii) is a recognised pension fund;

Detailed version

e) a person, other than an individual, that:

(i) is a [agreed description of the relevant non-profit organisations found in each Contracting State],

(ii) is a recognised pension fund to which subdivision (i) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State, or more than [__ per cent] of the beneficial interests in that person are owned by individuals resident of either Contracting State or of any other State with respect to which the following conditions are met

A) individuals who are residents of that other State are entitled to the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed, and

B) with respect to income referred to in Articles 10 and 11 of this Convention, if the person were a resident of that other State entitled to all the benefits of that other convention, the person would be entitled, under such convention, to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or

(iii) is a recognised pension fund to which subdivision (ii) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that it is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in the preceding subdivision;

Commentary on subparagraph d) of paragraph 2 of the simplified version

36. Subparagraph *d*) of the simplified version provides rules under which certain non-profit organisations (to the extent that they qualify as residents of a Contracting State as explained in paragraph 8.11 of the Commentary on Article 4) and recognised pension funds will be entitled to all the benefits of the Convention.

37. The entities of each State that would be described in subdivision (i) would generally correspond to those that do not pay tax in their State of residence and that are constituted and operated exclusively to fulfil certain social functions (e.g. charitable, scientific, artistic, cultural, or educational). The description of such entities that would be included in subdivision (i) with respect to each State would typically refer to the provisions of the domestic law of that State that describe these entities or to the domestic law factors that allow the identification of these entities. Depending on the wording used, States may also want to amend subdivision (i) in order to allow their competent authorities to agree subsequently to amend or supplement the description provided.

38. Subdivision (ii) refers to any entity that qualifies as a "recognised pension fund" under the definition of that term in paragraph 1 of Article 3.

Commentary on subparagraph e) of paragraph 2 of the detailed version

39. Subparagraph *e*) of the detailed version provides rules under which certain non-profit organisations (to the extent that they qualify as residents of a Contracting State, as explained in paragraph 8.11 of the Commentary on Article 4) and certain recognised pension funds will be entitled to all the benefits of the Convention.

40. Entities that would be described in subdivision (i) automatically qualify for treaty benefits without regard to the residence of their beneficiaries or members. These entities would generally correspond to those that do not pay tax in their State of residence and that are constituted and operated exclusively to fulfil certain social functions (e.g. charitable, scientific, artistic, cultural, or educational). The description of such entities that will be included in subdivision (i) with respect to each State will typically refer to the provisions of the domestic law of that State that describe these entities or to the domestic law factors that allow the identification of these entities. Depending on the wording used, States may also want to amend subdivision (i) in order to allow their competent authorities to agree subsequently to amend or supplement the description provided.

41. Under subdivision (ii), a recognised pension fund that falls within subdivision (i) of the definition of that term in paragraph 1 of Article 3 (which is the part of the definition that applies to an entity that administers or provides retirement benefits and ancillary or incidental benefits to individuals) will qualify for treaty benefits if more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State or if more than a certain percentage of these beneficial interests, to be determined during bilateral negotiations, are owned by such residents or by individuals who are residents of third States provided that, in the latter case, two additional conditions are met: first, these individuals are entitled to the benefits of a comprehensive tax convention concluded between that third State and the State of source and, second, that convention provides for a similar or greater reduction of source taxes on interest and dividends derived by pension funds of that third State. For purposes of this provision, the term "beneficial interests in that person" should be understood to refer to the interests held by persons entitled to receive pension benefits from the fund. Some States, however, consider that the risk of treaty shopping by recognised pension funds does not warrant the costs of compliance inherent in requiring funds to identify the treaty residence and entitlement of the individuals entitled to receive pension benefits. States that share that view may modify subdivisions (ii) and (iii) accordingly and may, for instance, simply replace these two subdivisions by one subdivision that would read "is a recognised pension fund", which, like the provision found in the simplified version, would ensure that any recognised pension fund covered by the definition found in paragraph 1 of Article 3 would automatically constitute a "qualified person".

42. Subdivision (*iii*) applies to the so-called "funds of funds" that are referred to in subdivision (*ii*) of the definition of "recognised pension fund" in paragraph 1 of Article 3. These are funds which do not directly provide retirement benefits to individuals but are constituted and operated to invest funds of recognised pension funds that are themselves covered by subdivision (*i*) of the definition of "recognised pension fund". Subdivision (*iii*) only applies, however, if substantially all the income of such a "fund of funds" is derived from investments made for the benefit of recognised pension funds qualifying for benefits under subdivision (*ii*).

Subparagraph e) (simplified version) / f) (detailed version): ownership / base erosion

Simplified version

e) a person other than an individual if, at that time and on at least half of the days of a twelve-month period that includes that time, persons who are residents of that Contracting State and that are entitled to benefits of this Convention under subparagraphs *a*) to *d*) own, directly or indirectly, at least 50 per cent of the shares of the person;

Detailed version

f) a person other than an individual, if

(i) at that time and on at least half of the days of a twelve-month period that includes that time, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) own, directly or indirectly, shares representing at least 50 per cent of the aggregate vote and value (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) of the shares in the person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

(ii) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions), to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of this paragraph;

Commentary on subparagraph e) of paragraph 2 of the simplified version

43. Subparagraph *e*) of the simplified version provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. Under that subparagraph, any entity that is a resident of a Contracting State may qualify for treaty benefits if, at the time when the relevant treaty benefit otherwise would be accorded and on at least half the days of a twelve-month period that includes that time, at least 50 per cent of the shares of that entity are owned, directly or indirectly, by persons who are residents of that Contracting State and that are themselves entitled to benefits of this Convention under the previous subparagraphs of paragraph 2 (i.e. subparagraphs *a*), *b*), *c*) or *d*) of the simplified version).

44. Under the definition of the term "shares" in paragraph 7, that term covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, units of a trust.

45. Unlike the corresponding provision in subparagraph *f*) of the detailed version, subparagraph *e*) of the simplified version does not require that the entity also satisfy a base erosion test. Also, in the case of an indirect ownership, it does not impose any requirement applicable to the intermediate owners.

Commentary on subparagraph f) of paragraph 2 of the detailed version

46. Subparagraph *f*) of the detailed version provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph *f*), the so-called ownership and base erosion test, is a two-part test; both parts must be satisfied for the resident to be entitled to treaty benefits under subparagraph *f*).

47. Under subdivision (i), which is the ownership part of the test, 50 per cent or more of the aggregate vote and value of the outstanding shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the person must be owned, directly or indirectly, at the time when the relevant treaty benefit otherwise would be accorded and on at least half the days of a twelve-month period that includes that time, by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs *a*), *b*), *c*) or *e*). In the case of indirect owners, however, each of the intermediate owners must be a qualifying intermediate owner. The term "qualifying intermediate owner" is defined in paragraph 7; under that definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company claiming benefits under subparagraph *f*).

48. Whilst subparagraph *f*) will typically be relevant in the case of private companies, it may also apply to an entity such as a trust that is a resident of a Contracting State and that otherwise satisfies the requirements of the subparagraph. According to the definition of shares in paragraph 7, the reference to "shares", in the case of entities that are not companies, means interests that are comparable to shares; this would

generally be the case of the beneficial interests in a trust. For the purposes of subdivision (i), the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary's actuarial interest in the trust. The interest of a beneficiary entitled to the remaining part of a trust will be equal to 100 per cent less the aggregate percentages held by income beneficiaries. A beneficiary's interest in a trust will not be considered to be owned by a person entitled to benefits under subparagraphs *a*), *b*), *c*) or *e*) if it is not possible to determine the beneficiary's actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under subdivision (i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under subparagraphs *a*), *b*), *c*) or *e*).

49. Subdivision (ii) constitutes the base erosion part of the test, which is broadly similar to the base erosion test in subdivision (ii) of subparagraph *d*) except for the fact that, unlike that other test, it also applies to a person that is seeking benefits under Article 10. That base erosion test is satisfied if

— less than 50 per cent of the person's gross income (and less than 50 per cent of the tested group's gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and

— less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

50. The term "ineligible persons" used in the previous paragraph refers to any persons other than the residents of each Contracting State who are entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2. Also, paragraph 7 includes the definition of the terms "tested group" and "gross income" which are used in subdivision (ii).

51. The base erosion test of subdivision (ii), unlike that of subparagraph *d*), applies if a person wishes to obtain the benefits of Article 10. Such a person shall, for the purpose of subdivision (ii), include in its gross income any dividends received even if the dividends are effectively exempt from tax in that person's State of residence. This is provided for in subdivision (i) of the definition of "gross income" in paragraph 7.

52. As in the case of the base erosion test in subparagraph *d*), for the purpose of applying the test in subdivision (ii), deductible (i.e. base-eroding) payments do not include arm's-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base under the tax law of the person's State of residence, trust distributions constitute such base-eroding payments. Depreciation and amortisation deductions, which do not

represent payments or accruals to other persons, are not taken into account for the purposes of subdivision (*ii*). Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Finally, payments of interest are not arm's-length amounts paid or accrued in the ordinary course of business for services or tangible property, and would therefore be taken into account if made to an ineligible person.

53. As explained in paragraph 33 above, which is applicable to the base erosion test of subparagraph *d*), States that want to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute "special tax regimes" and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity, may also want to modify the base erosion test of subdivision (*ii*) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subdivision (*ii*) as follows:

(ii) less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*);

B) to persons that are connected to the person described in this subparagraph and that benefit from a special tax regime, as defined in [reference to the paragraph of the convention that includes the definition of "special tax regime"] of this Convention, with respect to the deductible payment; or

C) with respect to a payment of interest, to persons that are connected to the person described in this subparagraph and that benefit from notional deductions described in [reference to the paragraph of Article 11 that relates to notional deductions for equity];

54. The following examples illustrate the application of the base erosion test of subdivision (*ii*) of subparagraph *f*) by a Contracting State (referred to in the examples as the "first-mentioned State"), taking into account the definitions of "tested group" and "gross income" in paragraph 7:

— Example A: Assume that at all relevant times, R2 (the entity seeking treaty benefits under subparagraph *f*)) is a wholly owned subsidiary of R1, which in turn is wholly owned by Z, an individual. R1, R2 and Z are all residents of the other Contracting State under Article 4. R2 and R1 are both members of the same tax

consolidation group. The ownership test in subdivision (i) of subparagraph *f*) is satisfied because Z, a qualified person under subparagraph *a*), owns indirectly at least 50 per cent of the aggregate vote and value of R2, and R1 is a qualifying intermediate owner.

During the relevant taxable period, R2 has 50 of exempt dividends paid by a company resident of a third State and 50 of interest arising in the first-mentioned State. R2 makes a deductible interest payment of 24 to an ineligible person and pays a 51 dividend to R1. In addition to the 51 dividend that it receives from R2, R1 receives additional income of 100 from persons outside the tested group. R1 makes a deductible interest payment of 51 to an ineligible person. R2 is seeking to claim the benefits of Article 11 of the Convention, but not of Article 10.

For purposes of applying the tested group base erosion test, the tested group consists of R1 and R2. The tested group's gross income for this purpose is 150 (50 of interest arising in the first-mentioned State plus 100 of additional income from persons outside of the tested group). R2 has made a base eroding payment of 24 and R1 has made a base eroding payment of 51 to ineligible persons. The base eroding payments of the tested group total 75 (24 + 51), which is not less than 50 per cent of the tested group's gross income of 150. Therefore, the base erosion test is not satisfied and R2 is not a qualified person under subparagraph *f*).

— Example B: Assume the same facts as Example A above, except that the income with respect to which R2 seeks to be a qualified person is 50 of dividends paid by a company resident of the first-mentioned State instead of 50 of interest arising in that State. For this purpose, R2's gross income is 100 (the 50 of dividends paid by a company resident of a third State and the 50 of dividends paid by a company of the first-mentioned State). The gross income of the tested group is 200 (R2's gross income of 100 plus R1's income of 100 from persons outside the tested group). R2 has made a base eroding payment of 24 and R1 has made a base eroding payment of 51. The base eroding payments of R2 equal 24, which is less than 50 per cent of R2's gross income of 100. In addition, the base eroding payments of the tested group total 75 (24 + 51), which is less than 50 per cent of the tested group's gross income of 200. Therefore, under this example, the base erosion test of subdivision (ii) is satisfied and R2 shall be a qualified person under subparagraph *f*) for purposes of obtaining a lower rate of taxation on the dividend paid by the company resident of the first-mentioned State.

Subparagraph g): Collective investment vehicles

Detailed version only

g) [possible provision on collective investment vehicles][1]

1 This subparagraph should be drafted (or omitted) based on how collective investment vehicles are treated in the Convention and are used and treated in each Contracting State: see the Commentary on the subparagraph and paragraphs 22 to 48 of the Commentary on Article 1.

Commentary on subparagraph g) of paragraph 2 of the detailed version

55. As indicated in the footnote to subparagraph *g*), whether a specific rule concerning collective investment vehicles (CIVs) should be included in paragraph 2, and, if so, how that rule should be drafted, will depend on how the Convention applies to CIVs and on the treatment and use of CIVs in each Contracting State.[1] Whilst no such rule will be needed with respect to an entity that would otherwise constitute a "qualified person" under other parts of paragraph 2, a specific rule will frequently be needed since a CIV may not be entitled to treaty benefits under either the other provisions of paragraph 2 or under paragraphs 3, 4 or 5 because, in many cases

— the interests in the CIV are not publicly-traded (even though these interests are widely distributed);

— these interests are held by residents of third States;

— the distributions made by the CIV are deductible payments;

— the CIV is used for investment purposes rather than for the "active conduct of a business" within the meaning of paragraph 3;

— the CIV does not meet the ownership test of paragraph 4, and

— the CIV does not qualify as a headquarters company under paragraph 5.

56. Paragraphs 22 to 48 of the Commentary on Article 1 discuss various factors that should be considered for the purpose of determining the treaty entitlement of CIVs and these paragraphs are therefore relevant when determining whether a provision on CIVs should be included in paragraph 2 and how it should be drafted. These paragraphs include alternative provisions that may be used to deal adequately with the CIVs that are found in each Contracting State. As explained below, the use of these provisions may make it unnecessary to include a specific rule on CIVs in paragraph 2, although it will be important to make sure that, in such a case, the definition of "equivalent beneficiary", if the term is used for the purposes of one of these alternative provisions, is adapted to reflect the definition included in paragraph 7.

57. If it is included, subparagraph *g*) will address cases where a Contracting State agrees that CIVs established in the other Contracting State constitute residents of that other State under the analysis in paragraphs 23 to 26 of the Commentary on Article 1 (such agreement may be evidenced by a mutual agreement as envisaged in paragraph 30 of the Commentary on Article 1 or may result from judicial or administrative pronouncements). The provisions of the Article, including subparagraph *g*), are not relevant with respect to a CIV that does not qualify as a resident of a Contracting State under the analysis in paragraphs 23 to 26 of the Commentary on Article 1. Also, the provisions of subparagraph *g*) are not relevant

1 See also paragraphs 67.1 to 67.7 of the Commentary on Article 10 and the report "Tax Treaty Issues Related to REITs" which deal with the treaty entitlement of Real Estate Investment Trusts (REITs). With respect to the application of the definition of "resident of a Contracting State" to REITs, see paragraphs 8-9 of the report "Tax Treaty Issues Related to REITs".

where the treaty entitlement of a CIV is dealt with under a treaty provision similar to one of the alternative provisions in paragraphs 31, 35, 40, 41 and 46 of the Commentary on Article 1.

58. As explained in paragraphs 33 and 34 of the Commentary on Article 1, Contracting States wishing to address the issue of CIVs' entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State.

59. As a result of that analysis, they may conclude that the tax treatment of CIVs established in the two States does not give rise to treaty-shopping concerns and decide to include in their bilateral treaty the alternative provision in paragraph 31 of the Commentary on Article 1, which would expressly provide for the treaty entitlement of CIVs established in each State and, at the same time, would ensure that they constitute qualified persons under subparagraph *a*) of paragraph 2 of the Article (because a CIV to which that alternative provision would apply would be treated as an individual). In such a case, subparagraph *g*) should be omitted. States that share the view that CIVs established in the two States do not give rise to treaty-shopping concerns but that do not include in their treaty the alternative provision in paragraph 31 of the Commentary on Article 1 should ensure that any CIV that is a resident of a Contracting State should constitute a qualified person. In that case, subparagraph *g*) should be drafted as follows:

g) a collective investment vehicle [a definition of "collective investment vehicle" would then be included in paragraph 7];

60. The Contracting States could, however, conclude that CIVs present the opportunity for residents of third States to receive treaty benefits that would not have been available if these residents had invested directly and, for that reason, might prefer to draft subparagraph *g*) in a way that will ensure that a CIV that is a resident of a Contracting State will constitute a qualified person but only to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries. In that case, subparagraph *g*) should be drafted as follows:

g) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by [residents of the Contracting Sate in which the collective investment vehicle is established or by][1] equivalent beneficiaries;

61. That treatment corresponds to the treatment that would result from the inclusion in a tax treaty of a provision similar to the alternative provision in paragraph 35 of the Commentary on Article 1. As explained in paragraphs 32 to 38 of the Commentary on Article 1, the inclusion of such an alternative provision would

1 The words "residents of the Contracting State in which the collective investment vehicle is established" would not be needed if the definition of "equivalent beneficiary" used for the purpose of that provision was identical to the detailed version of the definition of the term "equivalent beneficiary" in paragraph 7; see paragraph 145 below.

provide a more comprehensive solution to treaty issues arising in connection with CIVs because it would address treaty-shopping concerns whilst, at the same time, clarifying the tax treaty treatment of CIVs in both Contracting States. If that alternative provision is included in a tax treaty, subparagraph *g*) would not be necessary as regards the CIVs to which that alternative provision would apply: since that alternative provision provides that a CIV to which it applies shall be treated as an individual (to the extent that the beneficial interests in that CIV are owned by equivalent beneficiaries), that CIV will constitute a qualified person under subparagraph *a*) of paragraph 2 of the Article.

62. The approach described in the preceding two paragraphs, like the approach in paragraphs 35, 40 and 42 of the Commentary on Article 1, makes it necessary for the CIV to make a determination, when a benefit is claimed as regards a specific item of income, regarding the proportion of holders of interests who would have been entitled to benefits had they invested directly. As indicated in paragraph 43 of the Commentary on Article 1, however, the ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries. For that reason, the CIV and its managers often do not themselves know the names and treaty status of the beneficial owners of interests. It would therefore be impractical for the CIV to collect such information from the relevant intermediaries each time the CIV receives income. Accordingly, Contracting States should be willing to accept practical and reliable approaches that do not require such daily tracing. As indicated in paragraph 45 of the Commentary on Article 1, the proportion of investors in the CIV is likely to change relatively slowly even though the identity of individual investors will change daily. For that reason, the determination of the extent to which the beneficial interests in a CIV are owned by equivalent beneficiaries should be made at regular intervals, the determination made at a given time being applicable to payments received until the following determination. This corresponds to the approach described in paragraph 45 of the Commentary on Article 1, according to which:

> … it would be a reasonable approach to require the CIV to collect from other intermediaries, on specified dates, information enabling the CIV to determine the proportion of investors that are treaty-entitled. This information could be required at the end of a calendar or fiscal year or, if market conditions suggest that turnover in ownership is high, it could be required more frequently, although no more often than the end of each calendar quarter. The CIV could then make a claim on the basis of an average of those amounts over an agreed-upon time period. In adopting such procedures, care would have to be taken in choosing the measurement dates to ensure that the CIV would have enough time to update the information that it provides to other payers so that the correct amount is withheld at the beginning of each relevant period.

63. Another view that Contracting States may adopt regarding CIVs is that expressed in paragraph 40 of the Commentary on Article 1. Contracting States that adopt that view may wish to draft subparagraph *g*) so that a CIV that is a resident of a Contracting State would only constitute a qualified person to the extent that the beneficial

interests in that CIV are owned by residents of the Contracting State in which the CIV is established. In that case, subparagraph *g*) should be drafted as follows:

g) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.

Since the inclusion of the alternative provision in paragraph 40 of the Commentary on Article 1 would achieve the same result with respect to the CIVs to which it would apply, subparagraph *g*) would not be necessary, if that alternative provision is included in a treaty, as regards the CIVs to which that provision would apply.

64. A variation on the preceding approach would be to consider that a CIV that is a resident of a Contracting State should constitute a qualified person if the majority of the beneficial interests in that CIV are owned by individuals who are residents of the Contracting State in which the CIV is established. This result could be achieved by omitting subparagraph *g*) and simply relying on the application of subparagraph *f*) (the ownership and base erosion test).

65. Another possible view that the Contracting States could adopt would be to conclude that the fact that a substantial proportion of the CIV's investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be provided with respect to all income received by a CIV. An alternative provision that would ensure that result is included in paragraph 41 of the Commentary on Article 1 and subparagraph *g*) would not be necessary, if the Contracting States include that provision in their bilateral treaty, with respect to the CIVs to which the provision would apply. If that provision is not included in the treaty, the scope of subparagraph *g*) could be broadened in order to achieve a similar result by referring to "a collective investment vehicle, but only if [percentage to be determined bilaterally] per cent of the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established and by equivalent beneficiaries".

66. Similarly, the Contracting States may use the alternative provision in paragraph 46 of the Commentary on Article 1 where they consider "that a publicly-traded collective investment vehicle cannot be used effectively for treaty shopping because the shareholders or unit holders of such a collective investment vehicle cannot individually exercise control over it". In such case, subparagraph *g*) would not be necessary with respect to the CIVs to which the alternative provision would apply. States that share that view but that have not included the alternative provision in their treaty could draft subparagraph *g*) to read:

g) a collective investment vehicle if the principal class of shares in the collective investment vehicle is listed and regularly traded on a recognised stock exchange.

67. Finally, as explained in paragraph 39 of the Commentary on Article 1, States that share the concern described in that paragraph about the potential deferral of taxation

that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently. Depending on their drafting, such provisions may render subparagraph *g*) unnecessary.

Paragraph 3: active conduct of a business

Simplified and detailed versions

3. *a)* A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned State and the income derived from the other State emanates from, or is incidental to, that business. For purposes of this Article, the term "active conduct of a business" shall not include the following activities or any combination thereof:
   (i) operating as a holding company;
   (ii) providing overall supervision or administration of a group of companies;
   (iii) providing group financing (including cash pooling); or
   (iv) making or managing investments, unless these activities are carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer in the ordinary course of its business as such.

   b) If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other State from a connected person, the conditions described in subparagraph *a*) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned State to which the item is related is substantial in relation to the same or complementary business activity carried on by the resident or such connected person in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.

   c) For purposes of applying this paragraph, activities conducted by connected persons with respect to a resident of a Contracting State shall be deemed to be conducted by such resident.

Commentary on paragraph 3 of the simplified and detailed versions

68. Paragraph 3 of both the simplified and detailed versions sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active business conducted in its State of residence. This paragraph recognises that where an entity resident of a Contracting State actively carries on business activities in that State, including activities conducted by connected persons, and derives income from the other Contracting State that emanates from, or is incidental to, such business activities, granting treaty benefits with respect to such income does not give rise to treaty-shopping concerns regardless of the nature and ownership of the entity. The paragraph will provide treaty benefits in a large number of situations where benefits would otherwise be denied under paragraph 1 because the entity is not a "qualified person" under paragraph 2.

69. A resident of a Contracting State may qualify for benefits under paragraph 3 regardless of the fact that it is not a qualified person under paragraph 2. Under the active-conduct test of paragraph 3, a person (typically a company) will be eligible for treaty benefits if it satisfies two conditions: first, it is engaged in the active conduct of a business in its State of residence and second, the payment for which benefits are sought is related to the business. In certain cases, an additional requirement that the business be substantial in size relative to the activity in the State of source generating the income must be met.

70. Subparagraph *a*) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a business in that State may obtain the benefits of the Convention with respect to an item of income derived from the other Contracting State. The item of income, however, must emanate from, or be incidental to, that business.

71. The term "business" is not defined (except for the limited purpose of clarifying that it includes the performance of professional services and of other activities of an independent character; see subparagraph *h*) of paragraph 1 of Article 3) and, under the general rule of paragraph 2 of Article 3, must therefore be given the meaning that it has under domestic law. An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities.

72. Subdivisions (*i*) through (*iv*) of subparagraph *a*) identify specific functions that, either on their own or in combination, will be considered, for purposes of paragraph 3, not to constitute the active conduct of a business in a Contracting State, even when all such functions are conducted in the same State. These are: (*i*) operating as a holding company; (*ii*) providing overall supervision or administration of a group of companies; (*iii*) providing group financing (including cash pooling); and (*iv*) making or managing investments, unless these activities are carried on by a regulated bank (or financial

institution agreed to by the Contracting States), insurance company or registered securities dealer in the ordinary course of its business as such.

