

Roy Rohatgi

BASIC
INTERNATIONAL
TAXATION

Second Edition
Volume I: Principles



RICHMOND

Roy Rohatgi BASIC INTERNATIONAL TAXATION -
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Basic International Taxation

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(Second Edition)

By Roy Rohatgi

Volume One

Principles of International Taxation



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PREFACE TO THE FIRST EDITION

It all started over five years ago when a delegate at one of my international tax conferences in Mumbai (India) asked me if I could recommend a single book on basic international taxation. I could not and I promised him that I would write one for professionals like him. There are many excellent books on the elements of international taxation. However, most written materials on the subject are meant for the specialist. They deal with specific and often advanced issues in international taxation, normally from a specific country perspective. This book is meant to fill the gap.

The book is based on my own needs and past experiences as a practising professional. It is written from a professional perspective to provide a basic understanding of the various practical aspects of this subject in a single book. It should be useful to professionals as a quick reference with further research on a topic through suggested additional reading material and footnoted sources. Since the book follows a textbook style, it should also be suitable for students. It is not an advanced study of the subject, but neither is it an elementary text.

The book is not an original work in terms of its content. Except in its presentation and the choice of the material included in the various sections, it is based on secondary materials gathered from a wide range of books, journals and articles on the subject. It also makes extensive use of the various OECD reports and studies and the Cahiers issued by the International Fiscal Association. Many (but not all) of these sources are either footnoted or included in the suggested reading list at the end of each chapter. I wish to thank their authors for the contribution to the subject and dedicate this book to them.

The primary objective of the book is to clarify the basic principles of international taxation. These principles do change, but not radically except over time. The country examples are illustrative and provided solely to help the reader to get a better understanding of these principles. I have made my best efforts to ensure that my understanding of the tax principles is correctly presented and that the country examples are also correct. However, it has not been possible for me to guarantee that the applications of these principles in various countries are fully described or accurately explained in the book.

The tax laws change and the tax practices evolve through new judicial decisions and interpretations provided by revenue authorities and various international bodies (e.g. OECD, International Fiscal Association, etc.). I have tried to present the basic concepts in a simplified manner but it has not always been possible. In my attempts to simplify them and keep the book within a manageable size, I also had to cut out much of the detail in many cases. Unfortunately, every rule in international taxation has many exceptions. The interested reader is advised to research them further, where appropriate.

Some of the country information in the book may also be out of date. Due to time constraints and the difficulties in obtaining the latest country data, I have not been able to update them in all cases. I request the readers to advise me if they find any inaccuracies or changes in the law or practice so that corrections can be made in the next edition of the book. I am aware that the book has many shortcomings but if it helps the reader to get a

Preface

better understanding of the subject, my efforts would be worthwhile. The term “he” is used throughout the book for convenience only and does not reflect any gender bias.

I wish to acknowledge the permission given by the Organisation for Economic Co-operation and Development in Paris (France) to reproduce the text of the latest OECD Model treaty. I would also like to thank the International Bureau of Fiscal Documentation (IBFD) for providing me with the extracts of the glossary of terms from their own publication. My thanks are due to Miles Dean and Roy Saunders of International Fiscal Services Ltd. for their write-up on the “Recent Developments in International Taxation.” I am grateful to Lukas Claerhout formerly at Kluwer Law International for his support and encouragement over the years it has taken me to write the book. Finally, I wish to express my gratitude to the director and the staff at the IBFD Library in the Amsterdam for their assistance during my research.

I could not have written this book without the help of my family and my well-wishers throughout the world. I wish to thank the large number of my professional friends who were kind enough to find time to review the tax information relating to their country or to check the drafts of various chapters of the book. I would have liked to list them personally by name but the list would be too long. Finally, I would like to thank Mary (my mother-in-law) and Pauline (my wife) for their patience, support and assistance.

As mentioned, the tax law and practice in various countries around the world change too rapidly. No book, not even a weekly updated loose-leaf service, can be a substitute for appropriate research and professional advice on the current situation. The information contained in this book should not be relied upon to undertake any transaction without such advice.

Roy Rohatgi
(roy@itpa.org)
December 2001

PREFACE TO THE SECOND EDITION

The second edition largely follows the format of the first edition in style and content. Hence, my comments in the preface of the first edition still apply. However, the country examples have been updated on the basis of personal research supplemented by a detailed review of current international tax practices by leading professionals in the jurisdiction, wherever possible. In addition, I have attempted to include my own research and knowledge of issues in international taxation to provide the latest overview of each topic.

Both the principles and the practice are important to ensure full understanding of the subject. The success of the first edition published in December 2001 has led me to split it into two volumes covering:

Volume I – Principles of International Taxation

Volume II – Practice of International Taxation

The first volume contains the basic principles of international taxation, an analysis of model tax treaties and a broad overview of various domestic tax systems. It also provides a limited glossary of terms and a copy of the Model tax treaties. This volume should meet most of the needs of students of international taxation who have little or no knowledge of the subject.

The second volume includes more complex issues of interest to more advanced students and to international tax practitioners. It provides practical guidance on international tax planning techniques, a basic knowledge of anti-avoidance rules, advice on how to use offshore financial centres in international tax planning, an overview of some of the current issues in international taxation and a brief tax profile of several countries.

The two volumes should also make the book more affordable, particularly to students who will be able to split the cost. Moreover, while the first volume is unlikely to change radically over time and require fewer updates, I plan to update the second volume more frequently, say every two to three years.

I wish to thank Professor Klaus Vogel for his support ever since he launched the first edition of my book in December 2001 in Mumbai (India). I would also like to acknowledge my thanks to the many international tax professionals in various jurisdictions who have taken the time to review their country tax extracts in the book. Wherever possible, their name and contact details (and the review date) have been footnoted to enable the readers to contact them if they need further clarification. In addition, I would like to thank the Organisation for Economic Development and Co-operation for their permission to include again their latest Model Convention. I am grateful to Jacques Sasseville, who is the Head of the Tax Treaty Unit at the OECD in Paris, for his review and comments on my chapter on Model Tax Convention on Double Tax Avoidance (Chapter 3). I am also grateful to Professor Duncan Bentley of Bond University in Australia (as well as to other international tax specialists) who have helped in the review of specific extracts from my book. I would like to thank

Preface

Lukas Claerhout of Richmond Law and Tax, who have taken over the publication of this edition from Kluwer Law International. Finally, I owe my thanks to my wife, Pauline, for her continuous support in my research and writings for this book.

Like my first edition, this edition is based largely on my research of a wide range of secondary sources. Many of these sources have been cited either as footnotes or included in the suggested reading materials. I thank their authors and dedicate the book to them. I am aware that the book has several shortcomings due to the complex and fast-changing nature of the subject. I take full responsibility for them, as well as for my personal comments on certain topics. Finally, I hope I have been able to keep to the standards I set for myself, which is to provide a simplified basic knowledge of the subject in a single book. Please email me your comments and any suggestions you have for improvements.

Roy Rohatgi
roy@itpa.org
July 2005

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ABOUT THE AUTHOR

Roy Rohatgi is an international business consultant, who advises on international taxation and strategic management. His professional experience over the last four decades includes an in-depth knowledge of international taxation in several countries. Roy retired as a London partner in the worldwide firm of Arthur Andersen after nearly 25 years in 1994. During this period with the firm, he worked as a partner based in Europe, the Middle East and India. In the eighties, he spent several years in India where he established and ran the Indian firm of Arthur Andersen as managing partner. Roy is a visiting professor in international taxation for the Masters of Law program at the St. Thomas University School of Law, in Miami, Florida. He is also the Academic Director of the Diploma Course in International Taxation developed and run by him in Mauritius. He is a member of the International Fiscal Association and the International Tax Planning Association. Since 1995, he has been the conference director of the International Tax Planning Conference, which he organises in Mumbai (India) each year in December. Roy is mentioned in the Debrett's "People of Today" in the United Kingdom.

CHAPTER 1

AN OVERVIEW OF INTERNATIONAL TAXATION

Note: The purpose of this chapter is to provide the reader with a broad overview of the book and its contents.

1. WHAT IS INTERNATIONAL TAXATION

International taxation refers to the global tax rules that apply to transactions between two or more countries (also called States) in the world. It encompasses all tax issues arising under a country's income tax laws that include some foreign element.

Taxes are not international. There is no separate global tax law that governs cross-border transactions. Moreover, there is no international tax court or administrative body for international tax issues. All taxes are levied under their domestic law by federal, national or local governments. These tax laws have an impact on cross-border transactions. International taxation governs these domestic tax rules under customary international law and treaties.¹

International taxation also supports other objectives of domestic tax systems. These objectives normally include measures:

- to promote fairness by imposing equal tax burdens on domestic and foreign taxpayers with equal income and ability to pay, regardless of the source of the income;
- to enhance domestic competitiveness through fiscal measures and to promote economic growth;
- to obtain a fair share of the revenues from cross-border transactions; and
- to ensure an equitable balance between capital export and capital import neutrality.

The principles of international taxation are influenced by tax equity and tax neutrality within the national economic sovereignty of each nation. Tax equity requires that the tax revenues from international economic activities be shared equitably by nations. It also requires that taxpayers involved in cross-border activities be neither discriminated against nor given undue preference in their tax burdens.

Tax systems are neutral when they do not influence the economic choices of taxpayers. They may be tax neutral either on capital export or on capital import (see Chapter 2(1.7)). Developed countries tend to favour capital export or domestic neutrality, under which the taxpayer's choices between investing at home or abroad remain unaffected (i.e. world efficiency). On the other hand, developing countries generally prefer capital import or

¹ Brian Arnold and Michael McIntyre, *International Tax Primer* (Kluwer Law International, 2002) pp. 2–7; Charles McLure, *Globalisation, Tax Rules and National Sovereignty* (IBFD Bulletin, August 2001) pp. 328–341.

Chapter 1

competitive neutrality to ensure that the investment decisions of domestic and foreign investors in their country are on par (i.e. national efficiency).

The fairness and efficiency of tax systems depend not on the tax laws of any one country, but on the cumulative effects of the tax laws of all countries. As there is little global tax harmonisation, domestic tax systems often conflict on cross-border transactions and lead to excessive taxation. Countries are at differing levels of social and economic growth with varying fiscal needs. Each country applies its own taxing rules to transactions connected with its jurisdiction. The lack of a common view on international tax principles creates economic distortions and also encourages international tax competition.²

International taxation attempts to resolve these conflicts through the principles of enforceability and reciprocity. Countries may have unlimited rights of taxation over a person or object but they cannot normally enforce them outside their own jurisdiction. Therefore, they must respect the reciprocal taxing rights of other countries and co-operate with them to evolve rules of taxation that meet their mutual fiscal objectives.

2. INTERNATIONAL TAX CONFLICTS AND DOUBLE TAXATION

Each country exercises its own taxing rights under its domestic tax law. Where a taxpayer is subject to taxation on cross-border transactions in more than one jurisdiction he generally ends up with a higher tax liability than he would incur on similar transactions carried out wholly at home. In many cases, he is liable to double (or even multiple) taxation as a result of conflicting taxing rights.

This double taxation may be economic or juridical. Economic double taxation arises in international taxation when the same economic transaction, item or income is taxed in two or more States during the same period, but in the hands of different taxpayers. In juridical double taxation, two or more States levy their respective taxes on the same entity or person on the same income and for identical periods.

Double taxation is generally accepted as an impediment to international trade and investment, and an objective of international tax is that it should be avoided. It is initially addressed through appropriate domestic tax legislation. Many countries provide unilateral relief to avoid or minimise double taxation under their domestic laws. This relief could be a tax exemption or a tax credit or, as a minimum, an expense deduction for the foreign taxes paid. However, double taxation could still arise as a result of a difference of opinion between countries on basic taxing principles and taxing rights. Therefore, domestic measures are useful but may be inflexible and insufficient. These international tax conflicts are usually addressed through tax treaties (also called double taxation avoidance agreements or DTAAAs).

Tax treaties are governed by the principles laid down under the Vienna Convention on the Law of Treaties (VCLT). They are negotiated under international law as legally binding

² At present, countries do not follow a common definition of tax base and provide different deductions and incentives at varying tax rates to taxpayers. Moreover, a return on an investment can be realised through different forms of income (e.g. branch profits, dividends, interest, rent, royalties, etc.) with different tax consequences.

An Overview of International Taxation

State to State agreements signed by two or more countries (called “Contracting States” under the treaty). It is estimated that there are more than 2,500 bilateral treaties and protocols that modify or supplement them, in existence today. Due to their complexity, multilateral treaties are not common.

3. DOUBLE TAX TREATIES

Double tax treaties generally avoid and reduce the burden of juridical double taxation “in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods”.³ They confer rights and impose obligations on the Contracting States.⁴ Their primary objective is to limit the taxes that can be levied by the Contracting States under their domestic tax law. The Contracting States allocate the taxing rights under a contractual agreement and then require that the residence State grants double tax relief if it arises.

Tax treaties contain special provisions to enable the “competent authorities” of the States involved to resolve international tax differences. These disputes could arise from differing interpretations of tax terms, inconsistent tax positions on transactions or the status of the taxpayer, or an attempt by a Contracting State to recover an excessive share of tax revenue. Tax treaties also protect taxpayers from unfair tax discrimination on cross-border trade and investments. Moreover, they allow the exchange of information on tax matters between the national revenue authorities to curb international tax evasion.

Essentially, tax treaties involve a negotiated sharing of the tax revenues by two States. In developed countries with comparable tax systems, the treaty rules usually lead to a balanced sharing of tax revenues. In developing countries, however, these negotiations may be governed by economic and social factors as well as revenue considerations. Many of them promote capital, labour and technology flows through fiscal measures, such as tax exemptions and allowances. The tax due in the home country may be “spared” under a treaty as a special concession for them to retain the tax benefit of these incentives.

Diamond and Diamond⁵ list over 20 different types of tax treaty. As well as comprehensive DTAAAs on income and capital, the list includes treaties on inheritance, estates and gifts, and treaties on administrative assistance in tax matters. In addition, several countries have separate limited bilateral treaties for shipping and aircraft activities. Many groups of countries have also signed multilateral treaties to coordinate their tax policies and promote regional economic development.

This book deals only with comprehensive bilateral double tax treaties on income and capital. Nearly all of them today follow the internationally accepted format prescribed either by the Committee on Fiscal Affairs of the Organisation for Economic Co-operation and Development (**OECD Model**), or the version recommended by an Ad Hoc Group of Experts

³ OECD Model Convention: Introduction, para. 1.

⁴ In a bilateral treaty, the Contracting States are the source State (also called “host country”), where the income is derived from, and the residence State (also called “home country”), where the taxpayer has his tax residence.

⁵ Walter H Diamond and Dorothy Diamond, *Tax Havens of the World* (Matthew Bender).

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on International Co-operation in Tax Matters⁶ appointed by the United Nations (**UN Model**). These Model Conventions contain standard Articles with detailed Commentaries to assist both in the bilateral negotiations and in their subsequent application and interpretation.

4. DOMESTIC TAX SYSTEMS

The starting point for any study of international taxation is a broad knowledge and understanding of the domestic tax rules in various countries. Domestic tax law governs the tax rate, what is taxable, how the taxable income is computed and the tax compliance rules. It is essential to know the tax rules and how the rules are applied on cross-border transactions in a given country.

Under domestic tax laws, a tax liability arises in a country only if there is a connection between the tax jurisdiction and either the taxpayer (“tax subject”) or the taxable event (“tax object”). These connections include factors such as the tax residence of the taxpayer, the source of income, the place where the income is earned or derived, or the location of the asset. The definitions of residence and source are contained in the domestic law and often differ among countries.

As national tax systems, laws and practices are not harmonised, they can and do often conflict. Moreover, they may not be clearly expressed and may be subject to differing interpretations. For example, the meaning of the same terms and expressions may differ from one country to another. These conflicts lead to double taxation and normally require tax treaties both to avoid them and to provide relief, if needed.

Double tax treaties generally override domestic law. They are internationally binding obligations between sovereign States (not taxpayers) under public international law. However, once accepted as “the law of the land”, they are enforceable as part of domestic law. Many tax jurisdictions allow taxpayers to choose between the treaty and the domestic law provisions, whichever is the more advantageous to them.

5. INTERNATIONAL OFFSHORE FINANCIAL CENTRES

International finance centres provide a wide range of global financial services (tax and non-tax). Although tax mitigation is not the prime objective in many cases, international financial centres provide tax benefits in offshore transactions (i.e. transactions undertaken outside the country of an individual or an organisation). For example, they permit international investors to form tax-beneficial intermediary entities in their tax jurisdiction for various business objectives. These entities may act as holding companies managing the overseas investments and activities of a multinational enterprise, or they may only accumulate capital lawfully for reinvestment abroad.

Besides traditional “offshore” centres (also called tax havens) based in small islands, international financial centres for use by foreign taxpayers are also found in major “onshore” countries with highly developed economies. Since they provide similar services, they are

⁶ The Group was renamed in November 2004 by the Economic and Social Council of the United Nations (ECOSOC) as the Committee of Experts on International Co-operation in Tax Matters.

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sometimes termed “non-traditional offshore centres” or “preferential tax regimes”. These countries have special tax incentives for non-residents. Today, the difference between onshore and offshore financial centres has become blurred.

The range of offshore centres available makes their selection difficult. Besides tax, it entails several practical and commercial considerations. An ideal location should provide for no tax on capital gains and corporate income and nil withholding taxes on outgoing payments. In addition, there must be favourable tax treaties to reduce withholding taxes on the receipt of income from host countries. However, international financial centres should also possess certain non-tax advantages, such as freedom from exchange controls and a safe business infrastructure. Unfortunately, no country in the world meets all these requirements.

The global flow of capital, investment and trade in a fast changing world today requires businesses to respond quickly to meet international competition and exploit emerging opportunities. Onshore governments have various limitations that restrict their ability to react quickly to these international market changes. The offshore industry fulfils this international business need. Over half the world’s financial transactions today take place offshore and this upward trend is likely to continue.

6. ANTI-AVOIDANCE MEASURES

Tax authorities are increasingly concerned with the loss of their share of domestic and global tax revenues to other countries through unacceptable tax avoidance schemes. Most countries have anti-avoidance rules under their domestic law or judicial practices, and sometimes also in their tax treaties. These measures under domestic law include “substance over form” doctrine to prevent sham transactions, and the commercial justification rule under the “business purpose test”. In particular, they require that transactions should not have tax saving as their only or dominant purpose.

Some of the other anti-avoidance measures affecting cross-border transactions include:

- **Transfer pricing rules:** several countries have established detailed regulations to ensure that the transfer pricing on cross-border transactions between related entities is acceptable. Many of them follow the guidelines provided by the OECD. These rules require that transactions are bona fide and undertaken on an arm’s length basis.
- **Antihaven or antideferral measures:** many OECD countries today have controlled foreign corporation or “CFC” rules in their domestic law. These measures prevent companies from avoiding current taxation in the residence State through the accumulation of taxable income abroad, particularly in low tax jurisdictions. Since domestic law cannot tax foreign income until it is received or remitted, they effectively extend the residence rules to tax passive income retained overseas by their residents, on a current basis.
- **Thin capitalisation rules:** these rules prevent financing structures with high debt–equity ratios. Interest expense is tax deductible, whereas dividend payments are not. Therefore, high debt–equity ratios can reduce taxation on business profits. Under these rules, interest payments in thinly capitalised companies is disallowed and even taxed as constructive dividends.

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- **Antitreaty shopping provisions:** treaty shopping allows the unintended use of tax treaties by third-country residents. It makes bilateral treaties effectively “treaties with the world”, and leads to a loss of tax revenues in the source State. Some countries have specific anti-treaty shopping provisions in their domestic law, and sometimes contain Limitation on Benefits provision in their treaties to counter unintended treaty shopping.⁷
- **Exchange of information:** tax treaties provide for the exchange of information between the tax authorities of Contracting States. They allow tax information to be shared in suspected cases of tax avoidance and evasion. This exchange may be on request or spontaneous.

7. INTERNATIONAL TAX PLANNING

As mentioned above, international taxation deals with the rules applicable to cross-border transactions in various tax jurisdictions. International tax planning combines these transactions in the most tax-efficient structure within the law through the knowledge of international taxation. The primary objective of international tax planning is to minimise or defer global taxes lawfully to meet the desired business and other objectives of such transactions.

Tax planning may be defensive or offensive. As cross-border transactions entail taxation in more than one country, the former attempts to minimise the risks of paying excessive tax due to double or multiple taxation on the same income and taxpayer. Offensive tax planning deals with tax planning strategies that lawfully optimise the after-tax income and capital flows of a transaction as it travels from the overseas source State (“host country”) to the residence State (“home country”) of the taxpayer. These plans consider the transaction costs, the management structure, business risks as well as the relevant anti-avoidance measures.

The best tax schemes may not necessarily result in a low fiscal burden in absolute terms, but they should help to reduce the global incidence of taxation, as compared to the taxes levied separately by the countries involved. Therefore, the role of the international tax advisor varies widely depending on the nature of the cross-border transaction and how it is affected by the domestic laws (including tax law) and tax treaties of the countries involved.⁸

Judge Learned Hand in a famous tax case in the United States commented: “Anyone may arrange his affairs so that his taxes shall be as low as possible; he is not bound to choose that pattern which best pays the treasury. There is not even a patriotic duty to increase one’s taxes. Over and over again the Courts have said that there is nothing sinister in so arranging affairs as to keep taxes as low as possible. Everyone does it, rich and poor alike and all do right, for nobody owes any public duty to pay more than the law demands”.⁹

⁷ Treaty shopping may also be intended. Some source countries (particularly developing countries) permit loss of tax revenues through treaty shopping for non-tax reasons.

⁸ Brian Arnold and Michael McIntyre, *International Tax Primer* (Kluwer Law International, 2002) pp. 7–11.

⁹ Judge Learned Hand (1872–1961), Judge, US Court of Appeals, in the case of *Gregory v Helvering* (1935), 69F 2d 809 (US).

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8. STRUCTURE OF THE BOOK

The book discusses each of the above issues in international taxation under separate chapters, as follows:

Volume I: Principles of International Taxation

- **Chapter 1: Overview of International Taxation**
- **Chapter 2: Principles of International Tax Law**
- **Chapter 3: Model Tax Conventions on Double Tax Avoidance**
- **Chapter 4: Impact of Domestic Tax Systems**
- **Appendix Glossary of International Tax Terms**
- **Exhibits Model Tax Treaties (text only)**

Volume II: Practice of International Taxation

- **Chapter 5: Basic Principles of International Tax Planning**
- **Chapter 6: Anti-avoidance Measures**
- **Chapter 7: International Financial Centres**
- **Chapter 8: Some Current Issues in International Taxation**
- **Chapter 9: National Tax Systems (selected countries)**

There are some excellent books on the elements of international taxation. However, most of the literature deals with detailed and advanced aspects of the subject. This book is an attempt to provide a broad knowledge of the basic principles of international taxation in two volumes for a lay professional or student. Its content is based on a wide range of largely secondary sources, including specialist research studies, books and professional articles.

The study and practice of international taxation is more complex than that of domestic law. Therefore, the book is written in a textbook format with various country examples. Such a book must inevitably limit the extent of the detailed information it provides to keep it to a reasonable size. The subject has also been simplified to allow readers to understand the concepts and to conduct additional study and research on their own.

The references made in this book to tax laws and practices in various countries are given as examples of tax principles. They do not provide a complete description of tax systems or practices. Moreover, the country examples are not meant to be detailed or comprehensive. They have been provided primarily as illustrations to allow the reader to acquire a better understanding of the international tax principles. The book is not written from the perspective of any particular country, or reader. It has attempted to provide an objective view of the responsibilities of the tax authorities, as well as the rights of taxpayers.

As mentioned in the preface, despite the care taken to check the tax systems in various countries, it is not possible to guarantee the accuracy of the content in the book due to the frequent changes in tax laws and tax practices. The reader should not rely on this book when entering into any business transactions. No book, not even a weekly updated loose-leaf service, can be a substitute for the use of local professional advisors, who know how to interpret and apply the latest tax rules in their jurisdiction.

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Finally, this book is not intended to be comprehensive or definitive. It is confined largely to direct corporate taxes levied on companies or corporations, and deals with the basic principles and practices of international taxation. Although it is not meant to be an advanced text on international taxation, it should not be regarded as an elementary book on the subject.

9. SUGGESTED FURTHER READING

9.1. Books

Ault, Hugh et al, *Comparative Income Taxation: A Structural Analysis* (Kluwer Law International, 2004)
Arnold, Brian J. and McIntyre, Michael J., *International Tax Primer* (Kluwer Law International, 2002).
Graetz, Michael, *Foundations of International Income Tax* (Foundation Press, 2003).
Larking, Barry, *International Tax Glossary* (IBFD Publications, 4th edn., 2002).
Lymer, Andrew and Hasseldine, John, *The International Tax System* (Kluwer Academic Publishers, 2003).
Shelton, Ned, *Interpretation and Application of Tax Treaties* (Lexis Nexis UK, 2004).
Spitz, Barry, *International Tax Havens Guide 2003* (Aspen Publishers, 2003).
Thuronyi, Victor, *Comparative Tax Law* (Kluwer Law International, 2003).

9.2. OECD publications

The Committee on Fiscal Affairs of the OECD has also published several reports on specific international tax issues. Several of these reports are now contained in the *Model Tax Convention on Income and Capital*, Vol. II, published by the OECD. The reports include:

- 1979 *Transfer Pricing and Multinational Enterprises*
- 1981 *Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims*
- 1984 *Transfer Pricing and Multinational Enterprises: Three Taxation Issues*
 - Mutual Agreement Report
 - Multinational Banking Report
 - Allocation of Costs Report
- 1985 *Trends in International Taxation*
 - Equipment Leasing Report
 - Container Leasing Report
 - Hiring of Labour Report
- 1987 *Issues in International Taxation No. 1: Four Related Studies*
 - Tax Havens Report
 - Base Companies Report
 - Conduit Companies Report
 - Bank Secrecy Report
- 1987 *Issues in International Taxation No. 2*
 - Thin Capitalisation Report
 - Taxation of Entertainers, Artistes and Sportsmen
 - Exchange Gains and Losses Report
- 1989 *Tax Treaty Override Report*

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- 1992 *Model Tax Convention: Four Related Studies*
 - 183 Day Rule Report
 - Triangular Cases Report
 - Software Report
 - Contributions Report
- 1993 *Transfer Pricing Report*
- 1994 *Attribution Report*
- 1995 *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (“1995 Guidelines”)
- 1996 *Tax Treaties: Linkages Between OECD Member Countries and Dynamic Non-Member Economies Controlled Foreign Company Legislation*
- 1997 *Taxing International Business* (edited by Richard Vann)
- 1998 *Tax Sparing Harmful Tax Competition The Taxation of Global Trading of Financial Instruments*
- 1999 *The Application of the OECD Model Tax Convention to Partnerships*
- 2000 *Issues Related to Article 14 of the OECD Model Tax Convention Towards Global Tax Co-operation Improving Access to Bank Information for Tax Purposes*
- 2001 *Taxation and Electronic Commerce Taxing Insurance Companies*
- 2003 *2002 Reports Related to the OECD Model Tax Convention*

9.3. Journals and periodicals

The best sources for the further study of current international tax issues and new developments are the various international tax journals and periodicals published worldwide. Some of the best-known journals are:

International Fiscal Association, the Netherlands

- *Cahiers* (two volumes published annually)

Kluwer Law International, the Netherlands

- *EC Tax Review*
- *Intertax*
- *International Tax and Public Finance*

International Bureau of Fiscal Documentation, the Netherlands

- *Bulletin*
- *European Taxation*
- *Asia Pacific Tax Bulletin*
- *Transfer Pricing Journal*
- *Tax News Service*
- *Tax Treaty Database*

Bureau of National Affairs Inc., the United States and the United Kingdom

- *Tax Management International Journal*
- *Tax Planning International Review*
- *Tax Management International Forum*
- *Journal of International Taxation*
- *Indirect Taxes*

Euromoney Publications plc., the United Kingdom

- *International Tax Review*

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Monitor Press Ltd, the United Kingdom

- *International Tax Report*
- *International Tax Digest*

Tax Analysts, the United States

- *Tax Notes International*
- *Worldwide Tax Treaties*

Campden Publishing Ltd, the United Kingdom

- *Offshore Red*
- *OFC Report*

European Magazine Services Ltd, the United Kingdom

- *Offshore Investment*

9.4. Websites

One of the easiest and cheapest ways these days to access international tax data is on the Internet. Although there is often a concern that many of the websites have not been updated, a careful search on the Internet for international tax links and websites can be very rewarding.

There are several excellent websites on international taxation. Most international tax journals have their past issues on their website. The websites of the tax authorities in many countries provide information on the changes in their tax laws and procedures. In addition, the websites on country tax data and practices are provided by several local and international professional firms.

I have provided below some examples of websites. If you find other useful sites, please email their URL address to me on roy@itpa.org.

General

American Bar Association (Tax Section) - <http://www.abanet.org/tax/home.html>

CIOT overseas taxes - <http://tax.org.uk/misc/overseas.html>

Foreign and international taxation - <http://taxtopics.net/foreign.htm>

International tax websites - <http://www.uktax.demon.co.uk/intltax.htm>

International tax resources - <http://www.taxworld.org/OtherSites/International/international.htm>

International Taxworld - <http://www.taxworld.org/OtherSites/International/international.htm>

Low tax website - <http://www.lowtax.net/>

Low tax jurisdictions - <http://www.lowtax.net/lowtax/html/jurhom.html>

Tax and accounting sites directory - <http://www.taxesites.com/>

Tax up website - <http://www.taxup.com/>

UK accounting web (go to index and click international tax) - <http://www.accountingweb.co.uk/news/stories/135/13447.html>

Electronic commerce

E-Commerce in the European Union - <http://www.bmck.com/ecommerce/eu.htm>

E-Commerce special reports - <http://www.offshore-e-com.com/html/spec.library.html>

E-Commerce Ready for Action - <http://www.offshore-e-com.com/html/spec.econjurs4.html>

International Taxation of Electronic Commerce - <http://www.components-online.com/Ecommerce/Taxation/>

Offshore E-Commerce Links -

<http://www.offshorepress.com/osecomlinks.htm>

<http://www.offshore-manual.com/free22.html>

Glossary of terms

Find Law - <http://www.findlaw.com>

International Tax Glossary (IBFD) - <http://join.ibfd.nl/Taxglossary/>

Glossary of Tax Terms - <http://www.offshorebible.com/cp10c.html#C>

Government tax websites

Australian Tax Office - <http://law.ato.gov.au>

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Irish Tax and Customs - <http://www.revenue.ie/>
Ministry of Economy, Finance and Industry, France - <http://www.finances.gouv.fr/>
New Zealand Inland Revenue - <http://www.ird.govt.nz/>
Tax and Customs Administrations - <http://www.taxmaninternational.tk/>
Taxation in South Africa - <http://www.sars.gov.za/it/brochures/brochure.tax.in.sa.htm>
Taxation in the Netherlands - <http://www.minfin.nl/DEFAULT.ASP?CMS.ITEM=MFCR3713314F2708211D5BFFF00104B3FBE32>
UK Revenue and Customs - <http://www.hmrc.gov.uk/>
US Internal Revenue Service - <http://www.irs.ustreas.gov/>

International tax journals and newsletters

AMS Group weekly newsletter - <http://amsbvi.com>
BNA International - <http://www.bnai.com>
E-Commerce News - <http://www.tax-news.com/asp/newsecn.asp>
International Tax Review - <http://www.legalmediagroup.com/internationaltaxreview/>
Investors Offshore - <http://www.investoroffshore.com>
KYC News, Bermuda - <http://www.offshorebusiness.com/>
Mondaq Newsletter - <http://www.mondaq.com/>
Offshore Investment - <http://www.offshoreinvestment.com/>
Offshore News Online - <http://www.offshoreon.com/>
Tax Analysts - <http://taxbase.tax.org/>
Tax News - <http://www.tax-news.com>

Legal

Australasian Legal Information Institute - <http://www.austlii.edu.au>
Directorate of International Law - <http://www.eda.admin.ch/sub.dipl/e/home.html>
Findlaw - <http://www.findlaw.com/>
European Union laws - <http://europa.eu.int/eur-lex/en/lif/reg/en.register.092020.html>
International Law (UN) - <http://www.un.org/law/>
International Law Library - <http://www.lawguru.com/ilawlib/81.htm>
International Law Commission (UN) - <http://www.un.org/law/ilc/texts/treatfra.htm>
International treaties - <http://www.lawresearch.com/v2/citreaty.htm>
Law related journals - <http://stu.findlaw.com/journals/tax.html>
The Law Library - <http://www.waikato.ac.nz/library/resources/law/>
Law Research - International Tax Law by Country - <http://www.law-library.info/page/tax-international.htm>
Lex Mercatoria (US International Taxation) - <http://www.jus.uio.no/lm/tax.and.financial.regulation/tax.html>
Internet Law Library Laws of other Nations - <http://www.lawguru.com/ilawlib/52.htm>
Lextric Law Library - <http://www.lectlaw.com/tibz.htm>
Programmes for Wealth International - <http://www.progs4wealth.com/useful.htm>

Offshore centres

Money Net International - <http://www.moneynet-offshore.com/ber.legal.lawyers.shtml#>
Offshore Centres - <http://www.angloirishbank.co.im/taxcorporate/tax/index.html>
Offshore Information Centre - <http://www.offshoretaxinfo.com/>
Offshore World - <http://www.offshore-world.com/index2.htm>
Selecting an offshore company - <http://www.offshore-companies.com/jurisdiction.html>

Private organisations/Professional firms

Appleby, Spurling & Hunter, Bermuda - <http://www.ask.bm/>
Cross-border tax and transactions - <http://www.crossborder.com/>
International and expatriate Tax sources - <http://www.homeworkersexpats.com/expattax2.htm#Netherlands>
OCRA - <http://www.ocra.com/>
International Fiscal Services (UK) - <http://www.interfis.com/pages/whatwedo.asp>
KPMG Taxation of International Executives (countrywide data) - <http://www.us.kpmg.com/microsite/GlobalIES/TIES/index.html>
Maples & Calder, British Virgin Islands - <http://www.maplesandcalder.com/index.cfm>
PricewaterhouseCoopers - <http://www.pwcglobal.com/>

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Nishith Desai Associates, India - <http://www.nishithdesai.com>

Sovereign Group - <http://www.sovereigngroup.com/>

Public organisations

European Union - http://www.europa.eu.int/comm/internal_market/en/company/company/official/index.htm

Federation of International Trade Associations - <http://www.fita.org/aotm/0700.html>

Institute of Taxation in Ireland - <http://www.taxireland.ie/>

ICAEW international tax links - <http://www.icaew.co.uk/librarylinks>

International Bureau of Fiscal Documentation - <http://www.ibfd.nl/>

International Fiscal Association - <http://www.ifa.nl/>

International Tax Community - <http://www.taxcommunity.com/>

International Tax and Investment Organisation - <http://www.itio.org/>

International Tax Planning Association - <http://www.itpa.org/>

NAFTA Resources - <http://lanic.utexas.edu/la/Mexico/nafta/>

NYU Law - http://www.law.nyu.edu/library/foreign_intl/taxint2001.html

New York State Society of CPAs - http://www.nysscpa.org/useful_links/international_tax.html

Organisation for Economic Co-operation and Development - <http://www.oecd.org/taxation>

Royal Society of Fellows - <http://www.royalfellows.org/>

Tax Institute of Australia - <http://www.taxinstitute.com.au/>

United Nations (Committee of Experts on International Co-operation in Tax Matters)-

<http://www.un.org/esa/ffd/ffd taxation.htm>

United Nations Websites - <http://docs.lib.duke.edu/igo/guides/unindex.html>

United Nations tax publications and reports - http://www.unpan.org/analytical_report.asp

University of Sydney - <http://setis.library.usyd.edu.au/oztexts/parsons.html>

World Fact Book CIA information - <http://www.cia.gov/cia/publications/factbook/index.html>

CHAPTER 2

PRINCIPLES OF INTERNATIONAL TAX LAW

Note: The purpose of this chapter is to provide the reader with a broad knowledge of some of the concepts of international tax law, including treaties and regional tax agreements. It is not meant to be comprehensive.

1. INTERNATIONAL TAX LAW

1.1. Definition

According to Article 38(1) of the Statute of the International Court of Justice, the sources of public international law are (a) international conventions establishing rules expressly recognised by states, (b) international custom, as evidence of a general practice accepted as law, (c) the general principles of law recognised by civilised nations, and (d) certain judicial decisions and legal teachings.

Public international law governs the relations between States, and determines their mutual rights and obligations. It is based on international agreements and general international law. It is the body of law comprising the principles and rules of conduct that States feel themselves bound to observe and therefore commonly observe in their relationships. Although these rules primarily govern the relations of States, international organisations, and to some extent individuals may also be the subject of the rights conferred and duties imposed by public international law.¹

General international law comprises customary international law and the general principles of law. While customary international law refers to the international practice of States, the general principles relate to international aspects contained in their domestic laws. Customary international law is based on the common view of States on certain matters along with the belief that it is obligatory.² It tends to be more general and harder to establish given the large number of nations in the world and the difficulty of pinpointing the precise moment in time when it comes into being.³ Customary laws may (or may not) be codified through treaties.

1 Robert Jennings and Arthur Watts, *Oppenheim's International Law*, 9th Edition (Longman Group, 1992); J.G. Starke, *Introduction to International Law*, 10th Ed. (Butterworths, 1989) p. 3.

2 Ramon J. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation* (Kluwer Law International, 1999) p. 28.

3 According to Jennings, "the practice of states in this context embraces not only their external conduct with each other, but is also evidenced by such internal matters as their domestic legislation, judicial decisions, diplomatic despatches, internal government memoranda, and ministerial statements in parliament and elsewhere". See Jennings (1992) p. 27.

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International tax law refers to the principles derived from public international law that deal with tax conflicts involving cross-border transactions. These principles are based on the international tax aspects contained in the domestic tax law and the customary practices of countries, and tax treaties. With minor exceptions, tax laws are not “international”.⁴ Besides tax treaties, there are no overriding international laws of taxation that are enforceable on taxing States.

The sources of international tax law include:

- Multilateral international agreements, e.g. the Vienna Convention on the Law of Treaties, secondary law of international communities of States, mutual agreement procedures for equitable settlement of conflict of legal systems.
- Comprehensive bilateral double tax treaties, e.g. treaties and protocols, exchange of letters and notes, memoranda of understanding, and supplementary administrative agreements.
- Limited bilateral double tax treaties, e.g. reciprocal declarations, specific treaties on shipping and airlines, death duties and taxes on gifts.
- Customary international law and general principles of law, e.g. the principles of law recognised by civilised nations in their national legal systems, statute law, customary law and judicial decisions, and the practices of international organisations.⁵

1.2. Double Taxation

International tax law governs the taxing rights of sovereign nations. These rights depend on their fiscal jurisdiction. Each country has sovereign rights within its fiscal jurisdiction. Therefore, the substance of State sovereignty is jurisdiction, or the scope within which the effective and acceptable power of the State can be exercised. It is the “right to exercise (in regard to a portion of the globe) to the exclusion of any other State the functions of a State” (*Island of Palmas v USA, 1928*).⁶ The term “fiscal jurisdiction” refers to both (i) the right of legislation and (ii) the right of enforcement. A State cannot enforce what it cannot legislate. However, the reverse may be true. A State may legislate, even when it is unable to enforce.

There are two schools of thought on fiscal jurisdiction based on differing perceptions of State sovereignty. The first believes that there is no restriction on the State’s right to tax, and that it may be exercised without regard to other States.⁷ It is, therefore, not necessary to have a legal connection or link with a jurisdiction, provided there is a valid nexus with that State. The other school maintains that the sovereign right to tax is confined to a territory having a “legally relevant connection” between the State and the taxpayer.⁸

Although the issue is still unsettled, both views accept that “connecting factors” give a State the right to tax. These connecting factors link the taxpayer personally to a particular

4 Brian Arnold and Michael McIntyre, *International Tax Primer* (Kluwer Law International, 2002) pp. 2–7.

5 Asif H. Qureshi, *The Public International Law of Taxation* (Graham and Trotman, Martinus Nijhoff, 1994) pp. 1–9.

6 Sol Picciotto, *International Business Taxation* (Weidenfeld and Nicholson, 1992) p. 307.

7 Lotus case (1927): Since international law emanates only from the free will of States, they are free to assert any jurisdiction not explicitly prohibited by formal international agreements or a generally agreed positive principle.

8 Asif H. Qureshi, *The Public International Law of Taxation*, pp. 22–125.

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tax jurisdiction. They include personal links with the home State by virtue of residence, domicile or citizenship for natural persons, and the place of incorporation or location of a registered office, or management and control for legal persons. An economic activity is also connected with the host State, which exercises its taxing rights due to the territorial link.

The domestic laws in countries normally apply the following international tax principle, based on connecting factors:

- **Residence rule:** Unlimited taxation rights are granted to the country of residence, due to the “personal attachment” of persons. The country of residence (or nationality) may impose its taxes on the worldwide income of individuals or corporations due to the protection it offers to the tax subject.
- **Source rule:** Limited taxation rights are granted to the country of source due to the “economic attachment” of persons. The country of source reserves the right to tax the income that is derived from the economic activities within its territory.

Under the “economic attachment”, both States are entitled to tax income arising in their tax jurisdiction. The primary taxing rights remain with the country where the income is earned, i.e. the source State. No tax conflicts should normally arise if all States followed a territorial tax system and restricted their taxing rights to income arising in their own fiscal jurisdiction. However, the residence State retains its worldwide taxing rights to tax the foreign source income of its residents under the “personal attachment”. Tax conflicts arise largely (but not only) due to this right of the residence State that subjects its residents to tax on their foreign source income.⁹

As double taxation is generally considered undesirable, one of the objectives of international tax principles is to ensure that income is not taxed twice.¹⁰ There should be no need for these principles if every person or source of income were subject to tax in one State only. However, under various domestic laws the tax revenues on the same activity may be shared or the same income taxed by two countries. The sharing of income differs from tax overlaps. The term “double taxation” implies “over-taxation” due to overlapping taxing rights. Double or multiple taxation issues arise when the connecting factors grant competing taxing powers to two or more States on the same income.

International double taxation may be economic or juridical. Economic double taxation refers to a double tax on the same income in the hands of different persons (Examples: husband and wife, partnership and partners, company and shareholder, parent and subsidiary, etc.). The same tax object is taxed on legally different but economically similar or connected subjects in two jurisdictions (“economic identity of subject”). Juridical double taxation deals with the same tax object and the same tax subject. It is the imposition of comparable taxes by two or more States on the same taxpayer in respect of the same subject matter and for identical periods (“legal identity of subject”).

Juridical double taxation is the result of a conflict between two tax systems. It arises due to the overlapping claims of tax jurisdictions on interrelated economic activities. The

⁹ Double taxation may also arise due to other tax conflicts (see Chapter 2(1.3)).

¹⁰ Stef van Weeghel, *The Improper Use of Tax Treaties* (Kluwer Law International, 1998) p. 33.

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competing powers of fiscal sovereignty lead to double (or multiple) taxation in two or more jurisdictions; alternatively, it can lead to double tax exemption, i.e. non-taxation. International tax law is primarily concerned with juridical (i.e. based on jurisdiction) double taxation.

Although the domestic tax systems in most countries provide for unilateral relief, juridical double taxation conflicts are largely resolved through tax treaties negotiated under the principles of international tax law accepted by sovereign States. Through their distributive rules that avoid double taxation and relief methods when it does arise, they ensure a fair distribution of global tax revenues among nations (inter-nation equity). They also attempt to achieve global tax neutrality where tax issues do not affect the economic choices of taxpayers on international transactions.

1.3. Connecting Factor Conflicts

As mentioned above, double taxation issues arise due to tax conflicts when the connecting factors grant competing taxing powers to two or more States on the same income. For a tax liability to arise, there must be a taxable event on which a State can exercise its taxing rights, and there must be a person who is liable to pay the tax. Moreover, the two must have some connection with the taxing jurisdiction to be subject to its tax laws. Therefore, the three key components of any taxable transaction are:

- (i) **Tax subject:** the identity of the taxpayer, or a person's relationship to the taxed object that creates a tax liability;
- (ii) **Tax object:** the identity of the subject matter, or the facts that cause the tax liability; and
- (iii) **Connecting factor:** there must be a "reasonable connection" between the taxing powers of the State, and the taxpayer or the transaction. Without a connecting factor between either the taxpayer or the business activity and the tax jurisdiction, a State cannot levy its tax.

Each country follows its own tax practices under its own legal system, and defines the connecting factors under its own laws. As a result, different countries apply differing definitions of taxable entities and taxable events, and then use varying bases for computing the tax under their own tax accounting rules. For example:

- (a) More than one country may claim an item of income or gain as taxable within its jurisdiction. The tax residence of a company may be based on the country of incorporation or management. An individual may be resident in more than one tax jurisdiction. The tax rules in the residence country may not coincide with those applied in the source country.
- (b) Different jurisdictions may characterise a taxpayer differently under their domestic law. For example, a partnership may be fiscally transparent in one State and a taxable entity in another State.
- (c) The meaning of terms (such as income tax, total income, residence, domicile, immovable property, permanent establishment), and the characterisation of transactions may vary in different countries.

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These varying definitions lead to connecting factor conflicts, such as:

- Source-Source conflicts: two or more countries claim the same income of a taxpayer as sourced in their country.
- Residence-Residence conflicts: two or more countries regard the same taxpayer as tax resident in their country.
- Residence-Source conflicts: the same income is taxed twice, first by the country where it is derived under its “source rules”, and then in the country where the taxpayer resides under its “residence rules”.
- Income characterisation conflicts: two States characterise or classify the same income or capital differently and, therefore, apply differing tax provisions.
- Entity conflicts: an entity is characterised differently under the domestic laws of the two States and, therefore, it is subject to differing taxation.
- Mismatching tax systems: the two tax systems provide for differing rules for assessment, definition of taxable income, or computation of taxes.¹¹

The most common form of juridical conflict in international taxation relates to the Residence-Source taxation. A taxpayer satisfies a tax relationship in two States simultaneously. The unilateral tax rules under domestic law may relieve such tax conflicts, but tax treaties normally give a more favourable treatment. Other situations usually require the assistance of specific provisions under tax treaties.

1.4. Dual Role of Treaties

A treaty is an agreement between sovereign nations. Negotiated treaties frequently contain additional supporting data that form an integral part of the treaty, such as protocol, exchange of letters, or memorandum of understanding. A protocol is a treaty by itself that amends or supports the existing treaty. The exchange of letters clarifies the treaty provisions and forms part of the treaty. They differ from a memorandum of understanding, which may or may not be binding.

Under international law, tax treaties carry the obligation to ensure that they have the force of domestic law. Some countries follow the monistic principle, under which the municipal law is linked and subordinated to the international law under the “doctrine of incorporation”. Other countries follow the dualistic principle, which regards the international and municipal laws as separate and requires a specific domestic legislation under the “doctrine of transformation”. Each State is free to decide its approach under its own constitutional laws to comply with its international obligations.

Thus, there are two groups of countries, as follows:

- (i) **Direct effect:** treaties are self-executing and automatically become a part of the domestic law when they are ratified.¹² The monistic principle provides that they are enforceable under domestic law without further legislation. In some countries, they

¹¹ The same income may be subject to different tax systems. For example, tax on death may be taxed as estate duty or as capital gains tax. Similarly, social security tax under FICA (Federal Insurance Contributions Act) is an employment tax in United States but an income tax in Australia.

¹² Examples: France, Japan, Luxembourg, Netherlands, Portugal, Spain, Switzerland.

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require a formal or procedural executive or legislative act to incorporate them into domestic law.¹³

(ii) **Indirect effect:** treaty provisions must be enacted into domestic law and require special legislative steps.¹⁴ The Courts cannot enforce the treaty provisions until they are “transformed” into municipal law, usually by a legislative act or delegated legislation.

Under this dualistic doctrine, it is usually the related statute, and not the treaty, which has the legal authority under the domestic law.

Tax treaties are binding on the tax authorities and taxpayers under domestic law, once they become part of it, either by incorporation or transformation under its law. Its provisions are then enforceable and the taxpayer has rights and obligations under the treaty. The domestic Courts in the tax jurisdictions concerned can enforce them. The Courts must also respect the national obligations of the State under an international agreement.

The treaty’s “final provisions” govern the timing (See Chapter 2(2.2)). This provision allows for the required legislative and administrative action and ensures that the new tax rules apply from the beginning of an income tax year. The dates when the treaty enters into force and when it is enforceable under domestic law may differ from the effective date under the treaty itself. There can be different dates for each country and even different dates for different taxes in each country. Generally, retrospective application of the new treaty provisions is not permitted if they would affect the taxpayer’s rights adversely.

Thus, tax treaties serve a dual purpose and have a parallel life. They are both “State to State” agreements under the international law and also part of the statutes under the domestic law. They are binding on the Contracting States under public international law from the date of entry into force, but may be enforceable under the domestic law by the Courts only after they are incorporated in the domestic or municipal law.¹⁵ Each State follows its own rules for the inclusion of the treaty under its law.

1.5. Country Examples

Australia

Australia follows the dualistic doctrine. Each Australian treaty is incorporated by legislative action into the domestic law as a Schedule under the International Tax Agreements Act 1953. A tax treaty is applied and enforced in the domestic Courts as Parliamentary intent, and the Parliament can, if it wishes, override the treaty by subsequent legislation. Treaties generally prevail over domestic law, except when the Australian general anti-avoidance rule is applicable.

Canada

Each treaty is incorporated into domestic law by separate parliamentary legislation that provides that the treaty prevails over domestic law in case of conflict. In principle, as

¹³ Examples: Austria, Belgium, Germany, United States.

¹⁴ Examples: Australia, Canada, Denmark, India, Israel, New Zealand, Norway, Sweden, United Kingdom.

¹⁵ Klaus Vogel, Double Taxation Conventions, Introduction, m.no. 28–44.

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Parliament is supreme it can override the treaty through specific legislation. However, such overrides are rare.

The Income Tax Conventions Interpretation Act 1985 contains provisions that specifically allow tax treaty overrides in certain circumstances.¹⁶ The Act provides that the terms, which either are undefined (partly or wholly) in the treaty or require the use of the domestic law, have the meaning under the domestic law at the time when the treaty is applied and not when the treaty was entered into, except to the extent that the context otherwise requires.¹⁷

France

France follows the monistic doctrine of incorporation. A treaty has priority over prior or subsequent domestic legislation. Article 55 of the French Constitution 1958 mentions: “treaties or agreements properly ratified or approved shall possess, from the moment of publication, an authority superior to that of domestic laws providing, as regards each treaty or agreement, it is applied by the other party”.

Germany

International treaties require the approval of the Federal Parliament (*Bundestag*) and the Council of Constituent States (*Bundesrat*). Under Article 59 (paragraph 2) of the Fundamental Law, this formal approval introduces the treaty into the German legal system as an Act of Parliament with no precedence over domestic statutes. However, since Section 2 of the General Tax Code (AO) claims superiority of tax treaties over domestic tax law, subsequent law can only override treaty law if the law expressly contradicts the treaty provisions.

India

India follows the dualistic doctrine, and tax treaties strictly require an Act of Parliament. However, to avoid a time-consuming and cumbersome procedure, they are enacted into domestic tax law under delegated legislation powers granted by the Parliament to the executive branch of the government.¹⁸ Section 90 of the Indian Income Tax Act, 1961, empowers the central government to enter into tax treaties with the government of other countries. They do not have to be laid before Parliament since no separate legislation is required to give effect to a tax treaty. The tax treaty prevails even if it is inconsistent with the provisions of the Act.¹⁹

A treaty, once ratified and incorporated, prevails over statutes unless the Indian Parliament specifically legislates a treaty override. However, Article 51 of Part IV(c) of the Indian Constitution specifically mentions, “the State shall endeavour to foster respect

¹⁶ Brian Arnold, Canada amends Income Tax Conventions Interpretation Act (Tax Analysts, February 8, 1999).

¹⁷ The *Queen v Melford Developments Inc* 82 DTC 6281 (SCC) (Canada).

¹⁸ *Union of India and Anr. v Azadi Bachao Andolan and Anr.* (2003) SC 56 ITR 563, (India): Under the Income Tax Act, the charging provisions under Sections 4 & 5 are expressly made “subject to the provisions of this Act”. The Act includes Section 90. Hence, the treaty overrides the domestic law in all respects.

¹⁹ *Maganbhai v Union of India* (1969) SC 783 (India).

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for international law and treaty obligations in the dealings of organised peoples with one another”.

Ireland

Under the Irish Constitution, the status of a tax treaty differs from that of domestic law. Its legal validity, as part of the domestic law of the State, is derived from Article 29 of the Constitution. Treaties are negotiated and concluded by the government, but subject to approval by Parliament. A treaty becomes part of the domestic law when an Order is made under the Taxes Consolidation Act after the Parliamentary resolution. Sec. 826 TCA 1997 mentions that such agreements are to have the force of law in Ireland “notwithstanding anything in any enactment”.²⁰

Japan

Domestic tax law cannot override tax treaties in Japan under its constitution.

Netherlands

Under the Dutch constitutional law, a treaty is self-executing and becomes applicable under the domestic law at the time when it enters into force. The treaty has priority over subsequent domestic law under Article 94 of the Dutch Constitution. Tax treaty restricts the application of domestic tax law.

United Kingdom

The United Kingdom follows the doctrine of transformation. A provision in the tax law (currently ICTA 1988 s.788) allows the treaty to take effect by an Order in Council (delegated legislation). It also confers the authority to negotiate and conclude tax treaties to the government. When an agreement has been initialled in draft and approved by Ministers, it is signed and then published as a draft Order in Council and laid before Parliament for its approval. The legislative process is completed when the order is made by her Majesty in Council. Instruments of ratification must usually be exchanged before a treaty can come into force.

Thus, although the making of a treaty is an executive act its obligations under the domestic law must have legislative approval. The taxpayer’s rights under a treaty arise from an Act of Parliament, which confirms the treaty and gives it the force of domestic law. Subsequent legislation by Parliament intended expressly to override a tax treaty is possible.²¹ However, unintentional treaty overrides cannot occur, as statutes may not be interpreted to result in breaches of obligations under international law.²²

20 Charles Haccius and Pat O’Brien, *Double Tax Agreements*, (The Institute of Taxation in Ireland, 1998) p. G-15; John Ward, *The General Anti-Avoidance Rule in Ireland* (IBFD Bulletin, December 2003) p. 565.

21 *IRC v Collico Dealings Ltd.* (1961) 39 T.C. 509 at 527–528 (UK): The House of Lords held that the 1955 legislation was applicable on an Irish company despite tax exemptions under previous Anglo-Irish agreements since the wording of the legislation was unambiguous and prevailed over the agreement.

22 Philip Baker, *Double Taxation Conventions* (Sweet & Maxwell, 2003) pp. F-07; Jonathan Schwarz, *Tax Treaties: United Kingdom Law and Practice* (Sweet & Maxwell, 2002) pp. 1–8.

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United States

The United States follows the doctrine of incorporation. A tax treaty is self-executing and requires no further legislation. It becomes part of the domestic law, if it is consistent with the US Constitution, until it is either terminated or specifically contradicted by a subsequent federal (not state) legislation. The US tax treaties also contain a “saving” clause that preserves its right to tax its own residents under its domestic law, regardless of the treaty.

A treaty is a part of federal legislation enforceable by the US Courts, and has an equal status with other federal laws.²³ In case of a conflict between the treaty law and the federal law, the Courts and the tax authorities are bound to apply the measure that is later in time (“*lex posterior derogat legi priori*”).²⁴ However, the US Courts apply their discretion to avoid treaty overrides. The US Supreme Court held in *Cook v United States* that the intent of Congress to override international obligations of the United States through federal legislation must be “clearly expressed”.²⁵ The US Revenue also requires that such treaty waivers must be consistent.

The US Congress has rejected the view that treaties can only be brought into line with the changing tax laws by renegotiation, since it could give the foreign states an effective veto over the US domestic law changes applicable to international business.²⁶ Treaty overrides have been specifically permitted in several US tax laws. For example, Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) provided provisions for treaty override. Another example relates to the Tax Reform Act of 1984 that permitted treaty overrides in cases of “stapled” stocks issued by foreign corporations.²⁷

1.6. Is International Tax Law Enforceable

Every country has the sovereign right to establish its own tax rules, which govern its domestic and international transactions. However, countries may have legislative powers, but they may not have the enforcement rights over foreign jurisdictions.

International law only permits the enforcement by a country of its tax laws within its legislative jurisdiction. It forbids executive or administrative acts and enquiries by foreign tax authorities without the consent of the host country. For example, a State cannot send officials to gather tax evidence, examine books, value any property or interview witnesses. No legal documents may be served and no tax may be collected in another State without its consent. Generally, one State does not normally enforce the tax laws of another State, as a matter of sovereignty.²⁸

23 IRC Code, Sec. 7852(d)(1), as modified under the Technical and Miscellaneous Revenue Act of 1988.

24 *Whitney v Robertson* (1988) 124 U.S. 188, 190 (US).

25 *Cook v United States* (1933) 288 US 102 (US).

26 Sol Picciotto, *International Business Taxation*, p. 331.

27 Sol Picciotto, *International Business Taxation*, pp. 325–332.

28 *US v Harden* [1963] CLR 366 (SCC) (Canada); *Province of British Columbia v Gilbertson* 597 F: 2d 1161 (9th Cir. 1979) (US); *Government of India v Taylor* [1955] AC 491 (HL) (UK). In *Government of India v Taylor*, the Indian Government purchased a UK company operating in India and remitted the purchase payment immediately to England. The UK Courts refused to enforce a capital gains tax liability payable under the Indian tax laws.

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Tax authorities must follow the principles of international law when they enforce their domestic laws abroad. Since a State is unable to exercise its tax law in another State, it sometimes applies indirect pressure on nonresidents and foreigners present in its own territory. Such methods violate the principles of international law. “The mere fact that a State’s judicial or administrative agencies are entitled to subject a person to their personal or “curial” jurisdiction does not by any means permit them to regulate by their orders such person’s conduct abroad”.²⁹

Fiscal enforcement provisions on tax issues relating to cross-border transactions available today are limited. Under a tax treaty (OECD MC Article 26), the tax authorities of the Contracting States may exchange tax information. This Article permits the sharing of tax-related information to prevent tax evasion and frauds, unless it is contrary to the treaty provisions. The EC Directive 1977 (as amended) provides for assistance on tax matters among member countries. Similar provisions are also contained in the OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters (1988), which came into force in 1995. In 2003, the OECD Committee on Fiscal Affairs added a separate Article 27 on the “Assistance in the Collection of Taxes” in its Model Convention. (See Chapter 3(4-Article 27))

1.7. International Tax Principles and Tax Treaties – Comments

As mentioned earlier, the two prevailing key taxing concepts in international taxation are the residence and source principles. Both of them are based on the so called “benefit theory”. Under this theory, taxes are payments for services (or benefits) rendered by the State. Each jurisdiction has the right to tax derived from services rendered or benefits provided. The State of residence retains its rights to tax its citizens or residents on their worldwide income, while the State of source taxes the income derived within its own fiscal jurisdiction.³⁰

Although the above split of taxing rights between residence and source States is commonly accepted for distribution of taxing rights, it inevitably leads to double taxation. Double or “overlapping” taxation adversely affects international trade and economic development. It is considered as harmful to the exchange of goods and services and to the movement of capital and persons. This double taxation is then avoided through reciprocal acceptance of taxing rights and obligations under what is fair and equitable. They require the jurisdictions to agree to share the taxing rights and give relief where double taxation arises, either under their domestic laws or under a negotiated agreement or treaty.

Besides the allocation of taxing rights and eliminating double taxation, tax treaties also provide other measures, such as:

- Prevention of tax discrimination of nationals, permanent establishments and enterprises of the other State.

²⁹ F.A. Mann, *The Doctrine of Jurisdiction in International Law* – Hague Recueil 1964, Vol. I, pp. 145–149 and 156–158 (See extract in Asif Qureshi, *The Public International Law of Taxation*, pp. 310–313).

³⁰ Klaus Vogel, *Worldwide v Source Taxation of Income: A Review and Re-evaluation of Arguments* (Intertax, 1988).

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- Resolution of tax disputes due to differences in the interpretation or application of the tax treaty.
- Authority for tax authorities to exchange information on tax matters to ensure compliance by taxpayers and to prevent tax evasion.
- Provision for mutual assistance in tax collection.

These objectives are not directly related to the avoidance of double taxation. A negotiated treaty may still be necessary to achieve them even when double taxation is not an issue.

Some of the principles underlying international tax law and tax treaties include:

(i) Equity and fairness – The tax system should be equitable and fair for taxpayers, i.e. inter-individual equity. This principle requires equal taxation on taxpayers with equal income, regardless of source, based on their ability to pay (“horizontal equity”), and the levy of progressively higher taxation on higher income (“vertical equity”). In the international context, the system should also enable each country to receive a fair share of the taxes generated by transactions involving their jurisdiction. This allocation of the worldwide tax base is achieved through a negotiated agreement or tax treaty between fiscal jurisdictions as equal partners with reciprocal appreciation of mutual taxing rights i.e. inter-nation equity.

(ii) Neutrality and efficiency – Whereas tax equity relates primarily to the relationship of taxpayers to each other, neutrality refers to the relationship between the taxpayer and the State.³¹ A neutral tax system that does not interfere with market forces is regarded as a more efficient distributor of factors of production. Therefore, the concept of tax neutrality is often stated as one of the principles of international taxation. It requires that economic processes should not be affected by external influences, like taxation.

Ideally, tax systems should be neutral as between investing at home or abroad (capital export neutrality or CEN) and as between investment by domestic and foreign investors (capital import neutrality or CIN). The former is based on the policy that a country’s nationals should have the same tax choice when making a decision to invest at home or abroad. The latter expects that the same tax burden should be imposed on both residents and nonresidents. The overall objective is to promote free movement of capital. Any distortions in investment decisions arising from tax considerations should be avoided.

Under CEN, the residence State ensures that the total tax burden on investment abroad is the same (not more, not less) as investment at home to neither encourage nor discourage capital outflows. Foreign source income is taxed currently by the residence State without any tax deferral (similar to domestic income), and full tax credit is given for any source taxes paid. In the case of CIN, foreign investors bear the same (not more, not less) overall tax as domestic investors in the source State. It applies the same tax rate as residents on income derived by nonresidents and does not impose any withholding tax on outbound payments; the residence State gives full tax exemption.

Both systems have their supporters. CEN is considered as a better approach by many developed countries to achieve worldwide economic efficiency, i.e. allocation of economic

³¹ Dale Pinto, *E-Commerce and Source-Based Income Taxation* (IBFD Publications, 2003) pp. 23–32.

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resources to achieve optimal productivity. It favours taxation in the residence State with a grant of tax credit to relieve foreign taxes paid. CIN supports national efficiency and international competitiveness with only source taxation and full tax exemption in the residence State.³²

In reality, unless there is a completely harmonised global tax system, full neutrality under both CEN and CIN is impossible to achieve. The measures required for CEN conflict with those required for CIN, and vice versa. CEN favours worldwide taxation while CIN encourages a territorial tax system.³³ Moreover, pure forms of CEN or CIN are rarely used. Countries follow a combination of CEN and CIN principles depending on their overall economic policy, of which tax is one of the components. In practice, policy makers typically treat capital export neutrality as at best a secondary goal. In virtually every country of the world, capital inflows generally are considered desirable and are encouraged through tax and other economic policies.

(iii) Promotion of mutual economic relations, trade and investment – Many countries (particularly developing countries) regard this objective as more significant than the avoidance of double taxation.³⁴ The primary purpose of tax treaties for them is to promote economic growth through foreign investment and technology. They are prepared to bear the loss of tax revenues due to tax incentives. For example, double non-taxation (e.g. tax sparing credits), may be regarded as a justified cost to achieve non-fiscal objectives. As net capital importers, they are also more concerned with capital import neutrality.

Tax treaties only deal with direct taxes. Developing countries usually have a low direct taxpayer base and low levels of public expenditure. Direct taxes and treaty policies often play a less significant role as a revenue source and are considered more as a policy tool to achieve their non-tax (e.g. social and economic) objectives. They rely more on indirect taxes to meet their government budgetary needs due to the relative ease in collection and its wider tax coverage.

In the above sense, the tax policies and objectives of developing countries may differ from those of developed countries. The former countries regard direct taxation less as a means for financial resource mobilisation for the government and more as a tool to achieve higher economic growth. Tax levels may be kept low through incentives to enhance their competitiveness for capital, markets and technology. The lack of anti-avoidance measures like controlled foreign corporation and thin capitalisation may be acceptable and tax sparing as well as treaty shopping may be deemed as tax incentives. Tax competition is both widely practised and encouraged in these countries.³⁵

³² In his book, Vogel mentions that exclusive taxation by the source State, i.e. territorial taxation under capital import neutrality is preferable for business profits. It respects the sovereignty of nations in tax matters, avoids competitive distortions where investment is made and does not impede the free flow of investment. (See Klaus Vogel, *Double Taxation Conventions*, Introduction, m.no. 13–14).

³³ A.J. Easson, *Taxation of Foreign Direct Investment*, pp. 36–40, pp. 179–183.

³⁴ See Chapter 2(5.5); this objective is enshrined in the 1923 Report of the four economists appointed by the League of Nations and is the underlying *raison d'être* for the UN Model Convention.

³⁵ William Ramirez, *First Impressions of Tax in Asia* (International Tax Review, March 2004) p. 47.

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(iv) Prevention of fiscal evasion – One of the stated objectives of Model tax treaties is the prevention of tax evasion. They include limited anti-avoidance measures such as comprehensive taxation for residents (Article 4), restriction on tax concessions on dividend, interest and royalty income only to beneficial owners (Articles 10, 11 and 12) and provision for exchange of tax information among tax authorities (Article 26). A recent addition in the OECD MC is the new Article on mutual assistance in the collection of taxes (Article 27). Although, it does not include tax avoidance as an objective, the Commentary Update 2003 issued by the OECD Committee on Fiscal Affairs regards it as one of its purposes. This broadening of the treaty objectives to all forms of domestic tax avoidance rules is not accepted in many countries.³⁶

Some commentators also regard double non-taxation as tax avoidance and deem it as undesirable on neutrality and fairness grounds.³⁷ Paragraph 52 of the OECD Partnership Report 1999 reads as follows: “. . . the basic purposes of the Convention (is) to eliminate double taxation and to prevent double non-taxation”. Pursuant to this Report, the OECD MC 2000 has added a new paragraph 4 in Article 23A, and also made certain changes in the Commentary.³⁸ As double non-taxation can be both intended and non-intended, presumably the objective is to prevent unintended double non-taxation resulting from the application of the treaty. Despite this OECD view, double non-taxation is not yet widely accepted as either tax avoidance or evasion or as an objective of tax treaties.³⁹ Currently, a taxpayer may rely on a tax treaty even if it results in double non-taxation.

(v) Reciprocity – International taxation has the concept of reciprocity as one of its key principles. This principle affects a country’s approach to designing its international tax rules. As each State has full rights to tax income sourced in its own jurisdiction, it will accept a limitation of these rights only if the other tax jurisdiction provides for an equitable allocation of bilateral tax revenues. Fiscal reciprocity assumes that the States have comparable social and economic backgrounds and fiscal needs. Otherwise, reciprocity requires a holistic approach based on both fiscal and non-fiscal considerations to achieve a balanced allocation of taxing rights.

The reciprocity principle has raised questions on the fairness of existing Model treaties in recent years. On cross-border transactions, the source State has the first opportunity to tax the nonresident as and when the income arises in its tax jurisdiction. Unless the source country agrees to forego or limit its rights, it can exercise them. Under the Model treaties, the source State agrees to restrict many of its taxing rights over the income derived by

36 Stef van Weeghel, *The Improper Use of Tax Treaties*, pp. 34–36; See also Frank van Brunschot, *The Judiciary and the OECD Model Tax Convention and its Commentaries* (IBFD Bulletin) Section 2.6.

37 League of Nations Report issued in 1927 mentioned: “The most elementary and undisputed principles of fiscal justice, therefore, require that the experts should devise a scheme whereby all incomes would be taxed once and once only”. This “single taxation principle” may not be appropriate unless the countries have comparable tax systems as well as comparable social and economic needs. (See Chapter 2(5.5).

38 OECD Commentary: Article 23, paras. 32.6, 32.7, 56.1 to 56.3; Article 21, para. 3.

39 There are several judicial decisions, which indicate that double non-taxation is not an objective of a double tax treaty. Examples: *Estate of Hausmann v R* (1998) 4 CTC 2232 (Canada); *Lamesa Holdings v Commissioner* (1997) 36 ATR 589 (Australia); *Union of India v Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India); *Gladden Estate v The Queen* (1985) DTC 5188 (Canada). See also IFA Cahiers 2004 on Double Non-taxation.

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nonresidents within its territorial jurisdiction (See Chapter 3(1.3)). The taxing rights of the residence State are more or less unaffected. It retains its full or unlimited taxing rights on the worldwide income and capital of its residents, with an obligation to grant relief in the limited situations when juridical double taxation arises.

With the exception of avoidance of double taxation and prevention of tax evasion, the other objectives of tax treaties are still not fully accepted. Some of the other issues that may affect international tax principles and treaties are listed below.

- Generally, there is a consensus among nations that international double taxation is detrimental to worldwide trade and investment and should be avoided under the domestic laws and through negotiated tax treaties. Some commentators also believe that the tax system should discourage tax arbitrage, i.e. tax advantages arising from differences in tax rates and tax bases.⁴⁰ The latter objective may be difficult to achieve in real life unless every country has the same tax system and similar fiscal policies.⁴¹
- Each country has a primary duty to advance the interests of its citizens and residents. As countries are at differing levels of social and economic growth, their fiscal needs vary widely. Although the primary purpose of taxation is to raise revenue for the government, other non-fiscal objectives affect both domestic and international taxation. As mentioned above, the total benefits (tax and non-tax) provided by each country should be considered to determine both equity and reciprocity.⁴²
- Several developing countries consider that the current allocation of tax revenues between source and residence States under the Model tax treaties is inequitable. It unduly restricts the taxing rights of source States in favour of residence States.⁴³ This view is expressed by several commentators.⁴⁴ Reciprocity and inter-nation equity is also questioned in the tax rules applied to electronic commerce applications. The present allocation rules, as well as the latest OECD interpretations on e-commerce taxation, do not favour source countries when dealing with digital goods. Unless acceptable reciprocity is agreed, developing countries may have problems in accepting the existing Model treaties.⁴⁵
- Taxation is more than just a fiscal issue. It is affected by political, social and economic factors. As a result, there are significant differences among States on the relevance of taxation (and fiscal goals in general) within their national policy. Each country tries to justify its own approach and sometimes impose it on others. A State's size and its place in the world economy and political order, influence these efforts. Under these circumstances, it may not be appropriate to apply a single treaty model under a "one-size-fits-all" approach to all countries.⁴⁶

40 See Stef van Weeghel, *The Improper Use of Tax Treaties*, p. 33.

41 Michael Graetz, *Foundations of International Income Taxation* (Foundation Press, 2003) pp. 19–39.

42 For a brief summary of some of the other goals of international tax systems and tax treaties, read Jacques Sasseville, *The Role of Tax Treaties in the 21st Century* (IBFD Bulletin, June 2002).

43 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, p. 21.

44 Brian J. Arnold, Jacques Sasseville and Eric Zolt, *Summary of the Proceedings of an Invitational Seminar on Tax Treaties in the 21st Century* (IBFD Bulletin, June 2002) pp. 238–239.

45 See Report of the High Powered Committee of the Indian Government on E-Commerce, July 2001.

46 For a brief summary of some of the other goals of international tax systems and tax treaties, read Jacques Sasseville, *The Role of Tax Treaties in the 21st Century* (IBFD Bulletin, June 2002).

2. APPLICATION OF TAX TREATIES

2.1. *Vienna Convention on the Law of Treaties*

(i) *Background*

The rules under the Vienna Convention on the Law of Treaties (VCLT) apply to all international treaties, including tax treaties. The Vienna Convention on the Law of Treaties (VCLT) was adopted on May 22, 1969 and entered into force on January 27, 1980. At the international level, the VCLT is binding on treaties among States, which are signatories after it entered into force. As of 2004, there are 96 parties, who have ratified, acceded or succeeded to the VCLT, and 45 signatories, who have signed but not become parties to the Convention. Under the Vienna Convention, a “party” means a State that has consented to be bound by the treaty and for which the treaty is in force.⁴⁷

The VCLT does not have retroactive effect. However, since it essentially codifies the existing norms of customary international law on treaties, it is also considered to be binding on non-signatories and applicable to both past and future treaties. As a result, the Convention does not have to be specifically incorporated in the domestic law.

(ii) *Extracts from the VCLT*

1. For purposes of the present Convention:

- a. “treaty” means an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation.
- g. “party” means a State, which has consented to be bound by the treaty, and for which the treaty is in force.
- h. “third State” means a State not a party to the treaty.

Article 26: *Pacta sunt servanda*

Every treaty in force is binding upon the parties to it and must be performed by them in good faith.⁴⁸

Article 27: Internal law and observance of treaties

A party may not invoke the provisions of its internal law as justification for its failure to perform a treaty. This rule is without prejudice to Article 46.

⁴⁷ Countries that have ratified the Vienna Convention include Austria, Australia, Canada, Denmark, Germany, Greece, Italy, Japan, the Netherlands, New Zealand, Spain, Sweden and the United Kingdom. Non-signatories include France, India, Indonesia, Israel, Portugal, Singapore and South Africa. Several countries, including Brazil, Pakistan and the United States, have signed but not yet ratified the treaty.

⁴⁸ Under VCLT, good faith is also mentioned in its Preamble: “. . . the principles of free consent and of good faith and the *pacta sunt servanda* are universally recognized. . .” However, there is no further explanation in the VCLT of what good faith means. A United Nations Report in 2001 mentions that “good faith requires fairness, reasonableness, integrity and honesty in international behaviour”.

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Article 28: Non-retroactivity of treaties

Unless a different intention appears from the treaty or is otherwise established, its provisions do not bind a party in relation to any act or fact which took place or any situation which ceased to exist before the date of the entry into force of the treaty with respect to the party.

Article 29: Territorial scope of treaties

Unless a different intention appears from the treaty or is otherwise established, a treaty is binding upon each party in respect of its entire territory.

Article 30: Application of successive treaties relating to the same subject matter

1. Subject to Article 103 of the Charter of the United Nations, the rights and obligations of States parties to successive treaties relating to the same subject matter shall be determined in accordance with the following paragraphs.
2. When a treaty specifies that it is subject to, or that it is not to be considered as incompatible with, an earlier or later treaty, the provisions of that other treaty prevail.
3. When all the parties to the earlier treaty are parties also to the later treaty but the earlier treaty is not terminated or suspended in operation under Article 59 (VCLT), the earlier treaty applies only to the extent that its provisions are compatible with those of the later treaty.
4. When the parties to the later treaty do not include all the parties to the earlier one:
 - (a) as between States party to both treaties the same rule applies as in paragraph 3;
 - (b) as between a State party to both treaties and a State party to only one of the treaties, the treaty to which both States are parties governs their mutual rights and obligations.
5. Paragraph 4 is without prejudice to article 41 (VCLT), or to any question of the termination or suspension of the operation of a treaty under article 60 (VCLT) or to any question of responsibility which may arise for a State from the conclusion or application of a treaty the provisions of which are incompatible with its obligations towards another State under another treaty.

Article 31: General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There should be taken into account, together with the context:
 - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;

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- (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32: Supplementary means of interpretation

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of Article 31, or to determine the meaning when the interpretation according to Article 31:

- (a) leaves the meaning ambiguous or obscure; or
(b) leads to a result that is manifestly absurd or unreasonable.

Article 33: Interpretation of treaties authenticated in two or more languages

1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text will prevail.
2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
3. The terms of the treaty are presumed to have the same meaning in each authentic text.
4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of Articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty shall be adopted.

Article 34: General rule regarding third States

A treaty does not create either obligations or rights for a third State without its consent.

Article 42(2): Validity and continuance in force of treaties

1. The validity of a treaty or of the consent of a State to be bound by a treaty may be impeached only through the application of the present Convention.
2. The termination of a treaty, its denunciation or the withdrawal of a party, may take place only as a result of the application of the provisions of the treaty or of the present Convention. The same rule applies to suspension of the operation of a treaty.

Article 46: Provisions of internal law regarding competence to conclude treaties

1. A State may not invoke the fact that its consent to be bound by a treaty has been expressed in violation of a provision of its internal law regarding competence to conclude treaties as invalidating its consent unless that violation was manifest and concerned a rule of its internal law of fundamental importance.
2. A violation is manifest if it would be objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith.

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Article 60: Termination or suspension of the operation of a treaty as a consequence of a breach

1. 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.
2. (omitted)
3. A material breach of a treaty, for the purposes of this article, consists in:
 - (a) a repudiation of the treaty not sanctioned by the present Convention; or
 - (b) the violation of a provision essential to the accomplishment of the object or purpose of the treaty.
4. The foregoing paragraphs are without prejudice to any provision in the treaty applicable in the event of a breach.
5. (not applicable to tax treaties)

Article 61: Supervening impossibility of performance

1. A party may invoke the impossibility of performing a treaty as a ground for terminating or withdrawing from it if the impossibility results from the permanent disappearance or destruction of an object indispensable for the execution of a treaty. If the impossibility is temporary, it may be revoked only as a ground for suspending the operation of the treaty.
2. Impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from or suspending the operation of a treaty if the impossibility is the result of a breach by that other party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.

Article 62: Fundamental change of circumstances

1. A fundamental change of circumstances which has occurred with regard to those existing at the time of the conclusion of a treaty, and which was not foreseen by the parties, may not be invoked as a ground for terminating or withdrawing from the treaty unless:
 - (a) the existence of those circumstances constituted an essential basis of the consent of the parties to be bound by the treaty; and
 - (b) the effect of the change is radically to transform the extent of obligations still to be performed under the treaty.
2. A fundamental change of circumstances may not be invoked as a ground for terminating or withdrawing from a treaty:
 - (a) if the treaty establishes a boundary; or
 - (b) if the fundamental change is the result of a breach by the party invoking it either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty.
3. If, under the foregoing paragraphs, a party may invoke a fundamental change of circumstances as a ground for terminating or withdrawing from a treaty it may also invoke the change as a ground for suspending the operation of the treaty.

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Article 63: Severance of diplomatic or consular relations

The severance of diplomatic or consular relations between parties to a treaty does not affect the legal relations established between them by the treaty except in so far as the existence of diplomatic or consular relations is indispensable for the application of the treaty.

Article 64: Emergence of a new peremptory norm of general international law (*jus cogens*)

If a new peremptory norm of general international law emerges, any existing treaty which is in conflict with that norm becomes void and terminates.

(iii) Philosophy of the Vienna Convention Rules

Interpretations under international law follow one or more of the following approaches:

- (a) **“Textual” approach** - interpretation according to the ordinary meaning of the words of the treaty. Under this approach, the treaty is interpreted through an analysis of what the treaty negotiators mention in the text, which is presumed to be final, authentic and the most reliable expression of the intent.
- (b) **“Subjective” approach** - interpretation according to the intentions of the treaty negotiators. This approach relies on “*travaux préparatoires*” (negotiating history) relating to the treaty to determine the intentions of the negotiators. The text is only the starting point for the interpretation.
- (c) **“Teleological” approach** - interpretation according to the treaty’s purpose and objectives. This approach examines the overall object and purpose of the treaty and follows the interpretation that best fulfils them.

The VCLT follows the “textual” approach. Under its rules, the objectively expressed intent in the actual text of the agreements, rather than the subjective intent either of the negotiators or the parties, should be applied for treaty interpretation. It rejects the process of independently examining the motivation and intent of the negotiators or the parties in favour of the relative certainty of the textual approach.⁴⁹

2.2. How International Treaties Come into Force

International treaties regulate the relations between international persons or States under international law. The term “treaty” refers to an agreement, which is concluded between sovereign States in written form. It is a generic term used to cover a convention, agreement, arrangement, protocol or exchange of notes.

A treaty is initialled after negotiations and then signed. The heads of State, senior government officials and foreign affairs ministers are usually regarded as possessing “full powers” to sign a treaty as a representative of the State.⁵⁰ By signing the treaty, the Contracting States are expected to initiate the procedures necessary under their domestic law to conclude a treaty, but there is no legally binding commitment to do so.

⁴⁹ Michael Lennard, Navigating by the Stars – Interpreting the WTO Agreements (Journal of International Economic Law, 2002) pp. 20–22.

⁵⁰ Paul Reuter, Introduction to the Law of Treaties, pp. 17–29.

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A treaty does not apply internationally until it is concluded. It enters into force after the Contracting States declare their consent through an exchange of instruments, or ratify, under their respective constitutional laws. Once the treaty has been ratified under its legal procedures the State cannot invoke the provisions of domestic law (i.e. municipal law) regarding its competence to give the consent, unless it was “objectively evident to any State conducting itself in the matter in accordance with normal practice and in good faith”. Ratification differs from parliamentary consent. Whether parliamentary consent is necessary before ratification can take place is a matter for the domestic law of the State in question.

In the case of tax treaties, three dates are usually relevant for different purposes, as follows:

(i) The date of signature of the treaty: This date is relevant for the “taxes covered” (Article 2), as the list of taxes to which the treaty applies in each State is settled at that date. A provision is usually inserted in that Article to the effect that the treaty will also apply to any identical or substantially similar taxes that are imposed by either State after the date of signature.

(ii) The date when the treaty enters into force: This date binds the Contracting States. The date may be the date on which instruments of ratification are exchanged, although this is becoming less common in the case of tax treaties. If the domestic law of each State permits, a simpler procedure is now often used. The treaty requires each State to notify the other Contracting State of the completion of the steps required under its own law to bring the treaty into force, and the treaty then enters into force a certain number of days after the later of the two notifications.

(iii) The date on which the treaty “has effect” in relation to each of the taxes to which it applies: It is important to distinguish this date (or these dates) from that on which the treaty enters into force. Because the tax year begins on different dates in different countries (and in some countries on different dates for different taxes), a tax treaty is usually expressed to have effect for the tax year beginning in the next calendar year after it enters into force.⁵¹ If the domestic law of the Contracting State permits, there is nothing to prevent a tax treaty having effect from a date or dates earlier than that of entry into force.

2.3. Limitations of Double Tax Treaties

The primary purpose of a tax treaty is to allocate taxing rights and to provide relief if double taxation arises. A State cannot levy a tax, if (i) the other Contracting State does not exercise its allocated rights to tax under a treaty, or (ii) a tax treaty gives the State the right to tax, but no tax is due under its domestic law. Only the domestic tax law in each country has the taxing power under its legislative enactment. That law alone dictates the level of taxation, and how it should be computed.

Under the constitutional law of most countries, a treaty can restrict the taxing powers or the amount of the tax due under the domestic law, but not increase them. It sets the maximum

⁵¹ For example, in the United Kingdom the “year of assessment” for income tax begins on April 6, and corporation tax is charged for a “financial year” beginning on April 1, in each year. Tax treaties concluded by the United Kingdom are accordingly expressed to have effect in respect of income tax in relation to years of assessment beginning on and after April 6, and in respect of corporation tax in relation to financial years beginning on and after April 1, in the calendar year next following that in which the treaty enters into force.

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tax that may be imposed by a Contracting State, based on the agreement between the two Contracting States when the treaty was concluded. Thus, it can exempt or reduce taxes, but it cannot create new taxes or assessment procedures, or enlarge or initiate additional or new taxes, or increase the tax burden. As an exception in a few countries, a treaty can expand the scope of its taxes when the domestic law makes the treaty rule the domestic rule.⁵² In the Netherlands, a treaty has priority over domestic law even if it is less beneficial.⁵³

Generally, a treaty does not provide a basis for a higher tax charge than under domestic law unless the domestic legislation clearly demands that result. In countries that require parliamentary approval, the domestic law would preclude them from imposing additional taxes through tax treaties (Examples: Germany, India, United Kingdom). However, it appears that it is at least legally possible for a treaty to impose an additional tax in countries where treaties do not require parliamentary approval. It may impose taxes through a treaty since it does not have to be approved or enacted as domestic legislation.

In addition, the following MC Articles may increase their tax liability:

- **Article 9** – Associated enterprises subject to arm’s length pricing and profits may lead to an additional tax in a Contracting State unless correlative or corresponding relief is granted by the other Contracting State.
- **Article 25** – The mutual agreement procedure on treaty interpretation may deny treaty benefits or impose taxes.
- **Article 26** – The exchange of information may enable the tax authorities to request and to obtain more information than they could obtain under their domestic law, and thus increase the taxpayer’s exposure to tax.

Tax treaties are primarily intended to avoid over-taxation on the same income. They are not meant to grant “double” credit or exemption. A person entitled to benefits from more than one tax treaty can claim the most favourable treaty, but these benefits are mutually exclusive, not cumulative. In cases when the treaty benefits are waived, the taxpayer must not take inconsistent positions to achieve benefits greater than those that can be derived through double tax avoidance.

Treaties usually, but not always, have priority over domestic law. Therefore, as treaties remain unchanged for a period (average fifteen years) and take time to renegotiate, they provide certainty and protection against adverse changes in domestic tax laws. Many jurisdictions also allow the taxpayer to choose either the domestic tax regime or the tax treaty, whichever is more favourable.⁵⁴ This provision may be specifically mentioned in the

⁵² Philip Baker, *Double Taxation Conventions and International Tax Law*, pp. 6–8.

⁵³ In the Netherlands, the Hoge Raad in a 1980 decision denied a Dutch resident the right to deduct mortgage interest relating to a loan for house purchase in Belgium against his Dutch income because he was deemed a treaty resident in Belgium. Under the treaty, the right to tax the income from immovable property was given to Belgium. As a result, the taxpayer paid a higher tax liability than if the treaty had not existed. (BNB 1980/170)

⁵⁴ *Ostime v Australia Mutual Providence Society (1960) AC 459 (UK)*: The taxpayer was an Australian assurance company with its UK branch income taxable in the United Kingdom. The UK House of Lords held that the treaty took precedence over the domestic law and should apply. The treaty required that a permanent establishment should be taxed as if it were a separate enterprise earning an arm’s length profit, and not under the domestic tax law.

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domestic law (Examples: Belgium, Denmark, India, Luxembourg). Some countries provide a specific “non-aggravation” or “preservation” clause in their tax treaties (Examples: Japan, United States). This clause preserves the right to apply the domestic law if it is more advantageous.⁵⁵ The US tax treaties also contain a “saving clause” that reserves the right of each Contracting State to tax its own citizens and other tax residents, as if the treaty did not exist.⁵⁶

2.4. Can Domestic Law Override a Tax Treaty?

General

The OECD Treaty Override Report (1989) defined the term “treaty override” as a situation “where the domestic legislation of a State overrides treaty provisions of either a single treaty or all treaties hitherto having had effect in that State”.⁵⁷

Treaty overrides may be intentional or unintentional. Intentional treaty overrides include situations such as (i) later law overrides prior law, or ((ii) superior treaties (e.g. diplomatic treaties) supersede tax treaties.

Overrides that are not intended may arise in the following situations:

- A Court decision may be contrary to the common interpretation of the treaty partners. Such legal decisions could amount to a treaty override. However, a State has the legislative power to reverse the effect, and the reversing legislation in consultation with the treaty partner would be an acceptable remedy.
- A State may redefine an undefined treaty term under its domestic law, which effectively overrides the treaty. Such changes in domestic law are permitted only when they are compatible with the context of the treaty and accepted by the other Contracting State. Often such unilateral changes are made unjustifiably by States to combat treaty abuse. The correct remedy would be to renegotiate the treaty.⁵⁸
- A State may unintentionally override or contradict the treaty provisions.

Tax treaties are governed by the principle of “*pacta sunt servanda*” or good faith (VCLT Article 26). The Contracting States mutually undertake to respect and apply the treaty provisions under the international law. Moreover, VCLT Article 27 requires that the domestic law cannot serve as a justification for the non-compliance with treaty obligations. In general, tax treaties override existing domestic laws and are even given precedence over subsequent domestic laws. However, several countries allow treaty overrides if a subsequent legislative act either is specifically intended to override or provides for a clear statutory provision that cannot be reconciled with the treaty.⁵⁹

55 Article 1(2) of the US MC mentions: “The Convention shall not restrict in any manner any benefit now or hereafter accorded (a) by the laws of either Contracting State; or (b) by any other agreement between the Contracting States”.

56 US MC: Article 1(4) (See Exhibit 3).

57 Committee on Fiscal Affairs: Tax Treaty Override, para. 2 (OECD, 1989).

58 Klaus Vogel, Double Taxation Conventions, Introduction, m.nos. 131–132.

59 Sol Picciotto, International Business Taxation, p. 311.

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Constitutional Provisions

The constitutional provisions in each State decide the interaction of the domestic legislation and the international treaty obligations. Paragraph 14 of the 1989 OECD Report mentions: “The level attributed to treaty obligations, as incorporated in domestic law, determines whether derogations therefrom are unconstitutional or not. In the end, the choice is between giving priority either to a State’s international obligations, or to the sovereignty of decision of a country’s elected representatives”. Thus, the status of the treaty obligations depends on the priority given to them over other domestic laws under a country’s constitution.

The 1989 OECD Report identified the following constitutional systems:

(a) The constitution provides that the treaty is self-executing and becomes part of the domestic law without any further enactment, as “*lex specialis*” or special law (Examples: Argentina, France, Italy, Japan, Netherlands, Switzerland). In a self-executing treaty, usually a tax treaty has a status superior to prior and subsequent domestic legislation. It is constitutionally impossible for domestic legislation to override such a treaty.

(b) The constitution requires a parliamentary act to incorporate or approve a given international agreement, but once this has been done, it attributes a superior status to the provisions of an international agreement (Examples: Belgium, Finland, Germany, Iceland, Ireland, Luxembourg, Norway, Peru, Portugal, Singapore, Sweden). These countries always give priority to treaty law through express legal provisions or case law decisions. Treaty provisions override subsequent domestic tax legislation to avoid a breach of the international obligations, as “*lex posterior generalis non derogat legi priori specialis*” (later law does not override a special law).

(c) The constitution regards an international agreement to be on par with domestic legislation (Examples: Austria, Brazil, Denmark, Indonesia, Israel, Korea, Sri Lanka, the United States). Several countries give treaty obligations the same rank as the domestic law. In the case of conflict, the one last in date prevails under the maxim “*lex posterior derogat legi priori*” (later law overrides a special law). Therefore, a subsequent change in law could lead to a treaty override, and violate the State’s international obligations.

(d) The constitution is based on parliamentary sovereignty. It cannot bind itself or its successors (Examples: Australia, Canada, India, New Zealand, the United Kingdom). International agreements have no special status, and become part of the domestic law by parliamentary statute. A treaty, which can only have effect if legislative action is taken, can typically be overridden by subsequent legislative action.⁶⁰ Therefore, Parliament can override a prior treaty by a subsequent amendment or repeal.⁶¹

In practice, treaty override through subsequent legislation must be expressly intended. Even if the treaty overrides are feasible under the domestic law, it is presumed that a State does not want to breach its treaty obligations under public international law. The Courts generally maintain that the legislature does not intend to modify or abrogate a treaty.⁶²

⁶⁰ Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 33.

⁶¹ *IRC v Collco Dealings Ltd (1961)* 39 TC (UK): “what parliament has given, parliament may take away”. (525 per Harman L.J.).

⁶² Lord Reid in the *Collco* case mentioned: “. . . there is a presumption that Parliament did not intend to act contrary to the comity of nations”. A similar view was held by Senior Judge White in the United States: “. . . although it

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It would require legislation with a specific measure that was clearly irreconcilable with the treaty provisions or gave evidence of a clear intention to enforce a treaty override.⁶³ The less clear the intention to override, the less likely it is that the Courts would uphold that the legislation should override a tax treaty.⁶⁴

In summary, treaties normally override other, contrary, domestic laws. The tax laws in several countries specify that they are applicable regardless of any contrary legislation (Examples: Australia, Canada, India, Malaysia, United Kingdom). Consequently, if the treaty provisions, as implemented, conflict with other domestic laws, the treaty prevails.⁶⁵ Although treaty overrides by domestic law are possible, the countries are bound to comply with their international obligations under customary international law and the override must be specifically intended. Legislative silence may not be sufficient to break a treaty.⁶⁶

Improper Use of Treaties

The 1989 OECD Report regarded a treaty override through conflicting domestic legislation or unilateral action as illegal under international law. It suggested that members should avoid treaty overrides and consult with each other on any legislation likely to lead to treaty violations. It also discouraged unilateral overriding legislation to counter treaty conflicts. In situations where conflict of provisions was inevitable, the treaties should be renegotiated.⁶⁷

Subsequent additions to the OECD Commentary on “Improper Use of the Convention” in 2003 now illustrate several “anti-treaty abuse” provisions in OECD Member States. They deal with treaty shopping, controlled foreign corporation rules and preferential tax regimes that are considered as harmful tax practices. The Commentary also includes the prevention of both tax avoidance and tax evasion as a treaty objective. Moreover, it mentions that the application of provisions under the domestic law to counter treaty abuse does not constitute treaty override.

The OECD Commentary 2003 supports the view that these anti-abuse rules under domestic law do not have to be specifically included in tax treaties to be effective.⁶⁸ It argues that taxes are ultimately imposed through domestic law provisions, as restricted by tax treaties. Thus, a treaty abuse is essentially an abuse of the domestic law under which the tax is levied. To the extent anti-avoidance rules are part of the basic domestic taxation, these rules “are not addressed in tax treaties and therefore not affected by them”. It concludes that “a proper construction of tax conventions allows them to disregard abusive transactions” involving unintended treaty benefits. Therefore, “States do not have to grant benefits of a

is true that Congress may modify a treaty by statute, Court should not lightly attribute to Congress the intention to modify or abrogate a treaty...”.

63 *Woodland (K V Ceylon) Rubber & Tea Co. Ltd. v CIR* [1971] A.C. 321: The Privy Council held that the subsequent legislation was intended to be comprehensive and the treaty override was justified even though there was no explicit reference.

64 Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 33, p. 6.

65 *Ostime v Australia Mutual Providence Society* (1960) AC 459 (UK).

66 *Trans-World Airlines v Franklin Mint Corporation* (1984) (US).

67 Committee on Fiscal Affairs: *Tax Treaty Override*, Annex A (OECD, 1989).

68 OECD Commentary: Article 1, paras. 7 to 26; See Chapter 3(4-Article 1).

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double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into”.⁶⁹

Comment

These views expressed in the Commentary by the Committee on Fiscal Affairs could lead to a treaty override if applied unilaterally by Contracting States. They require specific provisions in the treaty itself to be applicable. According to Philip Baker, countering anti-avoidance through domestic tax rules cannot justify a unilateral treaty override and could amount to a breach of an international obligation.⁷⁰ This view was also taken by the Indian Supreme Court, which held that domestic anti-avoidance rules could not be applied unless they are contained in the treaty itself.⁷¹

The concern relating to the ambulatory use of domestic law to counter “treaty abuse” is also expressed by Vogel. A State can improve its treaty position unilaterally through subsequent changes in its domestic law. Such attempts by the State to circumvent or dodge a treaty could amount to infringement of the international legal duty to fulfil the treaties that it concluded in good faith (VCLT Article 26). However, the acceptance of the new law for some time by the other Contracting State may constitute subsequent practice under Article 31(3)(b) of the VCLT.⁷²

2.5. Remedies against Treaty Overrides

Treaty violations could be either the result of a treaty breach or a fundamental change of circumstances. A treaty breach could arise when the State legislates in breach of a treaty provision, and applies its law to actual tax situations. Such legislation will be treated as an override only if the treaty partner disapproves of it unequivocally. It then violates the rule “*pacta sunt servanda*” (i.e. must be performed in good faith) under VCLT Article 26. The Contracting States have a general obligation under the international law to seek a negotiated solution to treaty violations.

There is little that a State can do to stop the other State if it unilaterally passes a domestic law to override the tax treaty. The steps it can take are limited. It can terminate or suspend either part (breached or unbreached provisions) or the whole of the treaty, and demand renegotiation. It may also be possible to demand compulsory independent adjudication and penalties through an international forum. It may threaten or impose retaliatory measures. Some treaties and treaty provisions, which are conditional upon reciprocity, may cease to have effect.

Extenuating or “fundamental change of circumstances” can lead to treaty termination in certain circumstances, but it does not justify a treaty override (VCLT Article 62). The

⁶⁹ OECD Commentary: Article 1, paras. 9.2–9.4

⁷⁰ Philip Baker, *Double Taxation Conventions* (Sweet & Maxwell, 2003), F8-10; See Ramon J. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation*, p. 112; See Frank van Brunschot, *The Judiciary and the OECD Model Tax Convention and its Commentaries* (IBFD Bulletin, January 2005) Section 2.6.

⁷¹ *Union of India vs. Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India).

⁷² Klaus Vogel, *Double Taxation Conventions*, Introduction, m.nos. 125–126.

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fundamental change must not be the result of a treaty breach by the party invoking it. Similarly, an “impossibility of performance may not be invoked by a party as a ground for terminating, withdrawing from, or suspending the operation of a treaty if the impossibility is the result of a breach by that party either of an obligation under the treaty or of any other international obligation owed to any other party to the treaty” (VCLT Article 61(2)).