73. This list of activities is intended to clarify that the administrative support functions of multinationals, as well as the activities of operating as a holding company, do not constitute the active conduct of a business and, therefore, income that emanates from, or is incidental to, such activities cannot be entitled to treaty benefits under paragraph 3. Some States consider, however, that some or all of the activities listed in subdivisions (*i*) through (*iv*) should be included in what constitutes the active conduct of a business and these States may therefore wish to adopt a different formulation of subparagraph *a*).

74. Whether an item of income emanates from the company's active conduct of a business in the State of residence must be determined based on facts and circumstances. In general, an item of income emanates from the active conduct of a business in the State of residence if there is a factual connection between the actively conducted business and the item of income for which benefits are sought. For example, if a company conducts research and development in its State of residence and develops a patent for a new process, royalties from licensing the patent would be factually connected to the actively conducted business in the State of residence. In the case of dividends or interest paid to a parent company, the activities of the paying company will be relevant in determining whether the dividend or interest emanates from the parent's actively conducted business in its State of residence.

75. For the purposes of determining whether the activities of the paying company in the State of source have the required factual connection with the actively conducted business in the State of residence, it will be important to compare the lines of business in each State. The line of business in the State of source may be upstream or downstream to the activity conducted in the State of residence. Thus, the line of business in the State of source may provide inputs for a manufacturing process that occurs in the State of residence, or the line of business in the State of source may sell the output of the manufacturing process conducted by a resident. The following examples illustrate these principles:

— Example A: ACO is a company resident of State A and is engaged in the active conduct of a business in that State consisting in manufacturing product X. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO acquires product X from ACO and distributes it to customers in State B. Since the distribution activity by BCO of product X is factually connected to ACO's manufacturing of that product, dividends paid by BCO to ACO will be treated as emanating from ACO's business.

— Example B: ACO is a company resident of State A that operates a large research and development facility in State A that develops intellectual property that it licenses to affiliates worldwide, including BCO. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO manufactures and markets the ACO-designed products in State B. Since the activities conducted by BCO are factually connected to ACO's actively conducted business in State A, royalties

paid by BCO to ACO for the use of its intellectual property will be treated as emanating from ACO's business.

— Example C: ACO is a company resident of State A and is engaged in State A in the active conduct of a manufacturing business that requires the use of commodity X. ACO owns 100 per cent of the shares of BCO, a company resident of State B, which contains a large supply of commodity X. BCO extracts commodity X and sells it to ACO, which uses the commodity to manufacture goods that it sells in the open market. Since the business activity conducted by BCO provides upstream inputs to ACO for use in manufacturing its goods, BCO's business is factually connected to ACO's manufacturing activities in State A. Dividends paid by BCO to ACO will be treated as emanating from ACO's business.

76. An item of income derived from the State of source is "incidental to" the business carried on in the State of residence if production of the item facilitates the conduct of the business in the State of residence. An example of incidental income is income derived from the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.

77. Subparagraph *b*) of paragraph 3 states a further condition to the general rule in subparagraph *a*) in cases where the business generating the item of income in question is carried on either by the person deriving the income or by a connected person in the State of source. Subparagraph *b*) states that the business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The determination of substantiality is based upon all the facts and circumstances, including the comparative sizes of the businesses in each Contracting State, the relative sizes of the economies and markets in the two States, the nature of the activities performed in each State, and the relative contributions made to that business in each State.

78. The determination of whether subparagraph *b*) applies is made separately for each item of income derived from the State of source, with reference to the business in the State of residence from which the item of income in question emanates. It is therefore possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all the benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.

79. The substantiality requirement under subparagraph *b*) will not apply, however, if the business generating the item of income in question is not carried on in the State of source by the resident seeking benefits or by a connected person in the State of source. For example, if a small research firm in one State develops a process that it licenses to a very large pharmaceutical manufacturer in another State that is not a connected person with respect to the small research firm, the size of the business activity of the research firm in the first State would not have to be tested against the size of the business activity of the manufacturer. Similarly, a small bank of one State that makes a loan to a very large company that is not a connected person and that is operating a

business in the other State would not have to pass a substantiality test to be eligible for treaty benefits under paragraph 3.

80. Subparagraph *c*) provides attribution rules in the case of activities conducted by connected persons for purposes of applying the substantive rules of subparagraphs *a*) and *b*). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph *a*) that it be engaged in the active conduct of a business and that the item of income emanates from that active business, and for making the comparison required by the "substantiality" requirement in subparagraph *b*). The term "connected person" is defined in paragraph 7.

81. The following examples illustrate the application of paragraph 3 in relation to activities conducted by connected persons:

— Example A: PARENTCO is a resident of a third State and is the parent of HOLDCO, which itself is the parent of OPCO1 and OPCO2. OPCO1 and HOLDCO are residents of State A. OPCO2 is a resident of State B. OPCO1 and OPCO2 are engaged in the business of manufacturing the same product in their respective States of residence. HOLDCO manages the investments of the group and is considered not to be engaged in the active conduct of a business. HOLDCO receives dividends from OPCO2. Under subparagraph *c*), HOLDCO is deemed to be engaged in the active conduct of a business because it is deemed to conduct the activities of OPCO1, which is engaged in the active conduct of a business. Therefore, HOLDCO is treated as engaged in the active conduct of a business in State A. Nevertheless, the fact that HOLDCO's deemed business is the same as the business of OPCO2 is not sufficient to demonstrate that the dividends paid by OPCO2 are factually connected to HOLDCO's actively conducted business. Accordingly, such dividends will not enjoy by virtue of paragraph 3 the reduced rates of withholding of Article 10 of the convention between States A and B.

— Example B: ACO is a company resident of State A and is engaged in State A in the active conduct of a manufacturing business that requires the use of commodity X. All the shares of ACO are owned by HOLDCO, also a resident of State A, which also owns 100 per cent of the shares of BCO, a company resident of State B where there is a large supply of commodity X. BCO extracts commodity X and sells it to ACO, which uses the commodity to manufacture goods that it sells in the open market. HOLDCO is considered to be engaged in the active conduct of a business because it is deemed under subparagraph *c*) to conduct the activities of ACO. Since the business activity conducted by BCO provides upstream inputs for use in HOLDCO's deemed active conduct of a business, BCO's business is considered to be factually connected to HOLDCO's deemed manufacturing business, Dividends paid by BCO to HOLDCO will therefore emanate from HOLDCO's deemed active conduct of a business.

Paragraph 4: derivative benefits

Simplified version

4. A resident of a Contracting State that is not a qualified person shall nevertheless be entitled to a benefit that would otherwise be accorded by this Convention with respect to an item of income if, at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, persons that are equivalent beneficiaries own, directly or indirectly, at least 75 per cent of the shares of the resident.

Detailed version

[The question of how the derivative benefits paragraph should be drafted in a convention that follows the detailed version is discussed in the Commentary below.]

Commentary on paragraph 4 of the simplified version

82. Paragraph 4 of the simplified version sets forth a derivative benefits test that is potentially applicable to all treaty benefits, although the test must be applied to each individual item of income. This derivative benefits test entitles companies and entities that are residents of a Contracting State but that are not qualifying persons under paragraph 2 to be entitled to treaty benefits with respect to an item of income if, at the time that the benefit would otherwise be granted with respect to that item of income and on at least half of the days of any twelve-month period that includes that time, at least 75 per cent of the shares (as defined in paragraph 7) of that company or entity are owned, directly or indirectly, by persons that satisfy the definition of "equivalent beneficiary" found in paragraph 7. The definition of "equivalent beneficiary", which is crucial for the application of paragraph 4, basically refers to persons who would have been entitled to equivalent or more favourable benefits from the State of source if they had received the same income directly (subject to the conditions included in that definition).

Commentary on paragraph 4 of the detailed version

83. The drafting of the derivative benefits paragraph in a convention that follows the detailed version depends on the views of the Contracting States concerning treaty-shopping opportunities that might arise from such a paragraph with respect to residents of States whose tax system includes certain preferential features.

84. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons (as defined in paragraph 7) that benefit from regimes that constitute "special tax regimes" (see paragraphs 85 to 100 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic

law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). These States may want to ensure that any derivative benefits provisions included in their conventions do not allow base eroding payments to be made to such connected persons even if they qualify as equivalent beneficiaries. States that share these views are likely to want to adopt a derivative benefits paragraph drafted as follows:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if:

a) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, at least 95 per cent of the aggregate vote and value of its shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

b) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

i) to persons that are not equivalent beneficiaries;

ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation;

iii) to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from a special tax regime, as defined in [reference to the paragraph of the convention that includes the definition of "special tax regime"] of this Convention, with respect to the deductible payment, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of a special tax regime analogous to the definition of that term included in this Convention, the principles of that definition shall apply, but without regard to the requirement in subdivision (*v*) of that definition; or

iv) with respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from notional deductions of the type described in [reference to the paragraph of Article 11 that relates to notional deductions for equity].

85. States that do not consider that provisions on special tax regimes and notional deductions with respect to equity should be included in their tax treaties, however, may prefer to use the following version of the derivative benefits paragraph:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if:

a) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, at least 95 per cent of the aggregate vote and value of its shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and

b) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

i) to persons that are not equivalent beneficiaries; or

ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation.

86. Some States, however, may consider that the provisions of a derivative benefits paragraph drafted along the lines of the provision included in the previous paragraph create unacceptable risks of treaty shopping with respect to payments that are deductible in the State of source. Instead of not providing any derivative benefits, these States might prefer to restrict the scope of that provision to dividends, which are typically not deductible. States that share that view are free to amend the first part of the alternative provision so that it reads as follows:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded under Article 10 if:

87. Whether drafted as suggested in paragraph 84 or in paragraph 85 above, paragraph 4 on derivative benefits sets forth an alternative test under which a resident of a Contracting State that is not a qualified person under paragraph 2 may receive treaty benefits with respect to certain items of income. In general, this derivative benefits test entitles a company that is a resident of a Contracting State to treaty benefits if 95 per cent of the vote and value of its shares are owned, directly or indirectly, by seven or fewer equivalent beneficiaries and the company satisfies a base erosion test. The requirement that at least 95 per cent of the vote and value of the company seeking treaty benefits under paragraph 4 be owned, directly or indirectly, by

seven or fewer equivalent beneficiaries is intended to avoid the administrative burden of having to determine whether a large number of shareholders are equivalent beneficiaries; it is also consistent with the objective of the derivative benefits test to provide benefits for holding companies of a multinational group in the situations contemplated by the provision.

88. Subparagraph *a*) sets forth the ownership test. Under this test, seven or fewer equivalent beneficiaries must own, directly or indirectly, shares representing at least 95 per cent of the aggregate vote and value of the company and at least 50 per cent of any disproportionate class of shares on at least half of the days of any twelve-month period that includes the date when benefits would otherwise be accorded. In the case of indirect ownership, each intermediate owner must be a qualifying intermediate owner. The term "qualifying intermediate owner" is defined in paragraph 7 (see paragraphs 151 to 154 below); the following example illustrates the application of that definition in the context of paragraph 4:

— Example: HOLDCO, a company resident of State A, is a wholly owned direct subsidiary of ZCO, a company resident of State Z, which itself is a wholly owned direct subsidiary of XCO, a resident of State X. XCO's principal class of shares is primarily and regularly traded on the stock exchange in State X. HOLDCO is not entitled to benefits under paragraph 2 of the treaty between States A and B because it is a subsidiary of a company resident and publicly traded in a third State. HOLDCO is not engaged in the conduct of an active business in State A, and therefore it is not entitled to any benefits under paragraph 3. HOLDCO derives and beneficially owns interest arising in State B that would otherwise be entitled to the benefits of Article 11 of the treaty between States A and B. Assume that by virtue of the provisions of the income tax convention between State B and State X, XCO qualifies as an equivalent beneficiary under the definition of that term included in the treaty between States A and B.

  Although XCO indirectly owns all the shares of HOLDCO, ZCO, as an intermediate owner, must satisfy the definition of "qualifying intermediate owner" in paragraph 7 of the treaty between States A and B in order for HOLDCO to be eligible for the benefits of Article 11 of the treaty between States A and B with respect to the interest that it received from State B. If State Z does not have in effect a comprehensive convention for the avoidance of double taxation (or, if the definition of qualifying intermediate owner is drafted as suggested in paragraph 153 below, such a convention is in effect but ZCO benefits from either a "special tax regime" or notional deductions with respect to equity), ZCO will not be a qualifying intermediate owner and the requirements of subparagraph *a*) will not be satisfied with the result that HOLDCO will not be eligible, under paragraph 4, for the benefits of the convention.

89. Subparagraph *b*) sets forth the base erosion test applicable for purposes of paragraph 4. That test is broadly similar to the base erosion test in subdivision (ii) of subparagraph *f*) of paragraph 2 except that the list of ineligible persons is different (see below). The base erosion test of subparagraph *b*) is satisfied if

— less than 50 per cent of the company's gross income (and less than 50 per cent of the tested group's gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and

— less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

90. Paragraph 7 includes the definition of the terms "tested group" and "gross income" which are used in subparagraph *b*). Also, the term "ineligible persons" used in the previous paragraph refers to:

— if paragraph 4 is drafted as indicated in paragraph 84 above, persons who are not equivalent beneficiaries under the definition of that term in paragraph 7 as well as persons who are equivalent beneficiaries under that definition but fall within one of the three following categories:

1. they are equivalent beneficiaries solely by reason of being a headquarters company under paragraph 5 of this Convention or of the relevant convention;
2. they are connected persons (as defined in paragraph 7) with the company seeking treaty benefits under paragraph 4 and benefit from a special tax regime with respect to the payment, or
3. with respect to a payment of interest, they are connected persons (as defined in paragraph 7) with the company seeking treaty benefits under paragraph 4 and benefit from notional deductions with respect to equity.

— if paragraph 4 is drafted as indicated in paragraph 85 above, persons who are not equivalent beneficiaries under the definition of that term in paragraph 7 as well as persons who are equivalent beneficiaries under that definition solely by reason of being a headquarters company under paragraph 5 of this Convention or of the relevant convention.

91. The following illustrates the base erosion test of paragraph 4:

— Example: Company X, a resident of State X, owns Company Y, a resident of State Y. Company Y owns Company B, a resident of State B that seeks benefits of the treaty between States A and B under paragraph 4. Company X is an equivalent beneficiary and Company Y is a qualifying intermediate owner under the definitions of these terms in paragraph 7 of the treaty between States A and B. Accordingly, Company B would satisfy the ownership requirement of subparagraph *a*) because, first, Company X, an equivalent beneficiary, indirectly owns shares representing at least 95 per cent of the aggregate vote and value of Company B and at least 50 per cent of any disproportionate class of shares (as

defined in paragraph 7), and, second, each intermediate owner (i.e. Company Y) is a qualifying intermediate owner.

Company B's gross income for the taxable period in question consists of 100 of interest arising in State A and 200 of dividends from a third State which is exempt from tax under the law of State B. Company B seeks treaty benefits with respect to the 100 of interest. Under the law of State B, Company B, Company Y and Company X are not allowed to participate in a common tax consolidation or other regime that would allow the three companies to share profits or losses nor is there any loss sharing regime available. Accordingly, in this example, there is no tested group. Company B's gross income is 100 (the interest arising in State A). Company B will fail the base erosion test of subparagraph *b*) if Company B makes base eroding payments of at least 50 to ineligible persons described in the previous paragraph.

Paragraph 5 (detailed version): headquarters company

Detailed version only

5. A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group, regardless of whether the resident is a qualified person. A company shall be considered a headquarters company for this purpose only if:

a) such company's primary place of management and control is in the Contracting State of which it is a resident;

b) the multinational corporate group consists of companies resident of, and engaged in the active conduct of a business in, at least four States, and the businesses carried on in each of the four States (or four groupings of States) generate at least 10 per cent of the gross income of the group;

c) the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company generate less than 50 per cent of the gross income of the group;

d) no more than 25 per cent of such company's gross income is derived from the other Contracting State;

e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and

f) less than 50 per cent of such company's gross income, and less than 50 per cent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary

course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2.

If the requirements of subparagraph *b*), *c*) or *d*) of this paragraph are not fulfilled for the relevant taxable period, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable periods.

Commentary on paragraph 5 of the detailed version

92. Paragraph 5 sets forth an alternative test under which a resident of a Contracting State that is a headquarters company and that is not a qualified person under paragraph 2 may receive treaty benefits with respect to dividends and interest paid by members of the company's multinational corporate group. A headquarters company's multinational corporate group means the company and its direct and indirect subsidiaries (and does not include upper-tier companies).

93. A company seeking to qualify for benefits as a headquarters company must satisfy six conditions. First, under subparagraph *a*), the headquarters company's primary place of management and control, as defined in paragraph 7, must be in the Contracting State of which it is a resident. The same test is applied for publicly-traded companies. Subdivision (ii) of the definition of "primary place of management and control" allows the possibility that, in certain limited cases, the management of a subgroup (such as a subgroup responsible for a regional area) may be exercised more by a company that is not the top-tier company for the entire group of connected companies, and in certain narrow cases a lower-tier company may satisfy the headquarters company test.

94. Second, under subparagraph *b*), the multinational corporate group must consist of companies resident of, and engaged in the active conduct of a business (as defined in paragraph 3) in, at least four States (including either Contracting State), and the businesses carried on in each of the four States (or four groupings of States) must generate at least 10 per cent of the gross income of the group. The application of this requirement is illustrated by the following example:

— Example: Company X is resident of State X and is a member of a multinational corporate group consisting of itself and its direct and indirect subsidiaries

resident in States X, A, B, C, D, E and F. The gross income generated by each of these companies for year 01 and year 02 is as follows:

State	Year 01	Year 02
X	45	60
A	25	12
B	10	20
C	10	12
D	7	10
E	10	9
F	5	7
Total	112	130

For year 01, 10 per cent of the gross income of this group is equal to 11.20. Only the companies in States X and A satisfy the requirement of subparagraph *b*) for that year. The other States may be aggregated into groupings to meet this requirement. Since States B and C have a total gross income of 20, and States D, E and F have a total gross income of 22, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph *b*).

For year 02, 10 per cent of the gross income is 13. Only the companies in States X and B satisfy this requirement. Since States A and C have a total gross income of 24, and States D, E and F have a total gross income of 26, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph *b*). The fact that State A replaced State B in a group is not relevant for this purpose. The composition of the grouping may change annually.

95. Third, under subparagraph *c*), the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company must generate less than 50 per cent of the gross income (as defined in paragraph 7) of the group. A company whose multinational corporate group generates 50 per cent or more of the group's gross income in the Contracting State of source does not meet this condition.

96. Fourth, under subparagraph *d*), no more than 25 per cent of the company's gross income can be derived from the other Contracting State. Unlike the third condition described in the previous paragraph, this condition looks only at the gross income earned by the company seeking status as a headquarters company rather than the gross income earned by members of its multinational corporate group.

97. Fifth, under subparagraph *e*), such company must be subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3. Therefore, such company must be subject to the general corporate taxation rules for

companies that are engaged in the active conduct of a business in the Contracting State of residence, and not to a regime for headquarters companies.

98. Sixth, under subparagraph *f*), such company must satisfy a base erosion test that is broadly similar to the base erosion test in subdivision (*ii*) of subparagraph *f*) of paragraph 2 except that base eroding payments do not include payments in respect of financial obligations to a bank that is not a connected person with respect to the company. For example, unlike the base erosion test in subparagraph *f*) of paragraph 2, interest payments made by a company to a bank that is not a connected person to the company will not be treated as a base eroding payment for purposes of applying the base erosion test under paragraph 5. Paragraph 7 includes the definition of the terms "tested group" and "gross income" which are used for the purposes of this base erosion test.

99. As explained in paragraph 33 above which is applicable to the base erosion test of subparagraph *d*) of paragraph 2, States that want to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute "special tax regimes" and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity, may also want to modify the base erosion test of subparagraph *f*) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subparagraph *f*) as follows:

f) less than 50 per cent of such company's gross income, and less than 50 per cent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions):

   i) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph *a*), *b*), *c*) or *e*) of paragraph 2;

   ii) to persons that are connected persons with respect to such company and that benefit from a special tax regime as defined in [reference to the paragraph of the convention that includes the definition of "special tax regime"] with respect to the deductible payment; or

   iii) with respect to a payment of interest, to persons that are connected persons with respect to the company referred to in this paragraph and that benefit from notional deductions of the type described in [reference to the paragraph of Article 11 that relates to notional deductions for equity].

100. The six conditions of paragraph 5 must be tested with respect to the taxable year in which the company received the dividends or interest for which it is seeking benefits under the Convention. A company that does not satisfy the second, third or fourth conditions described above for the relevant taxable year may still be treated as a headquarters company if it satisfies such conditions by averaging the required ratios for the preceding four taxable periods (which does not include the taxable period that includes the payment for which a treaty benefit is being sought).

Paragraph 5 (simplified version) / 6 (detailed version): discretionary relief

Simplified and detailed versions

5/6. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3[or 4 (simplified version)] [, 4 or 5 (detailed version)], the competent authority of the Contracting State in which benefits are denied under the previous provisions of this Article may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which a request has been made, under this paragraph, by a resident of the other State, shall consult with the competent authority of that other State before either granting or denying the request.

Commentary on paragraph 5 (simplified version) / 6 (detailed version)

101. Paragraph 5 of the simplified version and paragraph 6 of the detailed version provide that where, under the previous paragraphs of the Article, a resident of a Contracting State is not entitled to benefits of the Convention, that resident may request that the competent authority of the State in which benefits are denied under these paragraphs grant these benefits. The only difference between the simplified and the detailed versions relates to the cross-reference to the paragraphs of the Article under which benefits of the Convention are otherwise granted.

102. Where a request is made under paragraph 5 (simplified version) or paragraph 6 (detailed version), the competent authority to which that request is made may grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if the person who made the request demonstrates to the satisfaction of the competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. Thus, persons that establish operations in one of the Contracting

States with a principal purpose of obtaining the benefits of the Convention will not be granted benefits of the Convention under the paragraph.

103. In order to be granted benefits under the paragraph, a person must establish, to the satisfaction of the competent authority of the State from which benefits are being sought, that, first, there were clear non-tax business reasons for its formation, acquisition, or maintenance and for the conduct of its operations and, second, that the allowance of benefits would not otherwise be contrary to the object and purpose of the Convention. For the purposes of determining that neither the establishment, acquisition or maintenance, nor the conduct of the operations, of a resident of a Contracting State had as one of its principal purposes the obtaining of benefits under the Convention, one of the factors that the competent authority will typically take into account is whether or not the resident has a substantial non-tax nexus to its State of residence. For example, in the case of a resident subsidiary company with a parent in a third State, the fact that the relevant withholding rate provided in the Convention is at least as low as the corresponding withholding rate in the income tax convention between the State of source and the third State is not by itself evidence of a nexus or relationship to the other Contracting State. Similarly, a relationship or nexus to the treaty State cannot be established by a desire to take advantage of favourable domestic laws of the treaty State, including the existence of a network of tax treaties.

104. Also, discretionary benefits typically will not be granted if the benefit requested would result in no or minimal tax imposed on the item of income in both the State of residence of the applicant and the State of source, taking into account the domestic law of both Contracting States as well as the provisions and the object and purpose of the Convention. For example, double non-taxation may occur through the use of a hybrid instrument that generates a deduction in the State of source where the income from that instrument is treated as exempt in the State of residence. On the other hand, the fact that there is no or minimal tax in both States may not be inconsistent with the object and purpose of the Convention in the case of dividends paid by a company resident of one State to a company resident of the other State that owns a substantial part of the shares of the paying company where the provisions of the Convention reveal that the Contracting States intended these dividends to be subject to low or no taxation in both States.

105. Whilst it is impossible to provide a detailed list of all the facts and circumstances that would be relevant to the application of the paragraph, examples of such facts and circumstances include the history, structure, ownership and operations of the resident that makes the request, whether that resident is a long-standing entity that was recently acquired by non-residents for non-tax reasons, whether the resident carries on substantial business activities, whether the resident's income for which the benefits are requested is subject to double taxation and whether the establishment or use of the resident gives rise to non-taxation or reduced taxation of the income.