Thus, in the case of a treaty violation either Contracting State could:

- make an official protest and invoke the mutual agreement procedures under OECD MC Article 25; or
- retaliate with a similar domestic override; or
- appeal to an international forum, e.g. International Court of Justice (VCLT Article 66); or
- terminate or suspend the treaty as a “material breach” (but cannot sue) under customary international law and practice (VCLT Article 60).

The VCLT provides for the termination and suspension of international treaties, if there is a treaty breach. The breach must be “material”, as defined in VCLT Article 60(3), i.e. a “violation of a provision essential to the accomplishment of the object or purpose of the treaty”. It should relate to a provision that was material in inducing a party to enter into the treaty. Depending on the gravity of the “material” breach, it could lead to partial or full suspension, or the termination of the treaty. Very often treaty overrides do not lead to full termination, but part suspension by a Contracting party.

VCLT provides the procedures to be followed for treaty termination under the international law. The treaty remains in effect between the two States until it is terminated or suspended under VCLT Article 60. A treaty also remains in force under the domestic law until it is terminated or overridden under the domestic legislation. Therefore, if the injured State does not terminate or suspend the treaty, it continues to apply.

3. INTERPRETATION OF TAX TREATIES

3.1. *General*

Treaty interpretation rules differ from domestic tax rules for several reasons. For example:

- As international treaties, VCLT governs double tax agreements. Therefore, their interpretation is based on the rules of interpretation under customary international law. As these principles and procedures of interpretation for agreements differ from rules applied to domestic legislation, an interpretation under the domestic law as a taxing statute may be misleading and unsuitable.
- Unlike the domestic law, which contains highly technical legislative language relevant to a specific jurisdiction, tax treaties are based on the mutual understanding among two or more Contracting States. Moreover, more than one language may be involved. They must be applied by the tax authorities and the Courts in each Contracting State in a uniform way (“common interpretation”) that may differ from the domestic laws and practices in each State.
- Tax treaties are primarily relieving in nature and do not impose tax, while the domestic tax law seeks to impose tax in specific circumstances. A treaty specifies general taxing

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principles to avoid double taxation. Moreover, as the life of a treaty can be long it must be flexible enough to adapt to changes in the domestic law while continuing to reflect the original negotiated balance of obligations and concessions.

- Tax treaties tend to be less precise and require a broad purposive “substance over form” interpretation. Therefore, they are often interpreted more liberally than domestic law in the context of their object and purpose.⁷³ On the other hand, in States that prefer a liberal, purposive interpretation of their domestic law, the interpretation of tax treaties may be stricter than under the statutes. In both cases, a neutral interpretation and common understanding requires the use of an international fiscal language, which may not be found in the domestic laws and may provide a definition quite independent from domestic laws.
- Treaty interpretation is a subject in itself and not merely an extension of statutory interpretation despite the fact that treaties may be enforceable only when made part of domestic law under a statute in certain countries. Therefore, tax treaties should be kept as free as possible from the interpretation rules under domestic law, unless specified in the treaty itself.

The primary purpose of double tax treaties is to avoid and relieve double taxation through equitable (and acceptable) distribution of tax claims between countries. Tax treaties require a common interpretation by both Contracting States to achieve this goal. Common interpretation also leads to an international tax language and terminology and to reliance on similar legal decisions and practices in other countries, where appropriate. Most countries accept the common interpretative principles of the VCLT under customary international law. Strictly speaking, the VCLT, and not the domestic law of the Contracting States, governs the interpretation of treaties.⁷⁴

3.2. Interpretation under the VCLT

As mentioned earlier, the VCLT applies to all treaties including tax treaties. Tax treaties are binding rights and obligations on the Contracting States under public international law. They are agreements between two countries and not agreements between two taxpayers or a country and a taxpayer. As international agreements, they are governed by the VCLT, either because it applies as a law-making treaty (*traité loi*) between the States, or because it reflects the customary international law applicable to them generally. The Courts generally apply the VCLT as “part of the law of the land”.⁷⁵

The Vienna Convention on the Law of Treaties (“VCLT”) of 1969 provides the general guidelines on treaty interpretation under the VCLT Articles 31 to 33. Additional guidance is

73 The Australian Tax Office defines the term “liberal” to refer to the rules of construction to be used in interpretation and not the scope of the provision.

74 Kees van Raad, Tax Treaty Issues – Current and Future Development (IBFD European Taxation, January 1996): “many national Courts look upon tax treaty provisions as somewhat exotically clothed rules which nevertheless could be interpreted like domestic law . . . Interpretation follows customary international law and Courts are often not well versed in this area of the law”.

75 Michael Edwardes-Ker, Tax Treaty Interpretation, Chapter 3.01.

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provided in the official Commentary on the preliminary draft of the VCLT, as supplementary means of interpretation under Article 32.⁷⁶

Article 31 provides the general rule of interpretation. Article 31(1) states: “A treaty shall be interpreted in good faith⁷⁷ 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” (“basic rule”).

The basic rule of interpretation refers to the following:

(a) The “ordinary meaning” of the words based on the actual words in the text:

- The interpretation should start fundamentally with the natural meaning of the words in the text, as expressed (i.e. not intended) in the context in which they occur. Therefore, the written text of the treaty is of primary importance.
- The interpretation should follow the “ordinary meaning”, i.e. the usual and natural meaning of the words. Where there is a difference, the ordinary meaning that defines the terms in the light of the object and purpose of the treaty should prevail.⁷⁸
- The ordinary meaning of terms used in the agreement can be, but is not necessarily, the everyday usage. It is the uniform legal usage (e.g. international tax language) or the specific legal usage employed by the Contracting States.
- A tax treaty is required to be interpreted as a whole and its meaning should be consistent with the entire agreement in its context and object and purpose, and not be based on its individual provisions.
- The treaty terms should be given their true meaning when the treaty was concluded and not what the parties subsequently believe it to be. Identical terms should be given the same meaning.
- A special meaning should be used only if it is established that the parties so intended (Article 31 (4)).
- One should depart from the natural or plain meaning only in cases where:
 - (i) a different conclusion of the treaty partners is clear beyond reasonable doubt,
 - (ii) the language is “ambiguous or obscure”, or
 - (iii) it leads to a result that is “manifestly absurd or unreasonable” (VCLT Article 32).

(b) The “expressed intentions” of the parties from the terms of the treaty in their “context”:

- The expressed intentions of the parties must be ascertained from the actual treaty text and not based on presumed intentions.
- The treaty interpretation must be the literal (and not the purposive) language of the treaty, unless the overriding intentions of the contracting parties are beyond doubt.

⁷⁶ See pages 1012–1018 in the Materials on International & EC Tax Law published by International Tax Centre based in Leiden, The Netherlands.

⁷⁷ Article 31(1) refers to interpretation “in good faith”. Tax treaties are voluntarily negotiated obligations to limit the taxing rights under the prevailing domestic laws of the two Contracting States. Each State has to interpret them based on common understanding and mutual trust, and cannot alter them unilaterally through subsequent changes in their domestic law. Thus, the principle of good faith protects the legitimate expectations of the two parties.

⁷⁸ Asif H. Qureshi, *The Public International Law of Taxation*, pp. 135–153.

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- The “context” is restrictively defined to include the entire text of the treaty, its preamble and annexures (VCLT Article 31(2)). It also covers additional material included in any related agreement or instrument, such as protocols, notes, letters, explanations or memoranda of understanding, which were mutually agreed upon by all treaty partners at the time the treaty was concluded.⁷⁹
- Context does not normally result in a “special meaning”. It only serves to qualify the ordinary meaning of a treaty term. It is a relative term and not an absolute term. A treaty term, phrase or provision provides context in relationship to some other treaty term.⁸⁰
- Other interpretative elements that are not considered as context but treated as primary materials similar to context (VCLT Article 31(3)) comprise:
 - (i) any subsequent agreements between the parties on treaty interpretations,⁸¹
 - (ii) subsequent practices in the application, and
 - (iii) any relevant rules of international law applicable to the relations between the parties.

(c) The “object and purpose” of the treaty:

- The term “object and purpose” is one term describing one object; it is not that object and purpose have separate meanings.⁸²
- The purpose is not the subjective purpose of the parties but the objective purpose as evidenced by the treaty itself. It refers not to the “words” but the “intentions” of the parties as reflected objectively by the treaty as a whole. Title and preamble often summarise the object and purpose.
- The object and purpose do not provide an independent method of interpretation of the individual treaty provisions. The treaty’s objectives may be used only in the general interpretation of the treaty text.
- The object and purpose is determined by a textual approach; the intention of the parties is only important to the extent that the intention is reflected in the text of the treaty.
- This rule does not prevent the rejection of a literal interpretation under international law when other factors so require. The common sense or purposive meaning must be relevant to the object and purpose.⁸³

The basic rule of interpretation under VCLT Article 31 is a single rule. It adopts a holistic approach for treaty interpretation. The ordinary meaning of the terms is determined by the expressed text in (not “and”) its context and object and purpose. Context is narrowly defined to include only the rest of the treaty and certain related documents connected with the treaty. The object and purpose is also to be established from the treaty as a whole by examining any

⁷⁹ The context excludes any unilateral material (e.g. US Technical Explanation and Senate reports, oral statements during negotiations, explanatory notes, etc.). US Technical Explanation agreed by the other party when concluding the treaty may be treated as part of the context.

⁸⁰ Edwin van der Bruggen, *Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Articles 31 and 32 of the Vienna Convention on the Law of Treaties* (European Taxation, May 2003) p. 143.

⁸¹ In certain cases, mutual agreements concluded between competent authorities may be considered as part of the interpretative context under VCLT Article 31(3).

⁸² Klaus Vogel, *Double Taxation Conventions*, Introduction, m.no. 69.

⁸³ Klaus Vogel and Rainer Prokisch, *IFA Cahiers Vol. 78A*, General Report, 1993, p. 73.

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preamble and other related provisions. To understand the meaning, one needs to examine the text at the same time as its context and object and purpose. It would be inappropriate to start with the words and then follow up with the context, and then the object and purpose. This approach does not permit a purposive interpretation unless it follows from the words of the text.

The rule also rejects both the subjective intentions based on the negotiators and the teleological (i.e. purposive) approach that relies on the general object and purpose of the treaty. Therefore, it does not support a purposive approach as the object and purpose is only meant to define the text, which is the true expression of the intention of the parties. The meaning is determined from the expressed text only and ignores both the intention of the treaty negotiators and any other subjective views of the meanings within the treaty.⁸⁴

VCLT Article 32 permits the use of other relevant material as “supplementary means of interpretation” to avoid an ambiguous, obscure, absurd or unreasonable meaning under Article 31, or to confirm the Article 31 result. Extra-textual materials are not a substitute for the study of the tax treaty itself. They do not constitute context and may only be used to confirm, but not to contradict, or as independent support for an Article 31 interpretation. It is not mandatory that it be looked at (although most commentators support a wide examination of potentially relevant supplementary material) and it can only be used as a secondary source to confirm the meaning under Article 31 if it is unclear.

Supplementary materials refer to the circumstances of a treaty’s conclusion (the historical background) and the preparatory work of the treaty or “*travaux préparatoires*” (negotiating history) when it was concluded. They include extra-textual material, such as international legal practices and other tax conventions, judicial decisions and legal writings. Unilateral material that only represents the reasons and goals of one contracting party is not regarded as a supplementary means of interpretation.⁸⁵

Under the VCLT Article 33, the original versions of the treaty in the language of each party, or a third language (usually English or French), are equally binding. Normally, the third language is only called upon when the two versions in the languages of the parties differ. In the case of discrepancies in meaning, the selected meaning should reconcile with both (or all) texts. In case of a drafting error, the object and purpose of the treaty guides the treaty interpretation, its context and the supplementary means of interpretation. Otherwise, the treaty is defective and the treaty provision is not applicable.

In summary, the VCLT approach is textual and the terms are interpreted in their context as well as their object and purpose. There is a simultaneous examination of (i) the “ordinary meaning” of the relevant words, (ii) their “context”, and (iii) the “object and purpose” of the treaty they form part of. However, the text is the starting point and overrides other considerations. According to Vogel, “. . . the wording of a provision defines not only the starting point for interpretation but also its limit. Should the wording be unclear . . . national

⁸⁴ Michael Lennard, *Navigating by the Stars – Interpreting the WTO Agreements* (Journal of International Economic Law, 2002) pp. 32–45. This article also provides the readers with a general analysis of the interpretative rules under the VCLT.

⁸⁵ Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993, p. 74.

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Courts may not replace the wording of the text with supposed intentions of the Contracting parties”.⁸⁶

The tax treaties are drafted by experts in international law. “It is reasonable to assume that those negotiating a tax treaty knew what they were doing, meant what they said, and said what they meant”.⁸⁷ However, unlike domestic law, it may be given a broad (not literal) purposive interpretation, within its text and context when appropriate to make it workable.

3.3. Model Conventions and Commentaries

Many countries use a Model Convention (“MC”) and its Commentaries for tax treaty interpretations. Generally, they use either the OECD MC or the UN MC. The OECD MC and its Commentaries reflect the views of the OECD Committee on Fiscal Affairs⁸⁸ on the provisions and on their application to specific situations. Similarly, the UN MC and its Commentaries represent the recommendations of the Ad Hoc Group of Experts appointed by the United Nations⁸⁹, and not the United Nations itself. The US Treasury applies the US MC for treaty negotiations with the United States, and many other countries have their own Model for that purpose. Both the UN MC and US MC essentially follow the form and text of the OECD MC.

The Model Conventions also provide a common format and wording as a basis for drafting bilateral tax treaties. The use of a standard form of words helps in the uniform interpretation and application of the treaties based on them. They can be used either without any change or adapted, as appropriate, by the Contracting States. Any deviations and references are meant to reflect the intentions of the treaty negotiators at that time. Thus, they provide certain mutually agreed ground rules to eliminate elaborate analysis and discussions.

The Commentaries are an interpretation of the MC that has been adopted by OECD Member States as the primary basis for drafting and interpreting tax treaties. For non-OECD States, the Commentaries are a persuasive factor in treaty interpretation.⁹⁰ The Introduction to the OECD MC mentions: “Although the Commentaries are not designed to be annexed 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”.⁹¹

86 Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993.

87 *Crown Forest Industries Ltd v The Queen* [1995] D.T.C. 6305, 6309 (Canada).

88 The Committee on Fiscal Affairs comprises of tax experts from OECD Member States. However, as many of them are also administrative (primarily tax) officials, their views may be influenced by their background and official duties, and hence may not be disinterested or impartial. The Courts (and taxpayers) in several countries frequently disagree with the views expressed in the Model Commentaries and Reports. Many commentators have suggested that the Committee should be broad-based to include independent tax experts to represent taxpayers’ rights and to take into account the interests of non-OECD countries.

89 The Group was renamed the Committee of Experts on International Co-operation in Tax Matters by the Economic and Social Council of the United Nations (ECOSOC) in November 2004.

90 The UN MC and Commentaries may be similarly treated as persuasive factors, if they are used in treaty negotiations.

91 OECD MC: Introduction, para. 29.

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The use of the Commentaries is mandatory and not discretionary if it is relevant under Article 31, rather than Article 32. There are wide-ranging views among commentators. Under these views, the Commentaries may fall into any of the four qualifying categories under VCLT Article 31 or as supplementary means of interpretation under Article 32.⁹² For example, some commentators regard the MC as part of the “context” under VCLT Article 31 of a treaty concluded by reference to it.⁹³ The MC text at the time when the treaty was negotiated may also provide a special meaning intended by both parties to the negotiated agreement under VCLT Article 31(4).

Some commentators regard the MC and the Commentaries when the treaty was concluded as a “soft obligation” on OECD Member States. The recommendations of the OECD Committee on Fiscal Affairs are deemed as an obligation on its Member States once they have been adopted by the OECD Council and approved by them, subject to their Observations and Reservations.⁹⁴ Therefore, in their view they should be considered as part of the context under the VCLT and not just supplementary means of interpretation. If the MC text is adopted unchanged it may be assumed that the Contracting States agreed to follow the OECD interpretation when the treaty was negotiated. If the OECD text is not adopted literally, it may be presumed to follow the Commentaries to the extent that it is consistent with the MC. If the MC text is wholly disregarded, the Commentary may be ignored. In certain cases of treaty deviations from the MC, other treaties of the Contracting States may provide insights, but any inference should be made with caution.⁹⁵

The above view is not supported. Under the 1960 Statute of the OECD, its recommendations are only binding on the Member States if they are “opportune”, i.e. suitable or convenient. Hence, legally they are not binding on the governments, Courts or the taxpayers of the OECD Member States. However, they may be treated as morally binding on the tax authorities. For non-OECD members, they are again persuasive, as a view of a group of tax experts comprising the OECD Committee on Fiscal Affairs.⁹⁶

Despite their legal limitations, the OECD Commentaries and Reports⁹⁷ are widely used by the Courts for treaty interpretations. In the Australian case of Thiel, the OECD

92 Philip Baker, *Double Taxation Conventions*, pp. E13–14.

93 Klaus Vogel, *Double Taxation Conventions*, Article 3, m.no. 68–74: According to Vogel, the term “context” includes the relevant provisions of the legal systems of both Contracting States and also the OECD MC and its Commentaries. See Chapter 2(3.5(a)).

94 According to the Australian Tax Office (Tax Ruling TR 2001/13), while not binding, there is a general or “quasi-political” rather than “legal” expectation that OECD Member States will comply subject to their specific “Observations and Reservations”.

95 Klaus Vogel, *Double Taxation Conventions*, Introduction, m.no. 79–82.

96 Klaus Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation* (IBFD Bulletin, December 2000) p. 614; According to Vogel, they may be regarded as very convincing and may be followed if other arguments are not more persuasive – See Annika Deitmer et al., *Invitational Seminar on Tax Treaty Rules Applicable to Permanent Establishments – In Memoriam of Professor Dr Berndt Runge* (IBFD Bulletin, May 2004) p. 184; See also Frank van Brunshot, *The Judiciary and the OECD Model Tax Convention and its Commentaries* (IBFD Bulletin, January 2005) pp. 5–9.

97 The OECD Committee on Fiscal Affairs has also published several reports on specific international tax issues. They may also qualify as supplementary means of interpretation under VCLT Article 32. Many of them are included in the second volume of the loose-leaf publication of the OECD MC.

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Commentaries were accepted for treaty interpretation.⁹⁸ In the *Crown Forest* case, the Canadian Supreme Court held that "... a Court may refer to extrinsic materials which form part of the legal context (these include accepted Model Conventions and official Commentaries thereon) without the need to first find an ambiguity before turning to such materials". OECD Commentaries are generally considered as supplementary means of interpretation under Article 32. They may also qualify as context under Article 31 in certain jurisdictions but only the Commentary at the time when the treaty was concluded may be considered appropriate for that purpose.⁹⁹

The OECD MC and the Commentaries are now "ambulatory" documents, subject to "periodic and more timely updates and amendments without waiting for a complete revision".¹⁰⁰ They are issued in a loose-leaf format to facilitate more frequent updates. The Introduction to OECD MC suggests that the existing treaties concluded under the previous or current Model treaties should be interpreted and applied along the lines of the latest Commentaries, where applicable, except where the OECD MC has been changed in substance.¹⁰¹

The use of subsequent amendments or additions to the Commentaries as an interpretation of previously concluded tax treaties is not universally accepted.¹⁰² According to Vogel, "changes in the Commentaries after the conclusion of a tax treaty can neither amend the treaty, nor retroactively determine its interpretation".¹⁰³ New developments or issues may be dealt with through interpretative changes in the Commentary but only within certain limits that do not substantially change the treaty itself.

The OECD Committee on Fiscal Affairs has attempted to make substantive changes in existing negotiated treaties through additions or changes in its Commentaries in recent years.¹⁰⁴ Some commentators believe that these changes overprotect the interests of the tax administration at the expense of the taxpayers. Therefore, they pose problems in terms of taxpayers' rights and constitutional principles, and may not be accepted by the Courts in many countries. It is felt that the loose-leaf publications of the OECD MC and Commentaries, the "bias" in the role of the Fiscal Affairs Committee and the frequent updates could make the Commentaries lose their authority.¹⁰⁵

98 *Thiel v FCT* (1990) 21 ATR 531 (537) (Australia): The Australian High Court held that the OECD Model Convention and its Commentaries should be regarded as part of the context under VCLT Article 31, applied as customary international law. In any event, they should be part of the supplementary means of interpretation.

99 *Crown Forest Industries Limited v The Queen* (1995) 95 DTC 5389 at 5396 (Canada): The Canadian Supreme Court applied a static interpretation based on the OECD MC 1977 and its Commentaries to interpret the US-Canada tax treaty concluded in 1980. Similar view was also expressed by the Court in the *Thiel* case (see above).

100 OECD MC: Introduction, para. 9.

101 OECD MC: Introduction, para. 33.

102 Michael Lang, *Later Commentaries of the OECD . . . , Not to Affect the Interpretation of Previously Concluded Tax Treaties* (Intertax, Vol. 25, Issue 1, 1997); Klaus Vogel, *Double Taxation Conventions*, Introduction, m.no. 82.

103 Klaus Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation* (IBFD Bulletin, December 2000) p. 615.

104 For example, they include tax avoidance and double non-taxation as additional objectives of the tax treaty, allow treaty override through domestic anti-avoidance rules and require the interpretation of Article 23 under which the residence State must accept the qualification under the domestic law of the source State.

105 Adolfo J. Martin Jimenez, *The 2003 Revision of the OECD Commentaries on the Improper Use of Tax Treaties: A Case for the Declining Effect of the OECD Commentaries* (IBFD Bulletin, January 2004) pp. 28–30.

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The ambulatory approach also creates problems under the VCLT on the legal basis for the reference to subsequent Commentaries. Under the VCLT, the new Commentaries are neither context under the general meaning nor special meaning, nor are they later agreements or practices regarding older treaties.¹⁰⁶ In certain OECD countries, the Commentaries may be considered as ordinary or special meaning for the interpretation of treaty terms under the VCLT, subject to their Observations and Reservations. In such situations, the applicable Commentary would be the version in force when the treaty was concluded.¹⁰⁷ The dynamic reference may not be valid as a subsequent agreement or practice mutually accepted by both parties under VCLT Article 31(3).¹⁰⁸

Thus, the MC text may be considered as only a recommended format with no legal binding force either at the international or national level. It is simply a document concluded by an international organisation.¹⁰⁹ The OECD Committee on Fiscal Affairs cannot amend the contents of a negotiated tax treaty through changes in its MC or its Commentary. Subsequent versions of the text of the Model Convention using different wording are not applicable to an existing treaty, unless it is renegotiated. The changes in the text of the Articles in the MC do not affect previous agreements.¹¹⁰

Although there is no agreed view on the legal status of subsequent Commentaries issued after a treaty has been concluded, they are widely used by taxpayers, tax authorities and, in particular, the Courts for guidance in interpreting older treaties. They may be considered similar to advance rulings given by the tax authorities of the countries, which have formally expressed their position on them without any Reservation or Observation.¹¹¹ In recent years, some countries have explicitly mandated their use by a protocol to a treaty (Example: Austria).¹¹²

The Courts in several countries have accepted that both the MC and the Commentaries make a significant contribution to the common application and interpretation of tax treaties.¹¹³ They are part of the historical context of the treaty negotiations and help either to clarify (but not change) the treaty text or to confirm alternative interpretations. Besides treaty interpretations, subsequent Commentaries contain the current thinking of the OECD Committee on Fiscal Affairs on international tax principles and on technical issues emerging from changes in business practices or technology (e.g. electronic commerce,

¹⁰⁶ Klaus Vogel, *The Influence of the OECD Commentaries on Treaty Interpretation* (IBFD Bulletin, December 2000) p. 612; Martin M.J. Ellis, *The Influence of the OECD Commentaries on Treaty Interpretation – Response to Professor Dr Klaus Vogel* (IBFD Bulletin, December 2000), p. 617.

¹⁰⁷ Klaus Vogel, *Reflections on the Future of the OECD Model Convention and Commentary* (IBFD Bulletin, December 1996).

¹⁰⁸ Philip Baker, *Double Taxation Conventions and International Tax Law* (Sweet & Maxwell, 1994) pp. 28–31.

¹⁰⁹ John F. Avery Jones, *Article 3(2) of the OECD Model Convention and the Commentary – Treaty Interpretation* (IBFD European Taxation, August 1993) p. 255.

¹¹⁰ *General and Country Reports in the IFA Cahiers*, Vol. 78A, 1993 contain a detailed discussion on the application of the VCLT to tax treaties.

¹¹¹ Asif H. Qureshi, *The Public International Law of Taxation*, p. 137; John F. Avery Jones, *The Effect of Changes in the OECD Commentaries after a Treaty is Concluded* (IBFD Bulletin, March 2002) pp. 102–109; Jorn Qviste, *Interpretation of Tax Treaties* (European Taxation, July/August 2001) pp. 284–286.

¹¹² Victor Thuronyi, *Comparative Tax Law*, p. 119.

¹¹³ Examples: Austria, Belgium, Canada, Denmark, Germany, Japan, Malaysia, Netherlands, New Zealand, Spain, Sweden, Switzerland, United Kingdom, United States.

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hybrid instruments, global trading, etc.). However, for them too to be acceptable they should not make material changes in a bilaterally negotiated treaty or its objectives.¹¹⁴

3.4. Other Extra-textual Material

Other extra-textual material includes:

(i) Mutual agreement procedures: Article 25(3) of the OECD MC permits competent authorities to “resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention”. The mutual agreement can be either (i) interpretative to avoid doubts or difficulties, or (ii) legislative to avoid double taxation. As subsequent agreements, they may be treated similar to context (VCLT Article 31(3)) or at least as supplementary data (VCLT Article 32). However, these interpretation agreements among competent authorities generally do not modify a treaty and may not be binding on the Courts.¹¹⁵

(ii) Unilateral material: Treaty interpretations by tax authorities may be helpful as a guide to a “common interpretation”. However, such materials or practices usually tend to be unilateral (i.e. giving the views of one Contracting State only) and hence may not be binding on the other State. To be effective, the interpretation of tax treaties must be acceptable to the authorities and the Courts of both Contracting States. Similar comments apply to public and private rulings given by the tax authorities or other statutory bodies in certain countries. All the same, they can be useful as an interpretation aid for treaties and may be used with caution.

(iii) Judicial decisions: Many countries now accept the “common interpretative principle” of legal decisions on treaty interpretation. In view of the use of Model treaties, this “common interpretation” of treaty provisions justifies the consideration of legal rulings in other countries, and references to international tax practices. The Courts or the authorities of one Contracting State may take into consideration the decisions made by the Courts or authorities of the other Contracting State (or even a third State).¹¹⁶

(iv) Parallel treaties: Parallel treaties are treaties on a similar subject matter concluded between third States or between one of the parties and a third State. Such treaties can provide interpretative guidance through their wording, explanatory notes and judicial decisions. For example, a similar provision may be contained, or left out, or be absent from another treaty.¹¹⁷

Some commentators consider “parallel treaties” of limited value as an interpretation aid. As each treaty is a result of separate bilateral negotiations, the same wording in different

114 OECD MC: Introduction, para. 33–36.

115 Klaus Vogel and Rainer Prokisch, IFA Cahiers Vol. 78A, General Report, 1993, pp. 70–71.

116 In *CIT v Vishakhapatnam Port Trust* [1983] 144 ITR 146 (India), Justice J. Rao held: In view of the standard OECD Model which is being used in various countries, a new area of general “international tax law” is now in the process of developing. Any person interpreting a tax treaty must now consider decisions and rulings worldwide relating to similar treaties. The maintenance of uniformity in the interpretation of a rule after its international adaptation is just as important as the initial removal of divergences. Therefore, the judgments rendered by Courts in other countries or rulings by other tax authorities would be relevant.

117 Similar interpretative assistance can also be obtained by comparing the negotiated treaty with the standard Model used by a State for treaty negotiations.

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treaties may have different meanings. On the other hand, different wording may represent the same or different negotiating intentions. Moreover, revisions in subsequent treaties may not necessarily be applicable to earlier treaties.¹¹⁸ Despite these limitations, they often provide persuasive support when used with some caution.

3.5. Interpretative Rule under OECD MC Article 3(2)

The OECD MC provides a treaty interpretative rule under its Article 3(2).¹¹⁹ It mentions under General Definitions that “As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the 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”.

As Article 3(2) is part of the treaty, it is also subject to the interpretation under the VCLT. The given meaning should enable the treaty provisions to be effective.¹²⁰ Therefore, it must be performed in good faith and should not defeat the object and purpose of the treaty, i.e. to avoid double taxation and to prevent tax evasion. The meaning need not always follow the definition under the domestic law. However, if used, the definitions under the domestic law of the taxes covered under the treaty have priority over definitions in other tax laws or in other laws.

Under Article 3(2), some of the questions that need to be answered are:¹²¹

- Does the treaty provide a definition of the term?
- If the treaty does not provide a definition, what is the domestic meaning of the term?
- Does the context require a meaning different from the domestic meaning?

Several terms are specifically defined in the OECD Model treaty. For example, Article 3(1) includes definitions of “person”, “company”, “enterprise”, “enterprise of a Contracting State”, “international traffic”, “competent authority”, “national” and “business”. The term “resident” is defined in Article 4(1), and “permanent establishment” in Article 5. Additional definitions include “dividends” in Article 10(3), “interest” in Article 11(3), and “royalties” in Article 12(2), as applied to the respective Articles. These definitions, when they are present, have priority over Article 3(2). Additional definitions are also found in negotiated tax treaties under other Articles, protocols or explanations.¹²²

The tax treaty contains many other “terms” or “words”, for which there is either no given definition or the definition is partial or inconclusive,¹²³ or limited to a specific Article only.

118 Philip Baker, *Double Taxation Conventions and International Tax Law*, pp. 43–44.

119 See Chapter 3(4-Article 3).

120 *Estate of Burghardt v Comms.* (1983) (US); *IRC v Exxon Corp.* (1982) (UK); *Union Texas Petroleum Corp. v Critchley* (1988) (UK); *The Queen v Melford Developments Inc* (1982) (Canada).

121 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, p. 114.

122 Examples include definitions of territorial scope, fiscal year, the term “tax”, industrial and commercial profits, technical services, etc. For example, the Memorandum of Understanding under the India-United States treaty defines technical services to mean services requiring expertise in a technology.

123 The treaty definitions may be inclusive or exclusive. An inclusive definition gives the term its ordinary meaning plus the other items included in the meaning (Example: a person includes an individual, a company or any other body of persons in Article 3(1)(a)). The definition is not exhaustive or all embracing. An exclusive definition is

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Several treaty terms are either defined differently from, or not recognised in, the domestic tax law.¹²⁴ As part of the treaty, Article 3(2) permits the use of the meaning under the domestic law in certain situations when the terms are not specifically defined under the treaty. The alternative would be to have a treaty definition for all the terms in the treaty.

Article 3(2) refers to the “meaning” of an undefined term and not its definition. A term may not be defined for purposes of a country’s tax laws but it should have an ordinary meaning.¹²⁵ The reference to domestic law is limited to undefined “terms” and excludes legal principles or doctrine. It also does not permit a general interpretation of the treaty itself, or a use to clarify unclear treaty provisions.¹²⁶ As the rule applies to the terms used in the treaty, the reference to domestic law, unless they are defined in the treaty, is restricted only to those words or group of words. However, it is unclear whether the word “term” applies to both words and concepts.¹²⁷

The Article mentions that the domestic definition of undefined terms in the treaty should not be applied if “the context otherwise requires”.¹²⁸ The phrase “unless the context otherwise requires” refers to the “expressed” and not the “implied” intentions of the Contracting States. The domestic law definition will not apply if the context of the terms clearly suggests a specific definition.¹²⁹ For example, the dictionary meaning may reflect the meaning of the treaty term in its context better than the meaning under the domestic law.¹³⁰ This statement does not imply that the ordinary domestic definitions may be inappropriate in a tax treaty in all cases.¹³¹

OECD MC Article 3(2) also leads to additional questions, such as:

(a) What is context?

The VCLT Article 31(2) defines the context as comprising the text, including the preamble and annexes, and any related agreement or instrument made and accepted by the parties when the treaty was concluded.¹³² Many commentators do not accept this narrow definition for tax treaty interpretation. They adopt a broad meaning of “context” under VCLT Articles 31 and 32 based on a consideration of (i) the treaty policies of the Contracting States both when the treaty was negotiated and subsequently, (ii) the domestic tax environment when the treaty

open-ended (Example: company means . . . in Article 3(1)(b)). Treaty definitions may also contain undefined terms (Example: the terms “individual” and body of persons are undefined), or be limited to a specified Article (Example: the term “dividends” as used in Article 10).

124 Kees van Raad, *The Term “Enterprise” in the Model Taxation Conventions – Seventy Years of Confusion* (Intertax, 1994/11).

125 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, p. 115.

126 Klaus Vogel, *Double Taxation Conventions*, Article 3, m.no. 62.

127 John F. Avery Jones, *Article 3(2) of the OECD Model Convention and the Commentary – Treaty Interpretation* (IBFD European Taxation, August 1993) p. 257.

128 OECD Commentary: Article 3, para 11–13.

129 *Padmore v IRC* [1987] STC 493, 499 (UK): The treaty definition of a person differed from the definition under the UK domestic law. A UK resident partner in a Jersey partnership claimed tax exemption on his share of the partnership profits under the UK-Jersey tax treaty. The Court held that a partnership was a resident person, as defined under the treaty, and the profits were, therefore, exempt in the hands of the individual partners. This decision was overruled by subsequent UK legislation.

130 Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 7.03.

131 *Leonard Andra and Partner GmbH v CIT* (India) 2000: The Calcutta High Court applied the definition of “royalties” under the Indian domestic law since the word was not defined in the India-Germany tax treaty.

132 In the most narrow sense, “context” is the text immediately before and after the term, preferably in the same sentence.

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was negotiated and (iii) the political, economic and diplomatic background of the treaty.¹³³ The broad definition includes not only the OECD MC and its Commentaries but also all their grammatical (analyse the whole law), historical (identify original intent), systematical (consider the provision as part of the whole law) and teleological (contemporaneous purpose) aspects.¹³⁴

The OECD Commentary also gives a wide meaning to the term “context” under Article 3(2).¹³⁵ It defines context as the intention of the Contracting States when they signed the treaty as well as the current meaning given to the term in the domestic law of the other Contracting State. The intention when signing the treaty also implies consideration of the domestic law meaning in both States at that time. Thus, these conditions effectively disallow the use of the domestic meaning by one State without proper consideration of the past and current meaning of the term in the other State. According to the OECD Commentary, this safeguard ensures the required “permanency of commitment” in good faith (*pacta sunt servanda*) under the treaty and denies any change in the domestic law, which might make the treaty “partially inoperative”.¹³⁶ Otherwise, a change in domestic law could effectively change the context.¹³⁷

(b) Does the context always take precedence or only if there is an essential difference?

The OECD Commentary specifically mentions that under paragraph 3(2) the domestic law applies “only if the context does not require an alternative interpretation”.¹³⁸ There are two differing points of view, as follows:

- (i) the meaning under the domestic law is authoritative and should be used always, and the context is only applicable if the context otherwise requires; and
- (ii) the meaning under the domestic law should only be used in the last resort, since context takes precedence.

In the first case, all the terms, which are not defined in the treaty, initially follow the domestic law of the State applying the treaty. The meaning under the treaty must be sought as a secondary option, only if the context demands it.¹³⁹ In the second case, the questions of interpretation are primarily resolved by reference to the double tax treaty itself. This approach relies on the treaty’s definitions and phrasing, followed by a careful study of the context within the entire agreement.

Assuming a broad definition of “context”, as defined above, it is contended that it should be always possible to establish an autonomous meaning under the treaty acceptable to both

¹³³ John F. Avery Jones et al., *The Interpretation of tax Treaties with particular Reference to Article 3(2) of the OECD Model – Part II* (British Tax Review, 1984) pp. 90–105; Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapters 7.06 & 23.15; Harry Shannon, *United States Income Tax Treaties: Reference to Domestic Law for the Meaning of Undefined Terms* (Intertax 1989) pp. 459–461; Edwin van der Bruggen, *Unless the Vienna Convention Otherwise Requires: Notes on the Relationship between Article 3(2) of the OECD Model Tax Convention and Article 31 and 32 of the Vienna Convention* (European Taxation, May 2003) pp. 142–156.

¹³⁴ Michael Lang, *The Application of the OECD Model Tax Convention to Partnerships* (Kluwer Law International, 2000) pp. 20–28.

¹³⁵ OECD Commentary: Article 3, para. 12.

¹³⁶ OECD Commentary: Article 3, para. 13.

¹³⁷ Peter J. Wattel and Otto Marres, *Characterisation of Fictitious Income under OECD-Patterned Tax Treaties* (European Taxation, March 2003) pp. 70–74.

¹³⁸ OECD Commentary: Article 3, para. 12.

¹³⁹ John F. Avery Jones, *The One True Meaning of a Tax Treaty* (IBFD Bulletin, June 2001) pp. 220–224.

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Contracting States (i.e. common interpretation), and a domestic meaning will rarely be needed. Any reference to domestic law would be limited to:

- treaty provisions referring expressly to domestic law,
- situations in which the context or supplementary interpretation convincingly suggests a reference to domestic law, and
- situations in which no convincing interpretation exists in the treaty in its context or in supplementary sources.

As a third alternative, the meaning of undefined terms may be determined by reference to all of the relevant information and all of the relevant context.¹⁴⁰ To “apply” the treaty is not the same as to “interpret” it. Under this approach, both the domestic and treaty meanings are given equal significance for treaty interpretation.

(c) Is the meaning of the treaty term based on the applicable domestic law when the treaty was concluded (“static approach”), or when it was applied (“ambulatory or dynamic approach”)?

As from 1995, Article 3(2) recommends the use of a dynamic approach, provided the context does not suggest otherwise. It mentions that the interpretation of terms should use the current meaning (“the meaning that it has at that time”) under the domestic law of the State applying the treaty. Although a dynamic approach keeps pace with changes in the domestic law, a Contracting State could override the treaty unilaterally through subsequent changes in either the domestic meaning or the scope of undefined terms. If such a change affects the basic intentions of the treaty partners, it is contended that the qualification “unless the context otherwise requires” should provide a safeguard against any possible treaty abuse.¹⁴¹

Some countries (Examples: Australia, Austria, Belgium, Canada, Germany, Norway, United Kingdom, United States)¹⁴² now accept the ambulatory meaning of treaty terms. Australia and Canada have ensured the use of the ambulatory approach through special domestic legislation. However, the approach is still not widely accepted by many other countries. In several countries, the current use of the meaning under the domestic law would be deemed as a treaty override and should be avoided, unless it can be accepted as a subsequent practice under VCLT Article 31(3)(b).¹⁴³

Similar concern also arises in the use of subsequent Commentaries on existing treaties. Unlike domestic law, OECD Commentaries present the views of the OECD and its Committee on Fiscal Affairs and do not have the appropriate parliamentary approval. A suggested approach is the use of an ambulatory method for changes in domestic law under Article 3(2) but a static method for post-treaty changes in the Commentaries.¹⁴⁴ Thus, subsequent changes in the OECD Commentaries cannot override the text of the treaty.¹⁴⁵

¹⁴⁰ Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, pp. 115–116.

¹⁴¹ Kees van Raad, 1992 Additions to Articles 3(2) ... of the 1992 OECD and Commentary (Intertax 1992/12); John F. Avery Jones, Article 3(2) of the OECD MC ... (IBFD European Taxation, August 1993).

¹⁴² Examples: *Burghardt v Commissioner* (1983) 80 TC (US) 705; *Ducking v Gollan* (1965) 42 TC 333 (UK).

¹⁴³ Klaus Vogel, *Double Taxation Conventions*, m.nos. 124–126.

¹⁴⁴ Peter Wattel and Otto Marres, *The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties* (European Taxation, July/August 2003) pp. 222–235; John F. Avery Jones, *The Effect of Changes in the OECD Commentaries after a Treaty is Concluded* (IBFD Bulletin, March 2002) pp. 102–109.

¹⁴⁵ Philip Baker, *Double Taxation Conventions and International Tax Law*, p. 30.

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The OECD MC Article 3(2) and its Commentary support the ambulatory interpretation provided the meaning of the terms of the original treaty as originally negotiated between the Contracting States is not seriously altered.¹⁴⁶ The subsequent Commentaries are supposed to reflect a common view as to what the meaning is and always has been and not to a new meaning, i.e. an elaboration rather than a change. Often, a study of the changes in the Commentary over time may be necessary to understand a treaty provision.

(d) Should the domestic interpretation of terms in one Contracting State be legally binding on the other Contracting State?

The reference to the domestic laws of both Contracting States could lead to either double taxation or double non-taxation, if they have conflicting meanings under their respective laws. The *Pierre Boulez* case highlighted this problem when the US tax authorities disagreed with the German tax authorities. The payments to Boulez were treated as “royalties” in Germany, but the US IRS held that they were “compensation for personal services” in the United States.¹⁴⁷ The case led to double taxation since the tax authorities in the USA and Germany were unable to agree on a common definition.

Article 3(2) mentions that “As regards the application of the Convention. . . any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State. . . .” The phrase “application of the Convention” under this Article refers to any decision by tax authorities or Courts concerning tax matters where the treaty is or is likely to be considered.¹⁴⁸ Hence, both States can claim to apply the treaty. While the treaty restricts the taxing rights of the source State under the classification and distribution rules it also requires the residence State to grant treaty relief by tax exemption or credit. The words in Article 3(2) require both States to apply their own domestic law.

Some commentators take a narrow meaning that describes the situation as one where one State “applies” the treaty to restrict its taxing rights while the other State merely “reads” the treaty. In their view, only the source State applies the treaty since it alone is restricted under the treaty provisions from applying its own domestic tax laws. The residence State only reads the treaty to determine whether the source State has correctly applied the Convention before giving the relief for double taxation. It only “applies” the treaty in accordance with the law of the source State. Therefore, the definition under the domestic law of the source State should apply and the residence State should accept this definition if the meaning under the two countries differs.¹⁴⁹

¹⁴⁶ OECD Commentary: Article 3, paras. 11–13.

¹⁴⁷ *Pierre Boulez* (1984) 83 TC No. 131 (US): The famous conductor, a German resident, entered into a contract with CBS records in the United States to conduct certain musical performances for making phonograph records against royalty payments. The agreement provided that all property rights belonged to CBS. The IRS treated it as “compensation for personal services,” a term not defined in the tax treaty, and applied the domestic tax definition. The US tax Court accepted the IRS position. (Note: This issue has now been clarified in favour of the taxpayer under the US Model Treaty 1996 – see Technical Explanation, Article 12, para. 178).

¹⁴⁸ H.Shannon, *US Income Tax Treaties, Reference to Domestic Law for the Meaning of Undefined Terms* (Intertax, 1989) p. 157.

¹⁴⁹ David Ward, *Interpretation of Tax Treaties* (IBFD Bulletin, 1986); John F. Avery Jones et al., *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model* (British Tax Review, 1984); John F. Avery Jones, *Article 3(2) of the OECD Model Convention and the Commentary – Treaty Interpretation* (IBFD European Taxation, August 1993).

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The OECD Commentary Update 2000 has adopted the latter view and suggested that the “qualification” conflicts should be avoided by obliging the residence State to accept the categorisation of the source State (See Chapter 2(3.6) below).¹⁵⁰ According to Vogel, the treaty’s special rules of interpretation should take precedence over Article 3(2). Neither the use of the domestic law in interpreting tax treaties nor the use of domestic definitions of terms is justified if they are not applicable under the treaty provisions.¹⁵¹

3.6. Conflicts of Qualification

Under the MC, Article 3(2) is the treaty interpretation rule. This Article allows a State to use its domestic law meaning when a term is not defined in the treaty, unless the context otherwise requires. The rule provides a choice between the meaning under the domestic law and an autonomous or independent meaning. Although an autonomous meaning under the context to achieve a common interpretation is preferable, it may not be always feasible. Moreover, often States prefer their domestic meaning (“*lex fori*”), when applying the treaty, for convenience and ease of use. They may also prefer it since it avoids the waiver of their sovereign taxing rights under the treaty from what is mentioned in their domestic law.

One of the reasons for double taxation (or double non-taxation) when domestic laws are used is differing qualification, i.e. characterisation (also called classification or categorisation), of the same income in the two States. The treaty uses terms derived from the domestic laws but the terms have different meaning.¹⁵² These undefined terms in the treaty can then be interpreted to have the meaning in either of the two States or even a third interpretation. The problem that arises when the two Contracting States apply different distributive rules on the same income and taxpayer due to different meanings of treaty terms in the two Contracting States is called a “conflict of qualification” in international tax law.¹⁵³ Similar problems also arise under a “conflict of attribution” when both Contracting States apply the same distributive rules but to different taxpayers.

As mentioned above, some commentators had suggested in the early nineties that the qualification according to the source State should be adopted in such cases.¹⁵⁴ Under this rule, the residence State should accept the categorisation of the source State and grant treaty relief even if it would have characterised the income differently under its own domestic law. This approach was further developed in the OECD Partnership Report 1999 and recommended by the OECD Committee on Fiscal Affairs in their Commentary Update 2000.

The new approach is contained in the OECD Commentary on Article 23 under “Conflicts of Qualification”.¹⁵⁵ It provides that the phrase “in accordance with the provision of the

¹⁵⁰ OECD Commentary: Article 23, para. 32.1–32.7; See Chapter 3(4-Article 23).

¹⁵¹ Klaus Vogel, *Double Taxation Conventions*, Article 3, m.no. 61–74; See also Frank van Brunschot, *The Judiciary and the OECD Model Tax Convention and its Commentaries* (IBFD Bulletin, January 2005) p. 8.

¹⁵² For some examples, see Ned Shelton, *Interpretation and Application of Tax Treaties*, p. 208.

¹⁵³ Klaus Vogel, *Double Taxation Conventions*, Introduction, m. nos. 89–101b.

¹⁵⁴ Jean-Marc Dery and David Ward, *Canada National Report* (IFA Cahiers, Vol. 78A, 1993); John F. Avery Jones et al., *Credit and Exemption under Tax Treaties in Cases of Differing Income Characterisation* (European Taxation, 1996).

¹⁵⁵ OECD Commentary: Article 23, paras. 32.1–32.7.

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Convention may be taxed”, as used in the Article, be given another interpretation. In the case of qualification conflicts arising from differences in the domestic law of the Contracting States, the source State would have taxed in accordance with its provisions when, following Article 3 (2), if it applies its domestic law to determine whether the treaty permitted it to tax. Therefore, the residence State is obliged to grant relief from double taxation under Article 23, regardless of its own different qualification. An autonomous meaning under Article 3(2) would only be required when the source State did not have a domestic meaning or it was required by the context.¹⁵⁶

The recommended approach, however, contains several limitations, such as:

(a) The approach avoids qualification issues only when different provisions of the treaty are used by the Contracting States in determining the treaty category of income due to differences in their domestic laws. Moreover, the residence State is obliged to give treaty relief for source taxation only if it is satisfied that the source State has correctly applied its domestic law. There is no obligation to give relief if double taxation is due to either (i) differing interpretation of the facts or (ii) different interpretations of the treaty provisions. In such situations, double taxation must be avoided under the mutual agreement procedure (Article 25).

(b) The approach does not avoid conflicts of qualification involving treaty provisions other than Article 23. This relieving Article applies when the treaty provides for “may be taxed” (“open”) rights to the source State with subsequent tax relief to be given by the residence State. The Article does not apply when the distributive rules provide for “shall be taxable” (“complete”) rights to one of the two States.¹⁵⁷ In addition, it may not resolve conflicts due to non-distributive provisions in a treaty.¹⁵⁸

(c) The approach does not prevent double non-taxation if the residence State provides relief under the exemption method.¹⁵⁹ The source State may apply a provision of the treaty that either limits (e.g. Articles 10 and 11) or excludes its right to tax, while the residence State takes the view that the taxing right belongs to the source State and it must give an exemption. Unlike double taxation, double non-taxation cannot be avoided through the mutual agreement procedure (Article 25). To avoid this double non-taxation, the Commentary makes certain additional recommendations, such as:

(i) If the double non-taxation is solely the result of differences in domestic laws of the two States, it must be granted since it is not the result of applying the treaty. However, if it arises as a result of the interaction of the domestic tax rules with the provisions of the treaty, then the residence State is not obliged to exempt the income under Article 23A(1).

¹⁵⁶ John F. Avery Jones, *The Relationship between Domestic Tax Systems and Tax Treaties* (IBFD Bulletin, June 2002) pp. 268–270.

¹⁵⁷ See Chapter 3(1.3).

¹⁵⁸ John F. Avery Jones, *The “One True Meaning” of a Tax Treaty* (IBFD Bulletin, June 2001) pp. 220–224; Klaus Vogel, *Conflict of Qualification: The Discussion is not Finished* (IBFD Bulletin, February 2003) pp. 41.44; Alexander Rust, *The New approach to Qualification Conflicts has its Limits* (IBFD Bulletin, February 2003) pp. 45–50.