106. The reference to "one of its principal purposes" in the paragraph means that obtaining benefits under a tax treaty needs not be the sole or dominant purpose for the establishment, acquisition or maintenance of the person and the conduct of its

operations. It is sufficient that at least one of the principal purposes was to obtain treaty benefits. Where the competent authority determines, having regard to all relevant facts and circumstances, that obtaining benefits under the Convention was not a principal consideration and would not have justified the establishment, acquisition or maintenance of the person and the conduct of its operations, it may grant that person these benefits, or benefits with respect to a specific item of income or capital. Where, however, the establishment, acquisition or maintenance of the person and the conduct of its operations is carried on for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will prevent the obtaining of benefits under one treaty from being considered a principal purpose for these operations.

107. Although a request under the paragraph will usually be made by a resident of a Contracting State to the competent authority of the other Contracting State, there may be cases in which a resident of a Contracting State may request the competent authority of its own State of residence to grant relief under the paragraph. This would be the case if the treaty benefits that are requested are provided by the State of residence, such as the benefits of the provisions of Articles 23 A and 23 B concerning the elimination of double taxation.

108. The paragraph grants broad discretion to the competent authority and, as long as the competent authority has exercised that discretion in accordance with the requirements of the paragraph, it cannot be considered that the decision of the competent authority is an action that results in taxation not in accordance with the provisions of the Convention (see paragraph 1 of Article 25). The paragraph does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before granting or denying a request to grant benefits made by a resident of that other State. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request has been presented obtain the agreement of the competent authority that is consulted.

109. The competent authority to which a request is made under the paragraph may grant benefits but it may then grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

110. The request for a determination under the paragraph may be presented before (e.g. through a ruling request) or after the establishment, acquisition or maintenance of the person for whom the request is made. The request must be presented, however,

before benefits may be claimed. If the competent authority determines that benefits are to be allowed, it is expected that benefits will be allowed retroactively to the later of the time of entry into force of the relevant treaty provision or to the time of the establishment or acquisition of the person for whom the request is made, assuming that all relevant facts and circumstances justify granting the retroactive application of benefits.

111. The competent authority that receives a request for relief under the paragraph should process that request expeditiously.

112. To reduce the resource implications of having to consider requests for discretionary relief, and to discourage vexatious requests, a Contracting State may find it useful to publish guidelines on the types of cases that it considers will and will not qualify for discretionary relief. However, any administrative conditions that a Contracting State imposes on applicants should not deter persons from making requests where they consider that they have a reasonable prospect of satisfying a competent authority that benefits should be granted.

Paragraph 6 (simplified version) / 7 (detailed version): Definitions

Definitions (preamble)

Simplified and detailed versions

6/7. For the purposes of this and the previous paragraphs of this Article:

113. Paragraph 6 of the simplified version and paragraph 7 of the detailed version include a number of definitions that apply for the purposes of these paragraphs themselves as well as the previous paragraphs of the Article. These definitions supplement the definitions included in Articles 3, 4 and 5 of the Convention, which apply throughout the Convention.

The term "recognised stock exchange"

Simplified version

a) the term "recognised stock exchange" means:

(i) any stock exchange established and regulated as such under the laws of either Contracting State; and

(ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;

Detailed version

a) the term "recognised stock exchange" means:

(i) [list of stock exchanges agreed to at the time of signature]; and

(ii) any other stock exchange agreed upon by the competent authorities of the Contracting States;

Commentary on the definition of "recognised stock exchange" in the simplified version

114. Subdivision (i) of the definition of "recognised stock exchange" in the simplified version applies to all stock exchanges established and regulated as such under the laws of either Contracting State. This general reference does not require a list of the stock exchanges established in each of these States.

115. Subdivision (ii) of the definition allows the competent authorities to agree to treat any other stock exchange as a "recognised stock exchange" for the purposes of paragraphs 1 to 6 of the Article. The possibility to treat stock exchanges established in third States as "recognised stock exchanges" takes account of the fact that the globalisation of financial markets and the prominence of some large financial centres have resulted in the shares of many public companies being actively traded on more than one stock exchange and on stock exchanges established outside the Contracting States. The agreement referred to in subdivision (ii) may be reached during the negotiation of the Convention or at any time afterwards. Paragraphs 117 and 119 below provide additional explanations with respect to the application of the definition of "recognised stock exchange" to stock exchanges established outside the Contracting States.

Commentary on the definition of "recognised stock exchange" in the detailed version

116. The definition of "recognised stock exchange" in the detailed version includes, in subdivision (i), stock exchanges that both Contracting States agree to identify at the time of the signature of the Convention. Although this would typically include stock exchanges established in the Contracting States on which shares of publicly listed companies and entities that are residents of these States are actively traded, the stock exchanges to be identified in the definition need not be established in one of the Contracting States. This recognises that the globalisation of financial markets and the prominence of some large financial centres have resulted in the shares of many public companies being actively traded on more than one stock exchange and on stock exchanges situated outside the State of residence of these companies.

117. The list to be included in subdivision (i) may include the names of specific stock exchanges. It may also include a generic description of a number of stock exchanges that would each constitute a "recognised stock exchange". For example, in the case of the United States, such a generic description could read "any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934". If the Contracting States wish to cover European Union stock exchanges that are officially recognised as such, such a generic description could read "any stock exchange established in States that are members of the European Union or are party to the Agreement on the European Economic Area and that are regulated by the European Union Markets in Financial Instruments Directive (Directive 2004/39/EC as amended) or by any successor Directive".

118. Subdivision (ii) of the definition allows the competent authorities of the Contracting States to supplement, through a subsequent agreement, the list of stock exchanges identified in the definition at the time of signature of the Convention.

119. The stock exchanges to be included in the definition should impose listing requirements that ensure that shares of entities listed on that stock exchange are genuinely publicly traded. The following factors should be considered when determining whether a stock exchange should be listed in the definition or subsequently added to that list through the competent authority agreement referred to in the preceding paragraph:

— What are the requirements/standards with respect to listing a company on the stock exchange?

— What are the requirements/standards in order to continue to be listed on the stock exchange, including minimum financial standards?

— What are the annual/interim disclosure and/or filing requirements for companies whose shares are traded on the stock exchange?

— What is the volume of shares traded on the stock exchange in a calendar year?

— Do the rules governing the stock exchange ensure active trading of listed stocks? If so, how?

— Are the companies listed on the stock exchange required to disclose on an ongoing basis financial information and information on events that may have a material impact on their financial situations?

— Is information on the trading volume and overall shareholding of the companies listed on the stock exchange publicly available?

— Does the stock exchange impose any minimum size requirements, such as minimum capitalisation or number of employees, for companies whose shares are traded on the exchange?

— Does the stock exchange impose a required minimum percentage of public ownership? If so, what is the minimum amount?

— For a company to be listed on the stock exchange, are the shares of companies required to be freely negotiable and fully paid for?

— Is the stock exchange required to disclose the share prices of its listed companies within a certain timeframe?

— Is the stock exchange regulated or supervised by a government authority of the State in which it is located?

— [In the case of a new stock exchange to be added to an existing list:] Why would a company prefer to list on the new exchange rather than on another exchange, including those exchanges that are already "recognised stock exchanges" in the tax treaty? For example, are there lesser corporate governance and financial disclosure requirements?

— [In the case of a new stock exchange to be added to an existing list:] Does the new stock exchange provide a more efficient vehicle for raising capital and, if so, why?

The term "shares"

Simplified and detailed versions

b) with respect to entities that are not companies, the term "shares" means interests that are comparable to shares;

Commentary on the definition of "shares" in the simplified and detailed versions

120. Neither the simplified nor the detailed version contains an exhaustive definition of the term "shares", which, under paragraph 2 of Article 3, should generally have the meaning which it has under the domestic law of the State that applies the Article. Subparagraph *b*), however, provides that the term "shares", when used with respect to entities that do not issue shares (e.g. trusts), refers to interests that are comparable to shares. These will typically be beneficial interests that entitle their holders to a share of the income or assets of the entity.

The term "principal class of shares"

Simplified version

c) the term "principal class of shares" means the class or classes of shares of a company or entity which represents the majority of the aggregate vote and value of the company or entity;

Detailed version

c) the term "principal class of shares" means the ordinary or common shares of the company or entity, provided that such class of shares represents the majority of the aggregate vote and value of the company or entity. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company or entity, the "principal class of shares" are those classes that in the aggregate represent a majority of the aggregate vote and value;

Commentary on the definition of "principal class of shares" in the simplified version

121. The simplified version's definition of the term "principal class of shares" generally corresponds to the definition included in the detailed version but, instead of dealing expressly with the case where no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company or entity, deals with that issue through the phrase "class or classes of shares".

Commentary on the definition of "principal class of shares" in the detailed version

122. The detailed version's definition of the term "principal class of shares" refers to the ordinary or common shares of a company or entity but only if these shares represent the majority of the voting rights as well as of the value of the company or entity. If a company or entity has only one class of shares, that class of shares will naturally constitute its "principal class of shares". If a company or entity has more than one class of shares, it is necessary to determine which class or classes constitute the "principal class of shares", which will be the class of shares, or any combination of classes of shares, that represent, in the aggregate, a majority of the aggregate vote and value of the company or entity. If a company or entity does not have a class of ordinary or common shares representing the majority of its aggregate vote and value, then the "principal class of shares" shall be any combination of classes of shares that represent, in the aggregate, a majority of the vote and value of the company or entity. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that would represent the majority of the aggregate vote and value of the company, it is only necessary to identify one such group that meets the conditions of subparagraph *c*) of paragraph 2 in order for the company to be entitled to treaty benefits under that provision (benefits will not be denied to the company or entity even if a second group of shares representing the majority of the aggregate vote and value of the company or entity, but not satisfying the conditions of subparagraph *c*) of paragraph 2, could be identified).

123. In a few States, certain publicly-listed traded companies are governed by a dual listed company arrangement and these States may wish to address expressly the situation of these companies in order to ensure that they are not inadvertently denied the benefits of conventions because of the definition of "principal class of shares". The term "dual listed company arrangement" refers to an arrangement, adopted by certain publicly-listed companies, that reflects a commonality of management, operations, shareholders' rights, purpose and mission through a series of agreements between two parent companies, each with its own stock exchange listing, together with special provisions in their respective articles of association including in some cases, for example, the creation of special voting shares. Under these structures, the position of the parent company's shareholders is, as far as possible, the same as if they held shares in a single company, with the same dividend entitlement and same rights to participate in the assets of the dual listed companies in the event of a winding up. States wishing to address the situation of such companies may therefore wish to add the following sentence to the definition of "principal class of shares":

> In the case of a company participating in a dual listed company arrangement, the principal class of shares will be determined after excluding the special voting shares which were issued as a means of establishing that dual listed company arrangement.

124. This additional sentence would be supplemented by the addition of the following definition of "dual listed company arrangement":

> the term "dual listed company arrangement" means an arrangement pursuant to which two publicly listed companies, while maintaining their separate legal entity status, shareholdings and listings, align their strategic directions and the economic interests of their respective shareholders through:
>
> *(i)* the appointment of common (or almost identical) boards of directors, except where relevant regulatory requirements prevent this;
>
> *(ii)* management of the operations of the two companies on a unified basis;
>
> *(iii)* equalised distributions to shareholders in accordance with an equalisation ratio applying between the two companies, including in the event of a winding up of one or both of the companies;
>
> *(iv)* the shareholders of both companies voting in effect as a single decision-making body on substantial issues affecting their combined interests; and
>
> *(v)* cross-guarantees as to, or similar financial support for, each other's material obligations or operations except where the effect of the relevant regulatory requirements prevents such guarantees or financial support.

125. Other States, however, may prefer not to include any specific reference to dual listed company arrangements in the Article because of possible concerns about the use of similar arrangements for avoidance purposes and may therefore prefer to address legitimate dual listed arrangements on a case-by-case basis through the other provisions of the Article, including the discretionary relief provision of paragraph 6.

The term "connected person"

Simplified and detailed versions

> *d)* two persons shall be "connected persons" if one owns, directly or indirectly, at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) or another person owns, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

Commentary on the definition of "connected person" in the simplified and detailed versions

126. The term "connected person" is used in paragraph 3 of the simplified version and in various parts of the detailed version. Although the definition is somewhat similar to the definition of "closely related" in Article 5, a main difference is that a direct or

indirect ownership of exactly 50 per cent of the beneficial interests could result in a person being "connected" to another person whilst the definition of "closely related" requires a direct or indirect ownership of more than 50 per cent of the beneficial interests.

127. As indicated in paragraph 33 above, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute "special tax regimes" (see paragraphs 85 to 100 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). If such provisions are included in the Convention, the Contracting States may consider it more appropriate to include the definition of "connected person" in Article 3, which includes definitions that apply throughout the Convention.

The term "equivalent beneficiary"

Simplified version

e) the term "equivalent beneficiary" means any person who would be entitled to benefits with respect to an item of income accorded by a Contracting State under the domestic law of that Contracting State, this Convention or any other international agreement which are equivalent to, or more favourable than, benefits to be accorded to that item of income under this Convention. For the purposes of determining whether a person is an equivalent beneficiary with respect to dividends received by a company, the person shall be deemed to be a company and to hold the same capital of the company paying the dividends as such capital the company claiming the benefit with respect to the dividends holds.

Detailed version

e) the term "equivalent beneficiary" means:

(i) a resident of any State, provided that:

A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, such convention shall be applied as if the provisions of subparagraphs *a*),

b), *c*) and *e*) of paragraph 2 (including the definitions relevant to the application of the tests in such subparagraphs) were contained in such convention; and

B) 1) with respect to income referred to in Article 10, 11 or 12, if the resident had received such income directly, the resident would be entitled under such convention, a provision of domestic law or any international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or equal to the rate applicable under this Convention. Regarding a company seeking, under paragraph 4, the benefits of Article 10 with respect to dividends, for purposes of this subclause:

I) if the resident is an individual, and the company is engaged in the active conduct of a business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a business activity is substantial shall be determined based on all the facts and circumstances; and

II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding; or

2) with respect to an item of income referred to in Article 7, 13 or 21 of this Convention, the resident is entitled to benefits under such convention that are at least as favourable as the benefits that are being sought under this Convention; and

C) notwithstanding that a resident may satisfy the requirements of clauses *A*) and *B*) of this subdivision, where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking benefits, if the item of income would not be treated as the income of the resident under a provision analogous to paragraph 2 of Article 1 had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which the income was derived by the company, such

resident shall not be considered an equivalent beneficiary with respect to the item of income;

(ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5, provided that, in the case of a resident described in paragraph 5, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4; or

(iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 does not exceed 25 per cent of the total vote and value of the shares (and any disproportionate class of shares) of the company;

Commentary on the definition of "equivalent beneficiary" in the simplified version

128. The definition of "equivalent beneficiary" in the simplified version is only relevant for the purposes of paragraph 4 on derivative benefits. That paragraph allows an entity that is a resident of a Contracting State and that is not a qualified person to access treaty benefits with respect to an item of income if persons that meet the definition of "equivalent beneficiary" own, directly or indirectly, more than 75 per cent of the beneficial interests in that entity.

129. According to the definition, an equivalent beneficiary is any person who, if it had received the relevant item of income directly, would have been entitled, in a Contracting State, to benefits that are either equivalent or more favourable than the benefits provided to that item of income by that Contracting State under the Convention. These equivalent or more favourable benefits may result from either the domestic law of that State, the Convention itself or any other international agreement to which that State is a party.

130. The last sentence of the definition applies for the purposes of determining the percentage of the capital of a company paying a dividend that a potential equivalent beneficiary will be deemed to hold in that company. This is relevant for the purposes of comparing the benefits accorded to dividends under the Convention with the benefits to which that potential equivalent beneficiary would have been entitled if it had received the dividend directly (e.g. either 5 per cent under subparagraph *a*) of

paragraph 2 of Article 10 or 15 per cent under subparagraph *b*) of paragraph 2 of Article 10). According to the last sentence, the potential equivalent beneficiary will be deemed to be a company holding the same capital in the company paying the dividends that the company that seeks the benefits of paragraph 4 is holding (whilst paragraph 4 may apply to entities that are not companies, the rate differential of Article 10 only matters with respect to dividends paid to a company).

Commentary on the definition of "equivalent beneficiary" in the detailed version

131. The definition of "equivalent beneficiary" in the detailed version is relevant for the purposes of the derivative benefits test in paragraph 4 but may also be relevant for the purposes of subparagraph *g*) of paragraph 2 dealing with collective investment vehicles, depending on how that subparagraph is drafted (see paragraph 56 above).

132. The definition recognises three different categories of persons who qualify as "equivalent beneficiary".

133. The first category (subdivision (i) of the definition) covers residents of third States that would be entitled to all of the benefits of a comprehensive income tax convention between that person's State of residence and the State from which benefits are sought (referred to below as the "tested convention") under provisions that are substantially similar to the rules in subparagraph *a*), *b*), *c*) or *e*) of paragraph 2. A company may also be an equivalent beneficiary under subdivision (i) if it is entitled to benefits under a convention pursuant to a headquarters company test under the tested convention that is substantially similar to paragraph 5, but only if the benefits being sought by the company are with respect to interest or dividends paid by a member of the equivalent beneficiary's multinational corporate group. If the tested convention does not have a comprehensive limitation-on-benefits article, the requirements of clause A) of subdivision (i) are also met if the resident of the third State applies the tested convention as if such convention included the provisions of subparagraphs *a*), *b*), *c*) and *e*) of paragraph 2 (including the relevant definitions for purposes of applying the provisions of such subparagraphs), and would have satisfied one of the limitation-on-benefits provisions by reason of one of the incorporated subparagraphs.

134. The following examples illustrate the application of subdivision (i) of the definition:

— Example A: HOLDCO, a resident of State R, is a wholly owned direct subsidiary of XCO, a resident of State X. XCO's principal class of shares is primarily and regularly traded on the X Stock Exchange, a stock exchange located in State X. HOLDCO is not entitled to benefits under paragraph 2 of the convention between States S and R because it is a subsidiary of a company resident of, and publicly traded in, a third State. HOLDCO is not engaged in the conduct of an active business in State R, and therefore it is not entitled to any benefits under paragraph 3. HOLDCO derives and beneficially owns interest arising in State S that would otherwise be subject to the 10 per cent rate of Article 11 of the

convention between States S and R. In order to determine if HOLDCO is entitled to benefits under the derivative benefits test of paragraph 4 of that convention, it is necessary to determine whether XCO satisfies the definition of equivalent beneficiary in paragraph 7. The income tax convention between States S and X contains a comprehensive limitation-on-benefits provision, including a rule for companies whose principal class of shares is primarily and regularly traded on the X Stock Exchange that is substantially similar to subparagraph *c*) of paragraph 2. Therefore, XCO satisfies the requirement of clause A) of subdivision (i) of the definition of equivalent beneficiary. The convention between States S and X would also subject interest arising in either State to the 10 per cent rate of Article 11, so XCO satisfies the requirement of clause B) of subdivision (i) of the definition of equivalent beneficiary. Accordingly, XCO is an equivalent beneficiary.

— Example B: Assume the same facts as in Example A, except that the income tax convention between States S and X does not include a comprehensive limitation-on-benefits provision. Accordingly, for the purpose of determining whether XCO is an equivalent beneficiary, that convention shall be applied as if it contained the provisions of subparagraphs *a*), *b*), *c*) and *e*) of paragraph 2 (including the relevant definitions for purposes of applying these subparagraphs) of this Convention. If this Convention defines a recognised stock exchange to include the X Stock Exchange, the principal class of XCO's shares would be primarily traded on a recognised stock exchange located in XCO's State of residence. Therefore XCO would satisfy subparagraph c) of paragraph 2 and would be an equivalent beneficiary. If however, the X Stock Exchange is not included in this Convention as a recognised stock exchange, XCO would not be an equivalent beneficiary.

135. A third-State resident cannot be an equivalent beneficiary if the person only satisfies:

— a test for affiliates of publicly traded companies substantially similar to subparagraph *d*) of paragraph 2;
— an ownership and a base erosion test are substantially similar to subparagraph *f*) of paragraph 2;
— a test for collective investment vehicles substantially similar to what may be included in subparagraph *g*) of paragraph 2;
— an active business test substantially similar to paragraph 3;
— a derivative benefits test substantially similar to paragraph 4;
— a discretionary relief provision substantially similar to paragraph 6; or
— any other limitation-on-benefits provision of the tested convention that is not a test under this Convention,

because such resident would not be a qualified person under provisions substantially similar to subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 of this Article.

136. Some States may wish to restrict and in some cases deny treaty benefits to individuals who are liable to tax on a remittance basis or taxed on a fixed-fee / forfait basis. If the Convention between the Contracting States does so, these States may also wish to prevent such individuals resident of third States from qualifying as an "equivalent beneficiary". This could be done by amending clause A) of subdivision (i) as follows:

A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, the resident would be entitled to the benefits of this Convention by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2 if such resident were a resident of one of the Contracting States under Article 4. Notwithstanding the preceding sentence, an individual

1) who is liable to tax in that individual's State of residence with respect to foreign source income or gains only on a remittance or similar basis, or

2) whose tax is determined in that State, in whole or in part, on a fixed-fee, "forfait" or similar basis,

shall not be considered an equivalent beneficiary; and

137. Subclause B) 1) of subdivision (i) requires an equivalent beneficiary to be entitled to a rate of tax on the type of income derived by the company seeking benefits under paragraph 4 under either the tested convention, domestic law or any international agreement that is less than or equal to the rate of tax applicable under this Convention to the company seeking benefits under paragraph 4. Thus, the rates to be compared are: first, the rate of tax that the State of source could impose under the Convention on income paid to that company if it qualified for the benefits; and, second, the rate of tax that the State of source could have imposed if the potential equivalent beneficiary had derived the income directly from the State of source.

138. As described above, subclause B) 1) provides that any reduced rates of taxation that are available under domestic law or any international agreement will be taken into account. This rule recognises that withholding taxes on many inter-company dividends, interest and royalties may be eliminated, for example, pursuant to provisions such as those of the Parent-Subsidiary and Interest and Royalties Directives[1] of the European Union, rather than by an income tax convention. This is illustrated by the following example:

— Example: EUCO1, a company resident of State EU1, wholly owns ACO, a resident of State A. ACO wholly owns EUCO2, a resident of State EU2, and derives interest arising in State EU2. The income tax convention between States A and EU2

contains the detailed version's definition of equivalent beneficiary and exempts interest from source taxation. States EU1 and EU2 are both members of the European Union. Under the Interest and Royalties Directive, interest paid by EUCO2 to EUCO1 may not be taxed by State EU2. Therefore, EUCO1 satisfies subclause *B*) 1) of subdivision (*i*) of the definition of equivalent beneficiary in the income tax convention between States A and EU2 even if the income tax convention between States EU1 and EU2 allows the source taxation of interest.

139. Subclause *B*) 1) *I*) of subdivision (*i*) provides a rule, applicable with respect to dividends, that allows an individual to be treated as a company for purposes of the rate comparison test of subclause *B*) 1). Since dividends beneficially owned by individuals are not entitled to the lower rate provided for by subparagraph *a*) of paragraph 2 of Article 10, whereas a company may be entitled to that lower rate if certain conditions are met, absent this provision, individual shareholders of a company seeking derivative benefits under paragraph 4 generally would not qualify as equivalent beneficiaries in the case of dividends derived from substantial participations in other companies. By treating individuals as companies for purposes of the rate comparison test, this rule allows a company seeking derivative benefits under paragraph 4 to take into account the shares owned, directly or indirectly, by the individual as if such shares were owned by a company described in subparagraph *c*) of paragraph 2 for purposes of determining whether the company seeking derivative benefits under paragraph 4 is 95 per cent owned by equivalent beneficiaries.

140. To be eligible to apply the rule in subclause *B*) 1) *I*), the company seeking derivative benefits under paragraph 4 must be engaged in the active conduct of a business in its State of residence. The rule treats an individual shareholder who otherwise meets the requirements of subclause A) of subparagraph (*i*) as if it were a company described in subparagraph *c*) of paragraph 2 but only if the company seeking derivative benefits under paragraph 4 is engaged in the active conduct of a business in its State of residence that is both substantial in relation to, and similar or complementary, to the business that generated the earnings from which the dividend is paid. The test in subclause *B*) 1) *I*) is similar to the active conduct of a business test under paragraph 3, but is not exactly the same because it does not require that the income from the State of source "emanate" from the business actively conducted by the company seeking derivative benefits under paragraph 4. The phrase "active conduct of a business" has the same meaning as in subparagraph *a*) of paragraph 3, and therefore does not include the activities described in subdivisions (*i*) through (*iv*) of that subparagraph. For purposes of determining if the company seeking derivative benefits under paragraph 4 is engaged in the active conduct of a business in a Contracting State, activities conducted by a person connected to that company shall be

1 Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

deemed to be conducted by the company. The phrase "substantial in relation to" has the same meaning as in subparagraph *c*) of paragraph 3. That substantiality requirement, however, must be applied regardless of whether the dividend is derived from a connected person. On the other hand, the dividend derived from the other Contracting State does not have to emanate from the active business of the company seeking derivative benefits under paragraph 4, as is required under subparagraph *a*) of paragraph 3, in order to obtain benefits, because the active business conducted in the Contracting State of residence for purposes of subclause *B*) *1*) *I*) needs only be "similar or complementary" to the active business conducted in the State of source, and not "the same or complementary" to that active business conducted in the State of source.

141. The following example illustrates the application of subclause *B*) *1*) *I*):

— Example: RCO is a company resident of State R. RCO is engaged in the active conduct of a business in State R that is similar to the business of SCO, a company resident of State S. RCO has been a resident of State R for 13 months and has also held 25 per cent of the capital of SCO for 13 months. Individual Y is the sole shareholder of RCO and is a resident of State Y. Paragraph 2 of Article 10 of the income tax conventions between States S and Y and between States S and R is identical to the corresponding provision of the OECD Model Tax Convention. RCO, therefore, satisfies the requirements set forth in subparagraph *a*) of paragraph 2 of Article 10 for purposes of the lower rate applicable to dividends. Absent subclause *B*) *1*) *I*), however, RCO would not be entitled to that lower rate because individual Y would only have been entitled to the 15 per cent rate (under subparagraph b) of paragraph 2 of Article 10) if he had received the dividends directly from SCO. By virtue of subclause *B*) *1*) *I*), however, Y shall be treated as a company within the meaning of paragraph *c*) of paragraph 2 of the income tax convention between States S and R for the purposes of the rate comparison test, which means that RCO will satisfy the rate comparison requirement. Therefore, assuming all other requirements (such as the base erosion test and the beneficial ownership requirement of Article 10) are satisfied, RCO will be entitled to the lower rate in Article 10 of the income tax convention between States S and R with respect to the dividends paid by SCO.

142. Subclause *B*) *1*) *II*) provides the rule for determining the percentage of the capital of a company paying a dividend that a potential equivalent beneficiary will be deemed to hold for purposes of the rate comparison test, which, like subclause *B*) *1*) *I*), will affect the entitlement to the lower rate of tax, under subparagraph *a*) of paragraph 2 of Article 10, of the equivalent beneficiary, had it derived the dividend directly. For these purposes, when applying the rate comparison test described in subclause *B*) *1*), the potential equivalent beneficiary's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding. The following example illustrates the application of subclause *B*) *1*) *II*):

— Example: XCO and YCO each own directly 50 per cent of RCO, a company resident of State R. For 13 months, RCO has held 25 percent of the capital of SCO and has been a resident of State R. State S has income tax conventions with States R, X

and Y; paragraph 2 of Article 10 of these income tax conventions is identical to the corresponding provision of the OECD Model Tax Convention. XCO is a resident of State X and would have qualified person status under subparagraph *c*) of paragraph 2 of the income tax convention between States S and R. YCO is a resident of State Y and would also have qualified person status under subparagraph *c*) of paragraph 2 of the income tax convention between States S and R. Both XCO and YCO, therefore, would satisfy subclause *A*) of the definition of equivalent beneficiary. For purposes of determining the rate of tax on dividends paid by SCO that XCO and YCO would have been entitled to under their respective tax treaties with State S, however, XCO and YCO are each treated, under subclause *B*) *1*) *II*), as holding directly 12.5 per cent of the capital of SCO (50 per cent of the 25 per cent shareholding in SCO is equal to 12.5 per cent, the amount of XCO's and YCO's respective indirect holdings in the capital of SCO that is treated as a direct holding). XCO and YCO, therefore, would not be entitled to the lower rate of tax of subparagraph *a*) of paragraph 2 of Article 10 and would not, therefore, be considered equivalent beneficiaries because they fail to meet the rate comparison test under subclause *B*) *1*) (see, however, paragraph 147 below concerning alternative provisions that would allow RCO to benefit from the 15 per cent rate of subparagraph *b*) of paragraph 2 of Article 10 of the income tax convention between States S and R).

143. Subclause *B*) 2) of subdivision (*i*) provides derivative benefits rules for items of income that fall within Articles 7, 13 or 21. The potential equivalent beneficiary must be entitled to a benefit under the tested convention that is at least as favourable as that which would apply under the Convention to such business profits, gains or other income. Thus, the benefits to be compared are: first, the benefits that the State of source would grant to the company seeking derivative benefits under paragraph 4 if it qualified for benefits with respect to the relevant item of income and, second, the benefits that the State of source would grant to the potential equivalent beneficiary if it derived the income directly. The following example illustrates the application of subclause *B*) 2):

— Example: RCO is a company resident in State R, which is wholly owned by XCO, a publicly traded company resident in State X. RCO has a contract to construct a major office complex in State S. Under the terms of the income tax convention between States S and R, a construction site constitutes a permanent establishment only if it lasts for more than twelve months. Under the terms of the income tax convention between States S and X, however, a construction site constitutes a permanent establishment only if it lasts more than six months. If the construction site lasts more than six months but less than 12 months, XCO would not be an equivalent beneficiary because it would not be entitled to the same protection, under Article 5 of the income tax convention between States S and X, that a qualifying person would be entitled to under Article 5 of the income tax convention between States S and R.

144. Subclause *C*) of subdivision (*i*) provides an additional limitation where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking derivative benefits under paragraph 4. In such case, notwithstanding that the resident may satisfy the requirements of subclauses *A*) or *B*) based on a comparison of the terms of the tested convention with the terms of the convention under which the company is seeking derivative benefits, the resident will not meet the requirements of this subclause if the relevant item of income would not be treated as the income of that resident under a provision analogous to paragraph 2 of Article 1 had it, rather than the company seeking derivative benefits under paragraph 4, been paid the item of income for which that company is claiming benefits. The following example illustrates the application of subclause *C*):

— Example: RCO, a publicly traded company resident of State R, owns shares of SCO, a company resident of State S, through P, a partnership organised in State S. P is fiscally transparent under the domestic tax law of State S and is treated as a company under the domestic tax law of State R. Accordingly, under the provisions of paragraph 2 of Article 1, dividends paid by SCO through P would not be considered derived by RCO, and thus would not be eligible for a reduction from source taxation in State S under Article 10. RCO interposes XCO, a resident of State X, between itself and P. Under the domestic tax law of State X, P is fiscally transparent, and therefore, XCO is considered to derive dividends paid by SCO to P.

  The income tax convention between States S and X contains the detailed version of paragraphs 1 to 7 of Article 29. In order to enjoy the dividend withholding tax reductions provided in that convention, XCO must satisfy the derivative benefits test. Although the dividend rates under paragraph 2 of Article 10 of the convention between States S and X are the same as those under Article 10 of the convention between States S and R, and subclause *A*) of subdivision (*i*) would be satisfied, dividends would not be considered derived by RCO if RCO, and not XCO, had owned SCO through the partnership P. Accordingly, by virtue of subclause *C*), RCO is not an equivalent beneficiary, and for that reason, XCO is not entitled to derivative benefits under paragraph 4 with respect to the dividends paid by SCO through P.

145. The second category of persons who qualify as "equivalent beneficiary" (subdivision (*ii*) of the definition) applies to persons who are residents of the same Contracting State as the company seeking derivative benefits under paragraph 4. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2, or under paragraph 5 as a headquarters company. A headquarters company, however, will solely be an equivalent beneficiary of the company seeking derivative benefits under paragraph 4 if the company seeking derivative benefits receives interest or dividends from a member of the headquarters company's multinational corporate group. A rate comparison test applies, however, for any resident satisfying the headquarters company test in paragraph 5 that derives

dividends or interest from the other Contracting State. That requirement is intended to ensure that the headquarters company is entitled to at least the same treaty benefits with respect to dividends or interest as the company seeking derivative benefits under paragraph 4 so that if, for instance, Article 11 of the Convention generally exempts interest from source taxation but does not do so with respect to interest paid to a headquarters company by a member of that company's multinational group, the headquarters company will not be an equivalent beneficiary of a company that would otherwise be entitled to the treaty exemption from source taxation applicable to a similar interest payment.

146. The third category of persons who qualify as "equivalent beneficiary" (subdivision (*iii*) of the definition), applies to persons who are residents of the Contracting State of source. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph *a*), *b*), *c*) or *e*) of paragraph 2, provided that such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares as defined in paragraph 7) of the company that requests the derivative benefits does not exceed 25 per cent. Under the ownership requirement in subparagraph *a*) of paragraph 4, ownership may be direct or indirect, but in the case of indirect ownership, each intermediate owner must be a "qualifying intermediate owner" under the definition of that term in paragraph 7 (see below).

147. As explained in paragraph 10 above, where paragraph 4 on derivative benefits applies, the definition of equivalent beneficiary will exclude persons who, under another convention, are entitled to relief from taxation by the State of source that is not as favourable as the relief provided under the Convention. Some States may want to address the resulting so-called "cliff effect" of denying all treaty benefits even if the difference in the relief provided by the two conventions is relatively minor by providing relief from taxation by the State of source that is similar to the relief that would have been provided under the other convention. This treatment could be achieved through the alternative provisions below that relate to the taxation of dividends, interest and royalties and that grant limited benefits that broadly correspond to those that would have been available under the other convention:

Provision on dividends to be added to Article 10

Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 4 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 of this Convention regarding a dividend, if such company fails to satisfy the criteria of that paragraph solely by reason of:

a) the requirement in clause *B*) of subdivision (*i*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29; or

b) the requirement, in subdivision (*ii*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29, that a person entitled to benefits under paragraph 5 of Article 29 would be entitled to a rate of tax with respect to the dividend that is less than or equal to the rate applicable under paragraph 2 of this Article;

such company may be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 (notwithstanding the requirements referred to in subparagraphs *a*) and *b*) of this paragraph) would have been entitled if such persons had received the dividend directly. For purposes of this paragraph:

c) such persons' indirect ownership of the voting stock of the company paying the dividends shall be treated as direct ownership, and

d) a person described in subdivision (*iii*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the dividends.

Provision on interest to be added to Article 11

Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 4 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 regarding a payment of interest, if such company fails to satisfy the criteria of that paragraph solely by reason of:

a) the requirement in clause *B*) of subdivision (*i*) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29; or

b) the requirement in subdivision (ii) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 that a person entitled to benefits under paragraph 5 of Article 29 would be entitled to a rate of tax with respect to the interest that is less than or equal to the rate applicable under paragraph 2 of this Article;

such company may be taxed by the Contracting State in which the interest arises according to the laws of that State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 (notwithstanding the requirements referred to in subparagraphs *a*) and *b*) of this paragraph) would have been entitled if such persons had received the interest directly. For purposes of this paragraph, a person described in subdivision (iii) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the interest.

Provision on royalties to be added to Article 12

Notwithstanding the provisions of paragraph 1 but subject to the provisions of paragraph 3 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 regarding royalties, if such company fails

to satisfy the criteria of that paragraph solely by reason of the requirement in clause B) of subdivision (i) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29, such company may be taxed in the Contracting State in which the royalty arises and according to the laws of that State, except that the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 (notwithstanding the requirement of clause B) of subdivision (i) of that definition) would have been entitled if such persons had received the royalty directly. For purposes of this paragraph, a person described in subdivision (iii) of the definition of the term "equivalent beneficiary" in subparagraph *e*) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the royalties.

The term "disproportionate class of shares"

Detailed version only

f) the term "disproportionate class of shares" means any class of shares of a company or entity resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company;

Commentary on the definition of "disproportionate class of shares" in the detailed version

148. Under the definition of the term "disproportionate class of shares", which is used in the ownership tests in various parts of the Article, a company or entity has a disproportionate class of shares if it has outstanding shares that are subject to terms or other arrangements that entitle the holder of these shares to a larger portion of the company's or entity's income derived from the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in one Contracting State has a "disproportionate class of shares" if some of the outstanding shares of that company are "tracking shares" that pay dividends based upon a formula that approximates the company's return on its assets employed in the other Contracting State. This is illustrated by the following example:

— Example: ACO is a company resident of State A. ACO has issued common shares and preferred shares. The common shares are listed and regularly traded on the principal stock exchange of State A. The preferred shares have no voting rights and only entitle their holders to receive dividends equal in amount to interest payments that ACO receives from unrelated borrowers in State B. The preferred shares are owned entirely by a single shareholder who is a resident of a third State with which State B does not have a tax treaty. The common shares account

for more than 50 per cent of the value of ACO and for 100 per cent of the votes. Since the owner of the preferred shares is entitled to receive payments corresponding to ACO's interest income arising in State B, the preferred shares constitute a "disproportionate class of shares" and because these shares are not regularly traded on a recognised stock exchange, ACO will not qualify for benefits under subparagraph *c*) of paragraph 2.

The term "primary place of management and control"

Detailed version only

g) a company's or entity's "primary place of management and control" is in the Contracting State of which it is a resident only if:

(i) the executive officers and senior management employees of the company or entity exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, in that Contracting State than in any other State; and

(ii) such executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, than the officers or employees of any other company or entity;

Commentary on the definition of "primary place of management and control" in the detailed version

149. The term "primary place of management and control" is relevant for the purposes of subparagraph *c*) of paragraph 2 and of paragraph 5 of the detailed version. This term must be distinguished from the concept of "place of effective management", which was used before 2017 in paragraph 3 of Article 4 and in various provisions, including Article 8, applicable to the operation of ships and aircraft. The concept of "place of effective management" was interpreted by some States as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company's business. The concept of the primary place of management and control, by contrast, refers to the place where the day-to-day responsibility for the management of the company or entity (and its direct and indirect subsidiaries) is exercised.

150. A company's or entity's primary place of management and control will be situated in the State of residence of that company or entity only if the following two conditions are satisfied:

— First, under subdivision (i), the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and for its direct and indirect subsidiaries, and the staff that support such management in preparing for and making those decisions conduct more of their necessary day-to-day activities, in that State than in the other State or any third State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a necessary, but not a sufficient, condition that the chief executive officer and other top executives normally are in the Contracting State of which the company is a resident.

— Second, the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries, and the staff that support such management in making those decisions conduct more of their necessary day-to-day activities, than the officers or employees of any other company or entity.

The term "qualifying intermediate owner"

Detailed version only

h) the term "qualifying intermediate owner" means an intermediate owner that is either:

(i) a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation; or

(ii) a resident of the same Contracting State as the company applying the test under subparagraph *d)* or *f)* of paragraph 2 or paragraph 4 to determine whether it is eligible for benefits under the Convention;

Commentary on the definition of "qualifying intermediate owner" in the detailed version

151. The definition of "qualifying intermediate owner" in the detailed version is relevant for the purposes of the ownership tests found in subparagraphs *d)* and *f)* of paragraph 2 as well as the derivative benefits rule of paragraph 4.

152. Under subdivision (i) of that definition, a qualifying intermediate owner is an entity resident of a third State that has in effect a comprehensive income tax convention with the Contracting State from which a treaty benefit is sought.

153. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of

specific treaty provisions with respect to income benefiting from regimes that constitute "special tax regimes" (see paragraphs 85 to 100 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). These States may want to restrict the scope of subdivision (*i*) so that it would only apply to residents of third States with which the State from which treaty benefits are sought has concluded comprehensive income tax conventions, and that do not benefit from a special tax regime or from notional interest deductions. This could be done by amending subdivision (*i*) as follows:

(i) a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation and that does not benefit from either

A) a special tax regime, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of special tax regime analogous to the provisions included in [reference to the paragraph of the convention that includes the definition of "special tax regime"], the principles of the definition provided in this Convention shall apply, but without regard to the requirement in clause (*v*) of that definition; or

B) notional deductions of the type described in [reference to the paragraph of Article 11 that relates to notional deductions for equity]; or

154. Under subdivision (ii) of the definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company to which the relevant ownership test is applied under subparagraph *d*) or *f*) of paragraph 2 or under the derivative benefits rule of paragraph 4.

The term "tested group"

Detailed version only

i) the term "tested group" means the resident of a Contracting State that is applying the test under subparagraph *d*) or *f*) of paragraph 2 or under paragraph 4 or 5 to determine whether it is eligible for benefits under the Convention (the "tested resident"), and any company or permanent establishment that:

(i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or

(ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the relevant taxable period;

Commentary on the definition of "tested group" in the detailed version

155. This subparagraph defines the term "tested group" for purposes of the base erosion rules in subdivision (ii) of subparagraphs *d*) and *f*) of paragraph 2 and in paragraphs 4 and 5. The tested group shall consist of the tested company to which the relevant base erosion rule is applied (which is referred to as the "tested resident") and any company that either participates as a member with that tested resident in a tax consolidation regime, fiscal unity or similar regime that allows members of the group to share profits or losses, or any company that, during the relevant taxable period, shares losses with the tested resident pursuant to a group relief or other loss sharing regime. If there is no tested group, then the relevant base erosion test applicable to a tested group does not apply.

The term "gross income"

Detailed version only

j) the term "gross income" means gross receipts as determined in the person's Contracting State of residence for the taxable period that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, "gross income" means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, "gross income" means such gross receipts reduced by the direct costs of generating such receipts, provided that:

(i) except when relevant for determining benefits under Article 10 of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise; and

(ii) except with respect to the portion of any dividend that is taxable, a tested group's gross income shall not take into account transactions between companies within the tested group;

Commentary on the definition of "gross income" in the detailed version

156. This subparagraph defines the term "gross income" for purposes of the base erosion rules in subdivision (ii) of subparagraphs *d*) and *f*) of paragraph 2 and in paragraphs 4 and 5. The starting point for calculating gross income is gross receipts as determined in the relevant entity's Contracting State of residence for the taxable period that includes the time when the benefit would be accorded. If the entity is engaged in a business that includes the manufacture, production or sale of goods, "gross income" means gross receipts reduced by the cost of goods sold. If the tested entity is engaged in a business of providing non-financial services, "gross income" means such gross receipts reduced by the direct costs of generating such receipts.

157. Subdivision (*i*) of the definition further provides that except for determining benefits with respect to dividends under Article 10, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise, regardless of the State of residence of the company paying these dividends. Subdivision (*ii*) provides that, except with respect to the portion of any dividend that is taxable, a tested group's gross income will not take into account any transactions between companies within the tested group.

The term "collective investment vehicle"

Detailed version only

k) [possible definition of "collective investment vehicle"][1].

Commentary on the definition of "collective investment vehicle" in the detailed version

158. As indicated in the footnote to the subparagraph, a definition of "collective investment vehicle" should be included if a provision dealing with collective investment vehicles is included in subparagraph *g*) of paragraph 2. That definition should identify the collective investment vehicles of each Contracting State to which that provision is applicable and could be drafted as follows:

> the term "collective investment vehicle" means, in the case of [State A], a [ ] and, in the case of [State B], a [ ], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this Article;

159. As explained in paragraph 36 of the Commentary on Article 1, it is intended that the open parts of that definition would include cross-references to relevant tax or securities law provisions of each State that would identify the CIVs to which subparagraph *g*) of paragraph 2 should apply.

Paragraph 7 (simplified version): mode of application to be determined by the competent authorities

Simplified version only

7. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

1 A definition of the term "collective investment vehicle" should be added if a provision on collective investment vehicles is included in paragraph 2 (see subparagraph *g*) of paragraph 2).

Commentary on paragraph 7 of the simplified version

160. Paragraph 7 of the simplified version allows the competent authorities of the Contracting States to determine, by mutual agreement, how the provisions of the previous paragraphs of the Article should be applied. They may, for instance, agree on the procedural aspects of making a request for treaty benefits under the discretionary relief provisions of paragraph 5.

Paragraph 8

161. As mentioned in paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11 and paragraph 21 of the Commentary on Article 12, potential abuses may result from the transfer of shares, debt-claims, rights or property to permanent establishments set up solely for that purpose in countries that do not tax, or offer preferential tax treatment to, the income from such assets. Where the State of residence exempts the profits attributable to such permanent establishments situated in third jurisdictions, the State of source should not be expected to grant treaty benefits with respect to such income. The paragraph, which applies where a Contracting State exempts the income of enterprises of that State that are attributable to permanent establishments situated in third jurisdictions, provides that treaty benefits will not be granted in such cases. That rule, however, does not apply if.

— the income bears a significant level of tax in the State in which the permanent establishment is situated, or

— the income emanates from, or is incidental to, the active conduct of a business through the permanent establishment, excluding an investment business that is not carried on by a bank, insurance enterprise or registered securities dealer.

162. Under subparagraph *c*), in any case where benefits are denied under this paragraph, the resident of a Contracting State who derives the relevant income may request that the competent authority of the other Contracting State grant these benefits. The competent authority who receives such a request may, at its discretion, grant these benefits if it determines that doing so would be justified; it shall, however, consult with the competent authority of the other Contracting State before granting or denying the request.

163. The following example illustrates the type of situation in which the paragraph is intended to apply. An enterprise of a Contracting State sets up a permanent establishment in a third jurisdiction that imposes no or low tax on the profits of the permanent establishment. The profits attributable to the permanent establishment are exempt from tax by the first-mentioned State either pursuant to a provision similar to Article 23 A included in a tax convention between that State and the jurisdiction where the permanent establishment is located or pursuant to the first-mentioned State's domestic law. The enterprise derives interest arising from the other Contracting State which is included in the profits attributable to the permanent establishment. Assuming that the conditions for the application of Article 11 are met, the State in which the interest arises would, in the absence of paragraph 8, be obliged to grant the

benefits of the limitation of tax provided for in paragraph 2 of Article 11 despite the fact that the interest is exempt from tax in the first-mentioned State and is subject to little or no tax in the third jurisdiction in which the permanent establishment is situated. In that situation, the benefits of the Convention will be denied with respect to that income unless the exception of subparagraph *b*) applicable to income that emanates from, or is incidental to, the active conduct of a business applies to the relevant income or unless these benefits are granted, under the discretionary relief provision of subparagraph *c*), by the competent authority of the State in which the interest arises.

164. The reference to the word "income" in subdivision (i) means that the provision applies regardless of whether the relevant income constitutes business profits. The rule therefore applies where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats the right or property in respect of which the income is paid as effectively connected with a permanent establishment situated in a third jurisdiction (including under a provision such as paragraph 2 of Article 21 in a treaty between the first-mentioned State and the third jurisdiction).

165. Where the conditions of subdivisions (i) and (ii) are met, subparagraph *a*) denies the benefits that otherwise would apply under the other provisions of the Convention if the relevant item of income is treated as being part of the profits of the permanent establishment situated in the third jurisdiction and the amount of tax levied on that item of income in that third jurisdiction is less than the lower of the following two amounts: *a*) the amount of that item of income multiplied by the minimum rate that the Contracting States have determined bilaterally for the purposes of the paragraph, and *b*) 60 per cent of the amount of tax that would be imposed on that item of income in the State of the enterprise if that permanent establishment were situated in that State.

166. The phrase "the amount of that item of income" refers to the amount of the relevant income after the deduction of all expenses relevant to that item of income that are deductible under the law of the relevant jurisdiction. Thus, for the purposes of determining the tax in the third jurisdiction that relates to that item of income, the overall tax applicable to the profits of the permanent establishment situated in that jurisdiction will first be computed after deducting all expenses that are deductible, in accordance with the law of that jurisdiction, in determining the taxable profits attributable to the permanent establishment. The tax that applies to the relevant amount of the item of income would then be determined by multiplying that overall tax applicable to the profits of the permanent establishment by the ratio of the net amount of the item of income (i.e. the gross amount of the item of income less the deduction of the expenses deducted in computing the taxable profits of the permanent establishment that relate specifically or proportionally to that item of income) to the taxable profits of the permanent establishment. A similar computation will be made for the purposes of determining the tax that would be imposed on that item of income in the Contracting State of the enterprise if the permanent establishment were

situated in that State; in that case, the expenses that will be deducted are those that are deductible in accordance with the law of that State.

167. For the purposes of the exception included in subparagraph *b*), the reference to income that "emanates from, or is incidental to, the active conduct of a business" should be interpreted as indicated in paragraphs 74 to 76 above.

168. Instead of adopting the wording of paragraph 8, some States may prefer a more comprehensive solution that would not be restricted to situations where an enterprise of a Contracting State is exempt from tax, in that State, on the profits attributable to a permanent establishment situated in a third jurisdiction, that would not include the exception applicable to income that emanates from or is incidental to the active conduct of a business and that would not require an evaluation of the tax that would have been paid in the State of the enterprise if the permanent establishment had been situated in that State. In such a case, the rule would be applicable in any case where income derived from one Contracting State that is attributable to a permanent establishment situated in a third jurisdiction is subject to combined taxation, in the State of the enterprise and the jurisdiction of the permanent establishment, at an effective rate that is less than the lower of a rate to be determined bilaterally and 60 per cent of the general rate of corporate tax in the State of the enterprise. The following is an example of a rule that could be used for that purpose:

> Where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned Contracting State treats that income as profits attributable to a permanent establishment situated in a third jurisdiction, the benefits of this Convention shall not apply to that income if that income is subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the jurisdiction in which the permanent establishment is situated that is less than the lesser of [rate to be determined bilaterally] or 60 per cent of the general statutory rate of company tax applicable in the first-mentioned Contracting State. If benefits under this Convention are denied pursuant to the preceding sentence with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.