¹⁵⁹ This issue does not arise under the credit relief method since the residence State does not have to provide any tax credit if the income is not taxed by the source State under its domestic law.

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It may presume that the source State has not taxed the income in accordance with the provisions of the treaty.

- (ii) If the double non-taxation arises due to different interpretations of the facts or treaty provisions, the new paragraph 23A (4) should be added to the treaty text and applied to permit the residence State to deny (“shall not apply”) the exemption relief under the treaty to the taxpayer.

The suggestions above of the OECD Committee on Fiscal Affairs assume that the avoidance of double non-taxation is one of the treaty objectives. For this purpose, it relies on the object and purpose of a treaty to avoid double taxation and then takes the view that double non-taxation should be avoided.¹⁶⁰

The new approach has several critics and few countries have used it so far.¹⁶¹ Some of the concerns expressed are as follows:

- The new approach requires the residence State to accept the characterisation under the domestic law of the source State. This acceptance may affect the allocation of taxing rights of the Contracting States, as negotiated by them. Moreover, the new approach could lead to treaty abuse by the source State through subsequent changes in the meaning of a term under the domestic law.¹⁶²
- The new approach is an attempt by the OECD Committee on Fiscal Affairs to modify the Model treaty through subsequent changes in its Commentary. It is, therefore, unlikely to be accepted under VCLT by the Courts (and taxpayers) in many countries. In any case, the Commentary can only clarify and provide guidance on treaty interpretation and not make radical changes that affect the context. Moreover, the change cannot be applied on treaties concluded prior to the Commentary Update 2000 since a dynamic interpretation will be unacceptable in such cases.
- Although some countries regard double non-taxation as undesirable, very few countries consider it as a treaty objective or accept the “single taxation principle” that require that all income be taxed in at least one State. Double non-taxation may be intended or unintended but does not constitute tax evasion. Double non-taxation is considered a problem only if it is inappropriate or abusive. If double non-taxation is unintended or unlawful and abusive, the treaty should be modified. Moreover, any “subject to tax” provisions should be included in the treaty itself and not inferred from the Commentary.
- There may be situations where either the State’s internal law is not applicable or a State does not have an appropriate domestic meaning, or it contains more than one meaning. In such cases, a meaning, using the interpretation rule under the VCLT, may be necessary to achieve a common interpretation of the treaty.

Despite these limitations, many supporters of the new approach believe that it does provide a practical solution in case of most qualification conflicts. Moreover, in their view the

¹⁶⁰ OECD Commentary: Article 23, para. 32.6; OECD Partnerships Report 1999, para. 52.

¹⁶¹ Klaus Vogel, Double Taxation Conventions, m.nos. 90–101b; See Chapter 3(4–Article 23).

¹⁶² Some commentators believe that there are safeguards to avoid the misuse by the source State of the new approach. Under OECD MC Article 3(2), the domestic meaning should apply only if the context does not require an alternative meaning. A State can be guilty of a treaty override since a material change in the treaty will also change the context and not convey good faith required under VCLT Article 26.

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interpretation can also be justified under the VCLT. Some of them, however, agree that as the dynamic interpretation of the Commentary may not be acceptable, the new provisions can only apply to treaties concluded after the issue of the Commentary Update 2000.¹⁶³

Ideally, an autonomous meaning acceptable to both treaty partners should be sought. If the autonomous meaning in the two States differs, any disagreement may then be resolved through the mutual agreement procedure under Article 25(3).

4. SOME LEGAL DECISIONS ON TREATY INTERPRETATIONS

4.1. *Legal Interpretations*

Although double tax treaties are international agreements under public international law, there is no international judicial authority to interpret tax treaties. Most countries accept the right of their Courts to interpret double tax treaties. The judicial bodies act as “the authorities of last resort”. The Courts apply their legal reasoning based on the facts and the law to decide on tax issues.

Legal decisions on treaty interpretation differ widely among countries. The Courts in civil law countries rely on sources, such as laws, treaties, regulations, jurisprudence and doctrine.¹⁶⁴ They tend to stress the exact wording of the law and are generally strict in their legal reasoning.¹⁶⁵ Common law countries follow similar sources but give more emphasis to judicial decisions and treat doctrinal writings largely as persuasive. They also pay close attention to the facts and are more flexible in their legal reasoning.

Treaty interpretations tend to be either literal, legislative or purposive, as follows:

- **Literal:** the Courts adopt a literal meaning of the treaty (i.e. not reading between the lines). This approach encourages certainty and stability but may reduce its effectiveness.
- **Legislative:** the Courts interpret the treaty according to the original legislative intent, even departing from the literal language of the statute. They take into account the legislative history.
- **Purposive:** the Courts consider the economic or social purpose, and look at the purpose of the legislation beyond what was contemplated in the words of the treaty. Emphasis is given to substance over form through a contemporary purposive interpretation.

The Courts in many countries still adopt a literal interpretation of the tax law.¹⁶⁶ France, Belgium and South Africa interpret the tax laws in favour of the taxpayer, when in doubt under the maxim “*in dubio contra fiscum*”.¹⁶⁷ Ireland considers legislative history but follows a literal interpretation. The Netherlands enforces the legal form but denies an interpretation that has tax avoidance as the dominant purpose under the “*fraus legis*” doctrine.

¹⁶³ John F. Avery Jones, *Conflicts of Qualification* (IBFD Bulletin, May 2003) pp. 184–186; Hugues Salome and Robert Danon, *The OECD Partnership Report – A Swiss View on Conflicts of Qualification* (Intertax, Vol. 31 Issue 5).

¹⁶⁴ Jurisprudence refers to judicial decisions and doctrines refer to writings of academics and tax administration.

¹⁶⁵ Frans Vanistendael, *Legal Framework for Taxation* (Tax Law Design and Drafting, 2000) pp. 33–35.

¹⁶⁶ Examples: Austria, Canada, India, Israel, Japan, Korea, New Zealand, Norway, Peru, South Africa, Switzerland, United Kingdom.

¹⁶⁷ It means: “In doubt (construe a provision) against the revenue (i.e. the government)”.

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However, there is an increasing trend towards a purposive and liberal approach to treaty interpretations.¹⁶⁸ For example, the UK Courts have taken a purposive view on treaties and deviated from the literal text in several decisions in recent years.¹⁶⁹ The Courts in several countries also apply a broad approach in treaty interpretation to satisfy either historical parliamentary intent or current economic intent. They consider preparatory material, foreign decisions and other legal commentaries.

Several civil law countries¹⁷⁰ follow the legislative approach. Germany follows the VCLT rules of interpretation and gives priority to the ordinary meaning of treaty terms. It also considers the legislative purpose to avoid an absurd result that could not have been intended by the legislature. The United States interprets treaties according to the legislative intent with an emphasis on substance over form under a purposive approach.

The Courts generally assume that, unless there is some clear statement to the contrary, the legislature expects them to apply the interpretation under customary international law, rather than the domestic rules.¹⁷¹

4.2. Reference to the VCLT

As mentioned earlier, tax treaties have a dual character (See Chapter 2(1.4)). They are a treaty between States as well as binding nationally as statutes. Therefore, they are subject to the rules of interpretation applicable to both international and domestic law. Several legal decisions have confirmed the application of the VCLT for tax treaty interpretations.¹⁷² Some specific examples include:¹⁷³

- The Canadian Supreme Court held in the *Crown Forest* case that “Articles 31 and 32 of the Vienna Convention on the Law of Treaties indicate that reference may be made to these types of extrinsic materials when interpreting international documents such as taxation conventions”.¹⁷⁴
- In the *Thiel* case in Australia, the judge stated that the VCLT and its Article 31 “seek to codify the international law in relation to treaties”.¹⁷⁵ Similar Australian decisions on the application of VCLT to tax treaties were noted in the *Lamesa* and *Chong* cases.¹⁷⁶
- In the *Gimpey* case, Barrington J held: “An international treaty has only one meaning and that is its meaning in international law. For guidance on this subject one must look to

¹⁶⁸ Victor Thuronyi, *Comparative Tax Law*, pp. 149–150.

¹⁶⁹ Examples: *Pepper v Hart* (1993) AC 593 (UK); *James Buchanan & Co. Ltd. v Babco Forwarding and Shipping (UK) Ltd* (1977) 3 All ER 1048 (UK); *Fothergill v Monarch Airlines Ltd.* (1981) AC 251 (UK).

¹⁷⁰ Examples: Germany, Switzerland, Luxembourg, the Netherlands, Austria.

¹⁷¹ *Shipping Corporation of India Limited v Gamlen Chemical Company Australasia*, (1980) 147 CLR (Australia).

¹⁷² Examples: *Thiel v FCT* (1990) ATC 4717 (Australia); *Melford Developments v R* (1982) DTC 6074 (Canada); *CIR v JFP Energy Inc* (1990) 14 TRNZ (New Zealand); *IRC v Commerzbank AG* [1990] STC (United Kingdom); etc.

¹⁷³ Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 3.03–3.16.

¹⁷⁴ *Crown Forest Industries Ltd v The Queen* (1992) 95 DTC, para. 54 (Canada): the Supreme Court referred to Model Conventions and Commentaries as extrinsic materials under the VCLT Article.

¹⁷⁵ *Thiel v FCT* (1990) ATC 4717, 4722 (Australia); Dawson J. commented “Switzerland is not a party to the Vienna Convention (although Australia is) but the relevant rules which it lays down are applicable, being no more than an indorsement or confirmation of existing practice.”

¹⁷⁶ *FCT v Lamesa Holdings BV* (1997) ATC 4752 (Australia); *Chong v FCT* (2000) ATC 4315 (Australia).

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the general principles of international law and in particular to the rules of interpretation set out in Article 31 of the Vienna Convention on the Law of Treaties”. “Article 31 is acknowledged to have codified the relevant principles of interpretation”.¹⁷⁷

- The Federal Canadian Court applied Article 32 of the VCLT to authorise the examination of the circumstances existing when the treaty was signed in the *Gladden* case.¹⁷⁸

4.3. Reference to the OECD MC and Commentaries

The OECD MC and Commentaries are generally considered as supplementary means of interpretation under VCLT Article 32. Under the VCLT Article 32, they can only be used strictly to avoid an ambiguous, obscure, absurd or unreasonable meaning under Article 31, or to confirm the Article 31 result. Although the OECD Committee on Fiscal Affairs does not intend for them to have a limited role,¹⁷⁹ it is difficult to justify including them as part of context under VCLT Article 31. Very few bilateral treaties have explicitly included the use of the Commentaries as a protocol to a treaty.¹⁸⁰ The Commentaries and judicial decisions also confirm that the expressed provisions in a negotiated tax treaty alone constitute a legally binding agreement.

Few Court decisions have considered their legal status. Although it is still controversial, the OECD MC and Commentaries are widely accepted by the Courts for treaty interpretation. There are legal decisions supportive of the MC and the Commentaries in several countries.¹⁸¹ Some specific references to the Model and the Commentaries in cases involving treaty interpretations include:¹⁸²

- MC Articles 3(1) (c) and 7(1): the definition of an “enterprise” in *Thiel v FCT* by the High Court of Australia.¹⁸³ A Swiss resident taxpayer converted his mutual fund units into shares in an Australian company and sold them at a profit. The Australian High Court held that an isolated activity could constitute an enterprise for treaty purposes under the OECD Commentary.
- MC Article 4(1): in the *Crown Forest* case, the Court interpreted the term “resident” under the US-Canada tax treaty.¹⁸⁴ It held that “the authority . . . that only those who are liable to tax on their worldwide income can be justifiably considered residents for the purposes of international taxation conventions is found in the first sentence of Article 4 of the OECD Model Convention. . .”.

¹⁷⁷ *Gimpey v Ireland* (1988) IR 567, 582 (Ireland).

¹⁷⁸ *Gladden Estate v The Queen* (1985) DTC 5188 (Canada): A US resident died owning Canadian shares. Under the Canadian tax law, the deceased person was deemed to have disposed of all his Canadian property just before death and was subject to capital gains tax. The tax treaty exempted real capital gains. The Court held that the Vienna Convention should apply, and it was “unreasonable and absurd” to cover a real gain in a treaty but not a deemed gain.

¹⁷⁹ OECD MC: Introduction, para. 29.

¹⁸⁰ Example: Memorandum of Understanding Re Interpretation of the Convention, May 31, 1996, United States-Austria.

¹⁸¹ Philip Baker, *Double Taxation Conventions and International Law*, pp. 24–29.

¹⁸² Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 23.24–23.26, 26.15–26.16.

¹⁸³ *Thiel v FCT* (1990) ATC 4717 (Australia).

¹⁸⁴ *Crown Forest Industries Ltd v The Queen* (1995) 95 DTC (Canada).

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- MC Article 26: in the Burbank case, the Court referred to both the OECD MC and the Commentary as aids to interpretation and stated that the defined purpose of the treaty was to avoid and relieve double taxation as well as to prevent fiscal evasion.¹⁸⁵ The Court held that the US IRS could pass tax information to the Canadian Revenue under the terms of the treaty, even when no US taxes were involved.
- MC Commentaries: in *Sun Life Assurance Co. of Canada v Pearson*, the English High Court held that “it is common ground . . . that the Commentaries must be referred to as a guide to the interpretation of the treaty”.¹⁸⁶
- MC Commentaries: in the Cudd Pressure case, the Canadian Court held that “the OECD Commentaries, therefore, can provide some assistance in discerning the legal context surrounding double taxation conventions at international law”.¹⁸⁷

4.4. Other Judicial Decisions

The decisions on tax treaties by the national Courts or authorities in the other Contracting State or third States may be applied but are not mandatory.¹⁸⁸ They tend to be persuasive but not binding. However, foreign judicial decisions may provide important insights. They may also include countries other than the treaty partner. There are examples of this principle of common interpretation in the legal decisions of many countries.¹⁸⁹

Common interpretation does not mean acceptance without review.¹⁹⁰ Generally, foreign Court decisions need to be applied with some caution since interpretation principles or approaches towards the application of the VCLT or the domestic law meaning may differ. This principle does not apply where the treaty expects each Contracting State to apply its own domestic laws.¹⁹¹

In *CIR v JFP Energy Incorporated (New Zealand)*, the New Zealand Court of Appeal accepted the US Technical Explanation to interpret the phrase: “borne by a permanent establishment” in OECD MC 15(2). It held: “. . . it is obviously desirable that the same interpretation answer should be given whether a double taxation treaty question arises in New Zealand or the US and in our view appropriate consideration should be given to the considered official opinion of the other party to the treaty as to its meaning”. Technical Explanation in the US MC did not form part of the treaty but reflected the unilateral views

¹⁸⁵ *United States v A.L. Burbank & Co.* (1975) 525 F 2d 9 (US).

¹⁸⁶ *Sun Life Assurance of Canada v Pearson* (1984) STC 461 (UK).

¹⁸⁷ *Cudd Pressure Control Inc. v The Queen* (1999) CTC 1, 12 (Canada).

¹⁸⁸ Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 29.06–29.17.

¹⁸⁹ Examples: A Dutch interpretation was used in Canada in *Hunter Douglas v MNR* 79 DTC 5340; UK and Canadian decisions were applied in Australia in *Thiel v FCT* 90 ATC 4717; a German decision was applied in New Zealand in *CIR v United Dominions Trust Ltd* (1973) 1 NZTC 61028; a Canadian decision was applied in United States in *Donroy Ltd v US* (1962) 301 F 2d 200; a German decision was applied in India in *CIT v Vishakhapatnam Port Trust* 144 ITR 146, 157–158; a United States Court decision was applied in Canada in *No. 630 v MNR* 59 DTC 300; etc.

¹⁹⁰ *Fothergill v Monarch Lines* [1981] AC 251 (UK): Mummery J held that the “decisions of foreign Courts on the interpretation of a Convention or treaty text depend for their authority on the reputation of the Court in question.” Lord Scarman also observed in the *Fothergill* case: “Our Courts will have to develop their jurisprudence in company with the Courts of other countries from case to case. . .”

¹⁹¹ Klaus Vogel, *Double Taxation Conventions*, Introduction, m.no. 77.

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of the US treaty negotiators. Nevertheless, the Court cited it since it was a help in the treaty interpretation on the case.

4.5. Country Examples¹⁹²

Australia

Australia ratified the VCLT in 1974 and follows its rules unless there are specific treaty interpretation or application requirements under the domestic law. Tax treaties are implemented as Schedules to the International Tax Agreements Act 1953 and subject to the Acts Interpretation Act 1901 under its domestic law. The domestic rules under Sections 15AA and 15BB of this Act reflect the parliamentary intention when enacting treaty-implementing laws and theoretically permit specific treaty overrides.¹⁹³ Otherwise, customary international law prevails over domestic law.

Several domestic cases have supported the use of the VCLT on tax treaties.¹⁹⁴ In the *Tasmanian Dam* case, Judge Brennan of the Australian High Court held: “The interpretation of the Convention . . . should follow the Article of the VCLT, the provisions of which codify existing customary law and furnish presumptive evidence of emergent rules of general international law”. He considered Article 31 of the Convention as “the leading general rule of interpretation of treaties”.

*Canada*¹⁹⁵

The Canadian Courts usually take a purposive view on treaty interpretations.¹⁹⁶ In *Stickel v MNR*, the judge held that the “treaties are to be construed in the most liberal spirit provided, however, that the sense is not wrested from their plain and obvious meaning; the Courts should examine treaty provisions to ascertain and give effect to the intention of the Contracting States as expressed in the words used by them”.¹⁹⁷ In the *Gladden Estate* case, the judge added, “a literal or legalistic interpretation must be avoided when the basic purpose of the treaty might be defeated or frustrated insofar as the particular item under consideration is concerned”.¹⁹⁸ In the *Crown Forest* case, the judge reviewed the intentions of the drafters of the treaty.¹⁹⁹

Canada ratified the VCLT in 1970 and its Courts have mentioned the VCLT in several tax cases. They accept that the Convention codifies the existing public international law.

¹⁹² See Hugh Ault and Brian Arnold, *Comparative Income Taxation*, pp. 430–432.

¹⁹³ See *Horta v Commonwealth (1994) 181 CLR 183* (Australia).

¹⁹⁴ Examples: *The Commonwealth v Tasmania* (1983) 158 CLR; *Koowarta v Bjelke-Petersen* (1981–82) 153 CLR 168; *Thiel v FCT* (1990) 171 CLR 338; *FCT v Lamesa Holdings BV* (1997) 77 FCR 597; *Chong v FCT* (2000) FCA 635 (Australia).

¹⁹⁵ Jacques Sasseville, *Interpretation of Double Taxation Conventions in Canada – An Update* (IBFD Bulletin, August/September 1994); James Hausman, *Interpreting Tax Treaties – A Canadian Perspective* (IBFD Bulletin, March 2001) pp. 93–99; Stephen R. Richardson, *Bilateral Income Tax Conventions and Canadian Domestic Law* (Special Seminar on Canadian Tax Treaties Policy, IFA Canadian Branch, 2000).

¹⁹⁶ *Stubart Investments Ltd. v The Queen* (1984) 84 DTC 6, 305 (Canada).

¹⁹⁷ *Stickel v MNR* [1972] FC 672, 679 (Canada).

¹⁹⁸ *Gladden Estate v R* (1985) 85 DTC (Canada).

¹⁹⁹ *Crown Forest Industries Ltd. v The Queen* (1995) 95 DTC (Canada).

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Grant J held in the *Hunter Douglas* case: “The Vienna Convention on the Law of Treaties, to which both Canada and the Netherlands are parties, contains the general rules of interpretation of international conventions”. The *Cudd Pressure* case reaffirmed that: “It is generally accepted that the Vienna Convention on the Law of Treaties codifies previously existing public international law. The principles set out in this Convention and what it says in Articles 31 and 32 regarding interpretation of treaties are applicable to the issues at hand”.²⁰⁰ The interpretative principles under VCLT were mentioned by the Canadian Supreme Court in the *Crown Forest* case to justify the use of extrinsic materials such as Model Conventions and Commentaries.²⁰¹

Canada passed a new law after the *Melford* case.²⁰² Under the Income Tax Conventions Interpretation Act of 1985, unclear treaty terms are interpreted on an ambulatory basis. Thus, under the Canadian domestic law the meaning when the treaty is applied now supersedes the definition of the terms at the time of signing the treaty.

France

Until 1990, the French Courts were not permitted to interpret treaties, unless the meaning was clear (the doctrine of “*acte clair*”), or the matter was under dispute. Only the Ministry of Foreign Affairs could issue rulings on treaty interpretations, which were held to be binding on the Courts. Under a 1990 decision of the Conseil d’Etat (“Supreme Court”), the French Courts are now empowered to interpret a treaty even if its provisions are not clear. Moreover, an interpretation ruling of the Ministry is no longer binding upon the Courts.²⁰³

Generally, tax treaties are given a strictly literal interpretation by the two highest Courts in France (e.g. the Cour de Cassation and Conseil d’Etat)²⁰⁴ under Article 34 of the French Constitution. They are interpreted against the tax authorities in case of doubt. Although France is not a party to the VCLT, it follows the rules as customary international law.

Germany

Germany signed the VCLT in 1970 and ratified it in 1987. The German Courts generally follow the VCLT approach to comply with the legislative intent in treaty interpretation. Under the VCLT, the treaty intentions must be evidenced in the actual text of the treaty. The parties should also attempt to find a common interpretation, wherever possible. The requirement to interpret the treaty “in the light of its object and purpose” requires that parties should look for an interpretation acceptable to both Contracting States and examine the meaning of the terms in the other partner’s jurisdiction.

²⁰⁰ *Cudd Pressure Control Inc. v The Queen* [1995] DTC 565 and 566 (Canada).

²⁰¹ *Crown Forest Industries Ltd. v The Queen* (1995) 2 SCR 802.

²⁰² *R v Melford Developments Inc* (1982) 82 D.T.C. 6281 (Canada): The Canadian Supreme Court applied the definition under the domestic law when the Canada-Germany tax agreement came into force to exclude a loan guarantee fee as interest income. It ignored the subsequent changes in the provision under the Canadian Income Tax Act of 1974.

²⁰³ Decision of June 29, 1990, Req. no. 78519, RJF 8-9/90 (Source: Philip Baker: Double Tax Conventions and International Tax Law, p. 25).

²⁰⁴ Under the French civil law, the Conseil d’Etat deals with public law while the Cour de Cassation handles private law disputes.

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India

The Indian Courts normally follow a literal approach on treaty interpretations, as in domestic tax law.²⁰⁵ Nonetheless, a decision of the Andhra Pradesh High Court in 1983 did provide for a more liberal treaty interpretation.²⁰⁶

Two decisions in the 1990s took an even more liberal viewpoint in favour of taxpayers.²⁰⁷ The Indian Courts held that under the India-Malaysia tax treaty, the term “may be” was meant not only to give the source country the option to tax, but also to deprive the residence country its right to tax. As a result, “may be” was interpreted as “shall only be” and the taxpayer was granted tax exemption rather than tax credit under the treaty. The judgments ignored the OECD Commentary as irrelevant in the concerned legal cases. These decisions were confirmed by the Indian Supreme Court in May 2004 in a similar case of *CIT v P.V.A.L. Kulandagan Chettiar*.²⁰⁸

A purposive decision was given in a 1998 Tax Tribunal case. It held that a retroactive amendment of the treaty could not be enforced under the principle of promissory estoppel. Here, a change in the India-Germany tax treaty provisions levied tax on certain royalties. The payments were exempt under the previous treaty. The new protocol was made effective from a date earlier than the date of notification and entry into force. The Tribunal maintained that a retroactive operation of a treaty could not be applied to impair an existing treaty benefit by an executive action. No retrospective effect can be given to a particular term of the protocol, unless the protocol itself authorises it. A change in treaty provisions with adverse effect can only be prospective.²⁰⁹

India is not a party to the VCLT but generally follows the VCLT rules as codification of customary international law. In a landmark decision in 2003, the Indian Supreme Court held that treaties should be interpreted liberally to implement the true intentions of the parties. Despite this view, the Court took a literal view of the India-Mauritius treaty. It stated that its duty was to decide what the law was and apply it and not to make it.²¹⁰

United Kingdom

The United Kingdom Courts have usually adopted a literal approach to domestic tax legislation and avoided a purposive interpretation. Each word is given its natural meaning, and no account is taken of any extrinsic material. The judge is bound to follow the statute on tax law, and ignore the legislative intention or equity considerations. The purposive approach or liberal interpretation is used under the “mischief rule” only if the result is absurd. Before this rule can be applied, the legislation must be ambiguous, or misleading.

205 Roy Rohatgi, Case History for Tax Planners in India (International Tax Review, October 1997).

206 *CIT v Vishakhapatnam Port Trust* (1983) 144 ITR 146 (India).

207 Karnataka High Court: *CIT v R M Muthaiah* 202 ITR 508 (India); Madras High Court: *CIT v S R M Firm* (1994) 208 ITR 400 (India).

208 *CIT v P.V.A.L. Kulandagan Chettiar* (2004) 267 ITR 0654 (India): In the *Kulandagan Chettiar* case, a tax resident in India owned rubber plantations in Malaysia, which were managed and controlled wholly in that country. The Indian Supreme Court held that the entity was resident in Malaysia under the treaty. Since there was no permanent establishment in India, the income was not taxable in India.

209 *The Tata Iron & Steel Co. Ltd v DCIR* (1998) ITAT (India).

210 *Union of India v Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India).

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In such cases, one may look at the intention of Parliament to determine what mischief the law was intending to prevent.

However, the UK Courts have taken a broad approach on treaty interpretations and used preparatory materials as an interpretation aid in many cases.²¹¹ They have applied the maxim “*ut res magis valeat quam pereat*” (so that the thing has validity rather than perishes) to give effect to the underlying treaty provisions.²¹² For example, the judge in the *Stagline* case²¹³ mentioned “the language of the rules should be construed on broad principles of general acceptance”. A similar view was also expressed in another UK case, where the judge stated that conventions are apt to be more loosely worded than Acts of Parliament.²¹⁴ In *Fothergill v Monarch Airlines Ltd*,²¹⁵ Lord Diplock said:

“The language of an international convention has not been chosen by an English Parliamentary draftsman. It is neither couched in the conventional English legislative idiom, nor designed to be construed exclusively by English judges. It is addressed to a much wider and more varied judicial audience than an act of Parliament that deals purely with domestic law. It should be interpreted unconstrained by technical rules of English law or by English legal precedent, but on broad principles of general acceptance”.

The *Fothergill* case involved the UK Carriage by Air Act, 1961. The Court held that “a strict literal approach to interpretation is not appropriate in construing legislation which gives effect to or incorporates an international treaty”. In case of ambiguity, “it may be possible to resolve the ambiguity by giving a purposive construction to the Convention, looking at it as a whole by reference to its language as set out in the relevant legislative instrument. The judges agreed that Courts may use the legislative history, the “*travaux preparatoires*”, the international case laws and the writings of jurists for interpretation of treaties. However, in their view, they should be used only as aids. They are not a substitute for the terms of a treaty and their use by the Courts is not mandatory, but discretionary. The Court also approved of the use of parallel judicial decisions in other countries. They mentioned, “the decision of a superior court, or the opinion of a court of cassation, will carry great weight”.

In the *Commerzbank* case, the UK Court also concluded that a strictly literal approach may be inconsistent with interpreting an international treaty and accepted the rules under the Vienna Convention. The treaty interpretation should look at the “clear meaning” in good faith, unconstrained by the domestic law. Supplementary means of interpretation may be used if the results are ambiguous, but in a discretionary, non-mandatory manner. The OECD Commentary, *travaux preparatoires* and foreign Court decisions on tax treaties have persuasive value only. Finally, “the primary necessity of giving effect to the plain terms of a treaty or construing words according to the general and ordinary meaning or their natural significance are to be the starting point or *prima facie* guide and cannot be allowed to

211 Michael Edwardes-Ker, *Tax Treaty Interpretation*, Chapter 3.09–3.15.

212 *Union Texas Petroleum Corporation v Critchley* (1988) STC 356 at 369 (UK).

213 *Stagline Ltd v Foscolo, Mango & Co Ltd*. [1932] AC 328 (UK).

214 *James Buchanan & Co v Babco Forwarding and Shipping (UK) Ltd*. [1978] AC 141 (UK).

215 *Fothergill v Monarch Airlines Ltd* [1981] AC 251 (UK).

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obstruct the essential quest in the application of treaties, namely, the search for the real intention of the Contracting parties in using the language employed by them”.²¹⁶

In *Memec plc v IRC*, the Court of Appeal followed a similar approach. It held that a literal interpretation will be “inconsistent with the purposes of the provisions or treaty in question”. Such interpretation should address a wider judicial audience in both Contracting States.²¹⁷

United States

The United States signed the VCLT in 1970. Although it has not ratified it yet, it accepts its principles under customary international law. The Courts usually adopt a liberal interpretation to give effect to the apparent intentions of the contracting parties²¹⁸ and the purpose of the treaty.²¹⁹ They also look at extra-textual materials such as legislative history in the Senate and Congress proceedings and the US Treasury reports, to implement congressional intent. This approach is arguably against the VCLT (or customary international law) since they are unilateral material.²²⁰

5. MODEL TAX CONVENTIONS

5.1. *Historical Background*²²¹

The first contemporary bilateral tax treaty on income and property was signed between Prussia and Austro-Hungary in 1899. After the First World War, the League of Nations took the initiative to evolve an internationally acceptable double tax treaty. In 1921, the Finance Committee of the Council of the League of Nations commissioned four eminent economists (Bruins, Einaudi, Seligman and Stamp) to study the issue of double taxation and tax avoidance. Their 1923 Report regarded double taxation as a barrier to new foreign investment, and considered that the function of the tax treaty was to promote such investment by removing this trade barrier. The treaty fulfilled this goal by preventing double taxation. Thus, the encouragement of foreign investment was the end and the avoidance of double taxation was just one of the means to achieve it.²²²

The Financial Committee of the League also appointed in 1922 a group of international tax officials to study the administrative and practical aspects of international double taxation and tax evasion.²²³ Several model tax treaties drafted by them were finally presented at a

²¹⁶ *IRC v CommerzBank AG* [1990] STC 285 (UK).

²¹⁷ *Memec plc v IRC* (1998) STC 754 at 766g-j (UK).

²¹⁸ *Factor v Laubenheimer* 290 US 276, 293 (US); *Bacardi Corporation v Domenech*, 311 US 150, 163 (US).

²¹⁹ *Estate of Burghardt v Commissioner* (1983) 80 TC 705, 713 (US).

²²⁰ Victor Thuronyi, *Comparative Tax law*, p. 119.

²²¹ Manuel Pires, *International Juridical Double Taxation of Income* Kluwer law International, 1989) pp. 93–105; *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (United Nations, 2003), pp. 25–32.

²²² See Joel Nitikman, *Current Tax Treaty Cases of Interest* (Tax Analysts, September 20, 1999) paras. 3–5. According to footnote 8 in his article, the above view was also held by the Fiscal Committee appointed by the League of Nations in 1929.

²²³ The group was set up in 1922 with senior tax officials from Belgium, Czechoslovakia, France, Italy, the Netherlands, Switzerland and the United Kingdom. In 1925, it was enlarged with members from Argentina, Germany, Japan, Poland and Venezuela. In 1927, the United States joined the group.

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General Meeting of Government Experts held in October 1928 in Geneva.²²⁴ In 1929, the Council of the League of Nations appointed a permanent Fiscal Committee. This Committee issued its draft Model Convention for the Allocation of Business Income between States for the Purposes of Taxation in 1933 (revised in June 1935). Although the 1935 Draft (Exhibit 5) was never formally adopted, it was subsequently combined with the 1928 Geneva Draft (Exhibit 4) to produce eventually the draft Mexico Model (Exhibit 6) in 1943.²²⁵ This draft treaty included both the prevention of double taxation and the allocation of taxing jurisdiction among its objectives.²²⁶

In March 1946, the Fiscal Committee met in London when a revised draft Model (Exhibit 7) was discussed at their tenth meeting.²²⁷ While the Mexico Draft approved source-based taxation and favoured capital-importing countries, the London Draft gave more taxing rights to capital-exporting nations, particularly on dividends, interest, royalties, annuities and pensions. The work of the League of Nations was taken over by the Fiscal Commission set up by the Economic and Social Council of the United Nations (ECOSOC) in October 1946. In 1951, the London Draft was abandoned in favour of the Mexico Draft. The subsequent efforts of the Fiscal Commission were unable to reconcile the taxing interests of the capital-exporting (or developed) and capital-importing (or developing) countries and it suspended its work in 1954.²²⁸

The Organisation for European Economic Co-operation (“OEEC”)²²⁹ took over the initiative in the late fifties. Its Fiscal Committee was requested to draft a Model treaty in 1956. From 1958 to 1961, the Committee prepared four interim Reports and finally published the first Draft Double Taxation Convention on Income and Capital (“OECD Model” or “OECD MC”) in 1963.²³⁰ The Fiscal Committee (renamed the Committee on Fiscal Affairs in 1971) evolved a Model treaty draft based on the 1946 London Draft. Its recommendations were adopted by the Council of the OECD in July 1963 (“1963 Draft”). A revised MC was published in 1977 (“1977 Model”). It was later revised in 1992 (“1992 Model”), and subsequently updated in 1994, 1995, 1997, 2000 and 2003 (Exhibit 1). A further update is expected in 2005. Since 1992, the MC and its Commentaries are published

224 During the period from 1923 to 1927, the group drafted several Model treaties. They included the Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes dealing with Income and Property Taxes (Exhibit 4), a Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties, a Bilateral Convention on Administrative Assistance in Matters of Taxation and a Bilateral Convention on Assistance in the Collection of Taxes.

225 The Second Regional Tax Conference held in July 1943 in Mexico adopted a Model Bilateral Convention for the Prevention of the Double Taxation of Income and a Model Bilateral Convention for the establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes. Both of them contained a related Protocol.

226 Although both objectives were (and are) meant ultimately for the encouragement of foreign investment, the preamble of the treaty today does not reflect this ultimate aim. (See footnote 222)

227 Detailed Commentaries on the London and Mexico drafts were issued by the Fiscal Committee subsequently. (Exhibit 8)

228 See Manuel Pires, *International Juridical Double Taxation of Income*, pp. 98–100.

229 This body was reconstituted as the Organisation for Economic Co-operation and Development (“OECD”) in September 1961.

230 The OECD published a Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Estates and Inheritances in 1966. The OECD Estate, Inheritance and Gift Model Convention was finally issued in 1982.

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by the OECD Committee on Fiscal Affairs in an ambulatory form (loose-leaf) to permit continuous future updates.

The OECD, as a group of developed countries, had similar taxing interests and tax treaty policies. Its Model treaty was intended for the use by its Member States, who had comparable tax systems and tax objectives, particularly on taxing rights of the State of residence. It was based essentially on two premises: (a) the country of residence would eliminate double taxation through the credit method or the exemption method; and (b) the country of source, in response, would considerably restrict the scope of its jurisdiction to tax at source and reduce the rates of tax where jurisdiction was retained.²³¹ Many countries felt that this approach did not address sufficiently the concerns of developing countries. The UN Manual states in its Introduction (Paragraph 15):

“Bilateral tax treaties have been negotiated in the light of various monetary, fiscal, social and other policies important to the negotiating parties. Conclusion of a treaty between two developed countries is facilitated by their approximately similar levels of development, so that the reciprocal flows of trade and investment – and hence the respective gain or loss of revenue to the parties from reducing taxes on those flows – have been relatively equal in magnitude. The presumption of equal reciprocal advantages and sacrifices underlying treaties between developed countries is not valid when the negotiating parties are at vastly different stages of economic development”.

The Fiscal Committee of the OECD also recognised as early as 1965 that its Model treaty was not appropriate for capital importing countries. Since income flows were largely from developing to industrialised countries, the revenue sacrifice was one-sided. This factor required greater allocation of taxing rights to the developing country in the various Articles of the Model.²³²

In the mid-1960s, the United Nations took renewed interest in the problem of double taxation “as part of its action aimed at promoting the flow of foreign investment to developing countries”.²³³ In August 1967, ECOSOC decided to set up an ad hoc working group to develop an appropriate framework for tax treaties between developed and developing countries and to provide guidelines for their negotiation. The committee called the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries comprising independent tax experts was appointed in 1968. The Committee’s efforts led to the UN Model treaty. The Group was renamed as the Ad Hoc Group of Experts on International Co-operation in Tax Matters and enlarged in 1980.²³⁴ The enlarged Group comprises 15 members from developing and 10 members from developed countries.²³⁵

231 UN Negotiation Manual, Part 1, para. 68.

232 UN MC: Introduction, para. 3; OECD Fiscal Committee, Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee (OECD, 1965) para. 164.

233 UN MC: Introduction, Para. 32.

234 By its resolution 2004/69 of November 11, 2004, ECOSOC has now renamed the Group the Committee of Experts on International Co-operation in Tax Matters. The mandate of the Group has been broadened to include tax treaties between developed and developing countries and international co-operation in tax matters. Moreover, the Committee will meet every year (previously every two years).

235 The Ad Hoc Group is still active. In December 2003, it held its 11th Meeting in Geneva, Switzerland. For a brief account of its activities to date, read Ned Shelton, Interpretation and Application of

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The UN Model Convention between Developed and Developing Countries (“UN Model” or “UN MC”) was issued in 1980 with its own Commentaries. An updated version was adopted in January 2001 (Exhibit 2). A companion publication – Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries – was also published in 1979 (revised in 2003). The term “UN Model” does not imply that it contains formal recommendations of the United Nations.²³⁶

Besides the two Model Conventions, many countries also have their own “model” treaty, which they use mainly in their treaty negotiations. These “model” treaties reflect their treaty policy based on domestic tax system and negotiating objectives. Most of them are unpublished. Some examples include:

- The US Treasury Department published a Model Income Tax Convention in 1981, but withdrew it subsequently in 1992. A new US model treaty (“The 1996 United States Model Income Tax Convention” – US MC) was released in September 1996 (Exhibit 3). It offers insights into the US Treasury’s views on treaty interpretations, and its negotiating posture in tax treaties, particularly its right to tax its citizens and corporations on their worldwide income. It also contains a separate section with detailed explanations (“Technical Explanation”) The US Model reflects its domestic policy, as a major net capital exporter, on anti-abuse rules such as treaty shopping, tax sparing and CFC rules. It contains a detailed Limitation on Benefits Article (Article 23). It also provides a “saving clause” to retain the taxing rights over its own residents (Article 1(4)).²³⁷
- The Netherlands Model of 1987 is similar to the OECD MC. The Dutch model allows for source tax exemption of interest and royalties, for reciprocal relief for pension contributions, and for tax arbitration and mutual assistance in collecting taxes. The Model also provides for capital gains tax on substantial participations by nonresident individuals. The 1987 Model is provided with detailed explanations and subsequent updates.

The OECD/Council of Europe Convention on Mutual Administrative Assistance in Tax Matters (1988) provides compliance assistance to tax authorities on a multilateral basis. It applies to all kinds of taxes, including social security contributions, and assists in the recovery of taxes. The Convention came into force on April 1, 1995.²³⁸

The chronological history of the evolution of Model tax treaties over the years is as follows:

(a) League of Nations:

- 1928 – Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes (1928 Draft)
- 1935 – Double Taxation and Tax Evasion Convention for the Allocation of Business Income between States for the Purposes of Taxation (1935 Draft)
- 1943 – Bilateral Convention for the Prevention of the Double Taxation of Income with Protocol (Mexico Draft)

Tax Treaties (Lexis Nexis, 2004) pp. 531–534. Additional information is available on its website: <http://www.un.org/esa/ffd/ffd/taxation.htm>

²³⁶ UN Model Convention: Introduction, para. 35.

²³⁷ Victor Thuronyi, Comparative Tax Law, p. 120.

²³⁸ Asif H. Qureshi, The Public International Law of Taxation, pp. 350–363.

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- 1946 – Bilateral Convention for the Prevention of the Double Taxation of Income and Property with Protocol (London Draft)
- (b) Organisation for European Economic Co-operation/Organisation for Economic Co-operation and Development:**
- 1963 – Draft Double Taxation Convention on Income and on Capital (1963 Draft)
 - 1977 – Model Tax Convention on Income and on Capital 1977 (1977 MC)
 - 1992 – Model Tax Convention on Income and on Capital 1992 (1992 MC), as updated in 1994, 1995, 1997, 2000 and 2003. The next update is proposed in 2005.
- (c) United Nations:**
- 1979 – Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (1979)
 - 1980 – United Nations Model Double Taxation Convention between Developed and Developing Countries (1980)
 - 2001 – United Nations Model Double Taxation Convention between Developed and Developing Countries (2001)
 - 2003 – Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (2003)
- (d) United States:**
- 1981 – United States Model Income Tax Convention (1981 with earlier Drafts in 1976 and 1977)
 - 1996 – United States Model Income Tax Convention of September 20, 1996

5.2. How do Model Tax Treaties Work

The main objective of the Model tax treaties is to avoid simultaneous taxation in both countries under their domestic tax laws. They are an attempt to resolve some (but not all) of the problems of overlapping tax jurisdictions through internationally accepted tax rules. They recognise that each State is entitled to exercise its sovereign taxing rights within its fiscal jurisdiction. To avoid double taxation, the States must agree to limit their own domestic tax rules under the tax treaty.

The Model tax treaty contains classification and assignment rules (also called “distributive rules”) for income subject to taxation under the domestic law of both States. Under a schedular system, tax objects (e.g. income, profit, capital) are placed in income categories with specified treaty “source rules“ to avoid source conflicts, and the taxing rights over them are then allocated through the “assignment rules“ to one or both of the Contracting States. The schedular structure of the Model treaties categorise different classes of active and passive income. These income categories are further sub-divided into various types of business and investment income. Active business income is usually allocated to the source State and passive investment income to the residence State. The State to which the taxing rights are not assigned either exempts or taxes the income with credit for the taxes paid in the other State.

Under the treaty distributive rules, there are more than fourteen categories of income that cover the entire tax base. They comprise of standard clauses (called Articles), which

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may be amended in negotiations by the Contracting States. These Articles may be grouped under:

- Personal scope – The treaty applies to tax residents of one or both Contracting countries under the respective domestic laws.
- Material scope – The treaty includes income and capital taxes at federal, state and municipal levels, irrespective of the manner in which it is imposed.
- Territorial scope – The treaty specifies the geographical area or tax jurisdiction covered under the tax agreement.
- Temporal scope – Generally, the duration of the treaty is indefinite once the treaty is ratified, but it can be terminated or renegotiated as and when required.
- Distributive rules – The treaty provides the rules for the avoidance of double taxation on income or capital.
- Method of relief – The Articles contain the recommended methods for relief in cases of double taxation between the two tax jurisdictions.

The Model treaties distinguish the income under each Article and then specify the State, which has the right to tax them under its “assignment rules”. The “assignment rules” allocate either an exclusive or a limited taxing right to the two countries, using one or more of the following distributive principles on different income sources:

- The exclusive right to tax is with the country of source of the object.
- The source country reserves the right to limited or “shared” taxation of the object.
- The source country may tax fully but does not have exclusive taxing rights.
- The exclusive right to tax is with the country of residence of the subject.

Thus, under these rules the source State bears the tax costs (i.e. loss of tax revenue), in cases where the State of residence has exclusive taxing rights. The State of residence bears the costs when the State of source has exclusive taxing rights, and when both States retain the full rights to tax. The residence State is obliged to grant treaty relief for the foreign taxes paid. In cases where both States share their taxing rights, the cost of eliminating double tax is also shared. In summary, the treaty provides a tax-sharing agreement between two Contracting States. The States either receive or give up their taxing rights on various heads of income, and then obtain a commitment from the State of residence to relieve any juridical double taxation.

Model tax treaties are relieving in nature. Most of its provisions are designed to create rights and benefits for taxpayers where none would otherwise exist. They allocate taxing rights but do not make the tax rules, which are based solely on domestic law.²³⁹ They do not require that the allocated taxing rights must be exercised by a State or dictate how they must be exercised. The use of treaties is also optional since the taxpayer can choose in many countries to apply the domestic tax law if it is more beneficial. The Model treaties may reduce but normally do not increase the taxing rights under the domestic law of each State.

²³⁹ There are a few countries (Examples: Australia, France) where tax treaties can expand the areas of domestic tax liability under their constitutional laws.

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Conflict rules under international law determine which law applies when a transaction or event is subject to two or more legal systems. According to Vogel, tax treaties, unlike conflict rules in private international law, do not have to choose between applicable domestic and foreign law. Each Contracting State applies its own domestic law and then limits the application of that law under the treaty. Treaties establish an independent mechanism to avoid double taxation through a restriction of tax claims in areas where overlapping tax claims are expected, or are at least theoretically possible.²⁴⁰

Therefore, strictly speaking, there are no taxing rules under international law. Treaty rules neither allocate taxing rights, nor resolve tax conflicts, nor do they provide source rules under international tax law.²⁴¹ As a bilaterally negotiated treaty, a treaty only creates obligations under international law to impose certain limits on the domestic tax provisions of the Contracting States. Thus, they are an extension of domestic tax rules affecting international transactions that are binding under international rules governing treaties. A tax treaty can be regarded as a *lex specialis* (e.g. special case) of domestic tax law.

5.3. Relief against Juridical Double Taxation

According to the OECD MC Introduction (para. 3), the main purpose of the Model Tax Convention is to provide “a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation”. As mentioned above, tax treaties provide for the relief to be given by the residence State for juridical double taxation. Unless the source State agrees to forego or limit its rights under a tax treaty, it exercises its rights first, as and when the taxable income arises. The country of residence is then obliged to give relief to avoid the double taxation.

There are two methods for the State of residence to relieve double taxation of income.²⁴²

(a) **Exemption method:** This method avoids or eliminates double taxation by exempting the income from tax in the residence State. It may be “full exemption” or “exemption with progression”.²⁴³ The exemption may be conditional on the levy of tax by the source State under the treaty. However, as treaties allocate taxing rights, and not taxation, double non-taxation can arise.

(b) **Credit method:** This method prevents or partly eliminates double taxation in the State of residence through the grant of credit for taxes paid in the source State. The tax credits could be based on:

- Ordinary or partial credit (i.e. limited to the amount of tax due on equivalent income, as computed under the domestic tax rules).
- Indirect credit for the underlying tax levied in the source State on dividend income.

²⁴⁰ Klaus Vogel, *Double Taxation Conventions* (Kluwer Law International, 1997) Introduction, m.no. 45a–45c.

²⁴¹ O’Hanlon J: A treaty does not impose an obligation on either Contracting State to introduce or continue any form of taxation, but merely regulates the position when such taxation is imposed (*Murphy (Inspector of Taxes) v Asahi Synthetics Fibres (Ireland) Ltd.* [1985] IR 509, 516 (Ireland)).

²⁴² See Chapter 4(8).

²⁴³ The income is included in the tax base of the taxpayer to determine the overall tax rate and the amount of tax. The taxpayer is then allowed a pro rata tax deduction for the exempt income. Since corporate tax is commonly levied at a fixed rate, the exemption from progression usually effects the taxation of individuals.

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- Tax sparing or matching credit for the tax not levied (i.e. “spared” by the source country) due to incentives or allowances. Tax sparing is a concession to ensure that the foreign tax incentives granted to attract foreign investment capital for particular activities are not recaptured by the residence State.

Both exemption and credit methods of double tax relief have advantages and disadvantages. For example:

(a) Exemption method

Advantages:

- It is capital-import neutral, i.e. it treats all taxpayers in the source State on the same tax basis.
- It recognises fully the tax benefits granted by the source State.
- It is the least complex administratively.
- It avoids dealing with two tax authorities.
- It eliminates actual and potential double taxation.

Disadvantages:

- It reduces the tax revenues due to the State of residence.
- The source State may deny certain allowances or deductions.
- The losses of the permanent establishment may be disallowed by the residence State
- It requires detailed financial Statements if exemption is given with progression.
- It encourages the use of low-tax countries or tax havens as source or residence States.

(b) Credit method

Advantages:

- It is capital-export neutral, i.e. it treats all taxpayers in the residence State on the same tax basis.²⁴⁴
- It allows the deduction of foreign losses of permanent establishment in the home country.
- It discourages the transfer of assets or income to low-tax countries or tax havens.
- It is easy to apply since the tax authority giving the tax credit computes the amount under its own laws and does not have to consider the foreign tax system.

Disadvantages:

- The taxpayer always pays the greater of foreign and domestic taxes.
- It could lead to excess foreign tax credits that may not be useable.
- It eliminates the tax relief and incentives given in the source State, unless the residence State spares the tax.
- It makes the export of capital less attractive.
- It is complicated and can be time-consuming.