Paragraph 9

169. Paragraph 9 mirrors the guidance in paragraphs 61 and 76 to 80 of the Commentary on Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the principal purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in

these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. Paragraph 9 incorporates the principles underlying these paragraphs into the Convention itself in order to allow States to address cases of improper use of the Convention even if their domestic law does not allow them to do so in accordance with paragraphs 76 to 80 of the Commentary on Article 1; it also confirms the application of these principles for States whose domestic law already allows them to address such cases.

170. The provisions of paragraph 9 have the effect of denying a benefit under a tax convention where one of the principal purposes of an arrangement or transaction that has been entered into is to obtain a benefit under the convention. Where this is the case, however, the last part of the paragraph allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.

171. Paragraph 9 supplements and does not restrict in any way the scope or application of the provisions of paragraphs 1 to 7 (the limitation-on-benefits rule) and of paragraph 8 (the rule applicable to a permanent establishment situated in a third jurisdiction): a benefit that is denied in accordance with these paragraphs is not a "benefit under the Convention" that paragraph 9 would also deny. Moreover, the guidance provided in the Commentary on paragraph 9 should not be used to interpret paragraphs 1 to 8 and vice-versa.

172. Conversely, the fact that a person is entitled to benefits under paragraphs 1 to 7 does not mean that these benefits cannot be denied under paragraph 9. Paragraphs 1 to 7 are rules that focus primarily on the legal nature, ownership in, and general activities of, residents of a Contracting State. As illustrated by the example in the next paragraph, these rules do not imply that a transaction or arrangement entered into by such a resident cannot constitute an improper use of a treaty provision.

173. Paragraph 9 must be read in the context of paragraphs 1 to 7 and of the rest of the Convention, including its preamble. This is particularly important for the purposes of determining the object and purpose of the relevant provisions of the Convention. Assume, for instance, that a public company whose shares are regularly traded on a recognised stock exchange in the Contracting State of which the company is a resident derives income from the other Contracting State. As long as that company is a "qualified person" as defined in paragraph 2, it is clear that the benefits of the Convention should not be denied solely on the basis of the ownership structure of that company, e.g. because a majority of the shareholders in that company are not residents of the same State. The object and purpose of subparagraph c) of paragraph 2 is to establish a threshold for the treaty entitlement of public companies whose shares are held by residents of different States. The fact that such a company is a qualified person does not mean, however, that benefits could not be denied under paragraph 9 for reasons that are unrelated to the ownership of the shares of that company. Assume, for instance, that such a public company is a bank that enters into a conduit financing arrangement intended to provide indirectly to a resident of a third State the benefit of

lower source taxation under a tax treaty. In that case, paragraph 9 would apply to deny that benefit because subparagraph c) of paragraph 2, when read in the context of the rest of the Convention and, in particular, its preamble, cannot be considered as having the purpose, shared by the two Contracting States, of authorising treaty-shopping transactions entered into by public companies.

174. The provisions of paragraph 9 establish that a Contracting State may deny the benefits of a tax convention where it is reasonable to conclude, having considered all the relevant facts and circumstances, that one of the principal purposes of an arrangement or transaction was for a benefit under a tax treaty to be obtained. The provision is intended to ensure that tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment.

175. The term "benefit" includes all limitations (e.g. a tax reduction, exemption, deferral or refund) on taxation imposed on the State of source under Articles 6 through 22 of the Convention, the relief from double taxation provided by Article 23, and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations. This includes, for example, limitations on the taxing rights of a Contracting State in respect of dividends, interest or royalties arising in that State, and paid to a resident of the other State (who is the beneficial owner) under Article 10, 11 or 12. It also includes limitations on the taxing rights of a Contracting State over a capital gain derived from the alienation of movable property located in that State by a resident of the other State under Article 13. When a tax convention includes other limitations (such as a tax sparing provision), the provisions of this Article also apply to that benefit.

176. The phrase "that resulted directly or indirectly in that benefit" is deliberately broad and is intended to include situations where the person who claims the application of the benefits under a tax treaty may do so with respect to a transaction that is not the one that was undertaken for one of the principal purposes of obtaining that treaty benefit. This is illustrated by the following example:

> TCO, a company resident of State T, has acquired all the shares and debts of SCO, a company resident of State S, that were previously held by SCO's parent company. These include a loan made to SCO at 4 per cent interest payable on demand. State T does not have a tax convention with State S and, therefore, any interest paid by SCO to TCO is subject to a withholding tax on interest at a rate of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on interest paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State; also, that treaty does not include provisions similar to paragraphs 1 to 7. TCO decides to transfer the loan to RCO, a subsidiary resident of State R, in exchange for three promissory notes payable on demand on which interest is payable at 3.9 per cent.

In this example, whilst RCO is claiming the benefits of the State R-State S treaty with respect to a loan that was entered into for valid commercial reasons, if the facts of the case show that one of the principal purposes of TCO in transferring its loan to RCO was for RCO to obtain the benefit of the State R-State S treaty, then the provision would apply to deny that benefit as that benefit would result indirectly from the transfer of the loan.

177. The terms "arrangement or transaction" should be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable. In particular they include the creation, assignment, acquisition or transfer of the income itself, or of the property or right in respect of which the income accrues. These terms also encompass arrangements concerning the establishment, acquisition or maintenance of a person who derives the income, including the qualification of that person as a resident of one of the Contracting States, and include steps that persons may take themselves in order to establish residence. An example of an "arrangement" would be where steps are taken to ensure that meetings of the board of directors of a company are held in a different country in order to claim that the company has changed its residence. One transaction alone may result in a benefit, or it may operate in conjunction with a more elaborate series of transactions that together result in the benefit. In both cases the provisions of paragraph 9 may apply.

178. To determine whether or not one of the principal purposes of an arrangement or transaction is to obtain benefits under the Convention, it is important to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it. What are the purposes of an arrangement or transaction is a question of fact which can only be answered by considering all circumstances surrounding the arrangement or event on a case-by-case basis. It is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention. It should not be lightly assumed, however, that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement or transaction and merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes. Where, however, an arrangement can only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit.

179. A person cannot avoid the application of this paragraph by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention. All of the evidence must be weighed to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken or arranged for such purpose. The determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.

180. The reference to "one of the principal purposes" in paragraph 9 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit. For example, a person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the Contracting States and one of the principal purposes for doing so is to obtain a benefit under a tax convention, paragraph 9 could apply notwithstanding the fact that there may also be other principal purposes for changing residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.

181. A purpose will not be a principal purpose when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit. Where, however, an arrangement is entered into for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will prevent obtaining one benefit under one treaty from being considered a principal purpose for that arrangement. Assume, for example, that a taxpayer resident of State A enters into a conduit arrangement with a financial institution resident of State B in order for that financial institution to invest, for the ultimate benefit of that taxpayer, in bonds issued in a large number of States with which State B, but not State A, has tax treaties. If the facts and circumstances reveal that the arrangement has been entered into for the principal purpose of obtaining the benefits of these tax treaties, it should not be considered that obtaining a benefit under one specific treaty was not one of the principal purposes for that arrangement. Similarly, purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.

182. The following examples illustrate the application of the paragraph (the examples included in paragraph 187 below should also be considered when determining whether and when the paragraph would apply in the case of conduit arrangements). When reading these examples, it is important to remember that the application of paragraph 9 must be determined on the basis of the facts and circumstances of each case. The examples below are therefore purely illustrative and should not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the provisions of paragraph 9:

— Example A: TCO, a company resident of State T, owns shares of SCO, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and, therefore, any dividend paid by SCO to TCO is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State

and beneficially owned by a company resident of the other State. TCO enters into an agreement with RCO, an independent financial institution resident of State R, pursuant to which TCO assigns to RCO the right to the payment of dividends that have been declared but have not yet been paid by SCO.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which TCO assigned the right to the payment of dividends to RCO was for RCO to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement.

— Example B: SCO, a company resident of State S, is the subsidiary of TCO, a company resident of State T. State T does not have a tax convention with State S and, therefore, any dividend paid by SCO to TCO is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, the applicable rate of withholding tax on dividends paid by a company of State S to a resident of State R is 5 per cent. TCO therefore enters into an agreement with RCO, a financial institution resident of State R and a qualified person under subparagraph *c*) of paragraph 2 of this Article, pursuant to which RCO acquires the usufruct of newly issued non-voting preferred shares of SCO for a period of three years. TCO is the bare owner of these shares. The usufruct gives RCO the right to receive the dividends attached to these preferred shares. The amount paid by RCO to acquire the usufruct corresponds to the present value of the dividends to be paid on the preferred shares over the period of three years (discounted at the rate at which TCO could borrow from RCO).

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which RCO acquired the usufruct of the preferred shares issued by SCO was to obtain the benefit of the 5 per cent limitation applicable to the source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that limitation under this treaty-shopping arrangement.

— Example C: RCO, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is now considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.

In this example, whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the principal purposes for making that investment and building the plant are related to the expansion of RCO's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the plant is to obtain treaty benefits. In addition, given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.

— Example D: RCO, a collective investment vehicle resident of State R, manages a diversified portfolio of investments in the international financial market. RCO currently holds 15 per cent of its portfolio in shares of companies resident of State S, in respect of which it receives annual dividends. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 10 per cent.

RCO's investment decisions take into account the existence of tax benefits provided under State R's extensive tax convention network. A majority of investors in RCO are residents of State R, but a number of investors (the minority investors) are residents of States with which State S does not have a tax convention. Investors' decisions to invest in RCO are not driven by any particular investment made by RCO, and RCO's investment strategy is not driven by the tax position of its investors. RCO annually distributes almost all of its income to its investors and pays taxes in State R on income not distributed during the year.

In making its decision to invest in shares of companies resident of State S, RCO considered the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, unless RCO's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax treaty to RCO.

— Example E: RCO is a company resident of State R and, for the last 5 years, has held 24 per cent of the shares of company SCO, a resident of State S. Following the entry-into-force of a tax treaty between States R and S (Article 10 of which is identical to Article 10 of this Model), RCO decides to increase to 25 per cent its ownership of the shares of SCO. The facts and circumstances reveal that the decision to acquire these additional shares has been made primarily in order to obtain the benefit of the lower rate of tax provided by Article 10(2)*a*) of the treaty.

In that case, although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of

Article 10(2) *a*), paragraph 9 would not apply because it may be established that granting that benefit in these circumstances would be in accordance with the object and purpose of Article 10(2) *a*). That subparagraph uses an arbitrary threshold of 25 per cent for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends and it is consistent with this approach to grant the benefits of the subparagraph to a taxpayer who genuinely increases its participation in a company in order to satisfy this requirement.

— Example F: TCO is a publicly-traded company resident of State T. TCO's information technology business, which was developed in State T, has grown considerably over the last few years as a result of an aggressive merger and acquisition policy pursued by TCO's management. RCO, a company resident of State R (a State that has concluded many tax treaties providing for no or low source taxation of dividends and royalties), is the family-owned holding company of a group that is also active in the information technology sector. Almost all the shares of RCO are owned by residents of State R who are relatives of the entrepreneur who launched and developed the business of the RCO group. RCO's main assets are shares of subsidiaries located in neighbouring countries, including SCO, a company resident of State S, as well as patents developed in State R and licensed to these subsidiaries. TCO, which has long been interested in acquiring the business of the RCO group and its portfolio of patents, has made an offer to acquire all the shares of RCO.

  In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that the principal purposes for the acquisition of RCO are related to the expansion of the business of the TCO group and do not include the obtaining of benefits under the treaty between States R and S. The fact that RCO acts primarily as a holding company does not change that result. It might well be that, after the acquisition of the shares of RCO, TCO's management will consider the benefits of the tax treaty concluded between State R and State S before deciding to keep in RCO the shares of SCO and the patents licensed to SCO. This, however, would not be a purpose related to the relevant transaction, which is the acquisition of the shares of RCO.

— Example G: TCO, a company resident of State T, is a publicly-traded company resident of State T. It owns directly or indirectly a number of subsidiaries in different countries. Most of these companies carry on the business activities of the TCO group in local markets. In one region, TCO owns the shares of five such companies, each located in different neighbouring States. TCO is considering establishing a regional company for the purpose of providing group services to these companies, including management services such as accounting, legal advice and human resources; financing and treasury services such as managing currency risks and arranging hedging transactions, as well as some other non-financing related services. After a review of possible locations, TCO decides to establish the regional company, RCO, in State R. This decision is mainly driven by

the skilled labour force, reliable legal system, business friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double taxation treaty network of State R, including its tax treaties with the five States in which TCO owns subsidiaries, which all provide low withholding tax rates.

In this example, merely reviewing the effects of the treaties on future payments by the subsidiaries to the regional company would not enable a conclusion to be drawn about the purposes for the establishment of RCO by TCO. Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded between State R and the five States where the subsidiaries operate unless other facts would indicate that RCO has been established for other tax purposes or unless RCO enters into specific transactions to which paragraph 9 would otherwise apply (see also example F in paragraph 187 below with respect to the interest and other remuneration that RCO might derive from its group financing activities).

— Example H: TCO is a company resident of State T that is listed on the stock exchange of State T. It is the parent company of a multinational enterprise that conducts a variety of business activities globally (wholesaling, retailing, manufacturing, investment, finance, etc.).

Issues related to transportation, time differences, limited availability of personnel fluent in foreign languages and the foreign location of business partners make it difficult for TCO to manage its foreign activities from State T. TCO therefore establishes RCO, a subsidiary resident of State R (a country where there are developed international trade and financial markets as well as an abundance of highly-qualified human resources), as a base for developing its foreign business activities. RCO carries on diverse business activities such as wholesaling, retailing, manufacturing, financing and domestic and international investment. RCO possesses the human and financial resources (in various areas such as legal, financial, accounting, taxation, risk management, auditing and internal control) that are necessary to perform these activities. It is clear that RCO's activities constitute the active conduct of a business in State R.

As part of its activities, RCO also undertakes the development of new manufacturing facilities in State S. For that purpose, it contributes equity capital and makes loans to SCO, a subsidiary resident of State S that RCO established for the purposes of owning these facilities. RCO will receive dividends and interest from SCO.

In this example, RCO has been established for business efficiency reasons and its financing of SCO through equity and loans is part of RCO's active conduct of a business in State R. Based on these facts and in the absence of other facts that

would indicate that one of the principal purposes for the establishment of RCO or the financing of SCO was the obtaining of the benefits of the treaty between States R and S, paragraph 9 would not apply to these transactions.

— Example I: RCO, a company resident of State R, is one of a number of collective management organisations that grant licenses on behalf of neighbouring right and copyright holders for playing music in public or for broadcasting that music on radio, television or the Internet. SCO, a company resident of State S, carries on similar activities in State S. Performers and copyright holders from various countries appoint RCO or SCO as their agent to grant licenses and to receive royalties with respect to the copyrights and neighbouring rights that they hold; RCO and SCO distribute to each right holder the amount of royalties that they receive on behalf of that holder minus a commission (in most cases, the amount distributed to each holder is relatively small). RCO has an agreement with SCO through which SCO grants licenses to users in State S and distributes royalties to RCO with respect to the rights that RCO manages; RCO does the same in State R with respect to the rights that SCO manages. SCO has agreed with the tax administration of State S that it will process the royalty withholding tax on the payments that it makes to RCO based on the applicable treaties between State S and the State of residence of each right holder represented by RCO based on information provided by RCO since these right holders are the beneficial owners of the royalties paid by SCO to RCO.

  In this example, it is clear that the arrangements between the right holders and RCO and SCO, and between SCO and RCO, have been put in place for the efficient management of the granting of licenses and collection of royalties with respect to a large number of small transactions. Whilst one of the purposes for entering into these arrangements may well be to ensure that withholding tax is collected at the correct treaty rate without the need for each individual right holder to apply for a refund on small payments, which would be cumbersome and expensive, it is clear that such purpose, which serves to promote the correct and efficient application of tax treaties, would be in accordance with the object and purpose of the relevant provisions of the applicable treaties.

— Example J: RCO is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO is jointly and severally liable with SUBCO for the performance of SUBCO's contractual obligations under the SUBCO-SCO contract.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract under which SUBCO agreed to perform part of the construction project was for RCO and SUBCO to each obtain the benefit of the rule in paragraph 3 of Article 5 of the State R-State S tax convention. Granting the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph as the time limitation of that paragraph would otherwise be meaningless.

— Example K: RCO, a company resident of State R, is a wholly-owned subsidiary of Fund, an institutional investor that is a resident of State T and that was established and is subject to regulation in State T. RCO operates exclusively to generate an investment return as the regional investment platform for Fund through the acquisition and management of a diversified portfolio of private market investments located in countries in a regional grouping that includes State R. The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates. RCO employs an experienced local management team to review investment recommendations from Fund and performs various other functions which, depending on the case, may include approving and monitoring investments, carrying on treasury functions, maintaining RCO's books and records, and ensuring compliance with regulatory requirements in States where it invests. The board of directors of RCO is appointed by Fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of Fund's global management team. RCO pays tax and files tax returns in State R.

RCO is now contemplating an investment in SCO, a company resident of State S. The investment in SCO would constitute only part of RCO's overall investment portfolio, which includes investments in a number of countries in addition to State S which are also members of the same regional grouping. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 5 per cent. Under the tax convention between State S and State T, the withholding tax rate on dividends is 10 per cent.

In making its decision whether or not to invest in SCO, RCO considers the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made, including the reasons for establishing RCO in State R and the investment functions and other activities carried out in State R. In this example, in the absence of other facts or circumstances showing that RCO's

investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

— Example L: RCO, a securitisation company resident of State R, was established by a bank which sold to RCO a portfolio of loans and other receivables owed by debtors located in a number of jurisdictions. RCO is fully debt-funded. RCO has issued a single share which is held on trust and has no economic value. RCO's debt finance was raised through the issuance of notes that are widely-held by third-party investors. The notes are listed on a recognised stock exchange, which allows for their trading on the secondary market, and are held through a clearing system. To comply with regulatory requirements, the bank has also retained a small percentage of the listed, widely-held debt securities issued by RCO. RCO currently holds 60 per cent of its portfolio in receivables of small and medium sized enterprises resident in State S, in respect of which RCO receives regular interest payments. The bank is a resident of State T which has a tax treaty with State S that provides benefits equivalent to those provided under the State R-State S tax treaty. Under the tax treaty between State R and State S, the withholding tax rate on interest is limited to 10 per cent (the domestic law of State S provides for a withholding tax of 30 per cent)

  In establishing RCO, the bank took into account a large number of issues, including State R's robust securitisation framework, its securitisation and other relevant legislation, the availability of skilled and experienced personnel and support services in State R and the existence of tax benefits provided under State R's extensive tax convention network. Investors' decisions to invest in RCO are not driven by any particular investment made by RCO and RCO's investment strategy is not driven by the tax position of the investors. RCO is taxed in State R on income earned and is entitled to a full deduction for interest payments made to investors.

  In making its decision to sell receivables owed by enterprises resident in State S, the bank and RCO considered the existence of a benefit under the State R-State S tax convention with respect to interest, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, in the absence of other facts or circumstances showing that RCO's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

— Example M: Real Estate Fund, a State C partnership treated as fiscally transparent under the domestic tax law of State C, is established to invest in a portfolio of real estate investments in a specific geographic area. Real Estate Fund is managed by

a regulated fund manager and is marketed to institutional investors, such as pension schemes and sovereign wealth funds, on the basis of the fund's investment mandate. A range of investors resident in different jurisdictions commit funds to Real Estate Fund. The investment strategy of Real Estate Fund, which is set out in the marketing materials for the fund, is not driven by the tax positions of the investors, but is based on investing in certain real estate assets, maximising their value and realising appreciation through the disposal of the investments. Real Estate Fund's investments are made through a holding company, RCO, established in State R. RCO manages all of Real Estate Fund's immovable property assets and holds these assets indirectly through wholly-owned companies resident of the States where the immovable property assets are situated; it also provides debt and/or equity financing to these local companies, which directly own the underlying investments. RCO is established for a number of commercial and legal reasons, such as to protect Real Estate Fund from the liabilities of and potential claims against the fund's immovable property assets, and to facilitate debt financing (including from third-party lenders) and the making, management and disposal of investments. It is also established for the purposes of administering the claims for relief of withholding tax under any applicable tax treaty. This is an important function of RCO as it is administratively simpler for one company to get treaty relief rather than have each institutional investor process its own claim for relief, especially if the treaty relief to which each investor would be entitled as regards a specific item of income is a small amount. After a review of possible locations, Real Estate Fund decided to establish RCO in State R. This decision was mainly driven by the political stability of State R, its regulatory and legal systems, lender and investor familiarity, access to appropriately qualified personnel and the extensive tax convention network of State R, including its treaties with other States within the specific geographic area targeted for investment. RCO, however, does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investments directly in these States and had obtained treaty benefits under the treaties concluded by their States of residence.

In this example, whilst the decision to locate RCO in State R is taken in light of the existence of benefits under the tax conventions between State R and the States within the specific geographic area targeted for investment, it is clear that RCO's immovable property investments are made for commercial purposes consistent with the investment mandate of the fund. Also, RCO does not derive any treaty benefits that are better than those to which its investors would be entitled and each State where RCO's immovable property investments are made is allowed to tax the income derived directly from such investments. In the absence of other facts or circumstances showing that RCO's investments are part of an arrangement, or relate to another transaction, undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to

deny the benefit of the tax treaties between State R and the States in which RCO's immovable property investments are located.

183. In a number of States, the application of the general anti-abuse rule found in domestic law is subject to some form of approval process. In some cases, the process provides for an internal acceleration of disputes on such provisions to senior officials in the administration. In other cases, the process allows for advisory panels to provide their views to the administration on the application of the rule. These types of approval processes reflect the serious nature of disputes in this area and promote overall consistency in the application of the rule. States may wish to establish a similar form of administrative process that would ensure that paragraph 9 is only applied after approval at a senior level within the administration.

184. Also, some States consider that where a person is denied a treaty benefit in accordance with paragraph 9, the competent authority of the Contracting State that would otherwise have granted this benefit should have the possibility of treating that person as being entitled to this benefit, or to different benefits with respect to the relevant item of income or capital, if such benefits would have been granted to that person in the absence of the transaction or arrangement that triggered the application of paragraph 9. In order to allow that possibility, such States are free to include the following additional paragraph in their bilateral treaties:

> 10. Where a benefit under this Convention is denied to a person under paragraph 9, the competent authority of the Contracting State that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph 9. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State.

185. For the purpose of this alternative provision, the determination that benefits would have been granted in the absence of the transaction or arrangement referred to in paragraph 9 and the determination of the benefits that should be granted are left to the discretion of the competent authority to which the request is made. The alternative provision grants broad discretion to the competent authority for the purposes of these determinations. The provision does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before rejecting a request to grant benefits if that request was made by a resident of that other State. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted if the request is made by a resident of that other State should ensure that Contracting States treat similar

cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request was presented obtain the agreement of the competent authority that is consulted.

186. The following example illustrates the application of this alternative provision. Assume that an individual who is a resident of State R and who owns shares in a company resident of State S assigns the right to receive dividends declared by that company to another company resident of State R which owns more than 10 per cent of the capital of the paying company for the principal purpose of obtaining the reduced rate of source taxation provided for in subparagraph *a*) of paragraph 2 of Article 10. In such a case, if it is determined that the benefit of that subparagraph should be denied pursuant to paragraph 9, the alternative provision would allow the competent authority of State S to grant the benefit of the reduced rate provided for in subparagraph *b*) of paragraph 2 of Article 10 if that competent authority determined that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.

187. For various reasons, some States may be unable to accept the rule included in paragraph 9. In order to effectively address all forms of treaty shopping, however, these States will need to supplement the limitation-on-benefits rule of paragraphs 1 to 7 by rules that will address treaty-shopping strategies commonly referred to as "conduit arrangements" that would not be caught by these paragraphs. These rules would deal with such conduit arrangements by denying the benefits of the provisions of the Convention, or of some of them (e.g. those of Articles 7, 10, 11, 12 and 21), in respect of any income obtained under, or as part of, a conduit arrangement. They could also take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result. The following are examples of conduit arrangements that would need to be addressed by such rules as well as examples of transactions that should not be considered to be conduit arrangements for that purpose:

— Example A: RCO a publicly-traded company resident of State R, owns all of the shares of SCO, a company resident of State S. TCO, a company resident of State T, which does not have a tax treaty with State S, would like to purchase a minority interest in SCO but believes that the domestic withholding tax on dividends levied by State S would make the investment uneconomic. RCO proposes that SCO instead issue to RCO preferred shares paying a fixed return of 4 per cent plus a contingent return of 20 per cent of SCO's net profits. The preferred shares mature in 20 years. TCO will enter into a separate contract with RCO pursuant to which it will pay to RCO an amount equal to the issue price of the preferred shares and will receive from RCO after 20 years the redemption price of the shares. During the 20 years, RCO will pay to TCO an amount equal to 3.75 per cent of the issue price plus 20 per cent of SCO's net profits.

  This arrangement constitutes a conduit arrangement that should be addressed by the rules referred to above because one of the principal purposes for RCO

participating in the transaction was to achieve a reduction of the withholding tax for TCO.

— Example B: SCO, a company resident of State S, has issued only one class of shares that is 100 per cent owned by RCO, a company resident of State R. RCO also has only one class of shares outstanding, all of which is owned by TCO, a company resident of State T, which does not have a tax treaty with State S. RCO is engaged in the manufacture of electronics products, and SCO serves as RCO's exclusive distributor in State S. Under paragraph 3 of the limitation-of-benefits rule, RCO will be entitled to benefits with respect to dividends received from SCO, even though the shares of RCO are owned by a resident of a third country.

  This example refers to a normal commercial structure where RCO and SCO carry on real economic activities in States R and S. The payment of dividends by subsidiaries such as SCO is a normal business transaction. In the absence of evidence showing that one of the principal purposes for setting up that structure was to flow-through dividends from SCO to TCO, this structure would not constitute a conduit arrangement.

— Example C: TCO, a company resident of State T, which does not have a tax treaty with State S, loans 1,000,000 to SCO, a company resident of State S that is a wholly-owned subsidiary of TCO, in exchange for a note issued by SCO. TCO later realises that it can avoid the withholding tax on interest levied by State S by assigning the note to its wholly-owned subsidiary RCO, a resident of State R (the treaty between States R and S does not allow source taxation of interest in certain circumstances). TCO therefore assigns the note to RCO in exchange for a note issued by RCO to TCO. The note issued by SCO pays interest at 7 per cent and the note issued by RCO pays interest at 6 per cent.

  The transaction through which RCO acquired the note issued by SCO constitutes a conduit arrangement because it was structured to eliminate the withholding tax that TCO would otherwise have paid to State S.

— Example D: TCO, a company resident of State T, which does not have a tax treaty with State S, owns all of the shares of SCO, a company resident of State S. TCO has for a long time done all of its banking with RCO, a bank resident of State R which is unrelated to TCO and SCO, because the banking system in State T is relatively unsophisticated. As a result, TCO tends to maintain a large deposit with RCO. When SCO needs a loan to fund an acquisition, TCO suggests that SCO deal with RCO, which is already familiar with the business conducted by TCO and SCO. SCO discusses the loan with several different banks, all on terms similar to those offered by RCO, but eventually enters into the loan with RCO, in part because interest paid to RCO would not be subject to withholding tax in State S pursuant to the treaty between States S and R, whilst interest paid to banks resident of State T would be subject to tax in State S.

  The fact that benefits of the treaty between States R and S are available if SCO borrows from RCO, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in SCO's decision (which may be influenced by

advice given to it by TCO, its 100 per cent shareholder). It may even be a decisive factor, in the sense that, all else being equal, the availability of treaty benefits may swing the balance in favour of borrowing from RCO rather than from another lender. However, whether the obtaining of treaty benefits was one of the principal purposes of the transaction would have to be determined by reference to the particular facts and circumstances. In the facts presented above, RCO is unrelated to TCO and SCO and there is no indication that the interest paid by SCO flows through to TCO one way or another. The fact that TCO has historically maintained large deposits with RCO is also a factor that indicates that the loan to SCO is not matched by a specific deposit from TCO. On the specific facts as presented, the transaction would therefore likely not constitute a conduit arrangement.

If, however, RCO's decision to lend to SCO was dependent on TCO providing a matching collateral deposit to secure the loan so that RCO would not have entered into the transaction on substantially the same terms in the absence of that deposit, the facts would indicate that TCO was indirectly lending to SCO by routing the loan through a bank of State R and, in that case, the transaction would constitute a conduit arrangement.

— Example E: RCO, a publicly-traded company resident of State R, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to RCO, which then licenses the technology to its subsidiaries that need it. RCO keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. TCO, a company located in a State with which State S does not have a tax treaty, has developed a process that will substantially increase the profitability of all of RCO's subsidiaries, including SCO, a company resident of State S. According to its usual practice, RCO licenses the technology from TCO and sub-licenses the technology to its subsidiaries. SCO pays a royalty to RCO, substantially all of which is paid to TCO.

  In this example, there is no indication that RCO established its licensing business in order to reduce the withholding tax payable in State S. Because RCO is conforming to the standard commercial organisation and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits, the arrangement between SCO, RCO and TCO does not constitute a conduit arrangement.

— Example F: TCO is a publicly-traded company resident of State T, which does not have a tax treaty with State S. TCO is the parent of a worldwide group of companies, including RCO, a company resident of State R, and SCO, a company resident of State S. SCO is engaged in the active conduct of a business in State S.

RCO is responsible for coordinating the financing of all of the subsidiaries of TCO. RCO maintains a centralised cash management accounting system for TCO and its subsidiaries in which it records all intercompany payables and receivables. RCO is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. RCO enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of RCO are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. RCO has 50 employees, including clerical and other back office personnel, located in State R; this number of employees reflects the size of the business activities of RCO. TCO lends to RCO 15 million in currency A (worth 10 million in currency B) in exchange for a 10-year note that pays 5 per cent interest annually. On the same day, RCO lends 10 million in currency B to SCO in exchange for a 10-year note that pays 5 per cent interest annually. RCO does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

In this example, RCO appears to be carrying on a real business performing substantive economic functions, using real assets and assuming real risks; it is also performing significant activities with respect to the transactions with TCO and SCO, which appear to be typical of RCO's normal treasury business. RCO also appears to be bearing the interest rate and currency risk. Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for these loans was the avoidance of withholding tax in State S, the loan from TCO to RCO and the loan from RCO to SCO do not constitute a conduit arrangement.

Observation on the Commentary

188. The *United States* does not agree with the statement in paragraph 77 that, when applying the substantiality requirement of subparagraph *b*) of paragraph 3, the relative sizes of the economies and markets of the two States should be taken into account.

Reservations on the Article

189. *Belgium*, *Hungary*, *Luxembourg* and *Switzerland* reserve the right not to include paragraph 8 in their conventions.

190. *Portugal* reserves the right not to include subparagraph *c*) of paragraph 8 in its conventions.

191. The *United States* reserves its right to expand the scope of paragraph 8 to include income treated as attributable to a permanent establishment in the State of source and to permanent establishments in States that do not have a tax convention with the State of source irrespective of the rate of tax, unless the residence State includes the income in its base.

COMMENTARY ON ARTICLE 30
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.

Reservation on the Article

3. The *United States* reserves its right not to follow Article 30.

COMMENTARY ON ARTICLES 31 AND 32 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 31 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.

NON-OECD ECONOMIES' POSITIONS ON THE OECD MODEL TAX CONVENTION

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-OECD economies.

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-OECD economies to discuss issues related to the negotiation, application and interpretation of tax conventions. Recognising that non-OECD economies 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 economies 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-OECD economies 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 economies.

4. This section reflects the following non-OECD economies' positions on the Model Tax Convention:

Albania	Argentina	Armenia
Azerbaijan	Belarus	Brazil
Bulgaria	Colombia	Costa Rica
Croatia	Democratic Republic of the Congo	Gabon
Georgia	Hong Kong, China	India
Indonesia	Ivory Cast	Kazakhstan
Lithuania	Malaysia	Morocco
People's Republic of China	Philippines	Romania
Russia	Serbia	Singapore
South Africa	Thailand	Tunisia
Ukraine	United Arab Emirates	Vietnam

5. Whilst these economies 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 economy some areas of disagreement. For each Article of the Model Tax Convention, the positions that are presented in this section indicate where an economy 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 an economy 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 Indonesia and the People's Republic of China wish to clarify expressly that in the course of negotiations with other countries, they will not be bound by their stated positions included in this section.

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. *Costa Rica*, *Serbia* and *Singapore* reserve their position on paragraph 2.

3. *India* reserves the right not to include paragraph 2 of Article 1 in its tax treaties.

4. *Costa Rica*, *Serbia* and *Singapore* reserve their position on paragraph 3.

Position on the Commentary

5. *India* does not agree with the view expressed in paragraph 7 of the Commentary on Article 1 that the term "income derived by or through an entity or arrangement" includes income derived by or through an entity that may not be a resident of either of the Contracting States. India considers that this term includes only such income that is derived by or through entities that are resident of one or both Contracting States.

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".

2.1 *Argentina*, *Colombia* and *Costa Rica* reserve the right not to include in paragraph 1 taxes imposed on behalf of political subdivisions or local authorities.

3. Since they have no tax on capital, *Brazil*, *Indonesia*, *Malaysia* and *Singapore* reserve the 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.

5.1 *Georgia* reserves the right to include taxes imposed on behalf of administrative-territorial units and local self-governing authorities.

5.2 *Colombia* reserves the right to limit the application of the Convention to taxes on capital to the extent that during the fiscal year concerned both Contracting States impose taxes on the same capital or on the same elements of capital.

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. *Armenia*, *Lithuania*, *Romania* and *Tunisia* 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.

8. *Costa Rica* and *Ukraine* reserve their position on that part of paragraph 2 which states that the Convention shall apply to taxes on capital appreciation.

POSITIONS ON ARTICLE 3 (GENERAL DEFINITIONS) AND ITS COMMENTARY

Positions on the Article

1. With respect to the definition of "company", *Albania* and *Belarus* reserve the right to replace the concept of "body corporate", which does not exist in their domestic law, by "any legal person or any entity which is treated as a separate entity for tax purposes".

2. [Deleted]

3. With respect to the definition of "national", *Albania*, *Romania* and *Russia* reserve the right to replace the term "nationality" by "citizenship" as the term "nationality" does not mean "citizenship" under their law.

4. *Bulgaria* reserves the right to propose in bilateral negotiations the insertion of the word "also" between the words "business" and "includes" in subparagraph *h*) of paragraph 1 of the Article.

4.1 *Argentina*, *Azerbaijan*, *Brazil*, *Costa Rica*, *Lithuania* and *Singapore* reserve the right not to include the definitions of "enterprise" and "business" in paragraph 1 of Article 3 because they reserve the right to include an article concerning the taxation of independent personal services.

5. With respect to the definition of "international traffic", *Bulgaria* and *Croatia* reserve the right to extend the scope of the definition to cover road and railway transportation in bilateral conventions.

6. *Serbia* reserves the right to extend the scope of the definition of "international traffic" to cover road transportation in bilateral conventions.

7. *Thailand* reserves the right to include in the definition of "person" any entity treated as a taxable unit under the taxation laws in force in either Contracting State.

8. *India* and *South Africa* reserve the right to include in the definition of "person" only those entities which are treated as taxable unit under the taxation laws in force in the respective Contracting States.

9. *India* reserves the right to include definitions of "tax" and "fiscal year".

10. With respect to the definition of "national", *Costa Rica* reserves the right to replace the concepts of partnership and association by "a group of persons".

11. *Hong Kong, China* reserves its position with respect to the definition of "national" in subparagraph *g*) of paragraph 1, because Hong Kong, China is not a sovereign state. Where the term "national" appears in Articles 4, 19, 24 and 25, Hong Kong, China reserves the right to use alternative provisions based on the concepts of "right of abode" and "incorporated or constituted in".

12. *India* reserves the right not to include subdivision (*ii*) of the definition of "recognised pension fund".

13. *Colombia* reserves the right to extend the scope of the definition of "recognised pension fund" to cover severance funds.

POSITIONS ON ARTICLE 4 (RESIDENT) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. *Albania*, *Armenia*, *Azerbaijan*, *Belarus*, *Bulgaria*, *Colombia*, *Costa Rica*, *Indonesia*, *Lithuania*, *Russia*, *Thailand*, *Ukraine* and *Vietnam* reserve the right to include the place of incorporation or a similar criterion (registration for Belarus and Vietnam) in paragraph 1.

2. The *United Arab Emirates* reserves the right to adopt its own definition of residence in its bilateral conventions and not necessarily follow Article 4.

2.1 *Hong Kong, China* reserves the right to modify the definition of "resident" in its bilateral agreements because it is not a sovereign state and it taxes on a territorial basis.

3. *Indonesia* reserves the right to base the inclusion of a pension fund in the definition of "resident" with the condition that the pension fund is liable to tax in the state of domicile.

3.1 *Malaysia* and *Singapore* reserve the right not to include the second sentence of paragraph 1 in their agreements.

4. *India* and *Russia* reserve the right to amend the Article in their tax conventions in order to specify that their partnerships must be considered as residents of their respective countries in view of their legal and tax characteristics.

4.1 *Gabon*, *Ivory Coast*, *Morocco* and *Tunisia* do 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 their domestic law, a partnership is considered to be liable to tax even though, technically, that tax is collected from the partners or in the case of Morocco from the principal partner; for that reason, Gabon, Ivory Coast, Morocco and Tunisia reserve the right to amend the Article in their tax conventions in order to specify that their partnerships must be considered as residents of their country in view of their legal and tax characteristics.

Paragraph 2

4.2 *Singapore* reserves the right to replace subparagraph *d*) by: "*d*) in any other case, the competent authorities of the Contracting States shall settle the question by mutual agreement."

4.3 *Kazakhstan* reserves the right to replace subparagraph *d*) by: "*d)* if the individual's status cannot be determined by reason of subparagraphs *a)* to *c)* of this paragraph, the competent authorities of the Contracting States shall settle the question by mutual agreement."

Paragraph 3

5. *Armenia*, *Bulgaria*, *Russia*, *Thailand* and *Vietnam* reserve the right to use the place of incorporation (registration for Vietnam) as the test for paragraph 3.

6. *Azerbaijan* reserves the right to use either "registration (incorporation)" or "place of effective management" as the criterion for determining the residence of a person in paragraph 3.

7. To determine the residence of a dual resident person, other than an individual, *Singapore* reserves the right to include a provision that will refer to the person's place of effective management and, if that cannot be determined, the provision will require the matter to be determined by mutual agreement.

8. *Costa Rica* reserves the right to deny benefits under the Convention to dual resident persons other than individuals.

8.1 *Costa Rica* reserves the right to add "domicile" and "residence" to the factors listed in paragraph 3.

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.

9.1 In the case of *Gabon*, since the phrase "and economic relations" used in paragraphs 13, 14 and 15 of the Commentary is ambiguous, these two types of relations should be distinguished and one type may have priority over the other. The State in which employment is exercised should therefore prevail over the personal relations for purposes of determining the State of residence of an individual.

POSITIONS ON ARTICLE 5 (PERMANENT ESTABLISHMENT) AND ITS COMMENTARY

Positions on the Article

1. [Deleted]

Paragraph 2

2. In paragraph 2, in addition to "the extraction of" natural resources, *Argentina*, *Brazil*, *Gabon*, *Ivory Coast*, *Morocco*, the *Philippines*, *Russia*, *Thailand*, *Tunisia* and the *United Arab Emirates* reserve the right to refer to the "exploration for" such resources.

2.1 *Indonesia* reserves the right to add to paragraph 2 the area of exploration and exploitation of natural resources and a drilling rig or working ship used for exploration and exploitation of natural resources.

2.2 *Colombia* and *Costa Rica* reserve the right to replace the words "of extraction" with the words "relating to the exploration for or the exploitation" in subparagraph 2 *f*).

3. *India* and *Indonesia* reserve the right to add to paragraph 2 additional subparagraphs that would cover a sales outlet and a farm, plantation or other place where agricultural, forestry, plantation or related activities are carried on.

4. *India*, *Indonesia*, *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. *Armenia* and *Ukraine* reserve 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. *Gabon* and *Vietnam* reserve 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.

6.1 *Argentina*, *Gabon* and *Ivory Coast* reserve the right to add to paragraph 2 an additional subparagraph that would cover places where fishing activities take place.

6.2 *Kazakhstan* reserves the right to add to paragraph 2 an additional subparagraph that would cover a pit, an installation and a structure for the exploration for natural resources.

6.3 *Azerbaijan* reserves the right to add to paragraph 2 an additional subparagraph covering an installation, structure or vessel used for the exploration of natural resources.

Paragraph 3

7. [Deleted]

8. *Argentina*, *Armenia*, *Brazil*, *Colombia*, *Georgia*, *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. *Albania*, *Costa Rica*, the *Democratic Republic of the Congo* and *Hong Kong, China* 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.

9.1 *Serbia* reserves the right to treat any building site, construction, assembly or installation project or a supervisory or consultancy activity connected therewith as constituting a permanent establishment only if such site, project or activity lasts for a period of more than twelve months.

10. *Bulgaria*, *Gabon*, *Ivory Coast*, *Malaysia*, *Morocco*, the *People's Republic of China*, *South Africa* and *Tunisia* 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*, *Malaysia*, the *People's Republic of China*, *Singapore*, *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 (in the case of Malaysia, the period for this permanent establishment is negotiated separately).

11.1 *India* and *Indonesia* reserve the right to replace "construction or installation project" with "construction, installation or assembly project or supervisory activities in connection therewith" and reserve the right to negotiate the period of time for which these should last to be regarded as a permanent establishment.

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 within the country for a period or periods aggregating more than six months in any twelve month period commencing or ending in the fiscal year concerned.

13. *Gabon*, *India*, *Indonesia*, *Ivory Coast*, *Morocco*, and *Tunisia* 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 such activities continue for the same project or a connected project for a period or periods aggregating more than a period to be negotiated.

13.1 *Singapore* reserves the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services through employees or other personnel engaged by the enterprise for such purpose but only where the employees or other personnel are present in the State for the same project or a connected project for a period or periods aggregating more than a period to be negotiated.

14. *Albania*, *Armenia*, *Azerbaijan*, *Lithuania*, *Serbia*, *South Africa*, *Thailand*, *Vietnam* and *Hong Kong, China* 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 [other than in the case of Armenia]), within the country for a period or periods aggregating more than six months within any twelve month period.

14.1 The *Democratic Republic of the Congo*, *Gabon*, *Ivory Coast*, *Morocco*, *South Africa* and *Tunisia* 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.

14.2 *Lithuania* reserves the right to insert special provisions regarding a permanent establishment relating to activities carried on in a Contracting State in connection with the exploration or exploitation of natural resources.

14.3 *Argentina* reserves the right to treat an enterprise as having a permanent establishment if the enterprise carries on activities in that State related to the exploitation or extraction of natural resources, including fishing activities, without a fixed place of business during a period exceeding three months in any twelve month period commencing or ending in the fiscal year concerned.

14.4 *Indonesia* reserves the right to insert a provision that deems a permanent establishment to exist if, for more than a negotiated period, an installation, drilling rig or ship is used for the exploration of natural resources.

14.5 *Indonesia*, the *United Arab Emirates* and *Vietnam* reserve the right to tax income derived from activities relating to exploration and exploitation of natural resources.

14.6 *South Africa* reserves the right to insert a provision that deems a permanent establishment to exist if, for more than six months, an enterprise conducts activities relating to the exploration or exploitation of natural resources.

14.7 *India* reserves the right to include a provision in Article 5 to the effect that an enterprise having a significant economic presence in a Contracting State, based on criteria identified in Chapter VII of the Final Report on Action 1 of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project, will be deemed to have a permanent establishment in that State.

14.8 *Colombia* reserves the right to deem an enterprise to have a permanent establishment whenever it carries on activities in the other Contracting State in connection with the exploration for or the exploitation of natural resources, as well as in certain circumstances where services are performed.

Paragraph 4

15. *Albania*, *Armenia*, *Azerbaijan*, *Gabon*, *India*, *Indonesia*, *Ivory Coast*, *Malaysia*, *Morocco*, *Russia*, *Thailand*, *Tunisia*, *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. *Albania* and *Thailand* reserve their position on subparagraph 4 *f)*.

16.1 [Deleted]

16.2 The *Democratic Republic of the Congo* reserves its position on subparagraphs 4 *d)*, *e)* and *f)*.

Paragraph 5

17. *Albania*, *Argentina*, *Armenia*, *Azerbaijan*, *Gabon*, *India*, *Indonesia*, *Ivory Coast*, *Morocco*, *Russia*, *Thailand*, *Tunisia*, *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.

17.1 *India*, *Malaysia* and *Thailand* reserve the right to treat an enterprise of a Contracting State as having a permanent establishment in the other Contracting State if a person habitually secures orders in the other Contracting State wholly or almost wholly for the enterprise.

17.2 *Indonesia* reserves the right to treat an enterprise as having a permanent establishment if a person acting on behalf of the enterprise, other than an independent agent, manufactures or processes for the enterprise goods or merchandise belonging to the enterprise.

17.3 *Singapore* reserves the right to use the version of paragraph 5 included in the Model Tax Convention immediately before the 2017 update of the Model Tax Convention.

17.4 *India* reserves the right not to include the word "routinely" in paragraph 5 of Article 5.

Paragraph 6

18. *Albania*, *Azerbaijan*, *Gabon*, *Ivory Coast*, *Morocco*, *Serbia*, *Thailand*, *Tunisia* 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. *Colombia*, *Gabon*, *India*, *Indonesia*, *Ivory Coast*, *Morocco*, *Russia*, *Thailand*, *Tunisia* and *Vietnam* reserve the right to provide that an insurance enterprise of a Contracting State shall, except with respect to re-insurance (other than in the case of India), 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.

19.1 *India* reserves the right not to include the words "to which it is closely related" in paragraph 6 of Article 5.

19.2 *Singapore* reserves the right to use the version of paragraph 6 included in the Model Tax Convention immediately before the 2017 update of the Model Tax Convention.

Positions on the Commentary

20. *Argentina*, *India*, *Morocco* and *Vietnam* do not agree with the words "the twelve month test applies to each individual site or project" found in paragraph 51 of the Commentary. They consider 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.

21. *Bulgaria*, *Serbia* and *Singapore* would add to paragraph 97 of the Commentary on Article 5 their views that a person, who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to conclude contracts.

22. *Bulgaria* does not adhere to the interpretation, given in paragraph 50 of the Commentary on Article 5, and is of the opinion that supervision of a building site or a construction project, where carried on by another person, are not covered by paragraph 3 of the Article, if not expressly provided for.

23. *Brazil* does not agree with the interpretation provided in paragraphs 122 to 131 on electronic commerce, especially in view of the principle of taxation at the source of payments in its legislation.

24. *India* deems as essential to take into consideration that irrespective of the meaning given to the third sentence of paragraph 2 — 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.

25. *Azerbaijan*, *India* and *Malaysia* do not agree with the interpretation given in paragraphs 24 (first part of the paragraph) and 25 (first part of the paragraph); they are of the view that these examples could also be regarded as constituting permanent establishments.

25.1 *Argentina* does not agree with the interpretation given in paragraph 24.

25.2 *Singapore* does not agree with the interpretation given in paragraph 25 (first part of the paragraph) and is of the view that the example could constitute a permanent establishment.

26. *India* does not agree with the interpretation given in paragraph 36; it is of the view that tangible or intangible properties by themselves may constitute a permanent establishment of the lessor in certain circumstances.

26.1 *Argentina* does not agree with the interpretation given in paragraph 36; it is of the view that the letting or leasing of tangible or intangible property by themselves may constitute a permanent establishment of the lessor in certain circumstances, particularly where the lessor supplies personnel after installation to operate the equipment.

27. *India* does not agree with the interpretation given in paragraph 41; it is of the view that ICS equipment may constitute a permanent establishment of the lessor in certain circumstances.

28. *India* does not adhere to the interpretation given in paragraphs 45 and 146 concerning the list of examples of paragraph 2 of the Article; it is of the view that the examples can always be regarded as constituting *a priori* permanent establishments.

29. *India* does not agree with the interpretation given in paragraph 71; it would not include scientific research in the list of examples of activities indicative of preparatory or auxiliary nature.

30. *India* does not agree with the view expressed in paragraph 111 of the Commentary on Article 5 that in some cases, a person who is acting exclusively for an enterprise, can be considered to be an independent agent. India considers that such a person cannot be considered to be an independent agent.