The choice often depends on the national policy on capital export neutrality or capital import neutrality. Many developed countries prefer the credit system since it is capital-export neutral and treats both domestic and foreign investors fiscally on par. The exemption

²⁴⁴ True capital export neutrality requires that the shareholders are taxed on the entire income of a foreign subsidiary on an accrual basis. Accrual taxation under the CFC rules is usually restricted to passive investment income.

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method is capital-import neutral. Unlike the credit method, tax exemption eliminates both factual and potential double tax.

Tax treaties restrict the taxation in one or both Contracting States but may not eliminate double taxation in all cases. For example:

- Tax conflicts could arise because of differing definitions of terms, under the treaty and the domestic law. This problem may become an issue when there is no autonomous or treaty definition and the domestic laws of the two States do not have a common or clear definition of the terms used in the tax treaty. As a result, the same income may be categorised or classified under two differing treaty provisions.²⁴⁵
- The Contracting States may interpret the same treaty provision differently and arrive at differing conclusions on its applicability. As a result, the residence State may not provide relief for source taxes leading to double taxation.
- The two Contracting States may apply different treaty rules on the same income due to differing treaty interpretations arising from overlaps in the treaty rules or unclear provisions.²⁴⁶
- Double taxation could also arise under the credit system, despite the treaty relief. For example, since the credit is based on the equivalent tax in the residence State under its domestic tax rules, the differences in how the tax is computed could lead to disallowed tax credits for the foreign taxes suffered.
- Tax treaties normally do not relieve economic double taxation.²⁴⁷

5.4. *Benefits of the Model Tax Treaties – Some Examples*

The benefits of the Model tax treaties include:

- They facilitate international trade and investment by eliminating tax impediments under the domestic tax laws of countries on cross-border income flows. They assist global taxpayers chiefly, but not exclusively, to avoid double taxation through provisions that restrict the domestic taxing rights of each Contracting State, and provide tax relief when it arises.
- They provide an internationally accepted format for drafting and negotiating bilateral agreements affecting income taxes. The treaty text classifies the income by type of income and source and provides the rules to assign or distribute them between the Contracting States. In the case of juridical double taxation, it specifies the method of relief that can be used for eliminating them. The treaty applies to all income taxes, including taxes imposed by provincial or state, local and subnational bodies.²⁴⁸
- They provide for a negotiated division of taxing rights over foreign source income of residents under an internationally accepted agreement governed by customary

²⁴⁵ John F. Avery Jones, *Problems of Categorising Income* (International and Comparative Taxation, Kluwer Law International, 2002) pp. 9–27.

²⁴⁶ Kees van Raad: *International Co-ordination of Tax Treaty Interpretation and Application* (Intertax, June/July 2001) pp. 212–218.

²⁴⁷ OECD Commentary: Article 23, paras. 1–2.

²⁴⁸ OECD MC: Article 2(1).

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international law. In particular, they set out the ultimate limits of the taxing powers under the domestic laws of the two States involved. Although the allocation of taxing rights remains a primary consideration in all treaties, it cannot be done unilaterally.

- They provide certainty over source rules. These rules avoid conflict with domestic source rules, if they are different, and ensure relief from double taxation in the residence State. As an internationally accepted agreement, they also restrict the rights of the tax authorities and thereby avoid ad hoc decisions taken by them.
- They provide certainty over time for taxpayers and assure international investors of a stable tax system. On average, the tax treaties of OECD countries remain unchanged for 15 years after they are signed or after a protocol is concluded, unless they are terminated, renegotiated or overridden.²⁴⁹ In most countries, changes in domestic tax laws are made every year. Since treaties generally override domestic law, the treaty guarantees the taxpayers that future increases in taxes over the treaty limits will be restricted.
- They eliminate discriminatory taxation of foreign nationals (including stateless persons) and nonresidents and provide a mechanism to resolve tax disputes through mutual consultations. They also help the tax authorities in the prevention of tax evasion through the exchange of tax-related information. A recent addition to the treaty (Article 27) also permits them to request assistance in the collection of taxes.
- They avoid excessive taxation in source States. The treaty provisions require the source State to grant selective tax benefits (e.g. reduced withholding taxes) and tax exemptions, based on negotiations, to the residence State. Moreover, as treaties are primarily relieving in nature, they do not impose tax. Generally, tax treaties cannot make the taxpayer worse-off than he would be under the domestic tax law.
- They assist global tax planning on cross-border transactions.
- Tax treaties are needed because national tax laws of various countries differ.

5.5. OECD and UN Model Conventions – Comments

What differentiates the UN MC from the OECD MC is the primary objective of each Model. The OECD MC mentions in its Commentary that “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. It is also a purpose of tax conventions to prevent tax avoidance and evasion”.²⁵⁰ The UN MC takes a broader view of taxation as a means to promote the flow of foreign investment to developing countries. It mentions in its Introduction (paragraph 44): “there is a need for international and regional organisations to provide guidelines to facilitate conclusion of tax treaties with a view to promote trade liberalisation and expansion as well as socio-economic growth”. It is a tool for economic growth and not just an agreement for the sharing of taxing rights.

Developing countries using the UN MC often (but not always) mention the promotion of mutual economic relations, trade and investment as one of the objectives of their tax

²⁴⁹ Jacques Sasseville, *Improving the Flexibility of Tax Treaties* (IBFD Bulletin, June 2002) pp. 271–272.
²⁵⁰ OECD Commentary: Article 1, para. 7.

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treaties.²⁵¹ This objective gives the treaty a wider perspective than just avoidance of double taxation. It justifies double non-taxation when countries give up their taxing rights, in cases such as tax sparing. It also permits tax treaties with countries that do not levy direct taxes on some or all of its residents.

The wider objectives of the UN MC also permit intended treaty shopping to meet non-fiscal goals through tax treaties.²⁵² Like tax sparing, this could provide tax benefits to the foreign investor when as a source country it is prepared to give up its taxing rights for other non-fiscal benefits. According to a recent Indian Supreme Court decision, treaties “are negotiated and entered into at a political level and have several considerations as their bases”. The latter may be political, social or economic in nature. In case of treaty abuse due to unintended use of a tax treaty, the Court held that this should be dealt with through specific Limitation on Benefits clause in the treaty.²⁵³

The drafters of the OECD Model assumed that the countries have more or less the same tax bases and the same tax systems.²⁵⁴ The UN Model is meant for treaties between countries with unequal economic status. While the OECD MC presents the views of developed countries and advocates CEN and residence taxation, the developing countries as net capital importers generally prefer CIN neutrality and more source taxation.²⁵⁵ They also prefer the UN MC for its wider treaty policy objective than just taxation and tax sharing, i.e. to promote social and economic growth. For developing countries, treaties are a means to an end and not an end in itself.

Model tax treaties deal with direct taxation only. The treaty objectives are also affected by the different policy on direct taxation of developing countries when compared with developed countries. Moreover, direct taxation often does not constitute the main source of government revenue and is considered both less significant and more cumbersome and costly to collect. As many developing countries rely more on indirect taxation, they can justify low or nil direct taxes under the domestic law and/or tax treaties for wider policy reasons.²⁵⁶

The UN MC is widely used by developing countries as a treaty policy document that favours source-based taxation and non-fiscal objectives. Its provisions are also found in many treaties concluded by transition countries in Eastern Europe. The UN MC has also influenced the tax treaty policy of several OECD Member States.²⁵⁷ Nevertheless, the reputation of the OECD Committee on Fiscal Affairs and its research on international tax issues is recognised. The developing countries often rely on the OECD MC and its

251 Many of the Indian tax treaties contain words such as promotion of mutual economic relations (or similar words).

252 Many developed countries also encourage treaty shopping through their jurisdiction to enable multinationals to establish holding companies and other business activities.

253 *Union of India and Anr. v Azadi Bachao Andolan and Anr.* [2003] 263 ITR 706 (India).

254 Peter J. Wattel and Otto Marres, *Characterisation of Fictitious Income under OECD-Patterned Tax Treaties* (European Taxation, March 2003) p. 69.

255 Unlike the OECD MC, the UN MC may not favour controlled foreign corporation rules intended to achieve capital export neutrality, as treaty policy.

256 Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International) p. 11.

257 Willem Wijnen and Marco Magenta, *The UN Model in Practice* (IBFD Bulletin, December 1997); Hugh Ault and Brian Arnold (ed.), *Comparative Income Taxation*, p. 428.

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Commentaries for guidance on issues involving treaty interpretation, where necessary, to supplement the UN MC Commentaries.²⁵⁸

Tax treaty policy of countries is influenced by their political, economic and social needs. While OECD Committee on Fiscal Affairs performs an excellent role as an international “think tank” on tax-related technical issues, its views on tax treaty policy understandably favour its Member States. To be a legitimate international body, the OECD should take into consideration and meet the expectations of both developed and developing countries and act, as well as be seen to act, in their overall interest. Moreover, it should involve all of them in the formulation of its views. Only a truly world tax organisation can fulfil such an ideal goal.²⁵⁹

6. MULTILATERAL TAX AGREEMENTS

6.1. General

There have been several efforts to agree on a multilateral tax treaty. In 1958, the OEEC Fiscal Committee attempted to draft a multilateral convention but was unsuccessful due to the difficulties of definition and application. Similar conclusions were also reached by the UN Group of Experts when drafting the UN Model Convention.²⁶⁰ A preliminary draft multilateral tax treaty, prepared in 1968 by the European Economic Community, has still not been pursued further. An EFTA working party concluded in 1969 that there were more disadvantages than advantages in a multilateral convention, compared with bilateral tax treaties, in terms of complexity and flexibility.²⁶¹

Multilateral treaties tend to be complex and difficult to apply and understand. They also require a reasonable degree of uniformity in the domestic tax systems of the various countries and in the application and interpretation of the treaties by them. Nevertheless, several regional groups of countries have entered into limited multilateral tax arrangements.

6.2. Andean Pact

Five South American countries²⁶² are members of the Cartagena Agreement of 1969, which established a sub-regional common market in Latin America. They signed a model multilateral tax treaty called the “Andean Pact” (Exhibit 9) in 1971. It aims at a common tax regime for foreign capital, patents, trademarks, licences and royalties among its members.

The Andean Pact is primarily based on the territorial or source tax principle. It gives the source State exclusive taxing rights. The profits are taxable in the State where the business

²⁵⁸ A number of developing countries have published their position regarding the OECD MC and Commentaries. (See Chapter 3(1.2))

²⁵⁹ Ned Shelton, *Interpretation and Application of Tax Treaties*, pp. 534–542.

²⁶⁰ Model Double Taxation Convention Between Developed and Developing Countries (1980) ST/ESA/102, p. 3.

²⁶¹ Report of the Working Party: The Feasibility of a Multilateral Double Taxation Convention Within European Free Trade Area (EFTA 64/69, 1969).

²⁶² The five members of the Andean Pact are Bolivia, Colombia, Ecuador, Peru and Venezuela. Chile is no longer a member.

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activities are undertaken. The concept of a permanent establishment is, however, retained. The income from personal services is taxable in the country where the work is performed. The sole right to tax royalties is reserved for the country where the technology is used. Only the country in which the property is situated at the time of its disposal taxes capital gains. There is also a provision for exchange of information and mutual assistance on tax matters among the member countries.

6.3. CARICOM Multilateral Tax Agreement

Several Caribbean countries²⁶³ renegotiated the CARICOM double tax agreement in 1994. It replaced an earlier multilateral tax agreement signed in 1973. The agreement applies to internal transactions within the member countries, and lays down common guidelines for them in their treaty negotiations with non-members. It meets the objectives of the Treaty of Chaguaramas to encourage free trade and movement of capital within the member countries and to harmonise their economic policies.

Like the Andean Pact, this agreement relies on the source or territoriality-based taxation in preference to the residence-based OECD MC. Therefore, the income is taxable only by the Member State where the income arises. Some of the specific treaty provisions include zero withholding on ordinary dividends. The maximum withholding rate on preference share dividends, interest, royalties and management fees is limited to 15% rate. Management fees (excluding independent professional services) are taxable in the source country at a rate not exceeding 15%. There is no limitation on benefits or beneficial ownership requirements for treaty benefits.²⁶⁴

6.4. Nordic Convention

The Nordic countries (Denmark, Finland, Faeroes Islands, Iceland, Norway and Sweden) in Europe have a multilateral tax convention for double tax avoidance and mutual assistance on tax matters. A revised multilateral treaty was signed in 1989. Generally, the Nordic treaty follows the OECD MC but with certain local variations.

The treaty provides for zero rate withholding tax, subject to certain exceptions, on the dividends paid by qualifying subsidiaries to qualifying parent companies within the Nordic region. It also contains special provisions to prevent “double tax exemption”. If the taxing rights allocated to a Contracting State cannot be exercised by the State under its domestic law, they revert to the other Contracting State. Interest is only taxable in the State of residence, while pensions and annuities are taxable solely in the paying State. Exploration activities

²⁶³ The CARICOM member countries currently are Antigua and Barbuda, the Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Surinam, and Trinidad and Tobago.

²⁶⁴ Bruce Zagaris, The 1994 CARICOM double taxation agreement (IBFD Bulletin, September 1996); Huub Bierlaagh, The CARICOM Income Tax Agreement for the Avoidance of (Double) Taxation (IBFD Bulletin – Tax Treaty Monitor, January 2000); Amos Peters, Exploring Caribbean Tax Structure and Harmonisation Strategies (IBFD Bulletin, May 2002) pp. 178–193.

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for 30 days in a 12-month period in the continental shelf of a Nordic country constitute a permanent establishment or a fixed base.

6.5. Council for Mutual Economic Assistance Agreement (“CMEA”)

Several East European countries²⁶⁵ signed a mutual economic assistance agreement in 1949. Although the CMEA (Council for Mutual Economic Assistance or COMECON) no longer exists, the two multilateral tax treaties, which were concluded in the late 1970s, have not been renounced. It still applies to Bulgaria, Mongolia and the countries of the Commonwealth of Independent States, except Georgia and Kazakhstan.²⁶⁶

The first treaty signed in 1977 deals with individuals; a similar treaty was concluded in 1978 for legal entities. The latter treaty applies to entities that have their legal seat in a country within the COMECON. It grants the residence State the exclusive taxing rights on all income and capital with no withholding taxes on dividends, interest and royalties in the source country. As an exception, the income from immovable property follows the taxation based on situs. Special rules apply to international economic organisations set up under a separate charter or under a bilateral or multilateral agreement. The treaty does not contain any provisions for the avoidance of double taxation or tax discrimination.²⁶⁷

6.6. Others

Other multilateral tax arrangements include the Central African Economic and Customs Union (UDEAC) in Africa.²⁶⁸ They provide for source taxation of employment income, dividends and commercial profits of permanent establishments. Interest and royalties are usually taxed in the residence State. Another similar multilateral tax treaty exists among the members of the West African Economic and Customs Community. Certain Arab countries signed a treaty in 1973 to establish a mutual double tax avoidance arrangement (Egypt, Iraq, Jordan, Kuwait, Sudan, Syria and the Arab Republic of Yemen).

7. EUROPEAN UNION

7.1. General

Several European countries established a common market under the Treaty of Rome (effective from 1958). This European Economic Community was eventually superseded by the Treaty of European Union (also called the Treaty of Maastricht or EC Treaty), which

²⁶⁵ The countries comprised Bulgaria, Czechoslovakia, German Democratic Republic, Hungary, Mongolia, Poland, Rumania and USSR.

²⁶⁶ The CIS countries include Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Moldavia, Russia, Turkmenistan, Ukraine and Uzbekistan.

²⁶⁷ Willem G Kuiper, *The Multilateral CMEA Tax Treaty – Its Relevance Today* (IBFD European Taxation, August 1991).

²⁶⁸ The present members of the Central African Economic and Customs Union (UDEAC) comprise Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon.

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entered into force in November 1993 to create a single European Community (EC). One of the main objectives of the Rome treaty was to eliminate internal trade and tariff barriers and create a Single Market. The EC Treaty established a single economic and monetary union based on the four fundamental freedoms that guarantee free movement of goods, persons, services and capital under the Single European Act of 1987.²⁶⁹ As from May 1, 2004, the European Union comprises of twenty-five Member States.

The EC Treaty contains several provisions that affect domestic taxation of Member States. They include:

- Establishment of a common market (Article 2);
- Development of an internal market without barriers on free movement of goods, persons, services and capital (Article 14);
- Co-ordination of national tax laws to develop a Single Market (Article 3(h)); and
- Prohibition of discrimination on grounds of nationality (Article 12).

In the area of taxation, the European Union has been successful in the harmonisation of value added taxes. It has been achieved through nearly 30 Directives²⁷⁰ of the EC Commission and over 300 rulings given by the European Court of Justice (ECJ). The Sixth Directive issued in 1977 (effective 1978) established a common VAT system with a uniform basis for assessment. Under a 1993 Directive, the Commission implemented a system based on a mixture of origin and destination principles.²⁷¹ Although Member States decide their own VAT rates, a 2001 Directive has set the minimum standard rate at 15%. The 2002 Directive on electronic commerce transactions was enforced from July 2003.

The early progress on direct taxes was slow since changes require a unanimous agreement of all Member States. In 1990, the Commission adopted the Parent-Subsidiary Directive, the Merger Directive and the Arbitration Convention (see below). The European Union also set up a Committee to assess the need for greater tax harmonisation. The Ruding Committee Report,²⁷² released in 1992, contained a number of recommendations on company taxation within the European Union. They included the elimination of withholding tax on cross-border inter-corporate dividends, interest and royalties, the broadening of the scope of the Parent-Subsidiary Directive, the harmonisation of the corporate taxable base, and levels of minimum and maximum corporate tax rates. The Report also recommended an expansion of the tax treaty network within the European Union and suggested guidelines for negotiation of treaties with non-EU countries.

²⁶⁹ The fundamental freedoms under the EC treaty are the free movement of goods, the free movement of persons, the freedom of establishment, the free movement of services and the free movement of capital and payments. The treaty also prohibits discrimination on ground of nationality.

²⁷⁰ Most of the tax-related measures have been introduced through various Directives of the European Commission. They are binding on the Member States and require them to amend their domestic laws accordingly.

²⁷¹ Under the various Directives and rulings, non-taxable persons (largely individuals) follow the origin principle and VAT is charged on them on intra-EU transactions only in the country of purchase. Transactions with taxable persons (e.g. businesses) are levied under the destination principle where the importer pays input VAT and then recovers it from his domestic customers on resale.

²⁷² Report of the Committee of Independent Experts on Company Taxation – Chairman, Onno Ruding (European Communities, Luxembourg, 1992).

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Recent progress has been more rapid. The Commission has now taken steps to eliminate measures that distort competition either under its Code of Business Conduct (see below) or as illegal State Aid. The Competition Directorate of the European Commission published its guidelines concerning State Aid (referred to in Articles 87–89 of the EC Treaty) in November 1998.²⁷³ They are designed to curb and remove State Aid that distorts or threatens to distort competition, otherwise called illegal State Aid, by favouring certain undertakings or production of certain goods. Unlike the Code of Conduct, State Aid provisions apply only to the Member States and not to their dependent territories. Moreover, they apply to companies, certain products and regional areas and include several exceptions.²⁷⁴

Most Member States and their dependent and associated territories have now introduced revised or replacement measures for illegal State Aid, subject to certain transitional provisions. For beneficiaries of those regimes on or before December 2000, a “grandfathering” clause has been provided under which benefits have to lapse no later than end of 2005, independently of whether or not they were granted for a fixed period. Some extensions of benefits for defined periods beyond 2005 are also permitted for the old tax regimes in Member States and their dependent and associated territories.²⁷⁵

The European Court of Justice (ECJ) has also over recent years given several decisions to safeguard the four fundamental freedoms and to prevent tax discrimination against nationals of Member States. Under these decisions, they must be treated equally with own nationals for tax purposes. The ECJ has taken a purposive interpretation based on the European legislative history as well as the legislative intent of the EU Directives. The Court has made exceptions only in special cases where they appropriately serve a legitimate public interest. The ECJ decisions are binding on the Member States and have forced several changes in their domestic tax laws.²⁷⁶

The Commission has also adopted regulations for a European Company (*Societas Europaea*) in October 2001 that became operational for use on October 8, 2004. Under the European Company statute, a European Company can be set up by the creation of a holding company or a joint subsidiary or by the merger of companies located in at least two Member States or by conversion of an existing company set up under national law. As of October 2004, only Austria, Belgium, Denmark, Finland and Sweden had taken steps to allow European companies. There is no special tax regime for them yet. Discussions are also in progress on home state taxation. Under this proposal, EU multinationals will file a tax return of the parent company consolidated with all its EU subsidiaries and branches under the tax law of its home state.

²⁷³ State aid is defined as tax measures that reduce the tax base (special deductions, depreciation, reserves, etc.) or reduce the amount of tax (exemption or credit) or defer, cancel or restructure a tax liability.

²⁷⁴ Christiana Palayi, *Limitations on Benefits and State Aid* (European Taxation, February/March 2004) pp. 87–88.

²⁷⁵ European Commission Release on June 3, 2003.

²⁷⁶ Mark Persoff, *The Impact of EU Developments on Member States' Tax Systems* (International Tax Review, February 2004) pp. 10–14; Hubert Hamaekers, *Taxation Trends in Europe* (IBFD Asia-Pacific Tax Bulletin, February 2003) pp. 42–50.

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7.2. Business Code of Conduct

In the ECOFIN²⁷⁷ meeting of 1997, a Code of Conduct was approved by the EC Council of Ministers. Unlike EC legislation or a Convention, the Code is not legally binding. The Code covers tax measures (legislative, regulatory and administrative) that have, or may have, a significant impact on the location of business in the European Union and unfairly reduce the tax revenue of Member States. It requires Member States to voluntarily refrain from introducing any new harmful tax measures (“standstill”) and amend any laws or practices that are deemed harmful in respect of the principles of the Code (“rollback”). The criteria for identifying potentially harmful measures include:

- an effective level of taxation which is significantly lower than the general level of taxation in the country concerned;
- tax benefits reserved for non-residents;
- tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base;
- granting of tax advantages even in the absence of any real economic activity;
- the basis of profit determination for companies in a multinational group that depart from internationally accepted rules, in particular those approved by the OECD; and
- lack of transparency.

The Code of Conduct Group (Business Taxation) was established on March 9, 1998 (chaired by Ms. Dawn Primarolo, UK Paymaster General) to assess the tax measures that may fall within the scope of the Code of Conduct for business taxation. In 1999, the Group identified 66 tax measures with harmful features (40 in EU Member States, 3 in Gibraltar and 23 in dependent or associated territories). While the Code attempted to harmonise the tax base of Member States it did not regard competition on tax rates as harmful.

In June 2003, the EU finance ministers (ECOFIN) included the Code of Conduct as part of a tax package comprising:

- the Code of Conduct for business taxation to amend, phase out or remove certain tax incentives given by EU Member States and their dependent and associated territories that were identified as harmful tax competition;
- a Directive to abolish withholding taxes on interest and royalties between EU group companies, as from January 2004 (“Interest and Royalties Directive”); and
- a Directive to ensure taxation of interest income of individuals either through exchange of information or interest withholding tax, as from January 2005 (“Savings Directive”).

7.3. European Union Tax Directives

Some of the major Directives issued by the European Union so far on direct taxation include:

(i) Parent-Subsidiary Directive (1990)

The European Union adopted the Parent-Subsidiary (Dividends) Directive (90/435/EEC) in 1990. This Directive avoids the double tax on dividends and other distributions paid

²⁷⁷The ECOFIN Council comprises of the ministers of economic and financial affairs from the EU Member States.

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by subsidiaries to parent companies (not individuals) that are located in two different Member States. The provisions were recently amended by Directive 2003/123/EC dated December 22, 2003 that are enforceable on all Member States by 1 January 2005. See Chapter 5(5.4).

(ii) Savings Directive (2003)

The Savings Directive (2003/48/EC) was finally adopted in June 2003 for implementation by end of 2004. The aim of the Directive is to ensure that savings income is effectively taxed when paid within the European Union. The EU Directive also applies to associated and certain dependent territories of EU Member States. They include Jersey, Guernsey, Isle of Man, Cayman Islands, British Virgin Islands, Monserrat, Turk and Caicos Islands and Anguilla among the British dependencies and the Netherlands Antilles and Aruba as Dutch dependencies.

The Directive requires Member States to permit automatic exchange of information for monitoring the tax collection on cross-border interest payments to European Union residents without requiring reciprocity. The Directive applies only to the savings income of individuals and not to the interest payments made to companies or trusts. Moreover, it excludes interest paid to beneficial owners who are nonresident in the European Union.

The Directive has a broad scope, covering interest from debt-claims of every kind, including cash deposits and corporate and government bonds and other similar negotiable debt securities. The definition of interest extends to cases of accrued and capitalised interest. This includes, for example, interest that is calculated to have accrued by the date of the sale or redemption of a bond of a type where normally interest is only paid on maturity together with the principal (a so-called “zero-coupon bond”). The definition also includes interest income obtained from indirect investment via collective investment undertakings (i.e. investment funds managed by a specialist fund manager who places the investments made by individuals in a diverse range of assets according to defined risk criteria).

As a transitional measure, three States (namely, Austria, Belgium and Luxembourg) are permitted to apply a withholding tax on interest payments.²⁷⁸ The rates are 15 percent for the first three years (2005–2007), 20 percent for the next three years (2008–2010) and 35 percent thereafter (2011 onwards). Those three countries will transfer 75 percent of the revenue to the residence country. This arrangement will be reviewed in 2010 or later. The recipient of the interest income has the option to avoid the withholding tax if he gives his consent to exchange of information. Otherwise, the final paying agent must provide the details of the beneficial recipient within the European Union to the tax authorities.

The transitional period continues unless certain conditions are met. Firstly, the European Union must have reached agreement with five non-EU countries, namely Switzerland, Liechtenstein, San Marino, Monaco and Andorra, to exchange the information about interest payments. These countries must adopt measures equivalent to those in the Directive for the EU Member States to be bound by their agreement. The European Union has accepted that

²⁷⁸ Several of the associated and dependent territories of the EU Member States have also elected for the withholding tax regime during the transitional period.

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the commitment by the United States to disclose information upon request (not automatic) constitutes “equivalent measures”.

The EC Council announced in June 2004 that the exchange of information should be on as wide a basis as possible in line with international developments. Moreover, this Directive should be introduced as part of the Member States’ national laws.²⁷⁹ The Commission reached agreement with the five non-EU countries, including Switzerland, subsequently. On July 19, 2004, the Council announced that the Directive should be applied as from July 1, 2005.

(iii) Interest and Royalty Directive (2003)

The European Commission issued its Directive (2003/49/EC) on cross-border payments of interest and royalties between associated companies in June 2003. It eliminates the taxes levied by source States, through either withholding or assessment, on qualifying intra-group payments of interest and royalties between associated companies and permanent establishments of Member States. Under the Directive, the interest and royalties are taxable only in the Member State where the companies receiving the payments as beneficial owner are located. The Directive does not apply on payments to entities outside the European Union or in cases of tax avoidance or abuse, or to a permanent establishment of a Member State located in a third State. (Article 1, Para. 8).

The Commission made amendments in December 2003 to provide that the exemption applies only if the recipient is subject to tax on the income. No specific level of taxation is required. In addition, the Directive now includes entities covered under the 2003 amendments to the Parent-Subsidiary Directive. The Directive is enforceable as from January 2004, except for the late 2003 amendments for which the latest implementation date is December 31, 2004. Transitional periods have been granted to Greece, Portugal and Spain, and also to Latvia, Lithuania, Czech Republic, Poland and Slovak Republic, who joined the European Union in May 2004.

To qualify as an associated company under the Directive, there must be a direct minimum holding (or voting rights) of 25% of the paying company by the receiving company or vice versa, or a third company must own at least 25% of both companies. All the companies must be tax resident in the Member States. The Directive, however, provides for certain exclusions (Articles 4 and 5) when the Directive is not applicable.²⁸⁰

(iv) Merger Directive (1990)

The Merger Directive (Directive Number 90/434/EEC of July 23, 1990) deals with the taxation applicable to mergers, divisions, transfers of assets and exchange of shares by companies within the EU Member States. It provides for a tax-free transfer of assets and shares on mergers by companies that are resident in the European Union. The two principal

²⁷⁹ European Commission Release on June 3, 2004.

²⁸⁰ Marcello Distaso and Raffaele Russo, *The EC Interest and Royalties Directive – A Comment* (European Taxation, April 2004) pp. 143–154; Philippe de Clippele and Benoit Verschueren, *Interest and Royalties Directive Moves to Full Enactment* (International Tax Review, May 2004) pp. 33–38.

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provisions include:

(a) The State of the transferring company will not recognise any taxable gains upon the transfer of assets and liabilities in a merger or asset transfer. The profits of the transferring company will continue to be taxed as income of a permanent establishment in that State. Moreover, its losses will be retained for future offset against the profits of the permanent establishment.

(b) The State of the shareholders of the transferring company will not recognise any capital gain in a share-for-share exchange. It will retain the tax basis of the old shares in the new shares.

7.4. Other Multilateral Agreements

Some other multilateral agreements concluded by the Member States of the European Union include:

(a) The Arbitration Convention (Arbitration Convention 90/436/1990 of 23 July 1990) permits the optional use of arbitration procedures to resolve transfer pricing conflicts within the Member States of the European Union. The Convention has adopted the arm's length principle contained in OECD MC Article 7(2) and Article 9. The Convention entered into force in October 1999.

(b) The Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive 85/611 harmonises the regulations over collective open-ended investment funds. If a Member State meets the UCITS criteria, its funds can be freely marketed in other European Union countries.

(c) The Mutual Assistance Directive (Directive Number 77/799/EEC (as amended in 1979 and 1989) harmonises Article 26 provisions under the bilateral tax treaties. The Directive deals with the exchange of information to assist in the assessment of taxes on income and capital and value added tax.²⁸¹

7.5. European Human Rights Convention

The European Human Rights Convention of the Council of Europe is not a EU Convention and includes non-EU members as well. It was concluded in Rome in 1951 and currently has 46 members. These members are subject to the European Court of Human Rights (ECHR) based in Strasbourg, France.

Over the past 50 years, the European Court has given its decisions on several tax cases affecting human right issues. The commonly used Articles for taxpayers include the right to a fair trial and public hearing (Article 6), the right to respect for private and family life (Article 8), the prohibition of discrimination (Article 14) and the protection of property (Article 1 of the First Protocol to the Convention). The Convention resembles the International Covenant on Civil and Political Rights ("ICCPR") of the United Nations. Out of the 154 States, which are party to ICCPR, 104 UN members allow taxpayers in their State to challenge the government.

²⁸¹ Asif H. Qureshi, *The Public International Law of Taxation*, pp. 363–367.

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Under the Convention, the right to a fair trial (Article 6) has been applied in several tax disputes. It has been cited in both civil and criminal cases. They include cases involving the presumption of innocence and the right to legal aid and certain guarantees in criminal cases. According to the European Court, although Article 6 does not usually affect civil tax proceedings, it does apply to criminal tax penalties or fines. For example, in a Swiss case, the Court held that 400% penalty for tax evasion was a criminal charge.²⁸² A similar decision was given in another case where UK tax authorities imposed substantial penalties for filing negligent or fraudulent tax returns. The most commonly used right under this Article has been the right to a tax decision within a reasonable time. In several “delay” cases, the Court held a period of over five years as unreasonable.

The European Court has taken up tax cases in several situations under Article 1 of the First Protocol. They include unreasonable tax objectives, disproportionate taxes and unfair balance between the interests of the taxpayer and the community. The cases filed by taxpayers that tax rates were excessive have so far not been successful in the Strasbourg Court. However, the Court has been more sympathetic in cases where the tax rules were either not published properly or were unclear or they were a breach of law.

Article 14 guarantees non-discrimination in tax matters²⁸³ while Article 8 provides for a right to privacy, including in tax matters. The latter Article has been raised by taxpayers when required to provide tax information to the revenue authorities. Article 9 on freedom of thought, conscience and religion has been raised in relation to church taxes. Article 4 of the Seventh Protocol disallows double or multiple punishments for the same tax conduct. Since heavy penalties are considered as a criminal offence under Article 6, further criminal prosecution for tax evasion may lead to double punishment.

So far, there have not been many cases where the taxpayer has been successful under the ECHR rulings.²⁸⁴

7.6. Comments

The European Union has achieved significant harmonisation of indirect taxes, particularly value-added tax, but its success in direct taxes has been limited. Its efforts so far have been directed towards tax base harmonisation. Apparently, Member States are relatively free to compete on tax rates provided there is no ring fencing (i.e. the same rates apply to resident and nonresident taxpayers).

Although the ECJ decisions are slowly helping to create an internal market with more harmonised tax systems, the measures undertaken so far appear to be largely to eliminate

²⁸² The Court also held in this case that tax penalties cannot be inherited since criminal liability dies with the offender. The Swiss tax authorities had tried to impose penalties for tax evasion imposed on the deceased father on his heirs.

²⁸³ In a Dutch case, an elderly lady with no children did not pay a child contribution while a man of similar age had to do so. The Court held that this tax treatment was discriminatory.

²⁸⁴ This brief write-up on ECHR is based on a paper presented by Philip Baker at the International Tax Planning Association in June 2001. For further study, read Philip Baker, Taxation and the European Convention on Human Rights in the Domestic Law of the Council of Europe Countries, *European Taxation*, December 2001 and other related articles in that issue of *European Taxation*.

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harmful tax competition in the Member States (See Chapter 4(8)). It is expected that the increasing need for tax revenues in the future, particularly to finance the rising social security costs in the Member States, will continue to put pressures on them to look at measures to protect their tax base.

8. HARMFUL TAX COMPETITION

8.1. Background

Harmful competition arises due to mismatches in the existing tax systems of countries that can be exploited by taxpayers. Such economic behaviour may be considered as unacceptable tax avoidance by certain countries since they believe that it undermines the integrity and fairness of their tax systems. In December 1997, ECOFIN adopted a Code of Conduct for European Union Member States. It required them to abolish existing practices that promoted harmful tax competition, and not to take new measures that may be harmful. In 1998, the OECD published its own report on harmful tax competition (“1998 Report”).²⁸⁵ This subsection provides a brief summary of the developments in the OECD initiative since 1998, and its status.²⁸⁶

8.2. Historical Development

(i) The 1998 Report

The 1998 OECD Report dealt with tax practices among nations that compete for geographically mobile activities, such as financial and other services (e.g. centralised operations of multinational activities), including the provision of intangibles. It did not apply to other types of tax competition such as (i) competition to attract foreign direct investment for industrial or commercial activities, or (ii) competition to attract passive, portfolio investment. The Report was approved by all the OECD Council members, other than Luxembourg and Switzerland.

According to the Report, harmful tax competition affects the location of activities, and erodes the tax base of other countries. The recent trend towards globalisation had led to increased competition among businesses in the global marketplace. As countries compete for related tax revenues through tax incentives in their own jurisdiction, they effectively divert real investment and “poach” at the tax base that “rightly” belongs to another nation. The spill over effect leads to unfair allocation of global tax revenues and interaction of tax systems that harm global capital flows. It also distorts trade and investment patterns and undermines the fairness, neutrality and the broad social acceptance of national tax systems.

The Report recommended measures to “counter the distorting effects of harmful tax competition on financing decisions and the consequences for national tax bases”. It, however, concluded that the problem could only be resolved satisfactorily through a collective or

²⁸⁵ Committee on Fiscal Affairs: Harmful Tax Competition – An Emerging Global Issue (OECD, 1998).

²⁸⁶ Alex Easson, Harmful Tax Competition: An Evaluation of the OECD Initiative (Tax Analysts, June 9, 2004) –

For a more detailed history and analysis of this OECD initiative, the readers are advised to study this paper. It examines the progress that has been made to date, evaluates some of the criticisms that have been generated, and attempts to provide an overall evaluation of the project.

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multilateral approach by all countries. It identified three types of tax regimes that could divert investment, and tax revenues, to other countries. They were:

- Tax havens: tax havens impose no tax or nominal tax, and assist nonresidents to avoid the taxes in their home country. They attract investment or transactions that are purely tax-driven without economic substance. Many of them have a weak regulatory framework or business infrastructure. As they usually have few or no tax treaties, they impose serious limitations on effective exchange of tax information.
- Preferential tax regimes: these regimes are based in countries with high taxes that allow certain business activities to be subject to low or zero effective tax under special tax rules. They include tax concessions, such as an artificial definition of the tax base, inadequate transfer pricing rules, tax exemption for foreign source income, negotiable tax rate or tax base, secrecy provisions, access to a wide treaty network, etc. Such regimes may also be isolated from the domestic economy (i.e. ring fenced), non-transparent or again lack effective exchange of tax information.
- “Normal” tax regimes: countries that collect significant revenues at low tax rates and do not have special tax concessions to attract mobile financial activities from abroad. (This category was excluded from the study.)

The Report concentrated only on tax havens and preferential tax havens, and suggested several indicators of harmful tax competition. In particular:

- Is the preferential tax regime the primary motivation for the location of an activity?
- Is there a shift of a business activity from one country to a country providing the preferential tax regime without generating significant new activity?
- Are the activities in the country commensurate with the amount of investment or income?

The OECD Report also made nineteen specific recommendations to curb harmful tax practices, as follows:

(a) Recommendations concerning domestic legislation and practices

- (1) Wider and more effective use of controlled foreign corporation or equivalent rules;
- (2) The adoption of controlled foreign corporation rules over foreign investment funds that may escape anti-abuse provisions;
- (3) The restriction over participation exemption and tax exemption of foreign source income on income from tax havens or listed harmful tax preferential tax regimes;
- (4) More extensive exchange of information, as provided under Article 26 of the OECD MC, to counter harmful tax practices;
- (5) The publication of advance tax rulings, where given, with the reasons for granting, denying or revoking such decisions;
- (6) The adherence to the OECD 1995 transfer pricing guidelines; and
- (7) The adequate access to banking information to tax authorities.

(b) Recommendations concerning tax treaties

- (8) More efficient use of the Exchange of Information Article under the tax treaties and the OECD Multilateral Convention for Mutual Assistance in Tax Matters by tax authorities;
- (9) The reduction in the risk of unintended use of the treaty by third-country residents through better use of the existing treaty restrictions and the development of additional provisions to curb treaty shopping;

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- (10) Further amendments in the MC Commentary to remove any uncertainty or ambiguity regarding the compatibility of domestic anti-abuse provisions with tax treaties;
- (11) The preparation of a list of specific exclusion provisions found in treaties to provide a reference point in treaty negotiations;
- (12) The termination of existing tax treaties (and also avoid future treaties) with tax havens;
- (13) The undertaking of co-ordinated enforcement programs among tax authorities, such as simultaneous examinations, specific exchange of information projects or joint training activities; and
- (14) The mutual assistance of tax authorities in the recovery of cross-border tax claims.

(c) Recommendations for international co-operation

- (15) The adoption of the Guidelines prescribed in the Report by member countries for dealing with harmful preferential tax regimes, and the establishment of a Forum on Harmful Tax Practices to carry out the guidelines and other recommendations;
- (16) The preparation of a list of tax havens;
- (17) The review by countries that have links with tax havens as dependencies to ensure that they do not encourage harmful tax competition;
- (18) The development and active promotion of principles of a good tax administration; and
- (19) The involvement of non-OECD member countries to promote the recommendations in the Report.

Under Recommendation 15, the Forum on Harmful Tax Practices (“Forum”) set out six “Guidelines” for the OECD Member States, as follows:

- (i) Member countries are to refrain from adopting new measures or extending the scope of or strengthening existing measures that constitute harmful tax practices, as defined in the report.
- (ii) Member countries should review their existing measures for identifying harmful tax practices and report them (if any) to the Forum.
- (iii) Member countries must remove those measures identified and listed as harmful tax practices by the Forum by mid-2003.
- (iv) Member countries may request that measures of another member that are not listed be examined.
- (v) Member countries should co-ordinate, through the Forum, their responses to harmful tax practices of non-members.
- (vi) Member countries should use the Forum to encourage non-members to associate themselves with the guidelines.

These Guidelines were meant both to remove harmful tax practices among Member States and to co-ordinate their responses to the harmful practices of non-member countries. The Forum was concerned that taxpayers will be tempted to move to them once these practices were eliminated by Member States.²⁸⁷

²⁸⁷Carlo Pinto, EU and OECD to Fight Harmful Tax Competition – Has the Right Path Been Undertaken (Intertax, December 1998); Mason Gaffney, Competition more Harm than Good (International Tax Review, December/January 1999); Tulio Rosembuj, Harmful Tax Competition (Intertax, 1999); Stanley Ruchelman and Susan Shapiro, Exchange of Information (Intertax, November 2002) pp. 408–435.

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(ii) Towards Global Tax Co-operation (2000–2003)

In June 2000, the OECD issued a progress report on its efforts to identify and eliminate harmful tax competition under the 1998 Report.²⁸⁸ This Report published two lists: a list of tax havens (Recommendation 16) and a list of potentially harmful measures of OECD Member States (Guideline 2). The primary focus of these Reports was on tax havens, and not on preferential tax regimes.

Preferential tax regimes: The OECD Forum identified and listed 47 potentially harmful practices within Member States, which were applicable to geographically mobile activities. A regime was considered potentially harmful if it had the potential to constitute a harmful tax practice. The Forum also agreed to develop a set of “application notes” for Member States to identify harmful features, to determine whether they were actually harmful and to consider how such features could be removed (see below).

The Guidelines required that the existing harmful preferential tax regimes in Member States were to be removed by April 2003, and the benefits to taxpayers under these regimes at 31 December 2000 must cease by the end of December 2005. Moreover, under a “standstill” provision the Member States must not adopt new measures or extend such harmful tax practices.

Tax havens: The list of non-member tax havens was reduced to 35 from the original list of 47 countries. Besides the six countries, which were deemed not to be tax havens (Brunei, Costa Rica, Dubai, Jamaica, Macao and Tuvalu), they excluded the six countries that had made advance commitments to the principles of the 1998 Report (Bermuda, Cayman Islands, Cyprus, Malta, Mauritius and San Marino). By April 2002, only seven jurisdictions remained on the list. Out of the offshore jurisdictions identified in the 2000 Report, 28 of them had agreed to phased commitments on transparency and effective exchange of information by 2006. Three countries were excluded as not harmful (Example: Barbados, Maldives and Tonga).²⁸⁹

The 2000 Report also listed the proposed “defensive measures” for co-ordinated action to be applied to uncooperative tax havens. They included:

- Disallow deductions, exemptions, credits or other allowances on transactions with uncooperative tax havens and on transactions that take advantage of their harmful tax practices.
- Require comprehensive information reporting rules for transactions that involve uncooperative tax havens or take advantage of their harmful tax practices, and provide for substantial penalties for inaccurate reporting or non-reporting of those transactions.
- Adopt CFC or equivalent rules if they do not have them and to apply them, if they have them, to curb harmful tax practices.
- Deny any exceptions that may otherwise apply to the application of regular penalties in the case of transactions that either involve entities organised in uncooperative tax havens or take advantage of their harmful tax practices.

²⁸⁸ Committee on Fiscal Affairs: Towards Global Co-operation (OECD, 2000) para. 4.

²⁸⁹ By the end of 2004, only five jurisdictions had refused to give their commitment: Andorra, Liberia, Liechtenstein, Marshall Islands and Monaco. This list excludes Antigua and Barbuda, which withdrew its commitment in October 2003 due lack of “level playing field” between preferential tax regimes and “so called” tax haven countries.

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- Deny the availability of the foreign tax credit or the participation exemption on distributions that are sourced from uncooperative tax havens and to transactions that take advantage of their harmful tax practices.
- Impose withholding taxes on certain payments to residents of uncooperative tax havens.
- Enhance audit and enforcement activities with respect to uncooperative tax havens and on transactions that take advantage of their harmful tax practices.
- Ensure that any existing and new domestic defensive measures against harmful tax practices are also applicable to transactions with uncooperative tax havens, and to transactions that take advantage of their harmful tax practices.
- Not to enter into any comprehensive income tax conventions with uncooperative tax havens, and to consider terminating any existing conventions, unless certain conditions are met.
- Deny deductions and cost recovery, to the extent otherwise allowable, for fees and expenses incurred in establishing or acquiring entities incorporated in uncooperative tax havens.
- Impose “transactional” charges or levies on transactions involving uncooperative tax havens.

During this period, the OECD modified its approach and timetable for tax havens. In the 2001 Progress Report, the “absence of a requirement for substantial activity” was deleted. For a tax haven to exist, besides nil or nominal tax, the only requirements were fiscal transparency and exchange of information. The OECD also maintained that tax competition was not harmful but that there were harmful tax practices that could be used to compete in a globally harmful way. From then onwards the OECD renamed the project as “Harmful Tax Practices”.

In April 2002, the OECD published a “model exchange of tax information agreement” to provide further guidance to tax havens.²⁹⁰ However, the required level was left to the OECD Member States and their needs, based on either bilateral or multilateral agreements to be entered by them. Moreover, whereas the OECD initiative was confined to mobile financial activities, these agreements required effective exchange by tax havens for all tax matters. The concept of transparency, which was closely linked with the exchange of information, was also prescribed with certain deadlines that must be met. These requirements did not apply to OECD Member States with preferential tax regimes.

The deadlines and requirements under the OECD commitments for tax havens were, as follows:

- (a) December 31, 2002 – Know the beneficial owner and ensure that proper financial accounts (audited or filed) under generally accepted accounting standards were kept. The information must be accessible by the regulatory body or tax authorities in the country for them to exchange the information, if required.
- (b) December 31, 2003 – Provide for exchange of information, including access to bank information, on criminal tax matters. The term was widely defined to include any matters involving tax frauds.

²⁹⁰ See Chapter 6(7.1).

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(c) December 31, 2005 – Provide for exchange of information on civil tax matters. The term included any issues affecting the determination, assessment, collection or enforcement of taxes.

These commitments were subsequently made conditional on (i) all OECD member countries accepting the same rules and the same timetable, and (ii) the same defensive measures were to be applied to them in case of non-compliance. There was only one standard and it applied irrespective of whether the country was within or outside of the OECD area. The OECD established a Global Forum to monitor including members from “tax haven” countries, to monitor the compliance with the commitments and ensure a “level playing field”.

(iii) 2004 Progress Report onwards

The 2004 Progress Report²⁹¹ mentions that its initiative on harmful tax practices was virtually complete. Nearly all the potentially harmful tax regimes among its Member States, as listed in its 2000 Report, had been abolished, were in process of being abolished, amended or found not to be harmful. There were only two regimes that required further investigation: the Luxembourg 1929 Company and the 50/50 practice or Administrative Company regime in Switzerland. Most OECD States met the exchange of information standards, as only four OECD countries (Austria, Belgium, Luxembourg and Switzerland) did not exchange bank information in civil tax matters. Moreover, Switzerland had agreed to effective exchange of information in bilateral treaties.

According to the Report, the future OECD work on preferential tax regimes will focus on monitoring remaining regimes and any new potentially harmful regimes identified. The emphasis for them was on lack of information exchange and lack of transparency, besides ring fencing. Although low tax was not a relevant criterion by itself any more, the other factors could make a regime potentially harmful.

The Report also concluded that the OECD efforts on tax havens had made good progress with the diluted requirements. The commitments for tax havens were now confined to (i) knowledge of beneficial ownership, (ii) exchange of tax information, and (iii) keeping of reliable financial accounts that could be accessed by the authorities.

The OECD has changed its approach from fighting tax competition to combating tax evasion by its residents using tax havens. It now maintains that tax harmonisation with the same level and structure of tax is (and was) not its objective. In its view, transparency and exchange of information were adequate to ensure more tax competition with greater compliance and less tax evasion and to safeguard their own tax base.

8.3. Guidance (Application Note) Report²⁹²

As part of the 1998 Report, the OECD had adopted certain Guidelines for dealing with harmful tax competition in Member States for geographically mobile (primarily financial)

291 Committee on Fiscal Affairs: Report on Harmful Tax Practices: The 2004 Progress Report (OECD 2004).

292 Committee on Fiscal Affairs: Consolidated Application Note – Guidance in Applying the 1998 Report to Preferential Tax Regimes (OECD, 2004).

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activities. These Guidelines defined what it termed as “harmful tax competition” and also laid down the criteria for defining both tax havens and preferential tax regimes. The rules applied for classification of such regimes and tax havens were as follows:

- (a) The four main criteria for harmful preferential tax regimes were:
 - (i) Nil or low effective tax rate on the relevant income.
 - (ii) Ring-fenced tax regime for tax concessions to nonresidents.
 - (iii) Lack of transparency with inadequate regulatory supervision and financial disclosure.
 - (iv) No effective measures for exchange of tax information.
- (b) The four key factors for identifying tax havens were:
 - (i) Nil or nominal taxes.
 - (ii) Lack of effective exchange of information.
 - (iii) Lack of transparency.
 - (iv) Absence of a requirement that the activity be substantial.²⁹³

The Guidance (Application Note) Report issued in March 2004 by the Forum further explained the criteria for harmful preferential tax regimes. Some of its significant comments are summarised below:

Nil or low effective tax rate

- The presence of a low or zero effective tax rates alone, due to either low tax rate or low tax base or both, did not make a preferential regime harmful. However, it was necessary (“gateway criterion”) to determine whether the other criteria made such regimes harmful.
- Every jurisdiction had the right to determine whether to impose direct taxes and, if so, to determine the appropriate tax rate for a particular activity. They were essentially political decisions for national governments.