31. *India* does not agree with the interpretation given in paragraph 97; it is of the view that the mere fact that a person has attended or participated in negotiations in a State between an enterprise and a client, can in certain circumstances, be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. India is also of the view that a person, who is authorised to negotiate the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident, can be said to exercise the authority to conclude contracts.

32. *India* does not agree with the interpretation given in paragraph 118; it is of the view that where a company (enterprise) resident of a State is a member of a multinational group and is engaged in manufacture or providing services for and on behalf of another company (enterprise) of the same group which is resident of the other State, then the first company may constitute a permanent establishment of the latter if other requirements of Article 5 are satisfied.

33. *India* does not agree with the interpretation given in paragraph 123; it is of the view that website may constitute a permanent establishment where it leads to significant economic presence of an enterprise.

34. *India* does not agree with the interpretation given in paragraph 124; it is of the view that, depending on the facts, an enterprise can be considered to have acquired a place of business through a website on any equipment, if opening the website on that equipment includes downloading of automated software, such as cookies, which use that equipment to collect data from that equipment, process it in any manner or share it with the enterprise.

34.1 *Argentina* does not agree with the statement given in paragraph 134, that the taxation by a State of profits from services performed in its territory does not necessarily represent optimal tax treaty policy.

35. *India* does not agree with the interpretation given in paragraphs 135 and 136 that a service permanent establishment will be created only if services are performed in the source State. It is of the view that furnishing of services is sufficient for creation of a service permanent establishment.

36. *India* does not agree with the interpretation given in paragraphs 139 and 167, it is of the view that taxation rights may exist in a State even when services are furnished by the non-residents from outside that State. It is also of the view that the taxation principle applicable to the profits from sale of goods may not apply to the income from furnishing of services.

37. *India* does not agree with the interpretation given in paragraph 140 that only the profits derived from services should be taxed and the provisions that are included in bilateral Conventions which allow a State to tax the gross amount of the fees paid for certain services is not an appropriate way of taxing services.

38. *India* does not agree with the conclusions given in paragraph 143 that taxation should not extend to services performed outside the territory of a State; that taxation should apply only to the profits from these services rather than to the payments for them, and that there should be a minimum level of presence in a State before such taxation is allowed.

38.1 *Argentina* does not fully agree with the interpretation given in paragraphs 139, 140 and 143.

39. *India* does not agree with the interpretation given in paragraph 152; it is of the view that for furnishing services in a State, physical presence of an individual is not essential.

40. *India* does not agree with the interpretation given in paragraphs 161 and 164.

41. *India* does not agree with the interpretation given in example 3 of paragraph 165 concerning the taxability of ZCO.

42. *Brazil* does not agree with the interpretation provided for in paragraphs 132 to 169 of the Commentary on the taxation of services, especially in view of the principle of taxation at source of payments in its legislation.

43. *India* does not agree with the interpretation in paragraph 27 of the Commentary on Article 5 according to which a satellite's footprint in the space of a source country cannot be treated as a permanent establishment. India is of the view that in such a case, the source State not only contributes its customer base but also provides infrastructure for reception of the satellite telecast or telecommunication process. India is also of the view that a satellite's footprint falls both in the international and national space. The footprint has a fixed location, has a value and can be used for commercial purposes. Accordingly, it can be treated as a fixed place of business in the space in the jurisdiction of a source country.

44. *India* does not agree with the interpretation in paragraph 38 of the Commentary on Article 5 as it considers that a roaming call is a composite process which requires a composite use of various pieces of equipment located in the source and residence countries and the distinction proposed in paragraph 38 was neither intended by the wording of Article 5 nor logical.

45. *India* does not agree with the interpretation in the last two sentences of paragraph 64 of the Commentary on Article 5 according to which even undersea cables and pipelines lying in the territorial jurisdiction of a source country cannot be considered as permanent establishment of an enterprise.

46. Regarding paragraph 104, *Colombia* believes that the arm's length principle should also be considered in determining whether or not an agent is of an independent status for purposes of paragraph 6 of the Article and wishes, when necessary, to add wording to its conventions to clarify that this is how the paragraph should be interpreted.

47. *Malaysia* disagrees with the last example in paragraph 89 regarding representatives of a pharmaceutical enterprise and is of the view that they may constitute a permanent establishment particularly if the representative also negotiates the essential elements of the contract, and not necessarily all the elements and details of the contract, on behalf of a foreign resident.

48. *Brazil* does not adhere to the interpretation of paragraphs 51 and 52 with regard to the twelve-month period.

49. *India* does not agree with the interpretation given in paragraph 55 because it considers that any work undertaken on a site shortly after the construction work has been completed, including repair works undertaken pursuant to a guarantee, may be taken into account as part of the original construction period, for determining whether a PE exists.

50. *India* does not agree with the interpretation given in paragraph 69 because it considers that collection of data for the purpose of determination or quantification of risk, by an enterprise in the business of managing risks, such as insurance, is not an activity of preparatory or auxiliary character.

51. *India* does not agree with the interpretation given in paragraph 74 because it considers that even when the anti-fragmentation provision is not applicable, an enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

52. *India* does not agree with the interpretation given in paragraph 96 because it considers that distribution of goods owned by an enterprise by an associated enterprise or a closely connected enterprise, particularly in a case where the risks are not born by such enterprise, such as the so called "low risk distributor", may give rise to permanent establishment of the enterprise, whose goods are being sold.

53. *India* does not agree with the view expressed in paragraph 5 of Commentary on Article 5 that by itself, treatment under VAT/GST is irrelevant for the purpose of interpretation and application of definition of permanent establishment. India considers that treatment under VAT/GST can be a relevant factor for this purpose.

54. *India* does not agree with the view expressed in paragraph 12 of the Commentary on Article 5 that where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location cannot be considered as being at the disposal of the enterprise. India considers that such a location can, in certain circumstances, be considered as being at the disposal of the enterprise.

55. *India* does not agree with the view expressed in paragraph 19 of Commentary on Article 5 that where a cross-frontier worker performs most of his work from his home situated in one State rather than from the office made available to him in the other State, his home should not be considered as being at the disposal of the enterprise. India considers that in such a case, the home of the employee can be considered as being at the disposal of the enterprise, for the purpose of application of Article 5.

56. *India* does not agree with the view expressed in the last two sentences of paragraph 30 of the Commentary on Article 5. India considers that operation of catering facilities in the example therein meets the time requirement for constituting a permanent establishment.

POSITIONS ON ARTICLE 6 (INCOME FROM IMMOVABLE PROPERTY) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. *India* and *Indonesia* wish to address the issue of the inclusion of the words "including income from agriculture or forestry" through bilateral negotiations.

1.1 *Costa Rica* reserves the right to include in paragraph 1, immovable property, the income derived from silvicultural activities.

Paragraph 2

2. Given the meaning of the term "immovable property" under its domestic law, *Belarus* reserves the right to omit the second sentence of this paragraph.

2.1 *Lithuania* reserves the right to include in the definition of the term "immovable property" any option or similar right to acquire immovable property.

2.2 *Colombia* reserves the right to include rights relating to all natural resources under this Article. Colombia also reserves the right to amend the definition of "immovable property" to include expressly other 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.

3.1 *Morocco* 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.

3.2 *Costa Rica* reserves the right to include in paragraph 2 the rights relating to exploration and exploitation of immovable property as well as any right that allows the use or enjoyment of immovable property situated in a Contracting State where that use or enjoyment relates to time sharing since under its domestic law such right is not considered to constitute immovable property.

Paragraph 3

4. *Lithuania* reserves the right to include in paragraph 3 a reference to income from the alienation of immovable property.

5. *Lithuania* also reserves 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.

POSITIONS ON ARTICLE 7 (BUSINESS PROFITS) AND ITS COMMENTARY

Positions on the Article

1. *Argentina*, *Azerbaijan*, *Brazil*, *Bulgaria*, *Costa Rica*, *Indonesia*, *Malaysia*, *Romania*, *Russia*, *Serbia*, *Singapore*, *South Africa* and *Thailand* reserve the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 Update, subject to their positions on that previous version (see annex below).

1.1 *India* reserves the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 update, subject to its positions on that previous version (see annex below). It does not agree with the approach to the attribution of profits to permanent establishments in general that is reflected in the revised Article, in its Commentary and in the consequential changes to the Commentary on other Articles (i.e. paragraph 21 of the Commentary on Article 8, paragraphs 32.1 and 32.2 of the Commentary on Article 10, paragraphs 25.1 and 25.2 of the Commentary on Article 11, paragraphs 21.1 and 21.2 of the Commentary on Article 12, paragraphs 27.1 and 27.2 of the Commentary on Article 13, paragraph 7.2 of the Commentary on Article 15, paragraphs 5.1 and 5.2 of the Commentary on Article 21, paragraphs 3.1 and 3.2 of the Commentary on Article 22 and subparagraph 40 *a*) of the Commentary on Article 24).

1.2 *Argentina* and *Indonesia* reserve the right to include a special provision in the Convention that will permit them to apply their domestic law in relation to the taxation of the profits of an insurance and re-insurance enterprise, even in the absence of a permanent establishment.

1.3 Whilst the *People's Republic of China* understands and respects the separate and independent enterprise principle underlying the new version of Article 7, due to its tax administration capacity it reserves the right to adopt the previous version of the Article and, in some cases, to resort to simpler methods for calculating the profits attributable to a permanent establishment.

1.4 *Colombia* reserves the right to use the previous version of Article 7, i.e. the version that was included in the Model Tax Convention immediately before the 2010 Update, and to disregard the changes to the Commentary on the Article made through that update.

2. *Malaysia*, *Thailand* and *Ukraine* 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 *Albania*, *Argentina*, *Azerbaijan*, *Brazil*, *Costa Rica*, *Croatia*, *Gabon*, *Indonesia*, *Ivory Coast*, *Lithuania*, *Malaysia*, *Morocco*, the *People's Republic of China*, *Russia*, *Serbia*, *Singapore*, *Thailand*, *Tunisia* and *Vietnam* 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.

2.2 [Deleted]

2.3 *Tunisia* reserves the right to propose in bilateral negotiations to add a criterion for the taxation in the Source State of the independent personal services, under the former Article 14, based on the amount (to be established through bilateral negotiations) of the remuneration paid.

3. *Argentina*, *Morocco* 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 activities have been carried out for reasons other than obtaining a benefit under the Convention.

3.1 *Indonesia* reserves 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 that permanent establishment or from other business activities carried on in that State of the same or similar kind as those carried on through that permanent establishment.

4. *Albania*, *Costa Rica* and *Vietnam* 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 *Morocco* and the *Philippines* reserve the right to adopt a length of stay and fixed base criteria in determining whether an individual rendering personal services is taxable.

4.2 The *United Arab Emirates* reserves the right to include a special provision in its conventions that will permit its domestic law to apply to all activities that are related to the exploration, extraction or exploitation of natural resources, including petroleum activities as well as rendering services in connection with these activities, when these activities are carried out on its territory.

5. *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 its domestic legislation concerning executive and administrative expenses for assistance services.

6. *Azerbaijan* and *Singapore* reserve the right to add a paragraph to clarify that expenses that will be allowed as deductions by a Contracting State shall include only expenses that would be deductible if the permanent establishment were a separate enterprise of that Contracting State.

7. *Armenia*, *Lithuania* and *Serbia* reserve the right to add to paragraph 2 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. *Serbia* reserves the right to specify that a potential adjustment will be made only if it is considered justified.

9. *Colombia* reserves the right to amend Article 7 to provide that, in applying paragraphs 1 and 2 of the Article, profits 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.

10. *Costa Rica* reserves the right to add a provision regarding expenses to be allowed as deductions.

11. [Deleted]

Positions on the Commentary

12. *Argentina*, *Brazil*, *Bulgaria*, *Indonesia*, *Malaysia*, *Romania*, *Russia*, *Serbia*, *Singapore*, *South Africa* and *Thailand* will interpret Article 7 as it read before the 2010 Update in line with the relevant Commentary as it stood prior to that update.

13. *Argentina* considers that the "separate entity approach" and the arm's length principle should be applied symmetrically to dealings between the permanent establishment and the head office of the enterprise — both to determine the correct attribution of profits (deduction of expenses) to the permanent establishment and the taxation of profits of the head office from those dealings — according to the fiction that the permanent establishment is a separate enterprise and that such an enterprise is independent from the rest of the enterprise of which it is a part.

14. *India* disagrees with the last sentence of paragraph 75.1 to the extent that income from issuance and trading of emission permits and credits will not be covered by Article 8 even under circumstances stated in paragraph 14.1 of the Commentary on Article 8.

ANNEX

POSITIONS ON THE PREVIOUS VERSION OF ARTICLE 7 AND ITS COMMENTARY

The following is the text of the non-OECD economies' positions on Article 7 and its Commentary as it read before 22 July 2010. That previous version of the positions on Article 7 and its Commentary is provided for historical reference as it will continue to be relevant for the application and interpretation of bilateral tax conventions that use the previous version of the Article.

Positions on the Article

1. *Argentina* and *Chile* reserve the right to include a special provision in the Convention that will permit them to apply their domestic law in relation to the taxation of the profits of an insurance and re-insurance enterprise.

2. *Malaysia*, *Thailand* and *Ukraine* 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 *Albania*, *Argentina*, *Brazil*, *Chile*, *Croatia*, *Gabon*, *India*, *Ivory Coast*, *Malaysia*, *Morocco*, the *People's Republic of China*, *Russia*, *Serbia*, *Tunisia* and *Vietnam* 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.

2.2 *Bulgaria* reserves the right to propose in bilateral negotiations the replacement, in this Article, of the term "profits" with the term "business profits", provided that it is defined in Article 3.

2.3 *Tunisia* reserves the right to propose in bilateral negotiations to add a criterion for the taxation in the Source State of the independent personal services, under the former Article 14, based on the amount (to be established through bilateral negotiations) of the remuneration paid.

Paragraphs 1 and 2

3. *Argentina*, *Morocco* 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 activities have been carried out for reasons other than obtaining a benefit under the Convention.

4. *Albania* and *Vietnam* 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 *Morocco* and the *Philippines* reserve the right to adopt a length of stay and fixed base criteria in determining whether an individual rendering personal services is taxable.

4.2 *Chile* and *India* reserve 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. Furthermore, India also reserves the right to apply such a rule under Articles 11, 12, 13 and 21.

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. *Armenia*, *India*, *Lithuania* and *Slovenia* 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.

7.1 *Estonia* and *Latvia* 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 would be deductible if the permanent establishment were a separate enterprise of that Contracting 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).

Paragraph 4

9. *Brazil* reserves the right not to adopt paragraph 4.

Paragraph 5

10. *Vietnam* reserves the right not to adopt paragraph 5.

Paragraph 6

11. *Brazil* reserves the right not to adopt paragraph 6.

Positions on the Commentary

12. *India* does not agree with the interpretation given in paragraph 25.

13. As regards paragraphs 41-50 of the Commentary on Article 7, *Chile* does not adhere to the specific methods provided as the rules on the amount of profit attributable to a permanent establishment; these must be established in and follow domestic law (including foreign exchange legislation).

POSITIONS ON ARTICLE 8 (INTERNATIONAL SHIPPING AND AIR TRANSPORT) AND ITS COMMENTARY

Positions on the Article

1. *Armenia* 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.

2.1 *Indonesia* reserves the right to allow the State of source to tax profits from the operation of ships in international traffic provided that the shipping activities arising from such operation in that State are more than casual and subject to certain limits.

3. *Albania*, *Argentina* and *Bulgaria* reserve the right to tax 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.

4. *South Africa* reserves the right to include in paragraph 1 profits from the leasing of containers.

4.1 *Azerbaijan* reserves the right to include a provision which provides for taxation of the profits from the leasing of containers in the same way as the profits from international transportation when such profits are supplementary or incidental to international transportation.

5. *Thailand* reserves the right to provide for taxation of the profits from shipping in accordance with domestic law.

5.1 *India* reserves the right to apply Article 12 and not Article 8 to profits from leasing ships or aircraft on a bare charter basis.

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.

6.1 *Bulgaria*, *Croatia*, *Russia* and *South Africa* reserve the right to extend the scope of the Article to cover international road and railway transportation in bilateral conventions.

6.2 *Morocco* reserves the right to provide for taxation of 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.

6.3 *Serbia* reserves the right, in the course of negotiations, to propose that the leasing of containers, even if directly connected or ancillary, be regarded as an activity separate from international shipping or aircraft operations, and consequently be excluded from the scope of the Article.

6.4 *Serbia* reserves the right to extend the scope of the Article to cover international road transportation in bilateral conventions.

6.5 *Vietnam* reserves the right to provide that the taxing right with respect to income derived from international transportation shall be shared 50/50.

6.6 The *United Arab Emirates* reserves the right to include in its bilateral conventions a provision to confirm that income from selling tickets on behalf of other enterprises, income derived from selling technical services to third parties, income from bank deposits and other investments, such as bonds, shares and other debentures, are covered by Article 8 provided that this income is incidental to the operation of air transport enterprises operating in international traffic.

7. *Costa Rica* reserves the right to include within the scope of "profits from the operation of ships or aircraft in international traffic" income generated by *a*) the temporary rental of ships or aircraft in empty hulk and *b*) the use or rental of containers (including trailers and auxiliary equipment used for the transport of containers).

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.

10. *Brazil*, *India* and *Malaysia* reserve their position on the application of this Article to income from ancillary activities (see paragraphs 4 to 10.1).

11. *Singapore* reserves its position on the application of this Article to income from ancillary activities. It takes the view that Article 8 does not cover any ancillary activities that are not expressly mentioned in Singapore's tax conventions.

12. *India* does not agree with the view that income derived by an enterprise from trading of emission permits and credits in the example given in paragraph 14.1 would be covered by Article 8.

POSITIONS ON ARTICLE 9 (ASSOCIATED ENTERPRISES) AND ITS COMMENTARY

Positions on the Article

1. *Brazil*, *Thailand* and *Vietnam* reserve the right not to insert paragraph 2 in their conventions.

2. *Bulgaria* and *Russia* reserve the right to replace "shall" by "may" in the first sentence of paragraph 2 in their conventions.

3. *Azerbaijan*, *Malaysia* and *Serbia* reserve the right to specify in paragraph 2 that a correlative adjustment will be made if the adjustment is considered to be justified.

4. *Ivory Coast*, *Morocco* and *Tunisia* reserve the right not to insert paragraph 2 in their conventions unless the commitment to make an adjustment does not apply in the case of fraud, wilful default or neglect. In such a case Tunisia reserves the right to limit the adjustment to periods not covered by its internal statute of limitation.

5. *Russia* reserves the right not to insert paragraph 2 in its conventions but is prepared in the course of negotiations to accept this paragraph based on the understanding that the other Contracting State is only obliged to make an adjustment to the amount of tax to the extent that it agrees, unilaterally or in a mutual agreement procedure, with the adjustment of profits by the first-mentioned State.

6. *Argentina* reserves its right to insert a provision according to which any appropriate adjustment to the amount of the tax charged therein on those profits shall not be implemented in the case of fraud, wilful default or neglect.

Position on the Commentary

7. As regards paragraph 1 of the Commentary on Article 9, *Brazil* reserves its right to provide for an approach in its domestic legislation that makes use of fixed margins derived from industry practices in line with the arm's length principle. In consequence, it reserves the right not adhere the application of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations where the guidelines contradicts this approach.

POSITIONS ON ARTICLE 10 (DIVIDENDS) AND ITS COMMENTARY

Positions on the Article

Paragraph 2

1. *Thailand* reserves the right to apply a 10 per cent rate of tax at source in the case referred to in subparagraph *a)*.

2. *Singapore* reserves its position on the period test included in subparagraph 2 *a*).

3. *Bulgaria*, *India*, *Lithuania*, *Malaysia*, *Russia*, *Serbia* and *Singapore* reserve the right not to include the requirement for the competent authorities to settle by mutual agreement the mode of application of paragraph 2.

3.1 *Azerbaijan* reserves the right not to include in its bilateral conventions the sentence stating that the competent authorities shall settle the mode of application of paragraph 2 by mutual agreement as it uses uniform regulations for the implementation of all its bilateral conventions.

4. [Deleted]

5. *Azerbaijan* and *Romania* reserve the right to tax at a uniform rate to be negotiated all dividends referred to in this paragraph.

6. *Gabon*, *Ivory Coast*, *Morocco*, *Russia*, *South Africa* and *Tunisia* reserve their position on the rates of tax in paragraph 2 and the minimum percentage for the holding in subparagraph *a)*.

7. *Colombia*, *Serbia* and *Vietnam* reserve the right to tax, at a uniform rate of not less than 10 per cent, all dividends referred to in paragraph 2.

7.1 *Argentina* reserves the right to include a provision in its bilateral treaties to provide that the taxation rate provided in paragraph 2 shall not be applicable where a local company distributes profits exceeding the total amount of aggregate tax profits at the end of the fiscal year immediately before the date of distribution, taking into account that the taxation on the dividends that exceed the aggregate profits is considered to be a taxation at the level of the company.

7.2 *Argentina*, *India* and *Indonesia* reserve the right to settle the rate of tax in bilateral negotiations.

7.3 *Costa Rica* reserves the right to increase the rates of tax on dividends in its bilateral conventions.

Paragraph 3

8. *Argentina*, *Russia* and *Tunisia* reserve the right to include a provision that will allow them to apply the thin capitalisation measures of their 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, *Albania*, *Armenia*, *Bulgaria*, *Belarus*, *Malaysia* and *Serbia* reserve the right to omit them from paragraph 3.

10. *Bulgaria* reserves the right to replace, in paragraph 3, the words "income from other corporate rights" by "income from other rights".

10.1 *Morocco* reserves the right to amplify the definition of dividends in paragraph 3 by adding the words "and other assimilated income" after the words "as well as income from other corporate rights" and before the words "which is subjected to the same taxation treatment…".

10.2 *India* reserves the right to modify the definition of the term "dividends".

10.3 *Argentina* reserves the right to expand the definition of dividends in paragraph 3 to cover certain payments that are treated as distributions of dividends according to its domestic law.

10.4 *Bulgaria* reserves the right to propose in bilateral negotiations the inclusion of a clause according to which a dividend which is treated as a hidden distribution of profits under its laws would remain taxable according to its laws, notwithstanding the relief under paragraph 2 of the Article.

10.5 *Costa Rica* reserves the right to amplify the definition of dividends in paragraph 3 so as to cover all income subjected under its domestic law to the taxation treatment of distributions.

Paragraph 5

11. *Argentina*, *Kazakhstan*, *Morocco*, *Russia* and *Tunisia* 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 a profit remittance tax on a permanent establishment at the same rate as is provided for in subparagraph 2 *a*).

14. *Indonesia* reserves the right to apply a branch profits tax, but that branch profits tax shall not affect the provisions contained in any production sharing contracts relating to oil and gas and contracts of works for other mining sectors.

14.1 *Colombia* reserves the right to apply its domestic rules on the taxation of dividends distributed from profits that have not been subject to tax at the level of the company, and to impose its tax on the transfer of profits attributable to permanent establishments that have not been subject to tax in Colombia.

Position on the Commentary

15. *India* does not adhere to the interpretation set out in paragraph 24. Under the domestic law certain payments are treated as distributions and are therefore included in the definition of dividends.

POSITIONS ON ARTICLE 11 (INTEREST) AND ITS COMMENTARY

Positions on the Article

1. *Bulgaria* and *Ukraine* reserve 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*, *Costa Rica*, *India*, *Ivory Coast*, *Latvia*, the *Philippines*, *Romania*, *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).

4. *Bulgaria*, *India*, *Lithuania*, *Malaysia*, *Russia*, *Serbia* and *Singapore* reserve the right not to include the requirement for the competent authorities to settle by mutual agreement the mode of application of paragraph 2.

4.1 *Azerbaijan* reserves the right not to include in its bilateral conventions the sentence stating that the competent authorities shall settle the mode of application of paragraph 2 by mutual agreement as it uses uniform regulations for the implementation of all its bilateral conventions.

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* and *Thailand* reserve 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 *Bulgaria*, *Morocco* and *Tunisia* 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.

7.2 *Costa Rica* reserves the right to extend the definition of interest to include other types of income, such as income derived from financial leasing and factoring contracts.

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.

8.1 *Morocco* reserves the right to include in paragraph 4 a reference to other business activities carried on in the other State of the same and similar kind as those effected through a permanent establishment.

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.

10. *India* reserves its right to treat the interest element of sales on credit (described in paragraphs 7.8 and 7.9) as interest.

11. *India* does not adhere to the interpretation set out in paragraph 20, it reserves the right to treat the difference between redemption value and issue price in accordance with its domestic law.

POSITIONS ON ARTICLE 12 (ROYALTIES) AND ITS COMMENTARY

Positions on the Article

1. *Bulgaria* and *Ukraine* 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.

2. [Deleted]

Paragraph 1

3. *Albania*, *Argentina*, *Armenia*, *Azerbaijan*, *Belarus*, *Brazil*, *Bulgaria*, *Colombia*, *Costa Rica*, *Croatia*, the *Democratic Republic of the Congo*, *Gabon*, *Indonesia*, *Ivory Coast*, *Kazakhstan*, *Malaysia*, *Morocco*, the *People's Republic of China*, the *Philippines*, *Romania*, *Russia*, *Serbia*, *Singapore*, *South Africa*, *Thailand*, *Tunisia*, *Ukraine*, *Vietnam* and *Hong Kong, China* reserve the right to tax royalties at source.

3.1 *Costa Rica* reserves the right to retain a 10 per cent rate of tax at source in its bilateral conventions.

4. *Armenia* reserves the right to tax copyright royalties for literary, scientific and artistic work at a reduced tax rate.

4.1 *India* reserves the right to: tax royalties and fees for technical services at source; define these, particularly by reference to its domestic law; define the source of such payments, which may extend beyond the source defined in paragraph 5 of Article 11, and modify paragraphs 3 and 4 accordingly.

Paragraph 2

5. *Argentina*, *Brazil*, *Gabon*, *Ivory Coast*, *Morocco*, *Russia*, *Thailand* and *Tunisia* 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. The *Philippines*, *Thailand* and *Vietnam* reserve the right to include fees for technical services in the definition of royalties.

7. *Argentina*, *Brazil*, *Gabon*, *Ivory Coast* and *Tunisia* reserve the right to include fees for technical assistance and technical services in the definition of "royalties".

7.1 *Morocco* reserves the right to include in the definition of the royalties, payments for services, technical assistance, technical and economic studies and all kind of services fees.

7.2 *Colombia* reserves the right to include payments received for the furnishing of technical assistance, technical services and consulting services within the definition of royalties.

8. *Albania*, *Armenia*, *Azerbaijan*, *Belarus*, *Brazil*, *Bulgaria*, *Colombia*, *Costa Rica*, *India*, *Indonesia*, *Kazakhstan*, *Malaysia*, the *People's Republic of China*, the *Philippines*, *Romania*, *Russia*, *Serbia*, *Thailand* and *Vietnam* 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.

8.1 *Serbia* reserves the right to include in the definition of royalties income derived from the leasing of ships or aircraft on a bare boat charter basis and containers.

8.2 *Malaysia* reserves the right to include in the definition of royalties income derived from the leasing of containers and ships or aircraft, including on a slot hire, time

charter, voyage charter, or a bare boat charter basis, whether or not such charters are crewed, equipped or provisioned.

9. *Belarus* reserves the right to include a reference to transport vehicles in the definition of royalties.

10. *Argentina*, *Brazil*, *Morocco* and *Romania* reserve the right to include in the definition of the royalties payments for transmissions by satellite, cable, optic fibre or similar technology.

10.1 *Argentina* and *Vietnam* reserve the right to include in the definition of royalties, payments for the use of or the right to use of "films, tapes or digital media used for radio or television broadcasting".

11. *Albania*, *Malaysia*, *Serbia* and *Vietnam* reserve the right to deal with fees for technical services in a separate Article similar to Article 12.

12. *Albania*, *Argentina*, *Armenia*, *Azerbaijan*, *Belarus*, *Brazil*, *Bulgaria*, *Colombia*, *Croatia*, *Gabon*, *Indonesia*, *Ivory Coast*, *Kazakhstan*, *Lithuania*, *Malaysia*, *Morocco*, the *People's Republic of China*, *the Philippines*, *Romania*, *Serbia*, *Singapore*, *South Africa*, *Thailand*, *Tunisia*, *Ukraine*, *Vietnam* and *Hong Kong, China* 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.

12.1 *Morocco* reserves the right to include in the paragraph a reference to other business activities carried on in the other State of the same and similar kind as those effected through a permanent establishment.

12.2 The *Democratic Republic of the Congo* and *Malaysia* reserve their position on the treatment of software.

12.3 *Kazakhstan* reserves the right to include in the definition of royalties payments for the use of, or the right to use, software.

Positions on the Commentary

13. *Argentina*, *Morocco*, *Serbia* and *Tunisia* 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.

15. *Brazil* does not agree with the interpretation provided in paragraphs 17.1 to 17.4, especially in view of the principle of taxation at the source of payments in its legislation.

16. *Malaysia* cannot adhere to the new additional sentence in paragraph 11.2, i.e. "Payments made under the latter contracts generally fall under Article 7". Malaysia treats payments for the provision of services as Special Classes of Income under her domestic law and not as business income.

17. *India* reserves its position on the interpretations provided in paragraphs 8.2, 10.1, 10.2, 14, 14.1, 14.2, 14.4, 15, 16 and 17.3; it is of the view that some of the payments referred to may constitute royalties.

17.1 *Colombia* does not adhere to the interpretations provided in paragraphs 8.2, 13.1, 14, 14.1, 14.2, 14.4, 15, 16 and 17.3; under its tax laws some of the payments referred to may constitute royalties.

18. *India* does not agree with the interpretation that information concerning industrial, commercial or scientific experience is confined to only previous experience.

19. *Malaysia* does not adhere to the interpretation in paragraph 14.2 because Malaysia is of the view that licence fees for rights to distribute software constitute royalties.

20. *India* does not agree with the interpretation in paragraph 9.1 of the Commentary on Article 12 according to which a payment for transponder leasing will not constitute royalty. This notion is contrary to the Indian position that income from transponder leasing constitutes an equipment royalty taxable both under India's domestic law and its treaties with many countries. It is also contrary to India's position that a payment for the use of a transponder is a payment for the use of a process resulting in a royalty under Article 12. India also does not agree with the conclusion included in the paragraph concerning undersea cables and pipelines as it considers that undersea cables and pipelines are industrial, commercial or scientific equipment and that payments made for their use constitute equipment royalties.

21. *India* does not agree with the interpretation in paragraph 9.2 of the Commentary on Article 12. It considers that a roaming call constitutes the use of a process. Accordingly, the payment made for the use of that process constitutes a royalty for the purposes of Article 12. It is also the position of India that a payment for a roaming call constitutes a royalty since it is a payment for the use of industrial, commercial or scientific equipment.

22. *India* does not agree with the interpretation in paragraph 9.3 of the Commentary on Article 12. It considers that a payment for spectrum license constitutes a royalty taxable both under India's domestic law and its treaties with many countries.

23. *Azerbaijan* and the *People's Republic of China* do not adhere to the interpretation in paragraph 10.1 because they take the view that some payments for the exclusive distribution rights of a product or a service in a given territory may be treated as royalties.

24. *Bulgaria* does not adhere to the interpretation, given in paragraph 14.4 of the Commentary on Article 12, and is of the opinion that a distribution intermediary who distributes software to clients and with relation to these clients requests from the software copyright holder or from another person who has the right to copy the software, to provide software copies, irrespective whether on a tangible media or electronically, uses the copyright in the software product.

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, 3 and 4.

2. The *People's Republic of China*, *Serbia* 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. *Singapore* reserves its position on the period test included in paragraph 4.

3.1 *Lithuania* reserves the right to insert special provisions regarding capital gains relating to activities carried on in a Contracting State in connection with the exploration or exploitation of natural resources.

4. *Lithuania* reserves the right to limit the application of paragraph 3 to enterprises operating ships and aircraft in international traffic.

5. *Colombia*, *Costa Rica*, *India* and *Vietnam* reserve the right to tax gains from the alienation of shares or rights in a company that is a resident of their respective country.

6. *Bulgaria* reserves the right to tax gains from the alienation of shares or rights in a company that is a resident of Bulgaria other than shares quoted on a regulated stock exchange.

7. *Bulgaria* reserves the right to extend the scope of the provision to cover gains from the alienation of railway and road transport vehicles.

8. *Vietnam* reserves the right to modify paragraph 4 so that the immovable property in question need only be 30 per cent of all assets owned by the company.

9. *Serbia* reserves the right to extend the scope of the provision to cover gains from the alienation of road transport vehicles operated in international traffic.

10. *India* reserves its position on paragraph 4.

11. *Lithuania* reserves the right not to include paragraph 4 in its conventions.

POSITIONS ON ARTICLE 14 (INDEPENDENT PERSONAL SERVICES) AND ITS COMMENTARY

Positions on the Article

[All the positions on Article 14 were deleted on 29 April 2000 when 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.]

POSITIONS ON ARTICLE 15 (INCOME FROM EMPLOYMENT) AND ITS COMMENTARY

Positions on the Article

1. [Deleted]

2. [Deleted]

3. *Lithuania* reserves the right to insert special provisions regarding income derived from dependent personal services relating to activities carried on in a Contracting State in connection with the exploration or exploitation of natural resources.

4. *Serbia* reserves the right to propose a separate paragraph which provides that remuneration derived by a resident of a Contracting State shall be taxable only in that State if the remuneration is paid in respect of an employment exercised in the other Contracting State in connection with a building site, a construction or installation project, for an agreed period during which the site or project does not constitute a permanent establishment in that other State.

5. *India* reserves the right to decide the period of stay referred in this paragraph through bilateral negotiations.

5.1 The *United Arab Emirates* reserves the right to modify paragraph 3 to provide that remuneration derived in respect of an employment exercised in connection with an aircraft operated in international traffic (including the crew of the aircraft and ground staff) shall be taxed exclusively in the country of residence of the operator of that aircraft.

5.2 *Azerbaijan* reserves the right to provide that the remuneration derived in respect of an employment exercised aboard ships or aircraft will be taxable only in the State of residence of their operator.

5.3 *Hong Kong, China* reserves the right to modify paragraph 3 to provide that the remuneration of an employee who works aboard a ship or aircraft operated in

international traffic shall be taxable only in the State of residence of the enterprise that operates such ship or aircraft.

Positions on the Commentary

6. *India* does not adhere to the interpretation set out in paragraph 6.2, because it does not recognise the concept of a partner being treated as an employer in the case of a fiscally transparent partnership.

7. *India* and the *People's Republic of China* do not adhere to the interpretation set out in paragraph 2.9, because they take the view that the payment that an employee receives in consideration for an obligation not to work for a competitor of his ex-employer constitutes remuneration derived from employment activities performed before the termination of the employment, and that such payment may be taxed in the Contracting State where the employment activities are performed before such termination.

POSITIONS ON ARTICLE 16 (DIRECTORS' FEES) AND ITS COMMENTARY

Positions on the Article

1. *Albania*, *Azerbaijan*, *Bulgaria*, the *Democratic Republic of the Congo*, *Indonesia*, *Lithuania* and *Serbia* 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. [Deleted]

3. *Morocco* reserves 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. Morocco also reserves the right to extend the Article to cover the remuneration of senior employees.

4. *Indonesia*, *Malaysia* and *Vietnam* reserve the right to extend the Article to cover the remuneration of top-level managerial officials.

POSITIONS ON ARTICLE 17 (ENTERTAINERS AND SPORTSPERSONS) AND ITS COMMENTARY

Positions on the Article

1. The *Philippines* and *Russia* reserve the right to exclude from the application of paragraph 1 artistes and sportsmen employed in organisations which are subsidised out of public funds.

2. *India* reserves the right to include performing as well as non-performing artists in the scope of the term "entertainers".

Positions on the Commentary

3. *Argentina* and *Brazil* do not agree with the interpretation in paragraph 3, according to which Article 17 should not be extended to a model performing as such and presenting clothes during a fashion show. They consider that, under some circumstances, a fashion show may be regarded as of an entertainment nature. Thus, the income derived by a model from the participation in such a fashion show may be included in Article 17 (as opposed to the income derived by a model from other activities, i.e. the photo session, where the activity performed is clearly not of an entertainment nature).

3.1 *Malaysia* does not agree with the interpretation in paragraph 3, according to which Article 17 should not be extended to a model performing as such and presenting clothes during a fashion show.

4. *Brazil*, *Malaysia* and the *People's Republic of China* do not adhere to the interpretation set out in paragraph 3, because they take the view that visiting conference speakers, including especially former politicians, could be covered by Article 17 if an entertainment character is present in their speeches.

5. *Argentina* does not share the interpretation in paragraph 9.1 because it considers that, in some cases, the fee that a former or injured sportsperson would earn for offering comments during a broadcast of a sports event in which that person does not participate, may be received for personal activities of that person of an entertainment nature. In such cases, he/she is offered the job (and the relevant income) because of his/her fame as a sportsperson and not for his/her reputation as a commentator, and therefore such income is covered by Article 17.

6. *India* does not agree with the interpretation in paragraph 3, according to which Article 17 should not be extended to a model performing as such and presenting clothes during a fashion show. India considers that, under some circumstances, a fashion show may be regarded as of an entertainment nature and accordingly covered by Article 17.

7. *India* does not agree with the interpretation given in paragraph 9 restricting the scope of Article 17 only to personal activities that have a close connection with

performance. India considers that any consideration received by an entertainer or a sportsperson for any personal activity, including appearance is covered by Article 17.

8. *India* does not agree with the third example in paragraph 9.1, related to reporting or commenting activities during the broadcasting of an entertainment or sports event, as it considers that such activities are covered by Article 17.

9. *Brazil* and *India* do not adhere to the interpretation set out in paragraph 11.2. They take the view that prize money in such races is paid in consideration for personal activities of the jockey and race car driver and is covered by Article 17.

10. With respect to paragraph 14 of the Commentary, *India* considers that the phrase "personal activities as such" in paragraph 1 of article 17 would not include activities financed by public funds and that the alternative provision included in paragraph 14 simply confirms that view.

POSITIONS ON ARTICLE 18 (PENSIONS) AND ITS COMMENTARY

Position on the Article

1. [Deleted]

2. *Brazil*, *Bulgaria*, *Ivory Coast*, *South Africa* and *Ukraine* reserve the right to include in paragraph 1 an explicit reference to annuities.

POSITIONS ON ARTICLE 19 (GOVERNMENT SERVICE) AND ITS COMMENTARY

Position on the Article

1. *Argentina* reserves the right to tax at source pensions covered by subparagraph 2 *b*).

Position on the Commentary

2. *India* does not agree that public bodies like State Railways and Post Offices are performing business activities.

POSITIONS ON ARTICLE 20 (STUDENTS) AND ITS COMMENTARY

Positions on the Article

1. *Albania*, *Brazil* and *Serbia* reserve 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. *Lithuania* and *Morocco* reserve the right to refer to any apprentice and to a trainee in this Article.

3. *Georgia* reserves the right to propose a separate paragraph which provides that remuneration which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State derives from an employment which he exercises in the first-mentioned State for a period or periods not exceeding two years shall not be taxed in the first-mentioned State if the employment is directly related to his studies or apprenticeship carried out in the first-mentioned State.

4. *Vietnam* reserves 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. *Thailand* reserves 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*, *Bulgaria*, *Costa Rica*, *India*, *Ivory Coast*, *Morocco*, the *People's Republic of China*, the *Philippines*, *Serbia*, *Thailand*, *Tunisia* and *Vietnam* reserve the right to add an article which addresses the situation of teachers, professors and researchers, subject to various conditions and are free to make a corresponding modification to paragraph 1 of Article 15.

7. *Gabon*, *Ivory Coast* and *Tunisia* reserve the right to provide that remuneration for services rendered by a student or business apprentice in the visiting State shall not be taxed in that State, provided that such remuneration was received for the purpose of his maintenance, studies or training.

8. *Morocco* reserves the right to add a second paragraph providing that the remuneration from employment derived from the visiting State shall not be taxed in that State, or, in case of taxation, the granting to visiting students of the same tax exemptions, reliefs or reductions as are granted to residents.

9. *India* and *Hong Kong, China* reserve the right to exclude "business apprentice" from this Article.

10. *India* reserves the right to provide that remuneration for services rendered by a student in a Contracting State shall not be taxed in that State provided that such services are directly related to his studies and is free to make a corresponding modification to paragraph 1 of Article 15.

11. *India* reserves the right to limit the exemption provided for in the Article to a period of six years.

POSITIONS ON ARTICLE 21 (OTHER INCOME) AND ITS COMMENTARY

Position on the Article

1. *Albania*, *Argentina*, *Azerbaijan*, *Belarus*, *Brazil*, *Colombia*, *Costa Rica*, *Gabon*, *India*, *Indonesia*, *Ivory Coast*, *Malaysia*, *Morocco*, *Russia*, *Serbia*, *Singapore 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.

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. *Brazil*, *Bulgaria*, *Indonesia*, *Malaysia*, the *People's Republic of China*, *Singapore*, *Thailand* and *Vietnam* reserve their positions on the Article if and when they impose taxes on capital.

3. *India* reserves the right to tax capital as per domestic law.

POSITIONS ON ARTICLES 23 A AND 23 B (EXEMPTION METHOD AND CREDIT METHOD) AND ITS COMMENTARY

Positions on the Article

1. *Albania*, *Argentina*, *Brazil*, *India*, *Ivory Coast*, *Malaysia*, *Morocco*, the *People's Republic of China*, *Serbia*, *Thailand*, *Tunisia* 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* and *Tunisia* reserve 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. *Brazil* reserves its position on paragraph 4 of Article 23 A.

POSITIONS ON ARTICLE 24 (NON-DISCRIMINATION) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. [Deleted]

2. *Brazil*, *Colombia*, *Romania*, *Russia*, *Singapore*, *Thailand* and *Vietnam* reserve their position on the second sentence of paragraph 1.

2.1 *Bulgaria* reserves the right to omit the words "other or" in the first sentence of paragraph 1.

2.2 *Indonesia*, *Malaysia* and *Tunisia* reserve the right to restrict the scope of the Article to residents of the Contracting States.

2.3 *Singapore* reserves the right to add a provision to state that the granting of tax incentives to its nationals designed to promote economic or social developments shall not be construed as discriminatory.

Paragraph 2

3. [Deleted]

4. *Albania*, *Bulgaria*, *India*, *Malaysia*, the *Philippines*, *Russia*, *Serbia*, *Singapore* and *Vietnam* reserve the right not to insert paragraph 2 in their conventions.

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* reserves the right to apply a profit remittance tax and a special taxation regime in respect of agricultural production activities.

7.1 *Morocco* reserves the right to add a paragraph stating that nothing in this article can be interpreted as prohibiting Morocco to apply its branch tax, its domestic thin-capitalisation and transfer-pricing legislation.

7.2 *Argentina* reserves the right to provide in paragraph 3 that no exemptions or concession provided for in its internal laws shall be granted as long as that would result in a transfer of taxes to foreign tax administrations.

7.3 *Colombia* reserves the right to impose its tax on the transfer of profits attributable to permanent establishments.

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.

8.1 *Malaysia* reserves its position on this paragraph in the case of interest, royalties, or fees for technical services paid to non-residents where withholding tax has not been deducted.

8.2 *Singapore* reserves its position on this paragraph in the case of interest paid to non-residents where withholding tax has not been deducted.

8.3 *Argentina* reserves the right not to include paragraph 4 of Article 24.

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. *Albania*, *Argentina*, *Brazil*, *Bulgaria*, *Colombia*, *Malaysia*, the *Philippines*, *Romania*, *Serbia*, *Singapore*, *Thailand*, *Tunisia*, *Vietnam* and *Ukraine* reserve the right to restrict the scope of the Article to the taxes covered by the Convention.

Positions on the Commentary

11. *India*, *Malaysia* and *Singapore* reserve their position on the interpretation set out in paragraph 44.

11.1 *Argentina* does not agree with the interpretation in paragraph 44 because Argentina considers that paragraph 3 of Article 24 does not preclude a State to establish, on any ground, a preferential tax regime that only residents are able to apply for.

12. *India* reserves the right to add a paragraph to clarify that this provision can neither be construed as preventing a Contracting State from charging the profits of a permanent establishment which a company of the other Contracting State has in the first-mentioned State at a rate of tax which is higher than that imposed on the profits of a similar company of the first-mentioned Contracting State, nor as being in conflict with the provisions of paragraph 3 of Article 7 (as it read before the 2010 update to the Model Tax Convention).

POSITIONS ON ARTICLE 25 (MUTUAL AGREEMENT PROCEDURE) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. The *Philippines* and *Thailand* reserve their positions on the last sentence of paragraph 1.

1.1 *Kazakhstan* reserves its position on the second sentence of paragraph 1 and reserves its right to supplement the paragraph with the following sentence: "In the case of judicial proceedings, a court decision cannot be reconsidered by the competent authority of Kazakhstan."

Paragraph 2

2. *Bulgaria*, the *Philippines* and *Thailand* 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 3

3. *Thailand*, *Tunisia* 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*, *Malaysia*, the *People's Republic of China*, the *Philippines*, *Singapore*, *Thailand* and *Ukraine* reserve the right to omit the words "including through a joint commission consisting of themselves or their representatives".

Paragraph 5

4.1 *Brazil*, *India*, *Indonesia*, the *People's Republic of China*, *Serbia*, *South Africa* and *Hong Kong, China* reserve the right not to include paragraph 5 in their conventions.

4.2 *Singapore* reserves the right to modify paragraph 5 in its agreements.

Positions on the Commentary

5. *India* does not agree with the interpretation given in paragraph 6.1 because it considers that a term not defined in the treaty can only have the meaning that it has under the laws of the State applying the Convention and cannot be defined by the Competent Authorities under Article 25, while resolving by mutual agreement, difficulties or doubts concerning the interpretation or application of the Convention.

6. *Argentina* considers that paragraph 1 of the Article does not bind the competent authorities to commence or accept a mutual agreement procedure case where the taxpayer alleges that taxation is not in accordance with the Convention in respect of a hypothetical case, rather than an actual case.

7. In relation to paragraph 25, *India* is of the view that the competent authorities can reach an agreement under Article 25 during pendency of domestic law action. However, the taxpayer has an option to either accept or reject the resolution order. If the taxpayer accepts the resolution order, he has to withdraw domestic law action.

8. *India* does not agree with the view expressed in paragraph 42 that a taxpayer may be permitted to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court had delivered its judgement in that suit.

9. With reference to paragraphs 86 and 87, because *Brazil* has a very strict tax secrecy policy that prevents the disclosure of information related to the case to a third party, it is of the view that mutual agreement procedures should not be discussed and implemented by anyone other than the competent authorities of the Contracting States, who should put their best efforts to reach a suitable bilateral solution.

10. *India* does not agree with the interpretation given in paragraph 14 because it does not agree with the view that the Mutual Agreement Procedure can be initiated where taxation appears as a risk which is probable. India considers that it can be initiated only where taxation appears as a risk which is certain.

11. *India* does not agree with the view that all the circumstances in which a State would deny access to the mutual agreement procedure must be made clear in the Convention. It is of the view that the wording of Article 25 would permit access to the mutual agreement procedure to be denied in respect of certain cases.

POSITIONS ON ARTICLE 26 (EXCHANGE OF INFORMATION) AND ITS COMMENTARY

Positions on the Article

1. [Deleted]

2. *India* reserves the right to include documents or certified copies of the documents within the scope of this Article.

2.1 *Morocco* and *Thailand* reserve the right not to include the words "The exchange of information is not restricted by Articles 1 and 2" in paragraph 1.

Position on the Commentary

3. As regards paragraph 10.3 of the Commentary, *Hong Kong, China* wishes to clarify its position on the exchange of information that existed prior to the entry into force of the bilateral agreement. In view of its domestic law requirements, Hong Kong, China will only exchange information relating to taxable periods after the agreement came into operation.

POSITIONS ON ARTICLE 28 (MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS) AND ITS COMMENTARY

Position on the Article

1. Considering that *Hong Kong, China* is not a sovereign state but a special administrative region of the People's Republic of China, Hong Kong, China reserves the right to replace "diplomatic missions" by "government missions" in this Article.

POSITIONS ON ARTICLE 29 (ENTITLEMENT TO BENEFITS) AND ITS COMMENTARY

Positions on the Article

1. *India* reserves the right to restrict the derivative benefit under paragraph 4 of Article 29 to equivalent beneficiaries that directly own shares of the resident.

2. *Singapore* reserves its position on paragraph 8.

3. *Indonesia* reserves the right to address Article 29 through bilateral negotiations.

POSITIONS ON ARTICLE 30 (TERRITORIAL EXTENSION) AND ITS COMMENTARY

Position on the Article

1. *Indonesia*, *Malaysia*, the *People's Republic of China*, *Singapore* and *Thailand* reserve their position on this Article.

ANNEX

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 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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