Ring fencing

- The Report did not prevent a country from providing a preferential regime to encourage an activity in a particular sector of its economy, even if the preference involved geographically mobile activities (i.e. a lower rate for some particular activity).
- A preferential regime was ring-fenced only in situations when it either explicitly or implicitly excluded resident taxpayers from the tax benefits of the regime, or when the enterprise qualifying for the regime did not have unrestricted access to the domestic market.
- Ring-fenced enterprises may be restricted from operating in the domestic market either explicitly or implicitly. The latter example would include requirements to do business only in foreign currencies. This condition did not apply if the ring fencing of the domestic market was done for non-tax reasons.
- Ring fencing applied only to regimes that deviated from the general structure of the tax system in the country. However, different taxation for significantly different domestic and

²⁹³The requirement that the local activities be substantial was dropped in 2001.

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foreign markets would not constitute ring fencing. It was also unaffected by measures applied to avoid or relieve double taxation.

- Worldwide or territorial tax systems, as well as differing source-based taxes on residents and nonresidents under the general tax system, did not constitute ring fencing. It was also possible to have separate preferential regimes for residents and nonresidents for non-tax reasons.
- The term “ring fencing” was not applicable to preferential regimes, which permitted qualifying enterprises to operate in the domestic market or allowed residents to benefit from them, but in practice, did not do so. There must be a deliberate legal restriction or other similar restriction on access to the domestic market.

Lack of Transparency

- Lack of tax transparency allowed taxpayers in the same or similar circumstances to be treated differently. Lack of transparency can arise either due to (i) the way the tax regime was designed or administered, or (ii) the existence of provisions to prevent effective exchange of information. For example, if taxpayers could negotiate their tax rates or tax bases they were unlikely to be transparent.
- Effective exchange of information required both the existence of relevant and reliable information and the ability to access such information when needed. A country lacked transparency if it did not maintain, or could not obtain information on legal and beneficial ownership, or could not provide reliable and up-to-date books and records of the entity for a reasonable time-period.
- To be effective, there must be legal access to the information. The access should include information on both criminal and civil tax matters, on request, but may exclude mere “fishing expeditions”. It should be available to the tax authorities of the requesting state in criminal tax cases on request even if it is not legally a crime in the requested country, or needed for its own tax purposes.

Others

- The Report also provided comments on harmful tax practices involving transfer pricing, tax rulings, holding companies and shipping, along with its recommendations. It mentioned that preferential tax regimes could serve legitimate commercial and policy objectives. For example, holding companies were acceptable as they allowed repatriation of profits without multiple layers of tax and were not generally harmful.
- It is not the preferential nature of the regimes that is of concern. It is only the characteristics of ring fencing, lack of transparency or lack of information exchange that create potential harm.²⁹⁴

The OECD definition of “harmful tax practices” affecting mobile financial services has changed since the 1998 Report. Although “ring fencing” is retained as a criterion for preferential tax regimes, the equivalent “non-substantial activities” for tax havens has been dropped. A general low or nil tax rate for all activities is not deemed as harmful. Special tax

²⁹⁴ Robert Goulder, TNI Newsletter Interview: Jeffrey Owens (Tax Analysts, March 22, 2004).

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regimes are permitted for certain activities, e.g. shipping. Holding companies are allowed, even though they have certain unacceptable features (e.g. treaty shopping). Advanced tax rulings on transfer pricing and general tax compliance issues are not harmful. Participation exemption for foreign dividends and capital gains are acceptable.

8.4. Comments

The primary purpose of the OECD initiative on harmful tax practices appears to be to remove preferential tax regimes within its Member States. However, as any attempt to do so would have simply shifted the activities to similar regimes in non-member countries, the OECD expanded the scope of its project to certain countries that it defined as “tax havens”. According to the 2004 Progress Report, it had substantially achieved its objectives within its Member States. The progress with tax havens was still ongoing.

From now on, the timetable for the commitment and the defensive measures on tax havens is dependent on the “level playing field” doctrine. They have to be applied simultaneously to all tax havens, as well as to both OECD and non-OECD countries with harmful preferential tax regimes. So far, four OECD countries have declined to exchange bank information upon request on civil tax matters. The EU Savings Directive provides for transitional provisions for certain Member States,²⁹⁵ and exempts them from information exchange obligations until, at least, 2010. Concerns have been expressed that the OECD initiative may not comply with the norms under the World Trade Organisation.²⁹⁶ There is also concern about certain non-OECD countries, which have escaped the OECD list, creating a further lack of a level playing field.²⁹⁷

Harmful tax practices in offshore transactions are not confined to tax havens. They are as prevalent through preferential tax regimes in developed countries. It is estimated that around 80% of the world’s offshore financial services industry is located in OECD Member States and over 10% in other non-OECD countries. Less than 10% of these activities are based in the traditional tax havens.²⁹⁸ It is difficult to foresee how and when the requirement of “level playing field” where the same norms apply simultaneously to all international financial centres, both offshore and onshore, will be met.

Preferential tax regimes appear to be a greater cause of tax base erosion for OECD Member States than tax havens. For example, a recent US study showed that more than half of the growth in profits of US foreign controlled corporations during 1998–2000 was in countries with low effective taxes. Eleven such countries accounted for 47% of the total pre-tax profits of US subsidiaries abroad in 2001 with just 9% of their employees. Besides the traditional tax havens like Bermuda and Cayman Islands, they comprised preferential tax regimes in OECD Member States, such as the Netherlands, Ireland, Luxembourg,

²⁹⁵ See Chapter 2(7.3).

²⁹⁶ Robert Goulder, TNI Newsmaker Interview with Jeffrey Owens (Tax Analysts, March 22, 2004).

²⁹⁷ In the June 2004 meeting of the OECD Global Forum, it added eleven non-OECD countries to the target list to achieve a “level playing field”. They comprised Barbados, Brunei, Costa Rica, Dubai, Guatemala, Hong Kong, Macao, Malaysia (Labuan), Philippines, Singapore and Uruguay.

²⁹⁸ Sir Ronald Sanders, Antigua and Barbuda’s chief foreign affairs representative address at a financial services conference in the Bahamas on September 7, 2003. See Tax Analysts, September 17, 2001.

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Switzerland, Belgium and Denmark. Non-OECD members included Hong Kong and Singapore.²⁹⁹ Preferential tax regimes are widely used by multinational enterprises to provide geographically mobile intra-group services including conduit or holding company base for overseas investments.³⁰⁰

The distinction between traditional offshore centres and non-traditional onshore centres is becoming increasingly blurred. Under the OECD criteria in the 1998 Report, both preferential tax regimes and tax havens (as defined) levied low or nil taxation, lacked transparency and did not permit effective exchange of information. The only difference was the absence of substantial activity in tax havens, which did not differ much from “ring fencing” requirement for preferential tax regimes. Therefore, in substance there were few differences in the two categories, as defined in the Report. Preferential tax regime could be considered as the description given to the regime of an OECD Member State that provided tax privileges for geographically mobile services. A non-member regime that did the same thing was called a tax haven.³⁰¹

The OECD initiative has had a significant impact on international financial centres classified by it as tax havens. Most of them have restructured themselves to meet the OECD demands. There is a general acceptance of the need for greater transparency and cross-border exchange of tax information. Moreover, as a result of this project (and efforts under the various international anti-money laundering and terrorist financing initiatives), the regulatory framework of several financial centres has significantly improved. Many of them have better financial and legal regulations today than some of the developed countries.³⁰²

The Harmful Tax Practices initiative on tax havens has slowed down and its future implementation and timing now seem uncertain. However, as mentioned earlier, the concerted effort behind the OECD harmful tax initiative appears to have been driven more by the concern of its Member States to protect their own direct tax base from erosion through tax competition within the OECD itself, than a dislike of the tax practices in tax havens. Although the future progress of this OECD project on tax havens may be in doubt, it seems to have made progress towards meeting this objective.

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299 Martin A. Sullivan, Economic Analysis, Tax Analysts, February 17, 2004 & October 20, 2004; Alex Easson, Harmful Tax Competition: An Evaluation the OECD Initiative, (Tax Analysts, June 9, 2004) Section IV (D).

300 Holding companies assist in reducing source taxes through treaty shopping and other tax avoidance techniques, and assist in tax-free repatriation or accumulation of foreign source income. Moreover, they do not depend on bank secrecy, are fully disclosed and considered legal.

301 Alex Easson, Harmful Tax Competition: An evaluation of the OECD Initiative, Section IV(C).

302 For example, in Delaware (USA) registered agents are not required to maintain records on beneficial owners of Delaware companies or make any disclosures (See Chapter 9(2)-United States).

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CHAPTER 3

MODEL TAX CONVENTIONS ON DOUBLE TAX AVOIDANCE

1. OECD MODEL CONVENTION ON INCOME AND CAPITAL (OECD MC)

1.1. General

The OECD MC consists of 30 Articles under seven chapters.¹ The specific subjects covered in the MC are listed below:

General

Personal scope (Article 1)

Taxes covered (Article 2)

Definitions

General definitions (Article 3)

Resident (Article 4)

Permanent establishment (Article 5)

Income clauses

Active:

Business profits (Article 7)

Shipping, inland waterways transport and air transport (Article 8)

Independent personal services (Article 14) – now deleted

Income from employment (Article 15)

Directors' fees (Article 16)

Artistes and sportsmen (Article 17)

Government service (Article 19)

Passive:

Income from immovable property (Article 6)

Income from movable property (Article 7)

Dividends (Article 10)

¹ Article 14 on independent personal services was deleted in the OECD MC Update 2000. A new Article 27 on assistance in the collection of taxes was added by the OECD MC Update 2003.

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Interest (Article 11)
Royalties (Article 12)
Capital gains (Article 13)
Pensions (Article 18)
Students (Article 20)

Residual:

Other income (Article 21)

Tax relief

Elimination of double taxation and treaty relief (Article 23)
Exemption method (Article 23A)
Credit method (Article 23B)

Special provisions

Associated enterprises (Article 9)
Capital (Article 22)
Non-discrimination (Article 24)
Mutual agreement procedure (Article 25)
Exchange of information (Article 26)
Assistance in the collection of taxes (Article 27)
Members of diplomatic missions and consular posts (Article 28)
Territorial extension (Article 29)

Final provisions

Entry into force (Article 30)
Termination (Article 31)

1.2. Other Contents of the Model Convention

Besides the text of the Articles, the OECD MC provides:

- Commentaries
- Observations
- Reservations
- Positions of non-OECD States

As from OECD MC Update 1997, the OECD Model is presented in two volumes. Volume I includes the text of the Articles contained in the Model together with Commentary on each Article. Volume II includes reprints of various reports issued by the OECD's Committee on Fiscal Affairs since 1977, together with information on the Positions of non-Member countries.

The Commentaries illustrate or interpret the provisions of the treaty, as recommended by the OECD. They are intended to guide the application and interpretation of treaties. The Commentary on each Article also contains the Observations and Reservations, where

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expressed by the OECD Member States. The Reservations express a disagreement with the text (or any variations permitted by the Commentaries) of the MC by Member States, while the Observations present their disagreements with the interpretation under the Commentaries.²

Unless mentioned in the Observations and Reservations, the OECD Member States are assumed to have agreed with the MC text and the interpretation given by the Commentaries.³ As from 1999, the MC also contains Positions on the OECD Articles and Commentaries received from several non-OECD States.⁴ It is arguable whether they are bound by the interpretations under the Commentaries, particularly as they were not involved in their preparation. In their case, the Commentaries are considered as a strong persuasive factor, if not necessarily binding, on them.⁵

The text of the MC and its Commentaries are periodically updated. Since 1992, they have been updated in 1994, 1995, 1997, 2000 and 2003. The next update is expected in late 2005. These updates are amendments that reflect both substantive changes in the Articles as well as clarifications and tax treatment of new developments (e.g. electronic commerce) in the Commentaries. Clearly, changes to the text of the Articles of the MC do not affect existing treaties unless their provisions are renegotiated accordingly. As regards the Commentaries, it is debatable whether the changes that are made to it can be applied to existing treaties.

The revised Commentaries reflect the current thinking of the OECD Committee on Fiscal Affairs, which is responsible for the MC. It suggests that its latest version should be applied to existing treaties, wherever possible. However, the OECD MC Introduction also mentions that the amendments are largely “intended to simply clarify, and not change, the meaning of the Articles or the Commentaries”,⁶ and they cannot be applied to support a contrary interpretation. Therefore, significant changes in negotiated tax treaties may be difficult to make through changes in the Commentaries.

In recent years, the Committee has attempted to make substantive changes in negotiated tax treaties through changes in the Commentaries.⁷ Some commentators believe that as the treaty amendments through renegotiation or protocols are time-consuming and difficult, changes through the Commentaries should be permitted to respond quickly to new circumstances. This view is not widely accepted. Tax treaties are “solemn obligations that should not be disregarded except in extraordinary circumstances”.⁸

2 Guglielmo Maisto, *The Observations on the OECD Commentaries in the Interpretation of Tax Treaties* (IBFD Bulletin, January 2005) pp. 14–19.

3 See Chapter 2(3.3); the –2005 Update makes a change in paragraph 31 of the MC Introduction to clarify that a Reservation is not required when a country merely wishes to modify the wording of a provision to confirm or incorporate an interpretation of that provision under the Commentary.

4 Albania, Argentina, Belarus, Brazil, Bulgaria, China, Croatia, Estonia, Gabon, Israel, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Russia, Slovenia, South Africa, Thailand, Tunisia, Ukraine and Vietnam.

5 OECD MC: Introduction, para. 28–32; According to the Australian Tax Office (Tax Ruling TR 2001/13), while not binding, there is a general or quasi-political rather than a legal expectation that OECD Member States will basically comply subject to their specific Observations and Reservations.

6 OECD MC: Introduction, para. 33–36.

7 See examples given in Chapter 2, footnote 105.

8 Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*, pp. 111–112.

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1.3. Distributive Rules under the Model Convention

The distributive rules are contained in Articles 6 to 22 of the OECD MC. These rules classify items of income and assign the taxing rights to one or both Contracting States. Under these rules, a scheduler system initially classifies the taxable income under different categories (“income classification rules”). Each category of income is then subject to specific source rules under the treaty (“treaty source rules”). The taxing rights for each source of income are then allocated to either the source or residence State, or to both States (“assignment rules”). In cases where both States have the right to tax, the tax credit or exemption relief is given on the doubly taxed income by the State of residence (“relief principle”).

Income classification rules: The income classification rules are normally based on activities, assets or contractual relationships, or relate to the alienation of assets, as follows:

- Activities – agriculture and forestry (in Article 6), business activities (Article 7), independent personal services (Article 14),⁹ and dependent personal services (Article 15).
- Assets or contractual relationships – immovable property (in Article 6), dividends (Article 10), interest payments (Article 11), royalties (Article 12).
- Alienation of assets – capital gains (Article 13)¹⁰.
- Others – associated enterprises (Article 9), students (Article 20), other income (Article 21).

The other Articles provide special rules for specific activities under the above four general classes of income. For example, Article 8 (shipping, inland waterways transport and air transport) is a special case of Article 7 (business profits). Article 16 (directors’ fees), Article 17 (artistes and sportsmen), Article 18 (pensions) and Article 19 (government service) are special rules for Article 14 (now included under Article 7) and Article 15 on personal services, and sometimes of Article 7 (business profits). Both Article 7 (business profits) and Article 9 (associated enterprises) provide taxing rights to the State where the profits originate economically. Article 7 allocates the business profits of the same resident taxpayer between the residence and source States. Article 9 deals with the taxation of two separate but associated taxpayers.

Treaty source rules: The tax treaty also specifies the basic source rules to be followed for each class of income by both the Contracting States. These rules decide the source of the income for treaty purposes, regardless of the domestic tax rules of each State, as follows:

- immovable property: the place where situated or *Situs*.
- industrial or business profits and professional services: a permanent establishment or fixed base.
- shipping and air transport: the place of effective management.
- dividend and interest income and directors’ fees: the residence of the payer.¹¹
- employment services and artistes and sportsmen: the place of work.

⁹ Article 14 was deleted under the OECD MC Update 2000. Professional services are now included as business income. This Article still exists in the UN and US Model treaties.

¹⁰ There are five rules based on the five paragraphs of the Article.

¹¹ Similar rule exists under the UN MC for royalties but not under the OECD MC.

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- government salaries and pensions: the country of the payer.
- other income: the residence of the recipient.

Assignment rules: The “assignment principle” applied in the OECD MC comprises:¹²

(a) Certain income “shall be taxable only” in a particular Contracting State. This term is mandatory and precludes the other State from exercising its right to tax. Therefore, the income or capital must be exempted from tax in the other Contracting State. (Examples: Articles 8(1), 8(2), 12(1), 13(3), 13(5), 15(2), 18, 19(1), 19(2), 21(1), 22(3), 22(4)).

(b) Certain income “shall be taxable only in the Contracting State . . . unless”. This term provides exclusive primary taxing rights to the first State. However, if certain conditions are met (or not met), the same income may be taxed in the second State. (Examples: Articles 7(1), 14(1), 15(1)).

(c) Certain income “may be taxed in that other State”. This term has an enabling rather than a mandatory implication. It gives a State the option or right to tax if it so wishes, without affecting the existing rights of the other Contracting State. (Examples: Articles 6(1), 13(1), 13(2), 15(3), 16, 17(1), 17(2), 22(1), 22(2)).

(d) Certain income “may be taxed in the other State” but “may also be taxed in the first State”. This term gives both States the optional right to tax, if they wish. The Article may impose limits on source taxation in certain cases. (Examples: Articles 10(2), 11(2)).

(e) In one case, the Article specifies, “shall not be taxed”. (Article 20).

The phrases “shall be taxable” or “may be taxed” are given the ordinary meaning of the words as “exclusive” or “non-exclusive” taxing rights, respectively.¹³

Hence:

(i) The first and second cases above provide for mandatory exclusion by the other State, unless excepted in the Article. The first case specifically refers to tax allocation and not relief, with exemption granted by the other State. The relief principle is applicable in the second case, if the other State satisfies the required conditions and exercises its non-exclusive taxing rights.

(ii) The third and fourth cases are similar and provide for an enabling, but non-exclusive, provision. Both States have the option to exercise the right, with or without limitation. Since the right of the other State is not denied, it would invariably lead to tax relief for juridical double taxation.

These rules either exempt an item of income in one or the other State from taxation or make it taxable, fully or partly, in both Contracting States, as follows (subject to several exceptions):

(a) Taxed in the residence State only (Article 7(1), 8(1), 8(2), 12(1), 13(3), 13(5), 15(1) first sentence, 15(2), 18, 19(1b), 19(2b), 21(1), 22(3) and 22(4)).

- Business profits, unless they can be attributed to a permanent establishment in the source State.

¹² OECD Commentary: Article 23, paras. 6–7.

¹³ Klaus Vogel, *Double Taxation Conventions*, Preface to Arts. 6 to 22, m.no. 3–5; OECD Commentary: Article 23, paras. 6–7.

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- Income, capital, and capital gains on certain shipping or air transport income if effective management is in the residence State.
 - Royalty income.
 - Capital and capital gains, other than from certain movable and immovable property.
 - Income from performance of independent personal services not attributable to a fixed base in the source State (Article 14 now included in business profits under the OECD MC).
 - Employment income from dependent personal services, including income from services performed in a source State on stays not exceeding 183 days in any 12-month period, provided it is paid by a nonresident employer and the expense is not borne by a permanent establishment in that State.
 - Private pensions and other similar payments.
 - Foreign government salaries and pensions paid for services rendered in the State of residence by employed individuals, who are nationals; if non-nationals, they must be resident for reasons other than for rendering their services.
 - Other income not specifically covered in the treaty, unless effectively connected to a permanent establishment or fixed base in the source State.
- (b) Taxed in the source State only (Article 8(1), 8(2), 13(3) 19(1a), 19(2a) and 22(3)).
- Income, capital and capital gains on certain shipping or air transport income if effective management is in the source State.
 - Foreign government salaries and pensions are taxable only in the source State, unless the individual is a permanent resident or national of the residence State.
- (c) Taxed in both the Contracting States without restriction (Article 6(1), 7(1), 13(1), 13(2), 13(4), 14(1), 15(1) second sentence, 15(3), 16(1), 17(1), 17(2), 22(1) and 22(2)).
- Income, capital and capital gains from immovable property (including shares of immovable property companies).
 - Business profits, capital and capital gains of a permanent establishment, unless dealt with separately.
 - Independent personal services attributable to a fixed base (now included in business profits).
 - Dependent personal services exercised in a source State, unless taxable only in the State of residence (see (a) above)
 - Directors' fees and income of artistes and sportsmen.
- (d) Taxed in both the Contracting States but with restriction in the source State (Article 10(2) and 11(2)) and without restriction in the residence State (Article 10(1) and 11(1)).
- Dividends and interest income (subject to withholding tax limits in the source State).
- (e) Income not taxed in the source State (Article 20).
- Payments from abroad to foreign students or business apprentices for maintenance, education or training are tax-exempt in the State of study or training.

Summary: The OECD Model applies four types of rules for taxing rights. They are:

- Rules assigning a particular class of income or capital to one State exclusively.
- Rules assigning a class of income or capital to both States.

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- Rules assigning a class of income or capital to both States, but limiting the level of taxation in the source State.
- Rules dealing with the taxation of students and allocation of business profits between related enterprises.

The distributive rules to assign and classify income, as given in Articles 6 to 21 of the Model treaty, relate to the income i.e. the tax object or events and not to the taxpayer i.e. the tax subject.

On cross-border transactions, the source State has the first opportunity to tax the nonresident as and when the income arises in its tax jurisdiction. Unless the source country agrees to forego or limit its rights, it can exercise them. With few exceptions, the present Model treaties restrict the taxing rights of the source State over the income derived by nonresidents from within its territorial jurisdiction. The residence State virtually retains its full or unlimited taxing rights on the worldwide income and capital of its residents, with the obligation to grant relief in cases of juridical double taxation.

1.4. Attribution Rules under the Model Convention

While the distributive rules under the Model treaty assign the taxing rights over tax objects under a schedular structure, they also refer to a tax subject or taxpayer to whom the income is attributed for tax purposes. The various distributive Articles include terms such as “derived by” (Article 6(1), 13(1), 15(1), 16(1) and 17(1)), “of” (Article 7(1) and 21), “accrued to” (Article 9(1), “paid to” (Article 10(1), 11(1), 18, 19(1)), “beneficially owned” (Article 12(1)) and “receives” (Article 20). The treaty does not contain any specific rule linking these items to a taxpayer in one of the Contracting States. Under Article 1 of the MC, the tax subject only has to be a resident of one or both Contracting States for the application of the treaty.

The OECD Commentary mentions that the scope of the Articles in the Model treaty is limited to juridical double taxation.¹⁴ They deal with situations where the same income or capital is taxable in respect of the same subject matter and for an identical period by more than one State in the hands of the same taxpayer.¹⁵ Therefore, the OECD MC is not meant to either avoid or relieve economic double taxation.

In the Partnerships Report issued in 1999, the OECD extended the scope of the MC to international economic double taxation due to attribution conflicts between partners and partnership. The MC also provides for relief of double economic taxation in cases of transfer pricing through corresponding adjustments under Article 9(2).

2. UN MODEL CONVENTION (UN MC)

2.1. General

The UN MC (“United Nations Model Double Taxation Convention between Developed and Developing Countries”) was first issued in 1980 and revised in 2001. It essentially follows

¹⁴ OECD Commentary: Article 23, paras. 1–3

¹⁵ OECD MC: Introduction, para. 1

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the OECD numbering, except that Article 28 on “Territorial Extension” has been excluded. Moreover, it does not contain the new Article 27 on “Assistance in Collection of Taxes”. The UN MC has retained Article 14 on “Independent Personal Services”, which was deleted and merged with OECD MC Article 7 in 2000. As a result, the UN MC currently consists of 29 Articles under the seven chapters. The UN MC has its own Commentaries to assist in their interpretation.

Although the UN MC is largely based on the OECD MC, the differences between both Models are significant.¹⁶ The UN MC puts more emphasis on source-based taxation, in contrast to the largely residence-based taxation under the OECD MC. It also stresses the role of tax treaties to promote the flow of foreign investment to developing countries. The UN MC mentions that its primary goal is to establish “fiscal guidelines for trade liberalisation and expansion with a view to releasing additional resources for sustainable growth and promoting bilateral tax co-ordination”.¹⁷

Like the OECD MC, the UN MC is not enforceable and its provisions are not binding. Its aim is to facilitate the negotiation of tax treaties. However, if the negotiating parties use the treaty wording it is presumed that they would find the UN Commentaries helpful in its interpretation. The UN Model has not been adopted formally by the United Nations and is primarily the work of an Ad Hoc Group of Experts. Its introduction therefore mentions that the MC should not be “construed as formal recommendations of the United Nations”.¹⁸ The adherence to the UN MC by members of the United Nations is voluntary. Nevertheless, over the years, the UN MC has gained wide acceptance in many developing countries. It has also influenced the general tax treaty policy of several OECD members.

The United Nations Model Double Taxation Convention Between Developed and Developing Countries of 1980 was revised for the first time in the 1990s. The draft text of the revised final version was finally published on January 11, 2001 (“UN MC 2001”).

The revisions in the UN MC 2001 were primarily meant to update it in line with many (but not all) of the technical changes made in the OECD MC and its Commentaries since 1980. It also took into consideration the changes in treaty policies of developing countries based on its own research.

Besides several minor changes that have been made to make certain Articles consistent with the OECD MC, the main changes in the UN MC 2001 from the 1980 version are as follows:

Article 4: This Article specifically includes a place of incorporation as a criterion for tax residence in paragraph 1. Moreover, the second sentence in the OECD MC 4(1), which was omitted in the previous 1980 version, has now been added.

Article 5: The paragraph 4 includes sub-paragraph (f) that refers to the exclusion of a fixed place solely for any combination of activities mentioned in subparagraphs (a) to (e), as under the OECD MC. The paragraph 7 includes independent agents acting wholly or almost

¹⁶ Bart Kusters, United Nations Model Tax Convention and its Recent Developments (Asia Pacific Tax Bulletin, January/February 2004) p. 4.

¹⁷ UN MC: Introduction, para. 32.

¹⁸ UN MC: Introduction, paras. 35–39.

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wholly on behalf of the enterprise as permanent establishments unless the transactions are conducted on an arm's length basis as independent entities. Moreover, the Commentary clarifies that subparagraph 5 (b) does not lead to a permanent establishment unless the stock agent conducts sales-related activities besides delivery of goods.

Article 9: This Article has a new paragraph 3 that denies the corresponding or correlative adjustment under Article 9 (2) in cases of fraud, gross negligence or wilful default. The paragraph does not exist in the OECD MC.

Articles 10–12: As in the OECD MC, the treaty benefits under these Articles now depend solely on the residence of the beneficial owner in the other Contracting State, regardless of the residence of any agent or other intermediary collecting the income on behalf of the beneficial owner. Previously, the benefits were granted only if the recipient was the beneficial owner.¹⁹ The UN Commentary now includes the OECD conclusions on the tax classification of software payments and contains most of the OECD Commentary changes up to the Commentary Update 1997.

Article 13: The paragraph 4 now extends the taxing rights of a Contracting State to gains on the alienation of interests in partnerships, trusts and estates, besides shares of companies, that directly or indirectly principally own immovable properties situated in that State. The term “principally” is defined as such immovable property comprising more than 50% of the total assets. The paragraph does not apply to such entities if they use these properties in their business activities, unless they are an immovable property management company, partnership, trust or estate.

Article 14: The paragraph 1(c) has been deleted. It provided for the taxation of independent personal services if the remuneration was paid for activities in the other Contracting State by a resident of that State or was borne by a fixed base in the other Contracting State and exceeded a specified amount. Unlike the OECD MC, the UN MC has not deleted Article 14.

Article 20: The paragraph 20 (2) dealing with grants, scholarships and remuneration from employment has been omitted (as in OECD MC).

Article 22: The UN MC now includes the first three paragraphs of OECD MC as part of the Model treaty. Only paragraph 4 is now subject to bilateral negotiations.

The other differences between OECD MC and UN MC have not been materially affected.²⁰

2.2. Significant Differences between the OECD and the UN MC

As mentioned above, although the UN MC largely (but not completely) follows the OECD MC and its Commentaries, it differs from the OECD MC on treaty policy.²¹

¹⁹ UN Commentary: Article 10, para. 5.

²⁰ Edwin van den Bruggen, A Preliminary Look at the New UN Model Tax Convention (British Tax Review, 2002 No. 2) pp. 119–134.

²¹ See Chapter 2(5.5).

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There are several provisions in the UN MC that are either not found in the OECD MC or are different from the OECD MC. They include both treaty policy issues as well as greater allocation of taxes to the source State. For example, it provides (i) a lower activity threshold under the permanent establishment rule, (ii) a limited “force of attraction” for profits attributable to a permanent establishment, (iii) a withholding tax on royalties, and (iv) non-exclusive taxing rights over other income, not specifically dealt with in the treaty, for the source country.

The UN Commentaries also reproduce much of the OECD Commentaries. Besides these extracts, they contain useful insights on treaty policy issues affecting developing countries and commentaries (somewhat limited) on Articles where the two Models differ.²² For example, the UN Commentary on Article 23 advocates tax sparing as a policy matter. Tax sparing credits are given by several developed countries (excluding the United States) under their tax treaties while many major developing countries insist on them for taxes spared by them.²³ The Commentaries of both the UN and OECD MCs accept tax sparing credits for developing countries but the former is far less sceptical as regards such credits.²⁴ Both Models provide suitable wordings for tax sparing provisions in their Commentaries to the Model treaty.²⁵

The UN MC 2001 contains several of the changes in the OECD Model and Commentaries until 1997, as well as the modifications suggested by its own study and analysis of the treaty practices and needs of developing countries. It has not yet considered the changes made by the OECD in its MC text and Commentaries after 1997. However, there are also changes in the OECD Model and its Commentaries that have not been adopted in the UN Model or its Commentaries in keeping with its different approach on treaty policy.

Some of the significant differences in the treaty text between the two Models are:

Article 5: The Article grants additional taxing rights to the source State in the following situations:

- Construction activities that last more than six months (OECD MC: 12 months) in any individual site or project; it also includes assembly and supervisory activities.
- Furnishing of services, including consultancy services, where the activities of that nature last for more than six months in aggregate within any 12-month period.
- A dependent agent, who habitually maintains a stock of goods for delivery on behalf of an enterprise and delivers them regularly, even if he has no authority to conclude contracts. (“stock agent”).
- The activities (other than reinsurance) of an insurance enterprise if it collects premiums or insures risks through a person other than an independent agent.

²² Additional background information is contained in the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries published in 1979 (revised in 2003). The 1979 Manual contains a series of Guidelines (effectively draft Articles of the treaty) together with a short commentary on each Guideline.

²³ See Chapter 4 (8.4).

²⁴ UN Commentary: Article 23, paras. 1 to 12, 18C; OECD Commentary: Article 23, para. 78.1.

²⁵ In the OECD Commentary 2003, 12 out of the 24 non-OECD countries expressed their Reservation on their right to include tax sparing in their treaties. The OECD Commentary permits tax sparing (“should not necessarily refrain”) for developing countries.

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- An independent agent who acts wholly or almost wholly for an enterprise, unless the transactions are on an arm's length basis.

Moreover, the exemption under the preparatory or auxiliary services does not apply to the use of facilities or maintenance of stock for delivery if they conduct sales-related activities.

Article 7: A limited “force of attraction” rule extends the profits attributable to a permanent establishment to income derived from other sales and business activities that are the same or similar to those performed by the permanent establishment. Several expenses paid by a permanent establishment to its head office, and vice versa, are ignored in computing the attributable profits. The paragraph that excludes profits attributable to the “purchase” function performed by the permanent establishment is omitted.²⁶

Article 8: The Article provides an optional provision (alternative B) that grants the source State a limited right to tax shipping profits, if the shipping activities in the source State are more than casual.

Article 9: Article 9 (3) denies the corresponding or correlative adjustment under Article 9 (2) in cases of fraud, gross negligence or wilful default. This paragraph does not exist in the OECD MC.

Articles 10 and 11: Unlike the OECD MC, the UN Model does not provide a limit on the maximum percentage rate for the withholding tax. The rate is left to bilateral negotiations.

Article 12: The Article grants shared taxing rights on royalty income to the source State, on a basis similar to interest (subject to a maximum rate to be determined by bilateral negotiations). The royalty definition also includes any payments made for the use of, or the right to use, (i) films or tapes for radio or television broadcasting, and (ii) industrial, commercial or scientific equipment.

Article 13: The OECD MC was amended in 2003 to include a new paragraph 4 to grant source taxing rights on gains derived from the sale of shares in companies deriving over 50% of their value from immovable property in that State. Unlike the UN MC, it does not yet include the provision for source taxation on similar gains on sale of interest in partnerships, trusts and estates or the exemption if such properties are used in their business activities. The OECD MC also does not include a paragraph granting non-exclusive taxing rights to the source State on alienation of shares in other companies (subject to qualifying shareholding), as provided under UN MC Article 13 (5).

Article 14: The Article grants two additional taxing rights to the source State on income from independent personal services. The source State may tax the income if (i) the remuneration is paid by a resident of the source State or is borne by a fixed base in that State, or (ii) the stay in the other Contracting State exceeds 183 days in a tax year. Unlike the OECD MC, this Article has not been deleted and merged with Article 7.

Article 16: The Article includes remuneration paid to top-level managerial officials as taxable in the State where the paying company is resident.

²⁶ The inclusion of this paragraph is left to bilateral negotiations.

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Article 18: The Article grants exclusive taxing rights on public pension schemes to the paying State. In addition, it accepts the exclusive right of the residence State to tax private pensions. However, it also offers an optional wording (alternative B) for them to be taxed by both States if they are paid by a resident of the other State or a permanent establishment situated in that State

Article 19: The UN MC does not contain the proposed changes in OECD Update 2005 to cover “non-periodic payments” besides pensions under this Article.

Article 21: The Article grants shared taxing rights to the source State on the residuary “other income” not dealt with in the other Articles of the treaty.

Article 23: This Article does not include the additional paragraph 4 in Article 23A, which was introduced in OECD MC Update 2001, that denies exemption relief in certain circumstances.

Article 25: The Article provides for more comprehensive implementation clauses under the mutual agreement procedures.

Article 26: The Article includes the prevention of tax fraud and tax evasion as additional objectives. The competent authorities must also develop comprehensive exchange of information systems. It excludes the changes and additional paragraphs proposed under OECD MC Update 2005.

Article 27: The UN Model Treaty does not include Article 27 on Assistance in the Collection of Taxes added under the OECD MC 2003.

According to a research project conducted by the International Bureau of Fiscal Documentation (The Netherlands) in the late 1990s, the UN MC is still widely used and has also influenced the OECD MC.²⁷ It concluded that the impact of the UN MC on actual tax treaties was significant, especially on issues relating to permanent establishment, the royalty definition, capital gains from the alienation of shares and the other income Article.²⁸

3. US MODEL CONVENTION (US MC)

3.1. General

A revised US MC was issued in 1996 (“United States Model Income Taxation Convention of September 20, 1996”) to replace the earlier 1981 Model that was withdrawn in 1992. Unlike the OECD and UN MCs, the US MC is primarily used in the negotiations of bilateral tax treaties with the United States. Its purpose is to align the tax treaties with US domestic laws and tax policies.

²⁷ The OECD MC 2003 includes a provision similar to Article 13 (4) of the UN MC granting taxing rights to the source State on gains from alienation of shares in a real estate company.

²⁸ Willem F.G. Wijnen and Marco Magenta, *The UN Model in Practice* (IBFD Bulletin, Vol. 51/12, 1997); Willem F.G. Wijnen, *Towards a New UN Model* (IBFD Bulletin, March 1998); Bart Kusters, *The United Nations Model Tax Convention and its Recent Developments* (IBFD Bulletin, January/February 2004), p. 11; UN Negotiation Manual, Annex 6 (United Nations, 2003).

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The US MC resembles the OECD MC but does not replace it. It is more detailed in its text and explanations, and incorporates several provisions of the OECD Commentaries in the treaty text itself. It also contains extensive “Technical Explanation” to provide further insight into the US treaty policy, the definition of terms and other provisions. Although these explanations are not explicitly part of the treaty text, they provide useful interpretations and clarifications. The Technical Explanation does not have the same legal significance as the OECD Commentaries.

3.2. Significant Differences Between OECD and US MC

Some of the significant differences from the OECD MC are summarised below:

Article 1: The treaty does not restrict, in any manner, the benefits under the domestic law of, or any other agreement between, the Contracting States (Article 1(2)). The taxpayer can choose the benefits under the domestic law selectively for any class of income, if they are more favourable (“non-aggravation” or “preservation” clause).

The “saving clause” under Article 1(4) reserves the right of each Contracting State to tax its own citizens and residents, including certain former citizens and long-term residents for up to ten years, as if the treaty had not come into effect. The saving clause is subject to certain specified exceptions (Article 1(5)).

Article 2: The Article excludes taxes on capital and taxes on income and capital imposed by political subdivisions and local authorities. Therefore, the US State and local taxes are not included.

Article 3: This Article follows the OECD general definitions with certain variations. For example, a “person” specifically includes an estate, a trust and a partnership. An “enterprise” covers an enterprise carried on by a resident of a Contracting State through a fiscally transparent entity (e.g. a partnership or trust) in that Contracting State. The term “international traffic” excludes transport by a ship or aircraft when such transport is solely between places in either Contracting State.

Article 4: The definition includes the liability to tax due to citizenship or place of incorporation as additional criteria for residence under a treaty. The income of a fiscally transparent entity under the laws of either Contracting State is deemed to be derived by a resident of a State to the extent that the income is treated as the income of a resident under the domestic tax law (“derived through entity” principle). A dual resident company is resident at its place of incorporation under the tie-breaker provision. The tax residence of a dual resident, other than an individual or a company, is determined by the mutual agreement of the competent authorities.

Article 5: An installation or drilling rig or ship used for the exploration or exploitation of natural resources is a permanent establishment if it lasts for more than twelve months. The maintenance of a fixed place of business for any combination of activities in Article 5(4) subparagraphs (a) to (e) is presumed to be of a preparatory or auxiliary character.

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Article 6: A resident may elect to be taxed on a net basis (similar to a permanent establishment) in the other Contracting State on the income derived from real property, even if no net basis election is available under the domestic law of the *Situs* State. The net basis election can be terminated only with the consent of the competent authority of the *Situs* State.

Article 7: The income earned by an enterprise from the rentals of tangible personal property, or from the performance of personal services are business profits. Deferred business profits attributable to a permanent establishment or fixed base are taxable even after they cease to exist.

Article 8: The profits derived by an enterprise from the international operations of ships or aircraft are granted exclusively to the residence State of the enterprise. The profits include rental income on full (time or voyage) or bareboat leasing (including incidental income) of ships or aircraft used in international traffic. The profits from the use, maintenance, or rental of containers (including barges, and related equipment for the transport of containers) in international traffic are taxable only in the residence State of the enterprise.

Article 10: The Article reduces the participation requirement from 25% shareholding to an ownership of 10% direct voting shares for the lower concessional withholding rate to apply in the source State. The source State may also impose an additional branch profits tax without violating the non-discrimination provisions under Article 24. This tax is limited to the lower concessional rate specified in Article 10 (2 (a)) of the treaty.

Article 11: The residence State has exclusive taxing rights over the interest income. The treaty exemption in the source State is denied if the interest income is contingent on (i) the receipts, sales, income, profits or other cash-flow of the debtor or a related person; (ii) any change in the value of any property of a debtor or related person; or (iii) any dividend, partnership distribution or similar payments made by the debtor to a related person. Such interest income may be taxed at the rate not exceeding the upper concessional rate applicable to dividends under Article 10 (2) (b) of the treaty.

Article 12: As in OECD MC, the residence State has exclusive taxing rights. The term “royalties” also includes copyrights on other work, such as computer software, audio, videotapes or disks, and other means of image or sound reproduction. In addition, it includes any gains that are contingent on the productivity, use or disposition of a property.

Article 13: The US MC does not include the new paragraph 4 added in OECD MC Update 2003 to grant source taxing rights on gains derived from the sale of shares in companies deriving over 50% of their value from immovable property in that State.

Article 14: Unlike the OECD MC, this Article has not been deleted and merged with Article 7. The Article applies only to individuals or to a group of individuals (e.g. a partnership). The taxing rights in the source State are limited to the income attributable to the services performed in that State.

Article 15: The employee “as a member of a regular complement” on a ship or aircraft operated in international traffic is taxable only in his State of residence.

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Article 16: The directors' fees and their other compensation may be taxed in the other Contracting State only to the extent that they relate to services rendered in that State.

Article 17: Income derived by a sportsman or entertainer may only be taxed by the other Contracting State if it exceeds US\$ 20,000 (or equivalent in the currency of the other Contracting State) in a taxable year. When paid to another person, the provision does not apply if the entertainer or performer or any person related to him does not profit from the income in any manner.

Article 18: Besides private pensions, the treaty text includes annuities, social security benefits, alimony and child support payments, and tax deductions for overseas pension contributions. Social security receipts are taxable only in the payer's State, while alimony is taxable only in the residence State. Child support is tax-exempt in both States. The contributions to a recognised pension plan by an individual, who performs services in the other Contracting State, "shall be" deductible in the State where the services are performed.

Article 19: Besides government employees, government service includes independent contractors engaged by the government for functions of a "governmental nature." The US MC does not contain the proposed changes in OECD Update 2005 to specifically cover "non-periodic payments" besides pensions under this Article.

Article 20: The Article exempts any payments received for full-time education at an accredited institution or full-time training by a visiting student, apprentice or a business trainee from outside the State. The tax exemption is limited to the first year of stay only for an apprentice or business trainee (but not a student).

Article 22: The Article on Capital (OECD MC Article 22) is excluded since there are no federal capital taxes in the United States. The US MC Article 22 deals with the "Limitation on Benefits" under the treaty. There is no similar Article under the OECD or the UN Model treaties.

Article 23: The Article contains an ordering provision when a US citizen is a resident in the other Contracting State. It provides special foreign tax credit rules in the United States for relieving double taxation imposed on them.

Article 24: The Article does not require the tax treatment on nationals of the other State to be the same as that imposed on its own nationals in the same circumstances, provided it is not more burdensome. Moreover, nonresidents who are taxable as US nationals on a worldwide basis differ in circumstances from nonresident foreign nationals. It also authorises the United States to impose a branch profits tax without violating the non-discrimination Article. The Article does not cover stateless persons.

Article 25: There is no time limit for a taxpayer to present his case to the competent authorities, and he can present his case to the authority of either Contracting State. The assessment and collection procedures must, however, be suspended during the mutual agreement proceedings. The paragraph also provides an illustrative list of tax issues that the competent authorities may take up for resolution under the mutual agreement procedure.

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The competent authorities can also agree to increases in any specific dollar amounts referred to in the treaty.

Article 26: The Article provides for a wider exchange of information from banks, etc. to overcome bank secrecy laws and practices. It also obliges each Contracting State to give administrative assistance within its own laws and practice to ensure that taxpayers do not enjoy unintended treaty benefits. Finally, it obliges the competent authorities of the requested State to allow the tax authorities to interview taxpayers and to examine the books and records in the other State with the consent of the persons who are the subject of the examination. It excludes some of the changes and additional paragraphs proposed under OECD MC Update 2005.

Article 27: The US Model Treaty does not include Article 27 on Assistance in the Collection of Taxes added under the OECD MC 2003.

4. ARTICLES IN THE MODEL CONVENTIONS

The OECD MC, which is now issued in a loose-leaf form, provides for regular updates. The recent updates in 1994, 1995, 1997, 2000 and 2003 modified several Articles and the related Commentaries. The next update is due in late 2005. The present Model Conventions do not provide solutions to all existing or emerging tax issues. There are several open issues. Many of them (but not all) are discussed in the OECD MC Commentaries and published reports.

The changes under OECD MC Update 2000 related primarily to the deletion of Article 14 (independent personal services), which is now covered under Article 7 (business profits). In addition, Article 23A (4) was added to disallow treaty relief under the exemption method on certain conflicts of classification. The OECD made its latest changes to the Model treaty and Commentaries in January 2003. The treaty now contains a new Article 27 on “Assistance in the Collection of Taxes”. It also includes a more detailed commentary in Article 1 on the relationship between anti-avoidance measures and tax treaties, and the specific measures that can be included in tax treaties to combat international tax avoidance and evasion.

The brief description of the Articles and the Commentaries below refers to the OECD MC (updated to year 2003).²⁹ Some significant differences (where applicable) in the Articles under the UN MC 2001 and US MC 1996 are given for comparative analyses. The UN MC and US MC exclude any consideration of changes made in the OECD MC and Commentaries after their respective publication dates.

Article 1: Persons Covered

OECD MC

Under Article 1, only persons who are residents under the treaty can claim its benefits. Therefore, the benefits of a tax treaty can be enjoyed only by individuals or entities, which

²⁹ The significant changes in the 2005 Update, issued as a public discussion draft in March 2005, are briefly mentioned in this chapter. They relate to Articles 5 (multiple permanent establishments), 8 (shipping, inland waterways and air transport), 15 (stock option plans), 18 (cross-border pensions) and 26 (exchange of information). The changes in Article 15 (2) relating to economic employer, proposed in the April 2004 discussion draft, have not yet been finalised.

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are persons and residents of one or both States, as defined by the treaty. However, the provisions under certain Articles apply to nonresidents as well (Articles 19, 20, 24(1), 26(1) and 27).

The OECD MC now contains special provisions relating to treaty issues affecting partnerships.³⁰ Partnerships cover entities, which qualify as such under civil or commercial law as opposed to tax law. Some countries regard a partnership as an independent taxable entity, like a company. In other jurisdictions, a partnership is treated as a fiscally transparent (or “pass-through”) entity, where the tax is levied pro rata on the partners. Each Contracting State normally applies its own rules to characterise entities (domestic and foreign) as a partnership and then recognise partnerships either as a taxable or fiscally transparent entity. Conflicting tax treatment in the Contracting States often creates complex tax issues.³¹

Under OECD MC Article 4, the treaty applies only to persons who are resident because they are liable to tax due to certain criteria in their domestic law. A partnership, which is treated as a company or a taxable entity in a State, is a resident of that Contracting State and entitled to the treaty benefits as a resident. However, a fiscally transparent entity does not qualify as a resident since the partnership itself is not taxable. In such cases, the treaty benefits could possibly be refused to the partners unless they are specifically provided for by a special rule.

The Commentaries include the recommendations on such issues based on the conclusions reached in the 1999 OECD Report on Partnerships.³² The significant recommendations of the Report were as follows:³³

- **Source State:** The source State should take into account the tax treatment in the residence State of the person claiming the treaty benefits as a resident to avoid conflicts of qualification. Under this principle, if the individual partners in a fiscally transparent partnership are taxable in the residence State, the source State should give the treaty benefits to them. This tax treatment should be denied to them only if the income is not allocated to them by their residence State for tax purposes.³⁴ Alternatively, if the partnership is a taxable entity and therefore resident in the other State, the source State should grant the treaty benefits to the partnership and not the partners.³⁵ The classification of the partnership or partners under the domestic law in the source State should be ignored for treaty purposes. It should base it solely on the “the way in which an item of income arising in its jurisdiction is treated in the jurisdiction of the taxpayer claiming the benefits of the treaty as a resident”.³⁶
- **Residence State:** A fiscally transparent partnership as an entity is not entitled to treaty benefits since it is not liable to tax to be a resident. In such cases, the residence State

30 OECD MC does not yet contain specific provisions on the taxation of trusts, trustees and beneficiaries. This topic is currently under study by the OECD Committee on Fiscal Affairs.

31 See Chapter 8(7.5).

32 Committee on Fiscal Affairs: The Application of the OECD Model Tax Convention to Partnerships (OECD, 1999).

33 OECD Commentary: Article 1, paras. 2–6.7.

34 Committee on Fiscal Affairs: The Application of the OECD Model Tax Convention to Partnerships (OECD, 1999) para. 52–53.

35 OECD Commentary: Article 1, para. 6.2–6.4

36 OECD Commentary: Article 1, para. 6.2–6.4.

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should give the treaty relief to the partners to the extent that the partnership's income is allocated (i.e. paid to or derived by) to them for tax purposes in their State of residence. The partners are then liable to tax on the partnership income, and they should be regarded as residents for treaty purposes.³⁷

- Resident partners in a foreign partnership: In cases where a foreign partnership is a treaty resident, any treaty provisions that restrict the taxing rights of the source State over the partnership's income do not apply to its right to tax the partners, who are resident in that source State, on their share of the income of the partnership.³⁸

A major change in the Commentary Update 2003 is the new definition of the purpose of tax treaties. The Commentary (Article 1, paragraph 7) now mentions specifically that, besides the principal purpose of eliminating international double taxation, one of the purposes of a tax treaty is to prevent tax avoidance and evasion. According to the Committee on Fiscal Affairs, countries were unlikely to enter into tax treaties that allowed abusive (i.e. improper or unacceptable) use of domestic tax laws through tax arbitrage to secure the tax benefits of both domestic laws and tax treaties using artificial legal structures. The wording in all previous Commentaries was less specific and only required that treaties "should not help tax avoidance or evasion".³⁹

The Commentary on Article 1 discusses the issue of treaty abuse. Under "Improper Use of the Convention", the Commentary clarifies the relationship between anti-abuse rules and tax treaties. In particular, it addresses the following two questions:

- (i) Should the benefits of the tax convention be given when the provisions of the tax treaty are abused?
- (ii) Do tax treaties override the domestic anti-avoidance rules?

The Commentary mentions that since taxes are ultimately imposed under the domestic law (restricted or sometimes broadened by the tax treaty), a treaty abuse could also be considered as an abuse of the domestic law under which the tax is levied. As anti-avoidance rules are part of the basic domestic tax rules for determining a tax liability, they do not have to be addressed in tax treaties and therefore are not affected by them. Therefore, some countries take the view that, as a rule, there should be no conflict between domestic anti-avoidance rules and treaty provisions. Other countries accept that treaty abuse may differ from the abuse of domestic law; however, it violates both the object and purpose of the treaty. They apply the domestic anti-avoidance rules as part of their duty to interpret the treaty in good faith. In both cases, tax treaty benefits do not have to be given on transactions contrary to the object and purpose of the relevant treaty provisions.⁴⁰

The Commentary supports the use of additional counteracting measures in the domestic law to maintain the equity and neutrality of national tax laws in an international environment. In particular, it refers to the OECD Reports on base and conduit companies.⁴¹ The

³⁷ OECD Commentary: Article 1, para. 5; Article 4, para 8.4.

³⁸ OECD Commentary: Article 1, para. 6.1.

³⁹ Brian J. Arnold, *Tax Treaties and Tax Avoidance: The 2003 Revisions to the Commentary to the OECD Model* (IBFD Bulletin, June 2004) pp. 244–260.

⁴⁰ OECD Commentary: Article 1, paras. 9.2–9.5 and 22.1.

⁴¹ Committee on Fiscal Affairs: *International Tax Avoidance and Tax Evasion* (OECD, 1987).

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Commentary Update 2003 gives examples of measures that are used by some countries, such as the Limitation on Benefits provision and various anti-abuse provisions aimed at particular income types (e.g. dividends, interest, royalties and other income).⁴² These examples include restrictions on the entitlement to treaty benefits in preferential tax regimes, as recommended under the 1998 OECD Harmful Tax Competition Report.

The Commentary disapproves of treaty shopping and indicates that the controlled foreign corporation rules found in domestic law do not have to be included in tax treaties to be effective. Thus, the purpose of a tax treaty as an instrument for the prevention of tax avoidance and evasion is reaffirmed in the Commentary. The Contracting States do not have to grant treaty benefits that would be contrary to the object and purpose of the relevant provisions of the Convention. The Commentary also mentions that the specific treaty obligations should be observed unless there is clear evidence of treaty abuse.⁴³

OECD Observations or Reservations: Belgium, France, Ireland, Luxembourg, the Netherlands, Portugal, Switzerland and the United States.

France, the Netherlands and Portugal have made Observations on the Commentary relating to partnership provisions. Several countries disagree on certain aspects of the Commentary on the Improper Use of the Convention (Examples: Belgium, Ireland, Luxembourg, the Netherlands and Switzerland). The United States reserves its right to tax its citizens and residents, including former citizens and long-term residents without regard to the treaty.⁴⁴

Non-OECD Positions: Brazil, Gabon, Ivory Coast, Morocco, Philippines and Tunisia.

UN MC

The UN Commentary allows the Contracting States to agree on any special provisions bilaterally considered as necessary and appropriate, as it does not recommend any special provisions on partnerships.⁴⁵

US MC

The treaty normally applies only to persons who are residents of one or both Contracting States, except as otherwise provided in the Convention. The US MC Article 1 specifically refers to certain treaty provisions that apply to persons who are not residents of either State (Examples: Article 19 (government service), Article 24(1) (non-discrimination), Article 26 (exchange of information and administrative assistance)).⁴⁶ Moreover, it contains the following additional provisions:

Article 1(2): The taxpayer can choose the benefits either under the domestic law or the treaty for any class of income, but he cannot mix them (i.e. no “cherry picking”). A treaty cannot restrict in any manner the present and future benefits granted under the domestic law

42 Adolfo J. Martin Jimenez, *The 2003 Revision of the OECD Commentary on the Improper Use of Tax Treaties* (IBFD Bulletin, January 2004) pp. 17–30; See Chapter 2(2.4).

43 OECD Commentary: Article 1, paras. 7–26.

44 OECD Commentary: Article 1, paras. 27–28.

45 UN Commentary: Article 1, para. 4.

46 US Model Technical Explanation (1996): Article 1, para. 10.

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of either Contracting State or under any other agreement (subject to Article 1(3)) between the Contracting States. Moreover, it cannot increase the tax burden under the domestic law (“non-aggravation” or “preservation” clause).⁴⁷

Article 1(3): Only the mutual agreement procedure of this treaty can be used to resolve a dispute as to whether a tax measure⁴⁸ is within the scope of the treaty. Unless the competent authorities decide that the measure is not within the scope of this treaty, the non-discrimination provision under this treaty shall apply to that measure, except when it affects the obligations under GATT on the trade in goods.⁴⁹

Article 1(4): The “saving clause” reserves the right of each Contracting State to tax its own citizens and its tax residents, as if the treaty had not come into effect. This clause also taxes former citizens and long-term residents for up to ten years, provided they gave up their tax residence primarily for tax avoidance purposes. The US domestic law considers tax avoidance as the principal reason if (i) the average net income tax of the individual taxpayer exceeds US\$124,000 (inflation-adjusted) in the previous five years, or (ii) his net worth is at least US\$2 million. An individual is a long-term resident if he is a lawful permanent resident (other than a citizen) in at least 8 out of 15 previous tax years.

Article 1(5): The saving clause under US MC Article 1(4) does not affect certain benefits given under the treaty. This paragraph lists the treaty benefits given to:

(a) Citizens and permanent residents – (i) The correlative benefits of transfer pricing adjustments under Article 9(2); (ii) the social security benefits and the exemption for child support payments under Article 18(2) and 18(5); and (iii) the treaty benefits under Article 23 (relief from double taxation), Article 24 (non-discrimination) and Article 25 (mutual agreement procedure).

(b) Non-citizens and temporary residents – (i) The benefits under Article 19 (government service), Article 20 (students and trainees) and Article 27 (diplomatic agents and consular officers); (ii) the benefit derived from the tax treatment of pension contributions (Article 18(6)).

Article 2: Taxes Covered

OECD MC

The Article covers taxes on income and capital that are imposed by the State or its political subdivisions or local authorities, e.g. provincial taxes, municipal or communal taxes, etc. It includes all taxes on income or capital, including capital gains, taxes on capital appreciation and taxes on total wages and salaries. It may also include surtaxes, surcharges and any additional taxes. Social security taxes and similar charges are excluded if there is a direct connection between the levy and the benefits. The Article applies regardless of the manner in which the taxes are imposed (e.g. direct assessment or withholding).⁵⁰

⁴⁷ US Model Technical Explanation (1996): Article 1, paras. 11–13.

⁴⁸ A measure is defined to include a law, regulation, rule, procedure, decision, administrative action or guidance, or any other form of measure.

⁴⁹ OECD Commentary: Article 25, paras. 44.1–44.7.

⁵⁰ OECD Commentary: Article 2, paras. 2–5.

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Article 2(3) lists the taxes covered by the treaty when it was signed. Although the list may not be exhaustive, in principle it would include all the taxes existing at that time, unless they have been specifically excluded.

Article 2(4) extends the Article to new taxes introduced after the treaty has been signed, provided they are identical or substantially similar to the taxes to which the treaty applies.⁵¹ The competent authorities in the Contracting States must notify each other of any significant changes in their taxation laws.⁵²

OECD Reservations: Australia, Canada, Greece, Japan, Korea and the United States.⁵³

Non-OECD Positions: Belarus, Brazil, Estonia, Latvia, Lithuania, Romania, Russia, South Africa, Tunisia and Ukraine.

UN MC

Similar

US MC

The US MC Article 2(1) only covers the US federal taxes (excluding social security taxes) and federal excise taxes on private foundations. Therefore, US state and local taxes are not included. Besides changes in tax laws, the US MC requires the competent authorities to notify each other of significant changes in their laws and practices that affect their treaty obligations. They are also obliged to notify each other of any official published material concerning the application of the treaty. The taxes covered in US MC Article 2(1) (b) are considered as income taxes for purposes of US foreign tax credit given under Article 23.⁵⁴

Article 3: General Definitions

OECD MC⁵⁵

Article 3(1) gives certain general definitions of treaty terms, which are not defined elsewhere in the MC. These definitions apply for all purposes under the treaty, unless the context otherwise requires.

(a) The definition of the term “**person**” is not exhaustive. The term “person” specifically includes an individual, company and any other body of persons. Although a body of persons is not defined in the OECD MC, it would include any legal entity (e.g. an association) that does not qualify as a company. A partnership is a person either as a company or as any other body of persons. According to the Commentary, the term “person” is used in a very wide sense.

⁵¹ It must be a tax and not an imposition similar to tax, e.g. a royalty payment. (*Ashanti Goldfields Corp Ltd v Merrifields* (1934) 19 TC 52 (UK)).

⁵² Michael Lang, “Taxes Covered” – What is a “Tax” according to Article 2 of the OECD Model? (IBFD Bulletin, June 2005) pp. 216–223.

⁵³ OECD Commentary: Article 2, paras. 10–12.

⁵⁴ US Model Technical Explanation (1996): Article 23, para. 331.

⁵⁵ OECD MC Update 2000: Additional definitions have been added as paragraphs 1(c) and 1(h) to ensure that independent personal services, previously under Article 14, are now covered under Article 7 as business income.

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Under the MC, the term “person” is used in several Articles. They include persons covered (Article 1), resident (Article 4), permanent establishment (Article 5(5)), associated enterprises (Article 9), interest (Article 11), royalties (Article 12), artistes and sportsmen (Article 17), non-discrimination (Article 24), mutual agreement procedure (Article 25) and exchange of information (Article 26).

(b) The term “**company**” is any body corporate, or any entity that is treated as a body corporate for tax purposes under the tax laws of the Contracting State where it is organised.⁵⁶ Thus, even when an entity is not a company under the civil or commercial law, the term “person” would include such entities if they have corporate status for fiscal purposes. The term “body corporate” itself is not defined in the Model treaty.

The definition of a company is applicable in the Articles on permanent establishment (Article 5(7)), dividends (Article 10) and directors’ fees (Article 16).

(c) The term “**enterprise**” is used in several Articles in the treaty. In the past, the OECD MC did not provide a definition of the term and left it to the domestic laws of the Contracting States.⁵⁷ The OECD MC and its Commentary now confirm that the term applies to the carrying on of any business. It would include any entity, which is used by a person to carry on income-generating activities that constitute a trade or business. The person should assume entrepreneurial risks and exercise the power to make business decisions. Certain case law decisions maintain that the word “enterprise” is part of an “international tax language” and this meaning should be applied for treaty purposes.⁵⁸

The term “enterprise” is used in the Articles on taxes covered (Article 2), permanent establishment (Article 5), income from immovable property (Article 6), business profits (Article 7), shipping, inland waterways transport and air transport (Article 8), associated enterprises (Article 9), capital gains (Article 13) and non-discrimination (Article 24).

(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.

They are used in the Articles on business profits (Article 7), associated enterprises (Article 9) and non-discrimination (Article 24).

(e) The term “**international traffic**” means any transport (e.g. journey) by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State. It excludes transport by an enterprise with its place of effective management in one Contracting State when it operates a ship or aircraft solely between places in the other Contracting State, even if part of the transport takes place outside the State. Thus, a cruise beginning and ending in the other State without a stop in a foreign port does not qualify as international traffic.⁵⁹

⁵⁶ OECD Commentary: Article 3, para. 3.

⁵⁷ OECD Commentary: Article 3, para. 4; See Kees van Raad, *The Term “Enterprise” in the Model Double Taxation Conventions – Seventy Years of Confusion* (Intertax, 1994).

⁵⁸ *Thiel v FCT* (1990) ATC 4717, 4728 (Australia); *Ostime v Australian Mutual Provident Society* (1959) 38 TC 492, 517 (UK).

⁵⁹ The definition of international traffic was clarified in paragraph 6.3 of the proposed amendments to the Commentary in 2004; the changes will be included in the OECD Commentary Update 2005.

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The term “**international traffic**” is used in the Articles on shipping, inland waterways transport and air transport (Article 8), capital gains (Article 13(3)), income from employment (Article 15(3)) and capital (Article 22(3)).

(f) The term “**competent authority**” for treaty purposes refers to the authority designated under the treaty.

The term is referred to in the Articles on taxes covered (Article 2), resident (Article 4), associated enterprises (Article 9), mutual agreement procedure (Article 25) and exchange of information (Article 26).

g) The term “**national**” is any individual or natural person with the nationality or citizenship of that State. A legal person (e.g. a company), partnership or association is a national of the Contracting State from the laws of which it derives its legal status.

Nationality is applicable in the Articles relating to dual resident individuals (Article 4), government service (Article 19) and non-discrimination (Article 24).

(h) The term “**business**” includes the performance of professional services and of other activities of an independent nature (OECD MC Update 2000). Therefore, these services and activities cannot be excluded from the scope of the term “business” under Article 7 of the Convention, based on their meaning under the domestic law.

Article 3(2) provides a general rule of interpretation that “any term not defined therein (in the treaty) shall, unless the context otherwise requires, 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.” The Commentary specifies that a Contracting State applying the treaty may use its own domestic definition only if the context does not require an alternative interpretation.⁶⁰

Hence, several undefined terms (Examples: beneficial owner, effective management, partnership, pension, resident, etc.) may follow the domestic law definition, unless the context of the treaty requires a different meaning.⁶¹ The Article mentions that the domestic law definition can be based on any of the laws of the State, whether or not a tax law, but priority should be given to the meaning in the applicable tax law over other laws. Undefined terms may also be clarified by the competent authorities under the mutual agreement procedures (Article 25).

The Article 3(2) expressly supports the use of the legal definition under the domestic law at the time when the treaty is applied (not when it was signed) under an “ambulatory” approach.⁶² However, the common interpretative principles under the VCLT may require the use of an external meaning under the context. To determine the context, a Contracting State should not ignore the intention of the Contracting States at the time when the treaty was signed and the meaning given to the term in the laws of the other Contracting State. The Commentary is unclear whether the context requires reference to the domestic meaning in

⁶⁰ See Chapter 2(3.5).

⁶¹ The Model treaty requires the use of the domestic law meaning in certain Articles (Examples: Articles 4(1), 6(2), 10(3)).

⁶² John F. Avery Jones et al, *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model* (British Tax Review, 14 and 90, 1984).

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the other State at the time when the treaty was signed or the current meaning under its laws. One view is that both the meanings should be considered.⁶³

Tax treaties are international agreements between States that are governed by the VCLT. However, as double tax treaties provide a link between two tax systems, they also reflect the terms as used in the internal law of the Contracting States. Thus, Article 3(2) provides an “internal” aid to the interpretation of tax treaties based on the meaning under the domestic law with an “external” aid represented by the contextual meaning under the VCLT.

OECD Reservations: Italy, Portugal and the United States.⁶⁴

Non-OECD Positions: Albania, Belarus, Bulgaria, Croatia, Lithuania, Romania and Russia.

UN MC

The UN MC does not contain the definitions of “enterprise” and “business”.

US MC

The US MC Article 3 contains the following variations:

Article 3(1)(a): A “person” additionally includes an estate, a trust and a partnership.

Article 3(1)(c): An “enterprise” includes an enterprise carried on by a fiscally transparent entity (e.g. a partnership) in that Contracting State. An enterprise carried on by a transparent entity is deemed to be an enterprise conducted by a resident of a Contracting State to the extent that its partners or other owners are residents. An enterprise of a Contracting State may carry on its business wholly in the other Contracting State or in a third State.

Article 3(1)(d): The definition refers to any transport by a ship or aircraft, except when such transport is solely between places in either Contracting State. Unlike the OECD MC, internal transport between places in either State is not considered international traffic.⁶⁵

Article 3(1)(i): The Article includes a new term “qualified governmental entity”. It is defined as (i) a governmental entity at the state, political subdivision or local authority level of a Contracting State, or (ii) a person wholly-owned (directly or indirectly) by a governmental entity that meets certain organisational and funding requirements, or (iii) a pension fund of a person in (i) or (ii) above. An entity that carries on any commercial activity cannot be a qualified governmental entity. The definition is used in US MC Articles 4, 10 and 22.

The US MC does not contain the definitions of “enterprise” and “business”.

Article 4: Residence

OECD MC

The term “resident of a Contracting State” is very widely used throughout the Model treaty.⁶⁶ Most of the distributive Articles of the treaty apply to a recipient of income (or owner of

⁶³ OECD Commentary: Article 3, paras. 11–13.1; Peter Wattel and Otto Marres, *Characterisation of Fictitious Income under OECD-Patterned Tax Treaties* (European Taxation, March 2003) pp. 71–72.

⁶⁴ OECD Commentary: Article 3, paras. 14–15.

⁶⁵ US Model Technical Explanation (1996): Article 3, para. 36–38; OECD Commentary: Article 3, para. 6.2.

⁶⁶ See Articles 1, 2, 4, 5, 6, 10, 11, 12, 13, 15, 16, 17, 18, 19, 20, 21, 22, 23, 24.

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capital) who is a resident of a Contracting State. Some Articles (e.g. Article 10) also refer to the State where the payer is a resident.

Article 4(1) defines residence under the tax treaty. The term “resident of a Contracting State” means a person who is (i) liable to tax in a Contracting State (ii) under its domestic law (iii) by reason of (iv) his domicile, residence, place of management or any other criterion of a similar nature. To qualify as a treaty resident, all four conditions must be satisfied. The Article also mentions that the government of each State, its political subdivisions and local authority are residents of that State.

The definition of residence applies to the person and not the income. A person must be liable to taxation under the domestic law because of his tax status under one of the criteria listed in Article 4(1). As a charging provision, a liability should exist due to a personal attachment to a Contracting State. Therefore, the term “liable to tax” refers to “subject related” taxation, and not to “object related” taxation.⁶⁷

The person must be liable to tax on the worldwide income (“full tax liability”) due to a locality-related attachment to that State as a resident under its domestic law.⁶⁸ The tax residence must be based on domicile, residence, place of management or any other criteria of a similar nature. The phrase “similar nature” suggests that it must resemble domicile, residence or place of management.⁶⁹ These criteria are generally recognised under international tax law to justify worldwide taxation of residents. Any other basis under the domestic law may not qualify.⁷⁰

To be liable to tax, the person has to be “subject to the tax laws of a Contracting State”.⁷¹ The term refers to the existing tax laws and to taxes covered by the treaty when it is applied. However, a person does not necessarily have to be “subject to tax”. The term “subject to tax” refers to a current tax liability. If a State can tax the person on his worldwide income under its current laws at a future date due to any of the listed criteria under the Article, the person is deemed liable to tax. Such a person is liable to tax presently but does not have to pay any tax. If the person cannot be a taxpayer under the present laws of the State (now or in future), he cannot be said to be liable to tax.

Thus, a person, who is liable to tax, may not necessarily have to be “subject to tax” i.e. actually pay tax.⁷² It would include persons who are not effectively taxed due to

67 J.D.B. Oliver, *Company Residence – Four Cases* (British Tax Review, 1996 No. 5) pp. 535.

68 Klaus Vogel, *Double Taxation Conventions*, Article 4, m.no. 24.

69 It is arguable whether the term domicile is sufficiently wide to include the place of incorporation of a company. According to Vogel, it would cover a statutory seat, main activity, circumstances, etc., but not nationality or incorporation (See Klaus Vogel, *Double Taxation Conventions*, Article 4, m.no. 30).

70 *The Queen v Crown Forest Industries Limited* (1995) 95 DTC 5389(Canada): A Canadian taxpayer rented barges from Norsk, a nonresident company incorporated in the Bahamas but carrying on business in the United States. Norsk claimed reduced Canadian withholding tax on rental payments under the Canadian-United States tax treaty as a treaty resident of the United States. Norsk was liable to tax on US source income to the extent it carried on a trade or business and had effectively connected income. The Court held that it was essential under the Article that the tax liability was by reason of one of the specified criteria under the domestic law and, therefore, taxation based on “effectively connected income” would not qualify. These criteria require the person to be taxable on a worldwide basis under the domestic law to qualify as a treaty resident.

71 OECD Commentary: Article 4, para. 8.2.

72 In *Union of India v Azadi Bachao and Anr.* (2003) 263 ITR 706 (India), the Indian Supreme Court held that a Mauritius company, which did not have to pay any capital gains tax under its domestic law, was still liable to tax and hence a treaty resident.

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circumstances such as losses, set-off of losses, a mistake or income below taxable limits or time-barred. Moreover, the person may not have any tax to pay due to exemptions (either complete or partial). The exemption may be subjective (i.e. taxpayer is exempt) or objective (i.e. taxable item is exempt).⁷³ The Commentary Update 2000 clarifies that tax-exempt entities (e.g. pension funds, charities, etc.) are liable to tax even if the Contracting State does not levy any tax on them. Most countries treat them as residents for treaty purposes. They are given the tax exemption only when they meet the specific requirements of the Contracting State and are required to pay tax when they do not meet those conditions.

The second sentence in Article 4(1) specifically excludes any person who is liable to tax only on “income from sources in that State or capital therein”. An offshore company would not be a tax resident, if its foreign income and capital are exempt from tax. The Commentary clarifies that this sentence was initially added to exclude foreign diplomats and consular staff, who may be subject to tax only on domestic-source income under the international law or agreement (Article 28). It “has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended”.⁷⁴

Article 4(2) provides the special rules if an individual is tax resident in both Contracting States under their respective domestic laws. Dual residence can arise if (i) the same criteria leads to residence in both States, (b) the two States interpret the same criteria differently, or (c) the two States use different criteria. This paragraph ensures that a person is only resident in one Contracting State for treaty purposes. An individual is deemed a treaty resident of one Contracting State only, based on the following four “tie-breaker” tests to be applied successively:

- a permanent home available at all times;
- centre of vital interests or closer personal and economic relations;
- the habitual abode (a regular and repeated use of a place over a period of time); and
- the nationality of the individual.

In cases where these tests do not provide a solution, the decision must (“shall”) be made by the competent authorities of the Contracting States to settle the issue.

The tie-breaker rules for individuals include the word “only” in relation to the four successive, but separate tests, in their order of precedence. The Commentary contains limited explanations of these connecting factors. A “permanent home” is any suitable accommodation, whether owned or not, if it is ready and available at all times continuously (as opposed to occasionally) for the individual’s use. The centre of vital interest deals with personal and economic interests, such as 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.⁷⁵ Habitual abode relates to the State where the taxpayer spends

⁷³ See Michael Lang, *Taxation of Income in the Hands of Different Taxpayers from the Viewpoint of Tax Treaty Law* (IBFD Bulletin, December 2001) pp. 597–598.

⁷⁴ OECD Commentary: Article 4, para. 8; In *The Queen v Crown Forest Industries Ltd* 95 DTC 5389 (1995), the Canadian Supreme Court held that the second sentence was not necessary to require that the taxpayer was liable to tax on his worldwide income for tax residence under this Article.

⁷⁵ OECD Commentary: Article 4, para. 15.

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most of his time, regardless of purpose. It relies on the frequency or duration of his physical presence or stay(s) in a Contracting State over a sufficient period.⁷⁶ The nationality of the individual is applied as the fourth tie-breaker. The mutual agreement procedure can only be initiated if the above criteria, when applied one after the other, do not break the dual residence.⁷⁷

The treaty residence of a person, other than an individual, if it is dual resident, is deemed to be the Contracting State in which it has its place of effective management (Article 4(3)). The interpretation of place of effective management for solving the case of dual-resident corporate entities varies widely.⁷⁸ For example, the place could be where the factual and day-to-day management takes place (“executive management”) or, where the top level or policymaking body makes its decisions (“board management”). These levels of management differ from shop floor management. Many countries regard the place of effective management as the place where key management and commercial decisions are taken by top-level managers.⁷⁹

The Commentary Update 2000 has now defined the place of effective management as “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made”. It is ordinarily the place where (a) senior management (e.g. board of directors) make business decisions and take corporate actions and (b) the actions of the enterprise as a whole are determined. However, this rule is not definitive and all relevant facts and circumstances must be examined to determine the place of effective management. The Commentary and the OECD Discussion Paper reject a purely formal criterion like registration or incorporation, in favour of the place where the entity is actually managed. The place of effective management is one of substance over form. An entity may have more than one place of management, but it can only have one place of effective management at any one time.⁸⁰

The single residence determination under Article 4 is for treaty purposes only. Therefore, dual residence remains under domestic law. Some countries have adopted anti-avoidance provisions to prevent a person from obtaining the domestic law benefits of residence when it is not a resident under a treaty (Examples: Canada, South Africa, the United Kingdom). Under the domestic laws in Canada (CITA Sec. 250(5)) and the United Kingdom (FA 1994

76 In general, the “habitual abode” criterion based on the actual length of stays should provide a solution to dual residence for individuals, but the length of period to be examined for the review may present difficulties.

77 Klaus Vogel, *Double Taxation Conventions*, Article 4, m.no. 82.

78 Jean-Marc Rivier, *IFA Cahiers Vol. 72A, General Report, 1987*; See also OECD Discussion Paper on “Place of Effective Management as Tie Breaker Rule” (OECD, February 2001) paras. 17–35.

79 The UK Inland Revenue has clarified that they regard “effective management” as the place where the head office as the central directing source (not as registered office) is located. This definition, which is applied in several European countries, refers to the centre of top-level management and differs from “central management and control” by directors. However, in most cases both will be located in the same place. (See Inland Revenue manual ITH348); See also John J. Avery Jones, *Place of Effective Management as a Residence Tie-Breaker* (IBFD Bulletin, January 2005) pp. 20–24.

80 OECD Commentary: Article 4, paras. 21–24; The Committee on Fiscal Affairs has circulated a Discussion Paper on “The Impact of the Communications Revolution on the Application of Place of Effective Management as a Tie Breaker Rule” (OECD, February 2001), and subsequently issued draft proposals in May 2003 for changes in the MC Article 4(3) and its Commentary. The proposals have yet to be finalised. (See Chapters 4(2.3) and 8(1.5(c))

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Sec. 249), a company, which is deemed as nonresident under the tie-breaker provision, is also regarded as nonresident for domestic tax purposes. Similar rules now apply to individuals in Canada.⁸¹

The MC only covers persons who are resident in one or both Contracting States. It does not deal with situations involving triangular cases.⁸²

OECD Observations or Reservations: Canada, France, Germany, Greece, Italy, Japan, Korea, Mexico, Spain, Turkey and the United States.⁸³

The Observations and Reservations of OECD Member States in the Commentary give additional insights on Article 4(3). The United States, Canada and Mexico reserve their rights to base the tax residence on the place of incorporation. Japan and Korea prefer the location of the “head or main office”. Turkey reserves the right to include the use of the “registered office” criterion (legal head office).⁸⁴

Non-OECD Positions: Albania, Belarus, Brazil, Bulgaria, China, Estonia, Gabon, Ivory Coast, Latvia, Lithuania, Morocco, Russia, South Africa, Thailand, Tunisia, Ukraine and Vietnam.

UN MC

The UN MC 1980 Article 4(1) omitted the second sentence, which limited the treaty definition of residence to worldwide taxpayers only. The second sentence in the OECD MC 4(1) has now been included under the UN MC 2001. This sentence excluded as a resident “any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein”. The UN Commentary stressed the clarification given in the OECD Commentary. The sentence is meant only to cover certain special situations and is inappropriate in treaties involving territoriality-based regimes.

Unlike the OECD MC, the Article specifically includes a place of incorporation as a criterion for tax residence. The UN MC Commentary also allows the consideration of the four factors mentioned below to define the place of effective management:

- the place of actual management and control;
- the place where management policy decisions at the highest level are taken;
- the place of management from an economic and functional point of view; and
- the place where the most important accounting books are kept.⁸⁵

US MC

Article 4(1): The US MC Article 4(1) contains the following variations:

- The liability to tax due to citizenship and place of incorporation are additional criteria for the determination of tax residence.

81 Jack Bernstein, Canadian Budget Affects Taxation of Dual Residents (Tax Notes International, March 8, 1998) p. 738; Canada’s 1998 Federal Budget – International Provisions (IBFD Bulletin, July 1998).

82 See Chapter 8(6).

83 OECD Commentary: Article 4, paras. 25–32

84 OECD Commentary: Article 4, para. 25–32; OECD Non-member Countries’ Positions: Article 4.

85 UN Commentary: Article 4, para. 10.

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- Tax-exempt entities established exclusively either (i) for a religious, charitable, educational, scientific or other similar purpose, or (ii) to provide pensions or similar benefits to employees under a pension plan are resident for treaty purposes.
- A qualified governmental entity is tax resident where it is established.
- An item of income, profit or gain through an entity that is fiscally transparent under the laws of either Contracting State is deemed to be derived by “a resident of a State” to the extent that the item is treated as income of a resident of that Contracting State for tax purposes (“derived through entity” principle).

Article 4(2) (d): The competent authorities shall “endeavour” (not “shall”) to settle the issue of dual residence for individuals as a last resort.

Article 4(3): A dual resident company is resident at its place of incorporation (not “effective management”) under the tie-breaker provision for corporations.

Article 4(4): The competent authorities shall “endeavour” (not “shall”) to determine the residence of persons, other than individuals and companies, by mutual agreement.

Article 5: Permanent Establishment (or “PE”)

OECD MC

Under Article 7 of the Model treaty, the income from business activities may be taxed in the source State only if the enterprise has a presence as a permanent establishment under Article 5. This Article provides for separate definitions⁸⁶ of permanent establishments, as follows:

(i) Basic permanent establishment (Article 5(1) and 5(2)): A permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. The place of business must qualify as the foreign enterprise’s place of business.⁸⁷

The “basic rule” contains the following conditions:

- the existence of a “place of business”, such as premises or sometimes 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; and
- the business of the enterprise must be carried on through this place of business by its personnel.⁸⁸

The term “place of business” comprises any premises, facilities or installation, whether or not they are used exclusively for business purposes.⁸⁹ The only requirement is that the

⁸⁶ Strictly speaking, there are only two kinds of permanent establishment, namely basic PE and agency PE. The construction PE under paragraph 5(3) is a subset of basic PE under paragraph 5(1). The subsidiary PE is not a separate PE definition.

⁸⁷ *Consolidated Premium Iron Ores Ltd* (1959) 265 F 2d. 320 (US): A Canadian company with only a mailing address in the United States but with no office, no telephone listing, no personnel and no bank account or books of account was not considered a permanent establishment. The Court held that the term implied the existence of an office staffed and capable of day-to-day business, or plant or facilities equipped for such purpose.

⁸⁸ OECD Commentary: Article 5, para. 2.

⁸⁹ According to Vogel, a place of business means all the tangible assets used by the enterprise for carrying on the business. It excludes any intangible assets. Moreover, the actual activity may be exercised outside the place of business. The living accommodation of a travelling salesman can also be a permanent establishment

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enterprise has a certain amount of space in the other State at its disposal i.e. available for its use.⁹⁰ The place of business does not have to be owned or rented by the enterprise. It is not necessary that it is exclusively used by the enterprise. It may be situated in the business facilities of another enterprise. It may exist even when no premises are available or required for business purposes and it simply has a certain amount of space at its disposal. It may be legally or illegally occupied. However, the mere presence of an enterprise at a particular place does not necessarily mean that it is at its disposal.⁹¹

The place of business must be fixed in terms of both time and location, i.e. a distinct *Situs* in which the business activity is carried out (“location test”) with a certain degree of permanency (“permanence test”). There must be a geographical or physical link with the place of business. If activities are performed at more than one precise location, these locations may constitute a single “place of business” provided they constitute a whole that is both commercially and geographically coherent. They would include activities that are confined to a specific area, even if moved around, e.g. construction activity, oil drilling rig, etc., or a place of business used regularly, e.g. a pedestrian street, outdoor market or fair. (“temporary fixed location”).⁹²

The “permanence test” refers to continuing for an indefinite period, but not forever.⁹³ The activities must not be of a temporary or occasional nature, and should normally be carried out on a regular basis by the foreign enterprise for a relatively long duration. Temporary interruptions are disregarded. A place of business may become a permanent establishment from inception if maintained for a qualifying period. A very short period may be sufficient if required by the nature of the business. Moreover, a place of business would qualify if the short period was due to special circumstances (e.g. death of a taxpayer or investment failure) or if it was used on a regular basis.⁹⁴

A permanent establishment begins to exist when the enterprise commences its preparatory activities to carry on its business through a fixed place of business. It excludes the time spent on the formation or set-up of the enterprise itself if these activities are substantially different from its core activity. Similarly, the permanent establishment ceases to exist when all the actions connected with its core activity, or its right to use for business purposes, are terminated. A temporary interruption of operations cannot be regarded as a closure.⁹⁵

The Commentary clarifies that carrying on of the business of the enterprise through a fixed place of business usually means that persons dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated. The term “personnel” includes both employees and others, such as dependent agents, who

(Bundesfinanzhof 4 BFH/NV 119 (1988)(Germany). Any space provided by a customer in the source State solely for performing any work on his behalf is not a permanent establishment of the foreign enterprise. (See Klaus Vogel, *Double Taxation Conventions*, Article 5, paras. 21–28).

90 This power may be held alone or jointly with other parties. If jointly, the place may be treated as a permanent establishment of each of the parties involved.

91 OECD Commentary: Article 5, para. 4–4.6.

92 OECD Commentary: Article 5, paras. 5–5.4.

93 In the French text of the Model treaty, the term used is “*établissement stable*”. The word “permanent” does not appear in the French treaty text.

94 OECD Commentary: Article 5, paras. 6–6.3.

95 OECD Commentary: Article 5, para. 11.

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receive instructions from the enterprise.⁹⁶ There must be a connection between the business activity of the enterprise and the place of business. The place of business must be the base for the enterprise's business activity in that State.⁹⁷

Although it is usual for the business to be carried on mainly by natural persons, a human being need not necessarily perform the activities. A business may be at least partly carried on without personnel since human intervention is not a requirement for the existence of a permanent establishment. For example, the presence of personnel is not necessary for a permanent establishment to exist when no personnel are in fact required to carry on business at that location (e.g. computer equipment).⁹⁸ A place where automatic equipment⁹⁹ is operated may be a permanent establishment, if the equipment is operated and maintained for the enterprise's own account, after the initial set-up, by the enterprise itself or its dependent agents.¹⁰⁰

The place of business does not have to generate profits directly, but the profits should arise wholly or partly through business activities of the permanent establishment. The activities need not be of a productive character. The permanent establishment does not necessarily have to be an establishment that one would normally regard as being a business establishment. It is also not important whether the profits are derived from the activities in the country of the permanent establishment, or from elsewhere. The words "through which" must be given a wide meaning to apply to any situation where the business activities are carried on at a particular location at the disposal of the enterprise.¹⁰¹

According to the OECD Commentary, an enterprise that merely leases equipment will not have a permanent establishment where the equipment is used by the lessee, even if the enterprise provides personnel to operate the equipment. If, however, this personnel's responsibilities go beyond the maintenance and operation of the equipment under the direction, control and responsibility of the lessee, the enterprise could be carrying on a business and, therefore, have a permanent establishment.¹⁰²

The OECD text provides a non-exhaustive "positive" list of fixed places of business. It includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry or any place of extraction of natural resources. A place of management or branch would normally require an office or similar facilities to constitute a permanent establishment. An office would denote a fixed facility for handling the administrative side of the business. Although they are *prima facie* examples of establishments that may be a permanent establishment, the list does not necessarily signify a permanent establishment; the conditions of Article 5(1) must be met for them to constitute a permanent establishment. They will be a permanent establishment only if the enterprise carries on its business

⁹⁶ OECD Commentary: Article 5, para. 2.

⁹⁷ OECD Commentary: Article 5, para. 2; the phrase "carries on" suggests an occupational undertaking to which one habitually devotes time, attention or effort with substantial regularity. (*Fahs v Crawford* F2d 315, 317 (US))

⁹⁸ OECD Commentary: Article 5, para. 42.6.

⁹⁹ Examples: vending and gaming machines, a telephone exchange, automatic filling stations, equipment for receiving or transmitting radio signals, computer equipment, etc.

¹⁰⁰ OECD Commentary: Article 5, para. 8–11.

¹⁰¹ OECD Commentary: Article 5, para. 4.6.

¹⁰² OECD Commentary: Article 5, para. 8.

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operations through them.¹⁰³ A registered office of a “brass plate” company would not qualify.

(ii) Construction permanent establishment (Article 5(3)): Construction PE is a subset of basic PE for any business activity connected with a building site or construction or installation project. It must satisfy the basic PE requirements except that a “duration test” replaces the “permanence test” since the construction or installation projects are seldom fixed in terms of time or place.¹⁰⁴

A building site or construction or installation project is a permanent establishment only if it lasts more than 12 months, provided it meets the other conditions of a basic PE. If the 12-month period is exceeded for any reason, a permanent establishment exists from the beginning of the project. The period starts with the preparatory work in the source State, and ends when the installation is tested and formally handed over or permanently abandoned. Seasonal, intended and temporary interruptions are included.

Time spent by subcontractors is counted as time spent by the general contractor; however, their work may form their own separate permanent establishments, if it lasts for more than 12 months. The 12-month test applies at the level of a partnership, if fiscally transparent in respect of its own activities. It includes the time spent at the site by the partners and the employees of the partnership. Each partner is considered to have a permanent establishment, regardless of the time spent by the partner himself, and is taxable on his share of the business profits derived by the partnership.¹⁰⁵

The time-frame normally applies to each individual site or project. Where several contracts are factually interrelated, the 12-month period is aggregated. Thus, several geographically and commercially connected sites within a State may be treated as a single installation, even if based on different contracts. The projects for the same client, concurrently or consecutively, as part of the same constructional entity or on the same site may be identified as one project. A building site may form a single unit even if the orders are placed by several persons (e.g. for a row of houses).¹⁰⁶ The nature of the same project may require continuous or frequent relocation as the project progresses (e.g. roads, canals, pipelines, etc.), or require work at various locations within a country for final assembly at another location.¹⁰⁷

The term “building site or construction project” includes the construction of buildings, roads, bridges or canals, renovation work, the laying of pipelines and excavating and dredging. It also includes all the work necessary to complete the project, such as related installation and assembly work, demolition and clearing operations. Maintenance and repair work is included, but delivering materials to the site does not come within the definition.¹⁰⁸ The term “installation project” means putting together or assembly of prefabricated elements, or parts of movable objects. The Commentary refers to both installation on

¹⁰³ OECD Commentary: Article 5, para. 12.

¹⁰⁴ John C Huston and Robert L Williams, *Permanent Establishment – A Planning Primer*, pp. 65–66.

¹⁰⁵ OECD Commentary: Article 5, para. 19–19.1.

¹⁰⁶ OECD Commentary: Article 5, para. 18.

¹⁰⁷ OECD Commentary: Article 5, para. 20.

¹⁰⁸ Klaus Vogel, *Double Taxation Conventions*, Article 5, m.no. 73a.

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construction projects and of new equipment. This paragraph also covers on-site planning and supervision.¹⁰⁹

(iii) Agency permanent establishment (Article 5(5)): The agency paragraph (Article 5(5)) replaces the requirement of a place of business under the basic rule by an agent (Article 5(1)). An enterprise that does not qualify under the basic rule may still have a deemed permanent establishment if it carries on business activities through a person,¹¹⁰ who is not an independent agent under Article 5(6). A foreign enterprise does not need to have a fixed place of business or the right to use such a place if it “uses” an agent. The agency clause does not require any special business activity. It can be any activity essential and significant to the principal’s business.¹¹¹

To qualify as an agency permanent establishment, either (a) a dependent agent or (b) an independent agent who is not acting in the ordinary course of his own business must (i) act on behalf of the enterprise (i.e. the principal),¹¹² (ii) must have the authority to conclude contracts in the name of the enterprise, and (iii) must exercise this authority on a habitual or ongoing (not isolated) basis. The contracts should relate to the core operations or essential and significant business activities of the enterprise.¹¹³ If these conditions are met, a permanent establishment exists to the extent that the person acts for the principal.¹¹⁴

A dependent agent is any person, who is not an independent agent under the treaty (Article 5(6)). Dependent agents are either legally or economically dependent on the principal, whether or not employed by the enterprise. They may be individuals or companies. They do not have to be resident or have a place of business in the State where they act for the principal. An employee is always a dependent agent due to his legal and economic dependence on the employer. Other agents may be dependent if the power to control or instruct them exceeds the level normally expected under an independent agency agreement. For example, if the principal controls an agent financially or exercises extensive controls over his business activities, he will be deemed a dependent agent.

An independent agent is treated the same way as a dependent agent of an enterprise for certain or all of his business activities if he acts outside the ordinary course of his business when acting for the principal. A person, who performs economic activities for the enterprise that differ from his own business operations, cannot be said to act in the ordinary course of his business. An independent status is also less likely if the activities of the agent are performed almost wholly for a single enterprise for a long time.

¹⁰⁹ OECD Commentary: Article 5, para. 17.

¹¹⁰ The term “person” is defined in Article 3(1)(a) to include an individual, a company or any body of persons. Therefore, an agent can be either individuals or companies.

¹¹¹ Arvid Skaar, *Permanent Establishment*, p. 464.

¹¹² Under common law, an agent always acts on behalf of the principal and legally binds him. He will constitute an agency PE unless he is legally and economically independent and acts in the ordinary course of his own business. Under civil law, the law of representation applies. A person binds the principal if he acts in his name (“direct representation”) but not when he intends to bind himself to the third party (“indirect representation”). A civil law commissionaire or commission agent normally concludes contracts in his own name as an undisclosed agent on behalf of the principal and does not bind him.

¹¹³ The paragraph excludes an agent whose activities are confined to auxiliary or preparatory activities listed under paragraph 4 of this Article, provided they do not form an essential or significant part of the activity of the enterprise.

¹¹⁴ OECD Commentary: Article 5, para. 34.

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The agent must have the authority (in form or substance) to conclude contracts that bind the principal. They are not limited to contracts that are literally in the name of the enterprise, provided they are binding on him. The agent has the authority where a bona fide third party is justified in believing that his actions create a legally binding obligation for the principal.

An agency permanent establishment would also exist if the agent concludes the contracts or negotiates the terms of a binding contract for formal approval by the principal. The lack of active involvement by the principal may suggest an implicit authority given to the agent. He does not have to literally “sign contracts” in the name of the enterprise for this purpose.¹¹⁵ Mere solicitation of business or negotiation of contracts, subject to approval, should not normally lead to an agency permanent establishment.¹¹⁶

The agent must exercise his authority to conclude “habitually” the contracts relating to the core business activity of the principal. The extent and frequency to determine what is habitual would depend on the nature of the contracts and the business of the principal.¹¹⁷ A temporary use of the authority would not qualify as an agency permanent establishment. The authority should be exercised repeatedly with some permanence and not just occasionally. It is not necessary for the continuous activity to be exercised by the same person, provided the post of an agent lasts for some time.¹¹⁸

This paragraph provides an alternative test for a permanent establishment as an exception to the basic rule under paragraph 5(1). An agent is deemed as a permanent establishment, provided he is a dependent and has the authority to conclude contracts habitually. He does not have to have a place at his disposal to carry on the business of the principal. If the enterprise satisfies the basic permanent establishment rule under Article 5(1), it is not necessary to satisfy the test under Article 5(5). For example, the agency rule is irrelevant if the enterprise has at its disposal (“available for use”) a physical place of business or if it provides such facilities directly to the agent for its activities. If the agent does not meet the conditions under this paragraph, it cannot be an agency permanent establishment.¹¹⁹

(iv) Subsidiary permanent establishment (Article 5(7)): The subsidiary PE is not a separate PE definition. A subsidiary is an independent legal entity. A permanent establishment is not based on ownership, control or association between related companies. The relationship with the parent company or fellow-subidiaries by itself does not lead to a permanent establishment. Moreover, the management or control by the parent company does not make it a permanent establishment.¹²⁰

¹¹⁵ OECD Commentary: Article 5, paras. 32–33.

¹¹⁶ Generally, no agency PE should exist if the agent is only authorised to negotiate the terms of the contract and the principal retains (and exercises) the power to reject it. In *American Wheelabrator and Equipment v MNR* (1951) 51 DTC 285 (Canada), a travelling salesman employed in Canada by a US enterprise but with no power to conclude contracts was not held to be a permanent establishment.

¹¹⁷ OECD Commentary: Article 5, para. 33.1.

¹¹⁸ Arvid Skaar, *Permanent Establishment*, pp. 484–486; Guisepe Persico, *Agency Permanent Establishment under Article 5 of the OECD Model Convention MC (Intertax, February 2000)* pp. 66–82; Arthur Pleijsier, *The Agency Permanent Establishment: The Current Definition (Intertax, May 2001, June/July 2001 and August/September 2001)*.

¹¹⁹ Arvid Skaar, *Permanent Establishment*, p. 468.

¹²⁰ OECD Commentary: Article 5, para. 40.

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Although a subsidiary is not an agent of the parent company solely due to the share ownership, it may be a permanent establishment in certain circumstances. Under Article 5(1), a permanent establishment requires a place of business at one's disposal. Article 5(5) supplements this rule by deeming a permanent establishment to exist where an enterprise does not have a place of business but acts through an agent. Therefore, the parent company may have a permanent establishment if either it carries on its business activities through a fixed place of business in the subsidiary's premises or the subsidiary conducts them as a dependent agent.

The parent company can also be considered to have a permanent establishment if the subsidiary, as an independent agent, acts outside its ordinary course of business for the parent company. To be a permanent establishment, the subsidiary must have the authority to conclude contracts in the name of the parent company and habitually exercise that authority.¹²¹ Similar rules apply to activities carried out by fellow-subidiaries or in cases when the parent company acts as a permanent establishment for the subsidiary.

In a recent case,¹²² the Italian Supreme Court (Corte Supreme di Cassazione) held that a subsidiary of Philip Morris monitoring its contracts with Italian licensees as an independent agent might be a permanent establishment.¹²³ Philip Morris Germany GmbH had a contract to supply cigarettes to the Italian state monopoly. It nominated an Italian group company, Intertaba, to supervise warehouses and sales outlets in Italy. The Court held that Intertaba could be deemed as a permanent establishment for several reasons including that its staff participated in contract negotiations and management of the business of the nonresident entity. Moreover, it could be considered a permanent establishment of several foreign companies within the group.¹²⁴

Subsequent to this case, the OECD Committee on Fiscal Affairs has proposed certain changes in its Commentary under Article 5. Briefly, they clarify that:

- Provision of management services as an independent business activity to another group company does not make the company a permanent establishment.
- Participation or attendance in meetings for contract negotiations is not enough to conclude that a company exercises an authority to conclude contracts.
- Deriving an economic benefit from the activities of another company in another country does not mean it has a permanent establishment in that country.
- The determination of a permanent establishment must be done separately for each group company; the existence in a State of a PE of a group company would not by itself make it a PE of other group companies.

¹²¹ OECD Commentary: Article 5, para. 41.

¹²² *Department of the Ministry of Finance v Philip Morris* (Court of Cassation, Decision 3368 of March 7, 2002) (Italy).

¹²³ A contrary view was taken in June 2003 by the French Supreme Court in the case of *Société Interhome AG* (*Conseil d'Etat* no. 224407). It held that the requirements of Article 5(5) on concluding binding contracts on behalf of the principal must be satisfied before a foreign subsidiary as a dependent agent is deemed its permanent establishment.

¹²⁴ Paolo Tognolo, *Philip Morris Case: The Position of the Italian Court of Cassation on PE Matters* (Tax Planning International Review, June 2002); Federico Trutalli, *Independent Legal Entities or Permanent Establishments?* (European Taxation, August 2002) pp. 364–370.

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These new provisions are included in the OECD Commentary Update 2005.

The parent company does not own fixed assets in the subsidiary but only its shares. Therefore, in the case of a subsidiary it is unlikely that it will normally satisfy the requirements of the basic rule, unless the parent company sends its employees to carry on its own business in the subsidiary's premises. However, it may be an agency permanent establishment.¹²⁵ In such situations, the income attributable to the PE under the arm's length principle would depend on the allocation of risks assumed and the assets used besides functions performed. This amount may differ from the arm's length payment made to the agent as its commission.¹²⁶

Exceptions to the above definitions

Under the Article, the following cases are not deemed to be permanent establishments:

- (i) Article 5(4)** – Preparatory and auxiliary business activities or functions including –
- (a) the use of facilities solely for storage, display or delivery of goods or merchandise belonging to the enterprise (it would include facilities used for packaging and despatch but not for sale);
 - (b) the maintenance of a stock of goods or merchandise of the enterprise solely for storage, display or delivery;
 - (c) the maintenance of a stock of goods or merchandise of the enterprise solely for processing by another enterprise;
 - (d) the maintenance of a fixed place of business solely for purchasing goods or merchandise, or for collecting (not evaluating or editing) information for the enterprise;
 - (e) the maintenance of a fixed place of business solely for any other activity of a preparatory or auxiliary nature for the enterprise; or
 - (f) the maintenance of a fixed place of business solely for any combination of activities in (a) to (e) above, provided it results in an overall business activity of a preparatory or auxiliary nature.

Preparatory or auxiliary activities are defined as services that 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”.¹²⁷ They are ancillary to the basic underlying profit-making activities. Examples include support services, such as advertising, supply of information, scientific research or servicing of patents. All preparatory and auxiliary activities are exempt from permanent establishment taxation under Article 5(4)(e). Therefore, the list of exceptions under sub-paragraphs (a) to (d) gives specific examples, and is not meant to be exhaustive.¹²⁸

¹²⁵ As an example, a subsidiary may be a PE when it concludes a contract for joint business activities without the ability to fulfil it except in partnership with the parent company.

¹²⁶ Discussion Draft on Attribution of Profits to Permanent Establishments (part III), paras. 256–261 (OECD, April 2002).

¹²⁷ OECD Commentary: Article 5, para. 23; according to Vogel, the inability to allocate income and expenditure may be taken to suggest the non-existence of a permanent establishment (See Klaus Vogel, Double Taxation Conventions, Article 5, m.no. 9).

¹²⁸ Klaus Vogel, Double Taxation Conventions, Article 5, m.no. 109.

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An activity cannot be considered as preparatory or auxiliary, if it is similar to the essential and significant part of the activity of the enterprise as a whole.¹²⁹ The Commentary gives examples of activities that are not auxiliary or preparatory. They include management office or co-ordination centres, after-sales activities (e.g. supply of spare parts, and repair or maintenance services), manufacturing by a research establishment, and services performed for other enterprises.¹³⁰ A permanent establishment would exist if any of the exempt functions were performed for other enterprises or with core activities. For example, a research facility or warehouse will be a permanent establishment if it is also engaged in selling activities. The cohesive activities of an organisation cannot be split into several small operations to regard them as preparatory or auxiliary.¹³¹

(ii) Article 5(6) – The use of a broker, a general commission agent¹³² or an agent of independent status, provided they are acting in the ordinary course of their own business or trade, does not constitute a permanent establishment. A general commission agent handles goods or services for several principals,¹³³ while a broker merely brings various commercial parties together. They generally work independently under a contract for services, and not under a contract of employment, and would not generally qualify as dependent agents.

To be an independent agent, the person must not be a dependent agent, i.e. he must be both legally and economically independent. An independent agent is generally responsible for the result of his work and not subject to close supervision. The limitations on the size of the agent's activities are not relevant. What is relevant is the freedom given to him to act on behalf of the principal. The provision of information to the principal by the agent is also not relevant, unless it is required to get approval for his actions.¹³⁴ Extensive control and detailed instructions with limited discretionary powers given to non-employees would suggest their lack of legal independence.¹³⁵

Independence must be a matter of law and fact, and the degree of control exercised by the enterprise would be a critical factor. The level of control is based on facts, such as: Does he act for more than one principal? Is he subject to detailed instructions and comprehensive controls? Who bears the entrepreneurial risks? Who pays the expenses? etc. The relationship does not have to be apparent to outsiders. An agent, who works wholly or almost wholly for one principal, is unlikely to be economically independent since he would not be in business

¹²⁹ OECD Commentary: Article 5, para. 24 and 26.1; In the German pipeline case, the exclusion under Article 5(4) was denied since the Dutch operator was engaged in the transport of crude oil owned by third parties as its core activity (Bundesfinanzhof 30 October 1996, II R 12/92).

¹³⁰ OECD Commentary: Article 5, para. 21–35.

¹³¹ OECD Commentary: Article 5, para. 27.1.

¹³² *Fleming v London Produce Co.* (1968) 44 TC 582 (UK): A general commission agent is an agent who holds himself out as being ready to work for clients generally, and who does not in substance confine his activities to one principal, or to an insignificant number of principals.

¹³³ Under civil law, a general commission agent acting in his own name (undisclosed agent) as a commissionaire does not bind the principal and, therefore, cannot usually be an agency permanent establishment. Under common law, a general commission agent usually binds the principal. He will constitute an agency PE unless he is legally and economically independent and acts in the ordinary course of his business.

¹³⁴ OECD Commentary: Article 5, paras. 38.2–38.5.

¹³⁵ In *Donroy Ltd v United States* 301 F.2d 200, 206 (9th Cir.)(1982), the Court held that an independent agent generally means one who, exercising an independent employment, contracts to do a piece of work according to his own methods and without being subject to control of his employer except as to the result of the work.

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if the principal did not require his services. However, legal dependence may exist even with several principals if they act together to control the agent. Economic independence involves taking business risks of loss and earning profit from one's own entrepreneurial skills and knowledge.¹³⁶

The Article also requires that an independent agent must act in the ordinary course of his business when acting on behalf of the principal.¹³⁷ What is "ordinary course" would depend on customary business practices, facts and circumstances, and not just legal arrangements. If the agent is independent, it is immaterial if he has the power to conclude binding contracts for the principal.¹³⁸ However, if he concludes contracts in the name of the principal for business activities that are economically related to the principal and unrelated to his own business operations, he will not be acting "in the ordinary course" of his business. Hence, he may be deemed an agency permanent establishment for those particular activities.

The analysis and treatment of permanent establishments vary between taxing jurisdictions.¹³⁹ Additional treaty issues arise under this Article for transactions involving electronic commerce. The Commentary Update 2003 includes an analysis of the application of the permanent establishment definition in electronic commerce.¹⁴⁰

One of the best definitions of a permanent establishment is given by Justice Rao: "In our opinion, the words 'permanent establishment' postulate the existence of a substantial element of an enduring or permanent nature of a foreign enterprise in another country which can be attributed to a fixed place of business in that country. It should be of such a nature that it would amount to a virtual projection of the foreign enterprise of one country into the soil of another country".¹⁴¹

OECD Observations or Reservations: Australia, Canada, Czech Republic, Denmark, Greece, Hungary, Ireland, Italy, Korea, Mexico, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Turkey, the United Kingdom and the United States.¹⁴²

Non-OECD Positions: Albania, Argentina, Brazil, Bulgaria, China, Estonia, Gabon, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Russia, Slovenia, South Africa, Thailand, Tunisia, Ukraine and Vietnam.

¹³⁶ OECD Commentary: Article 5, para. 38–38.8.

¹³⁷ OECD Commentary: Article 5, para. 37.

¹³⁸ Klaus Vogel, *Double Taxation Conventions*, Article 5, m.no. 169–174.

¹³⁹ Todd M Landua et al, *How to Minimize the Global PE Risk* (International Tax Review, June 2002); Alessandro Caridi, *Proposed Changes to the OECD Commentary on Article 5* (European Taxation, January and February, 2003) pp. 8–19; Perla Gyongyi Vegh, *The 2003 OECD Model* (European Taxation, July/August 2003) pp. 244–249.

¹⁴⁰ OECD Commentary: Article 5, para. 42.1 to 42.10; Arvid Skaar, *Electronic Commerce* (Intertax, May 2000); D. A. Albregtse, *The Server as a Permanent Establishment and the Revised Commentary on Article 5 of the OECD Model Tax Treaty* (Intertax, October 2002); See Chapter 8(1).

¹⁴¹ *CIT v Vishakhapatnam Port Trust* (1983) 144 ITR 146 (India).

¹⁴² OECD Commentary: Article 5, paras. 43–65.

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UN MC

Under the UN MC Article 5, the definition of permanent establishment contains additional criteria, as follows:

Article 5(3)(a) reduces the qualifying period for all construction permanent establishment to six months. Moreover, it clarifies that an assembly project is included. Supervisory activities on a building site or a construction, assembly or installation project also constitute a permanent establishment if they continue for more than six months.

Article 5(3)(b) adds the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose.¹⁴³ There is a permanent establishment if the services are performed by an enterprise of a Contracting State for a period or periods aggregating more than six months in any 12-month period, on the same or a connected project within the other State. The mere furnishing (i.e. provision) of any service may lead to taxation as a deemed “service” permanent establishment even if the enterprise has no fixed base or place of business in that State to carry on its business, as required under Article 5(1).¹⁴⁴

Article 5(4) excludes from the exempt activities the facilities used solely for the delivery of goods or merchandise belonging to the enterprise, and the maintenance of a stock of goods or merchandise solely for delivery. The UN MC 2001 includes sub-paragraph (f) in OECD MC that refers to the exclusion of a fixed place solely for any combination of activities mentioned in subparagraphs (a) to (e).

Article 5(5)(b) regards a dependent agent, who habitually maintains a stock of goods or merchandise and regularly delivers them on behalf of the enterprise, as an agency permanent establishment, even if he has no authority to conclude contracts (“stock agent”). The UN Commentary clarifies that this subparagraph applies only if the sale of the goods is the result of any sales-related activities (e.g. advertising or promotion) conducted in that State on behalf of the resident (whether or not by the enterprise itself or by dependent agents). There is no permanent establishment if all the sales-related activities take place outside the State and only delivery by an agent takes place in the State.¹⁴⁵

Article 5(6) refers to the collection of premiums or insurance of risks (other than reinsurance transactions) in the other State by an insurance enterprise of a Contracting State. The insurance enterprise is deemed to have an agency permanent establishment unless the activities are performed through an independent agent, as defined in Article 5(7) UN MC.¹⁴⁶

Article 5(7) deems an independent agent acting in the ordinary course of his business as an agency PE if his activities are devoted wholly or almost wholly on behalf of an enterprise,

143 OECD Commentary: Article 5, para. 10; under the OECD Commentary, the term “personnel” includes persons in paid employment with the enterprise. Thus, personnel include both employees and other persons receiving instructions from the enterprise (e.g. dependent agents). See Edwin van der Bruggen, PE Implications When Furnishing Consulting Services Under OECD and UN Model Treaties (Tax Analysts, May 21, 2001) Section III.

144 UN Commentary: Article 5, paras. 9–15; The UN Commentary refers to management and consultancy (i.e. advisory) services under this paragraph. Although it does not mention technical services, the wording is wide enough to include them. (See Chapter 8(10.1)).

145 UN Commentary: Article 25, para. 25.

146 Arvid Skaar, Permanent Establishment, pp. 532–536.

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unless the transactions are conducted on an arm's length basis. Thus, for a PE to exist the UN MC requires that the commercial and financial relations between the enterprise and the independent agent must differ from those that would have been made between independent enterprises.¹⁴⁷

US MC

The significant differences from the OECD MC are:

Article 5(3): An installation or drilling rig or ship used for the exploration or exploitation of natural resources is a permanent establishment if it lasts or the activity continues for more than twelve months.

Article 5(4) (f): The maintenance of a fixed place of business solely for any combination of activities in subparagraphs (a) to (e) is presumed to be of a preparatory or auxiliary character. It is not necessary to prove that the overall combination of activities has a similar character.

The Technical Explanation mentions that two factors are needed to determine if an agent is economically dependent, namely (i) the extent to which he bears the business risk, and (ii) whether he has an exclusive or near exclusive relationship with the principal. It defines the business risk as the "risk of loss". An agent, who bears little or no risk from the activities that it performs, is not economically independent.¹⁴⁸

Article 6: Income from Immovable Property

OECD MC

The Article gives the right to tax the income derived by a resident of a Contracting State from immovable or real property (including the income from agriculture or forestry) situated in the other Contracting State to that State. This right is given due to the close economic connection between the source of the income and the State of source. As a *lex specialis*, all income from immovable property is taxable under this Article, even if it represents business profits.

This taxing right is not exclusive ("may be taxed"). Although both Contracting States may tax the income from immovable or real property, the State of source or *Situs* (where situated) of the asset or right has the primary taxing right. Its domestic rules determine how the income should be computed or taxed. The Article does not apply to income from immovable property located in the State of residence or in a third State; the provisions of Article 21(1) apply to such income.¹⁴⁹

Under Article 6(2), the definition of the term "immovable property" is based on the domestic law of the State, where the property is situated. The term "law" means the entire law rather than just the tax law.¹⁵⁰ Immovable property expressly includes "property accessory

147 UN Commentary: Article 5, paras. 29–31; Edwin van der Bruggen, A Preliminary Look at the New UN Model Tax Convention (British Tax Review, 2002 No. 2) pp. 122–124.

148 US Model Technical Explanation (1996): Article 5, para. 81–82.

149 OECD Commentary: Article 6, para. 1.

150 Klaus Vogel, Double Taxation Conventions, Article 6, m.no. 22.

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to immovable property, livestock and equipment used in agriculture and forestry, rights under domestic law attached to landed property, usufruct of immovable property, and rights to variable or fixed royalty payments for the working of, or the right to work, mineral deposits, sources and other natural resources". Under Article 6(3) the provisions also apply to all types of income derived from the direct use,¹⁵¹ letting (i.e. rentals), or use in any other form (direct or indirect) of the immovable property.¹⁵² Ships, boats and aircraft are excluded from this Article. Moreover, the income from debt secured by an immovable property is specifically excluded and is taxable as interest income under Article 11.¹⁵³

Article 6(4) clarifies that the rule also applies to income from immovable property of industrial, commercial and other enterprises. Thus, the *Situs* principle under this Article takes precedence over the rules governing permanent establishment (Article 7).¹⁵⁴ The Article applies to all income arising directly or indirectly from immovable property in the *Situs* State, even if there is no permanent establishment in that State. In case the immovable property is part of the permanent establishment, the income will be included in its taxable income, but the right of source State has priority over the right of the other State.

OECD Reservations: Canada, Finland, France, New Zealand, Spain and the United States.¹⁵⁵

Non-OECD Positions: Belarus, Estonia, Latvia, Lithuania and Morocco.

UN MC

Similar

US MC

Under US MC Article 6(5), a resident of a Contracting State may elect to be taxed on a net basis (similar to a permanent establishment) in the other Contracting State on the income from real property situated in that State. The election is binding for the tax year and subsequent years unless the competent authority of the *Situs* State agrees to terminate the election. This alternative is granted to the taxpayer even if the net basis election is not available under the domestic law of the other Contracting State.

Article 7: Business Profits

OECD MC:

The Article provides for the taxation of the cross-border business profits of an enterprise. It grants the taxation rights over these profits exclusively to the residence State if the business presence in the source State is minimal. Thus, there is no taxation in the source State if there is no permanent establishment. If there is a permanent establishment of an enterprise

¹⁵¹ The word "use" implies that the person receiving the income retains a proprietary interest, however vestigial, in the immovable property. (See *Boulez v Commissioner* (1984) 83 TC (US) 584, 593 (US)).

¹⁵² OECD Commentary: Article 6, para 3.

¹⁵³ OECD Commentary: Article 6, para. 2.

¹⁵⁴ OECD Commentary: Article 6, paras. 3–4.

¹⁵⁵ OECD Commentary: Article 6, paras. 5–10.

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under Article 5, the source State has the taxing rights over the income attributable to it. To be taxable in the source State under this Article, (a) there must be an enterprise of a Contracting State, (b) there must be a permanent establishment of the enterprise in the other State, (c) the enterprise must carry on business in the other State through the permanent establishment and (d) the enterprise must earn business profits from the permanent establishment.

The concept of business profits and the underlying terms (namely “business” and “profits”) are not defined in the treaty text or the Commentaries. The Commentary suggests that the term “profits” comprises broadly all the income derived by an enterprise.¹⁵⁶ Therefore, the term “business profits” covers all forms of profits from independent commercial activity,¹⁵⁷ including income derived from a contract to abstain from these forms of business activities.¹⁵⁸ Cross-border leasing activities, i.e. the use of, or the right to use, industrial, commercial or scientific equipment (including container leasing),¹⁵⁹ are taxable as business profits.¹⁶⁰ The MC Update 2000 now specifically includes the income from the performance of professional services and other activities of an independent character as business profits under this Article.

Article 7(1) mentions that an enterprise shall only be taxed (exclusive) on the business profits (also referred to as “industrial and commercial profits”) in the State of residence. However, the source State may also tax (non-exclusive) the income of a permanent establishment of an enterprise in the other State.¹⁶¹ The Article limits this taxing right of the source State to the business profits attributable to the permanent establishment. The taxing right applies to the worldwide income of the permanent establishment¹⁶² including any income derived from the State of residence and third States.¹⁶³ The OECD MC does not approve of the “force of attraction” principle and excludes any income, which is not attributable to the permanent establishment. This paragraph does not limit the right of a Contracting State to tax its own residents based on profits of a related resident enterprise in the other State under its controlled foreign corporation rules.¹⁶⁴

The OECD MC requires the use of the “distinct and separate enterprise” and the “arm’s length” principle to determine the attributable business profits.¹⁶⁵ Under Article 7(2), this

¹⁵⁶ OECD Commentary: Article 7, paras. 32–36.

¹⁵⁷ Anything which occupies the time and attention and labour of man for the purpose of profit is business (*Transvaal Associated Hide and Skin Merchants (Pty) Ltd. v Collector of Taxes*, Botswana (1967) SATC 97).

An isolated activity of acquiring shares with a view to their sale at a profit was treated as a business carried on by an enterprise (*Thiel v FCT* (Australia)).

¹⁵⁸ Klaus Vogel, Double Taxation Conventions, Article 7, m.no. 22.

¹⁵⁹ The profits from container leasing are included under Article 8, if they are supplementary or incidental to the international operation of ships or aircraft.

¹⁶⁰ OECD Commentary: Article 7, para. 37.

¹⁶¹ Klaus Vogel, Double Taxation Conventions. Article 7, m.no. 69-71.

¹⁶² Several countries attribute only the income derived from domestic sources within their jurisdiction to the permanent establishment and exclude foreign source income (Examples: Australia, France, Italy, Malaysia, South Africa, the United Kingdom).

¹⁶³ Robert J Patrick, IFA Cahiers Vol. 65B, General Report, 1980.

¹⁶⁴ OECD Commentary: Article 7, para. 10.1.

¹⁶⁵ The OECD Committee on Fiscal Affairs is currently studying the issues relating to attribution of profits to permanent establishments. The final Report on the Attribution of Profits to Permanent Establishments, with proposed changes in the Commentary, is expected by January 2007. The report will be in four parts. Part 1

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rule is binding on both the State of the permanent establishment and the State of residence. Therefore, the business profits of the permanent establishment must be computed by each Contracting State, as “the profits which it might be expected to make if (a) it were a distinct and separate enterprise (b) engaged in the same or similar activities (c) under the same or similar conditions and (d) dealing wholly independently with the enterprise of which it is a permanent enterprise”. It is equivalent to the profits that a permanent establishment might be expected to earn as an independent entity under conditions and at prices prevailing in the ordinary market. The profits should be computed preferably from the separate accounts of the permanent establishment, with adjustments, if required, under the arm’s length principle or “direct method”.¹⁶⁶ Indirect methods are also allowed under Article 7(2).¹⁶⁷

Article 7(4) permits a profit apportionment using various formulae. The use of this method is restricted to exceptional conditions and may be used only if (i) it is customary and accepted in the country concerned, and (ii) it is compatible with the general objectives of the “distinct and separate enterprise” or “arm’s length” principle.¹⁶⁸ The taxable profits should approximate closely to the results under the separate accounts or “direct” method. Article 7(6) adds that the method for profit attribution must be applied uniformly and consistently every year, unless “there is good and sufficient reason to the contrary”.¹⁶⁹

Article 7(3) mentions that the taxable profits must be computed after the deduction of all expenses, which are incurred for the purposes of the permanent establishment.¹⁷⁰ The expenses should include a share of the actual executive and general administration expenses, wherever incurred for its benefit. They may be incurred exclusively for the permanent establishment, or could be a reasonable allocation of the central expenses of the enterprise. Besides head office overheads, other similar deductions may relate to the allocation of R & D costs, interest expenses, etc. that are actually incurred by the enterprise. It may be necessary to estimate or to calculate the amount of the allocable expenses. The deduction does not depend upon the reimbursement of such expenses by the permanent establishment.¹⁷¹

Under Article 7(7), if the profits include items of income that are dealt with separately under the special distributive rules in the treaty, these other rules take precedence over this Article. This Article is therefore overridden as regards income from immovable property (Article 6) and shipping, inland waterways transport and air transport (Article 8). Certain

will set out the general principles and apply them to businesses excluding those in the financial sector. It will deal with thin capitalisation and the attribution of profits to intangible assets. Part 2 will apply the principles to banking, Part 3 to global trading and Part 4 to the insurance sector. (For details, see Chapter 8(4))

¹⁶⁶ The Commentary clarifies that the same rules apply to the allocation of profits among permanent establishments of an enterprise.

¹⁶⁷ OECD Commentary: Article 7, paras. 11–15, 24–25.

¹⁶⁸ *Sun Life Assurance Company of Canada v Pearson* [1986] STC 335 (UK).

¹⁶⁹ See Chapter 8(4).

¹⁷⁰ The expenses are deemed to be incurred for the purposes of the permanent establishment if an independent enterprise would have done so in similar circumstances. Therefore, the expenses are deductible if there is a business connection with the permanent establishment, regardless of where they were incurred, or whether there was an immediate or exclusive benefit for the permanent establishment. This requirement overrides any limitations on expense deductions under the domestic law of the Contracting State, unless specifically mentioned in the treaty itself. (See Edwin van der Bruggen, *About the Deductibility of the Head Office Expenses* (Intertax, Vol. 30, August/September 2002) pp. 270–284.

¹⁷¹ OECD Commentary: Article 7, paras. 16–24; Kees van Raad, *Deemed Expenses of a Permanent Establishment under Article 7 of the OECD Model* (Intertax, June/July 2000) pp. 253–258.

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other business income or profits are also dealt with in special Articles under the treaty.¹⁷² These Articles apply regardless of whether the enterprise does or does not have a permanent establishment. However, the income under these Articles is taxable under Article 7 if it is effectively connected with a permanent establishment.¹⁷³ The Commentary mentions that such income may then be taxed either as part of the business profits of the permanent establishment, or separately, in conformity with the treaty and the domestic tax laws of the Contracting States.¹⁷⁴

Article 7(5) excludes from the profits attributable to a permanent establishment, any profits (and related expenses) arising from the purchasing function performed for the parent enterprise. A fixed place of business solely engaged in the purchase of goods for an enterprise is not a permanent establishment (Article 5(4) (d)). This paragraph would exclude from the profits of a permanent establishment, any profits attributable to the purchasing activities for the head office.

The Commentary refers to the taxation of activities in space and the presence of satellites with a human crew. Since these activities are usually excluded from source taxation, the tax rules of the residence State, as modified by the treaty, will apply. Any difficulties or doubts should be settled by the mutual agreement procedure.¹⁷⁵

OECD Observations or Reservations: Australia, Belgium, Greece, Ireland, Italy, Korea, Luxembourg, New Zealand, Mexico, Norway, Portugal, Spain, Turkey and the United States.¹⁷⁶

Non-OECD Positions: Albania, Argentina, Brazil, Bulgaria, Croatia, Gabon, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Slovenia, Thailand, Tunisia, Ukraine and Vietnam.

UN MC

The UN MC Article 7 contains the following variations:

Article 7(1) extends the taxing rights of the source State to the income attributable to (i) the sale of goods or merchandise in that State of the same or similar kind as sold through the permanent establishment, and (ii) other business activities of the same or similar kind in that State as those conducted through the permanent establishment. Thus, the UN MC applies a limited “force of attraction” principle to include similar transactions and activities of the head office. The UN MC does not allow the full “force of attraction” principle to tax other unconnected income derived by the enterprise in the State of the permanent establishment.

Article 7(3) mentions that no expense deduction shall be granted to the permanent establishment for payments to the head office or any of its other offices (other than as reimbursement of actual expenses) of (i) royalties, fees or other similar payments for the use of patents or other rights, (ii) commission payments, (iii) fees for specific services

¹⁷² See Article 10 (dividends), Article 11 (interest), Article 12 (royalties) and Article 21 (other income).

¹⁷³ See OECD MC Articles 10(4), 11(4), 12(3) and 21(2).

¹⁷⁴ OECD Commentary: Article 7, para. 35.

¹⁷⁵ OECD Commentary: Article 7, para. 4.

¹⁷⁶ OECD Commentary: Article 7, paras. 38–54.

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performed, (iv) fees for management, and (v) except in the case of a bank, interest payments on loans made to the permanent establishment. Similarly, no account shall be taken of such expenses charged by the permanent establishment to the head office or any of its other offices in the determination of the profits of a permanent establishment, except as reimbursement of expenses. Therefore, a permanent establishment cannot deduct charges and payments made to or from the head office, such as interest, royalties, management fees, etc. These payments to third parties, when they are incurred by the head office on behalf of the branch, may be deducted on an apportionment or actual basis but without any profit mark-up. A company cannot make a profit from itself. However, a deduction of payments with a profit mark-up is allowed if it represents sales or service, which is normally provided to external customers by the enterprise or the permanent establishment.

Article 7(5) is omitted. The tax exemption of profits from the purchase of goods or merchandise by a permanent establishment for the enterprise is left to bilateral negotiations.

The UN Commentary mentions that payments “for the use of, or right to use, industrial, commercial or scientific equipment” remain taxable under Article 12 as royalties and not as business income under Article 7.¹⁷⁷

US MC

The Technical Explanation clarifies that the term “effectively connected” income differs from “attributable profits”. They are similar but not identical. The former term refers to any economic connection or relationship between narrowly specified items and the business activity. The latter term implies “owing to or produced by” and limits the taxing rights to a direct one-way economic relationship between the profits and the permanent establishment. The profits attributable to a permanent establishment include both income from sources within as well as outside the Contracting State.¹⁷⁸

The Article covers the following significant variations from the OECD MC:

Article 7(2): The attributable business profits of a permanent establishment include only the profits derived from its assets or activities. Therefore, the limited force of attraction under the IRS Code 864(c) (3) does not apply under the US MC.

Article 7(3): The Technical Explanation mentions that the expense deduction under this paragraph does not apply to notional expenses charged to the permanent establishment by another unit of the enterprise. Thus, it disallows a deduction for a royalty deemed paid to the head office or other permanent establishments of the enterprise. Similarly, the permanent establishment may not increase its profits by notional fees for services performed for another unit, or claim a deduction for related expenses.¹⁷⁹

Article 7(7): This paragraph defines “business profits” for treaty purposes. It means income from any trade or business, including the income derived by an enterprise from the performance of personal services, and from the rental of tangible personal property. It also includes the income from derivative financial instruments to the extent that it is attributable

¹⁷⁷ UN Commentary: Article 7, para. 25.

¹⁷⁸ US Model Technical Explanation (1996): Article 7, para. 92; Shannon et al, United States Income Tax Treaties, p. 81.

¹⁷⁹ US Model Technical Explanation (1996): Article 7, para. 97.

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to a trade or business of dealing in such instruments, or related to a trade or business carried on through a permanent establishment.¹⁸⁰

Article 7(8): Deferred business profits attributable to a permanent establishment or fixed base are taxable even after they cease to exist.

The Article does not contain a paragraph similar to OECD MC Article 7(4) since it is deemed unnecessary. The Technical Explanation mentions that, in its view, the apportionment basis is permitted under the Commentary on OECD MC Article 7(2) and 7(3).

Article 8: Shipping, Inland Waterways Transport and Air Transport

OECD MC¹⁸¹

The Article provides that the profits from the operation of (a) ships or aircraft in international traffic, as defined in Article 3(1)(e) of the OECD MC, or (b) boats engaged in inland waterways transport “shall be” taxable only (exclusive) in the Contracting State in which the place of effective management (not residence) of the enterprise is situated. A company may manage one or more enterprises.¹⁸²

International traffic covers any shipping or aircraft transport by an enterprise with a place of effective management in a Contracting State, except on operations that are solely between places within the other Contracting State. Thus, the definition does not apply to any transport when the ship or aircraft is operated between two places in the other Contracting State even if part of the transport takes place outside the State. For example, a cruise to nowhere, i.e. beginning and ending in the same Contracting State with no stops in a foreign port is not international traffic.¹⁸³ Inland waterways transport is not defined. The Commentary mentions that the Article applies to transport on rivers, canals and lakes, and includes inland waterways transport by an enterprise of one Contracting State between two places in the other Contracting State (unlike international traffic).¹⁸⁴

The definition of international traffic allows the other Contracting State to tax its domestic traffic on ships or aircraft within its own borders, while the State of effective management has the exclusive taxing right over both its domestic traffic and cross-border traffic between the Contracting States, as well as traffic with, or within, third States. As a *lex specialis* (“special law”), this provision denies the taxing rights to a Contracting State, either as the residence State or as the State of permanent establishment, if the effective management is located in the other Contracting State. Third-country traffic may, however, be affected by the domestic law and treaties with those countries.

Effective management is not defined. In many countries, the place of effective management is usually the State where the top-level management takes the major decisions

¹⁸⁰ US Model Technical Explanation (1996): Article 7, para. 103.

¹⁸¹ The Commentary to this Article was updated in 2004 to take into account the developments in international transport activities. The proposed amendments will be included in the Commentary Update 2005.

¹⁸² While Article 4(3) refers to the effective management of a company, Article 8(1) refers to the effective management of the enterprise. A company or individual may carry on more than one enterprise. (See R. Doernberg and K. Raad, *The 1996 US Model Tax Convention*, p. 70)

¹⁸³ OECD Commentary: Article 3, para. 6.3.

¹⁸⁴ OECD Commentary: Article 8, para. 16.

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of the enterprise, and where the economic activities are managed.¹⁸⁵ If the place of effective management is aboard a ship or boat, then it is deemed to be in the State of the home harbour or the port of the ship or boat. In case there is no such home harbour, the State of residence of the operator of the ship or boat is used. Where the operation is conducted effectively through a permanent establishment that differs from the place of effective management of the whole enterprise, the Contracting State where the permanent establishment is situated is considered the place of effective management.¹⁸⁶

The proposed 2005 Commentary Update defines the term “profits” under this Article even more broadly. Besides profits from activities directly connected with international transportation by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise), it includes both income from activities that permit, facilitate or support international traffic operations, as well as any ancillary activities.¹⁸⁷ The latter are defined as activities that are not necessary for own operations but are so closely related to them that they cannot be regarded as a separate source of business.¹⁸⁸

The profits from charters or lease rentals of ships or aircraft on full basis are included; however, bareboat charters are excluded unless the income is an ancillary activity. Other profits from transportation that are either directly connected, or as an ancillary activity, with international traffic operations are also included. The proposed Commentary includes the provision of goods or services (e.g. ground handling services) to other transport enterprises under, say a pooling arrangement for reducing costs of maintaining the facilities needed for operations of their ships or aircraft abroad. Income from investments is included provided they are an integral part of the business of operating the ships or aircraft in international traffic.

Article 8(4) taxes the profits from a participation in a pool, a joint business or an international operating agency under this Article. The Commentary also provides for profits from operation of fishing, dredging or hauling vessels on the high seas to be treated by Contracting States as income under this Article. The provisions exclude clearly separate and independent business activities, e.g. hotel business (except as a hotel for transit passengers only), shipbuilding yard, etc. and sundry investment income. They are taxable under Article 7 as business profits.¹⁸⁹

The Article does not apply when the income is not derived from the activities defined in this Article, or if the place of effective management, as a business activity, is in a third State. Moreover, since the treaty applies only to residents of one or both Contracting States (Article 1), the Article is not applicable if the person is not resident in either State even when the place of effective management is located in a Contracting State. In such situations, the treaty itself may not apply and both the Contracting States are free to tax the profits under their domestic law.¹⁹⁰

185 Klaus Vogel, *Double Taxation Conventions*, Article 8, m.no. 38.

186 OECD Commentary: Article 8, paras. 18–21.

187 OECD Commentary: Article 8, paras. 4–4.3.

188 Examples: agency selling passage tickets, airport bus service, advertising and commercial publicity, inland transport for delivery or collection, etc.

189 OECD Commentary: Article 8, para. 4–14.

190 R. Doernberg and K. Raad, *The 1996 US Model Income Tax Convention*, p. 71.

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OECD Observations or Reservations: Australia, Canada, Denmark, Germany, Greece, Hungary, Ireland, Mexico, New Zealand, Norway, Poland, Portugal, Slovak Republic, Sweden, Turkey, the United Kingdom and the United States.¹⁹¹

Non-OECD Positions: Albania, Argentina, Brazil, Bulgaria, China, Croatia, Estonia, Gabon, Latvia, Lithuania, Malaysia, Morocco, Philippines, Slovenia, South Africa, Thailand, Ukraine and Vietnam.

UN MC

The UN MC Article 8 offers an alternative text (alternative B) for shipping activities under this Article, in addition to the OECD text (alternative A). The alternative B (Article 8B(2)) grants an exclusive taxing rights over the profits from the operation of ships in international traffic to the State of effective management, unless the shipping activities in the other Contracting State are more than casual. Shipping activities are deemed to be more than casual if the ship visits the other State on a fixed schedule or on planned irregular visits to pick up or unload cargo or passengers.¹⁹² If they are more than casual, the latter State also has a non-exclusive (“may be”) right to tax. The taxable profits in that other State must be determined under an appropriate allocation of the total net profits from its shipping operations, and the amount should then be reduced by a percentage, as agreed in bilateral negotiations, for general overhead and financing expenses.

US MC

The US MC Article 8 refers to shipping and air transport in international traffic only. It gives exclusive taxing rights to the State of residence (not effective management) of the enterprise. Even if the enterprise has a permanent establishment in the other State, it is taxable only in the residence State. The place of residence need not be the place of effective management of the enterprise. The term “international traffic” also includes transport by nonresidents, i.e. enterprises of third States.

Article 8(1): The profits of an enterprise from the operation of ships or aircraft in international traffic shall be taxable (exclusive) in the residence State of the enterprise.

Article 8(2): The profits under this Article include the income from the rental of ships or aircraft on a full (time or voyage) leasing basis with crew, when operated in international traffic by the lessor. Moreover, they also include the profits from bareboat (i.e. without crew) leasing rental when the lessee operates either the ships or aircraft in international traffic, or when the rental income is incidental to other profits of the lessor from the operation of ships or aircraft in international traffic.

The Article text also clarifies that the profits from inland transport of goods or passengers within either State are also included if the transport is undertaken as part of the international traffic of goods or passengers by the enterprise.¹⁹³

¹⁹¹ OECD Commentary: Article 8, paras. 27–42.

¹⁹² UN Commentary: Article 8, para. 13.

¹⁹³ OECD Commentary: Article 8, para. 5.

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Article 8(3): The profits from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) in international traffic are taxable only (“shall be”) in the residence State. It is not necessary for the enterprise to be engaged in the operation of ships or aircraft in international traffic or to avoid a permanent establishment in the other Contracting State.¹⁹⁴

Article 9: Associated Enterprises

OECD MC

Article 9 deals with transactions between associated enterprises that are resident in the two Contracting States. The treaty does not cover associated enterprises in third countries. Under the domestic law, the State can generally make profit adjustments on cross-border transactions between associated enterprises or related persons, when appropriate. Article 9 itself does not give the power to make such adjustments if that power does not exist under the domestic law since a treaty cannot impose additional taxes or determine the taxable profits. Its aim is to ensure that the international profit allocation between the associated enterprises under the domestic law follows the arm’s length principle in such adjustments. It also requires that the other Contracting State make corresponding adjustments to avoid double taxation.

Under Article 9(1), a Contracting State may (i.e. discretionary) adjust the profits on transactions with associated enterprises in the other Contracting State and tax them. However, this adjustment can only be made “if 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” due to the relationship. The transactions between related enterprises do not, by themselves, justify an adjustment under this Article. No adjustment is permitted if the transactions between the enterprises have taken place on normal open market commercial terms (i.e. arm’s length basis).¹⁹⁵

An associated enterprise is widely defined to include an enterprise under common effective control in both Contracting States. The definition refers to direct or indirect participation (not defined) in the management, control or capital of an enterprise in the other State, either (a) by an enterprise of a Contracting State, or (b) by the same persons.¹⁹⁶ The text does not provide any minimum or maximum participation requirement and leaves it to be decided by the domestic law.

If a primary adjustment is made by a Contracting State under this Article, it obliges the other Contracting State to make a corresponding or correlative adjustment to avoid economic double taxation. The adjustment must follow the other provisions of the treaty and the competent authorities must consult with each other, if necessary. The Commentary does not specify any method nor does it suggest any period for making such a corresponding adjustment. However, it suggests that an adjustment may be made for the doubly taxed profits

¹⁹⁴ The OECD MC Article 8 only covers the income from the use, maintenance or rental of containers if it is incidental to other income from international traffic.

¹⁹⁵ OECD Commentary: Article 9, para. 1; See Chapter 6(6.7).

¹⁹⁶ The participation by the same persons would include associations that jointly manage enterprises, e.g. co-ordination centres, operational headquarters, etc.

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either (i) by reopening the tax assessment in the other Contracting State and adjusting the taxable profits, or (ii) by the grant of an additional credit under Article 23 (double tax relief) for the income taxed in the first Contracting State.

The other Contracting State is not required to make the adjustment, unless it agrees with it in principle and amount.¹⁹⁷ Article 9(2) also provides for recourse to the competent authority procedure under Article 25, but there is no obligation on them to reach a solution.¹⁹⁸ Several OECD countries have reserved the right to exclude the corresponding adjustment paragraph in their treaties.¹⁹⁹ The Commentary, however, specifically mentions that the inclusion of Article 9(1) suggests the intention to avoid economic double taxation covered under Article 9(2) of the treaty.²⁰⁰

The OECD MC does not cover the relief for any secondary adjustments, which reclassify the profits that now accrue to the “wrong” associated enterprise. The additional profits resulting from the adjustment may be treated as a constructive dividend or a capital contribution or as an amount receivable from the other Contracting State. Any adjustment is left to the domestic laws of the Contracting States, subject to the other treaty provisions.

The Commentary refers to the thin capitalisation issue among related parties. It concludes that the Article does not prevent the use of domestic tax rules to make an arm’s length correction for the interest rate, or to reclassify a loan as equity capital or some other form of payment. The thin capitalisation adjustment is permitted provided it does not increase the taxable profits of the borrower to more than the arm’s length profit.²⁰¹

OECD Observations or Reservations: Australia, Belgium, Canada, Czech Republic, Finland, France, Germany, Hungary, Mexico, Norway, Poland, Portugal, Switzerland and the United States.²⁰²

The United States believes that constructive dividends to overcome thin capitalisation may not be necessary. Several countries have reserved their right on paragraph 2.

Non-OECD Positions: Brazil, Bulgaria, Ivory Coast, Malaysia, Morocco, Russia, South Africa, Slovenia, Thailand, Tunisia and Vietnam.

UN MC

Under the UN MC 2001, this Article has an additional paragraph. Article 9(3) denies the corresponding or correlative adjustment under Article 9(2) in cases of fraud, gross negligence or wilful default. This paragraph does not exist in the OECD MC.²⁰³

197 OECD Commentary: Article 9, para. 6.

198 OECD Commentary: Article 25, paras. 9 and 29.

199 OECD Commentary: Article 9, paras 16–17.

200 OECD Commentary: Article 25, para. 10.

201 OECD Commentary: Article 9, para. 2.

202 OECD Commentary: Article 9, paras. 12–19.

203 UN Commentary: Article 9, para. 9.

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US MC

The significant variations are:

Article 9(1): The Technical Explanation mentions that the term “control” refers to all types of control, whether or not legally enforceable and irrespective of how they are exercised or exercisable.²⁰⁴

Article 9(2): The Article text specifically requires that a Contracting State must agree with the initial tax adjustment in the other State before it is obligated to make a corresponding or correlative adjustment in related party transactions.

Article 10: Dividends

OECD MC

The Article provides two separate rules for treaty relief on dividends paid to a resident of a Contracting State by a resident of the other Contracting State:

- Dividends unconnected with a “permanent establishment” may be taxed as dividends in both the Contracting States. (Article 10(1) & 10(2))
- Dividends paid on shareholdings effectively connected with a permanent establishment in a Contracting State are taxable under Article 7 as business profits of the permanent establishment. (Article 10(4))

The Article grants shared taxing rights on dividends paid by a company resident in one State to a resident of the other Contracting State. It may be taxed in both Contracting States. However, if the beneficial owner of the dividends is a resident of the other Contracting State, the taxing right of the source State is limited to specified lower rates under the treaty. The Commentary Update 2003 clarifies that the term “beneficial owner” is used in a wider sense as an anti-avoidance measure under the treaty. It specifically excludes dividend payments to an intermediary such as a nominee or agent, as well as to conduit companies where the formal owner has very narrow rights in reality over the income, unless the beneficial owner is also a resident of the Contracting State of the recipient. They are resident but, as they do not own the income for tax purposes, are not liable to potential double taxation.²⁰⁵

The treaty provides two rates of concessional withholding rates on dividends paid directly or indirectly to the beneficial owners who are resident in the other Contracting State. The maximum withholding rate of source tax on the gross dividend is fixed at 5% for dividends paid to a company (other than a partnership), provided it directly holds at least 25% of the nominal share capital of the paying company; a higher withholding rate limit of 15% applies in all other cases. There is no minimum holding period. The treaty provisions do not grant the lower concessional tax rate in the source State to non-companies, e.g. individuals and partnerships.

The competent authorities are required (“shall”) to decide by mutual agreement how these tax limitations under the treaty are to be applied. Generally, they are applicable when

²⁰⁴ US Model Technical Explanation (1996): Article 9, para 123.

²⁰⁵ OECD Commentary: Article 10, paras. 12.–12.2; Klaus Vogel, Double Taxation Conventions, Preface to Article 10–12, m.no. 11: According to Vogel, it is not necessary for the recipient and the beneficial owner to be resident in the same State.

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the dividends are “paid”, i.e. when the funds are put in the hands of the shareholders in a manner required by contract or by custom.²⁰⁶ The withholding tax under this Article affects only the taxation of the dividends and not the taxation of the underlying corporate profits from which the dividends are paid.

The term “dividends” follows the definition in the country of source (paying country) under this Article.²⁰⁷ Dividends include the distribution of profits by companies limited by shares, limited partnerships with share capital, limited liability companies and other joint stock companies.²⁰⁸ Moreover, the term includes benefits in money or money’s worth, such as bonus shares, bonuses, liquidation profits, disguised profit distributions as well as similar benefits received by connected third parties, but excludes capital distributions by companies.²⁰⁹

Article 10(3) contains a list of items that are treated as dividends for the purposes of this Article. It refers to income from corporate securities that carry a right to participate in the profits without being debt-claims. It specifically includes shares, jouissance shares or jouissance rights,²¹⁰ mining shares, founders’ shares and other rights that share in the profits. In addition, it mentions that any corporate income, which is taxed as income from shares under the domestic law of the State where the company making the distribution is a resident, must also be defined as dividends under this Article.

The interest on participating or convertible bonds is not normally dividends. The Commentary, however, justifies such interest as dividends if the lender effectively shares the business risks of the debtor company. It provides examples to include situations where:

- the loan significantly exceeds the equity contributions and is substantially unmatched by redeemable assets;
- the creditor shares in the company’s profits;
- the loan repayment is subordinated to claims of other creditors or dividend payment;
- the level or payment of interest depends on the company’s profits; or
- the loan contract contains no fixed provisions for repayment.²¹¹

The provisions under Article 10 (1) and (2) do not apply if the dividend is received on shareholdings effectively connected with a permanent establishment in the Contracting State of a beneficial owner resident in the other State (Article 10 (4)). In such cases, it forms part of the business profits of the permanent establishment under Article 7 and is taxed on a net basis. If it is not effectively connected with that business, there is no force of attraction rule to tax it as the income of the permanent establishment.

The taxation right of the source State is based on the payment of the dividend and not the origin of the profits out of which the dividend is paid. Article 10 (5) normally prohibits “extra-territorial” or “secondary” taxation, i.e. when a source State taxes distributed or undistributed profits of nonresident companies solely because the underlying profits arose

²⁰⁶ OECD Commentary: Article 10, para. 7; Klaus Vogel, *Double Taxation Conventions*, Article 10, m.no. 22; Stef van Weeghel, *The Improper Use of Tax Treaties*, pp. 57–64.

²⁰⁷ Klaus Vogel, *Double Taxation Conventions*, Article 10, m.no. 199.

²⁰⁸ OECD Commentary: Article 10, para. 1.

²⁰⁹ OECD Commentary: Article 10, paras. 28–29.

²¹⁰ See Glossary.

²¹¹ OECD Commentary: Article 10, para. 25.

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partly or wholly from a permanent establishment in that State. Its right to tax such dividends is restricted to payments made to its own residents or to a permanent establishment in its own State. Thus, this Article prevents a State from taxing dividend income except where the payer or the payee is a resident of that State.²¹²

The Article does not apply either to a dividend paid by a company resident in a third State, or to a dividend paid by a company resident in a Contracting State that is attributable to a permanent establishment, which another enterprise of the same State has in the other Contracting State. In such cases, Article 21 applies.²¹³ Moreover, the provisions under this Article relate primarily to dividend payments under the classical tax system.²¹⁴ The Commentary discusses the tax issues under the imputation system but leaves the solution to bilateral treaty negotiations.²¹⁵

OECD Observations or Reservations: Belgium, Canada, Denmark, France, Germany, Ireland, Italy, Luxembourg, Mexico, New Zealand, Poland, Portugal, Spain, Turkey, the United Kingdom and the United States.²¹⁶

Non-OECD Positions: Argentina, Belarus, Brazil, Bulgaria, Estonia, Gabon, Israel, Ivory Coast, Latvia, Lithuania, Morocco, Romania, Russia, Slovenia, South Africa, Thailand, Tunisia and Vietnam.

UN MC

Article 10(2) does not prescribe the maximum rates of concessional withholding tax under the treaty. The minimum equity ownership for the lower concessional withholding tax limit is reduced from 25% to 10% direct shareholding. The UN Commentary clarifies that this percentage is illustrative only.²¹⁷ Although it leaves the concessional withholding rates on dividends to be agreed in bilateral negotiations, the UN Commentary provides broad guidance on factors to consider in treaty negotiations.²¹⁸

The UN MC extends Article 10(4) to dividends effectively connected to a permanent establishment under the limited force of attraction principle (Article 7(1)).

The UN Commentary also contains its comments on the levy of branch profits tax on permanent establishments. This tax was justified as a means to achieve parity with source country taxation of a subsidiary. It mentions that developing countries were generally not opposed to this tax. It did not recommend a maximum tax rate. It also discussed the potential conflict of this tax with the treaty's non-discrimination clause under Article 24 since it was levied only on foreign branches.²¹⁹

212 OECD Commentary: Article 10, para. 33–35; See Chapter 4(7.1).

213 OECD Commentary: Article 10, para. 8; Article 21, paras. 4–5.

214 See Chapter 5(5).

215 Klaus Vogel, Reflections of the Future of the OECD Model Convention and Commentary (IBFD Bulletin, November/December 1996) p. 527.

216 OECD Commentary: Article 10, paras. 69–85.

217 UN Commentary: Article 10, para. 6.

218 UN Commentary: Article 10, paras. 8–13.

219 UN Commentary: Article 10, paras. 19–25.

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US MC

There are several differences from the OECD MC:

Under Article 10(2), the same concessional withholding tax rates are given as under the OECD MC, namely: Article 10(2)(a) – 5%; Article 10(2)(b) – 15%. However, the Article reduces the participation requirement from 25% shareholding to ownership of 10% direct voting shares for the lower concessional withholding rate limit to apply.

The US Model text mentions that the treaty entitlement is given only if the dividend is paid to a resident of the other Contracting State as a beneficial owner of the dividend. The US MC applies a specific definition of the term “beneficial owner”. The Technical Explanation defines the term to mean any person resident in the other Contracting State to whom that State attributes the dividend for the purposes of its tax.²²⁰

Article 10(3): The lower concessional withholding rate limit does not apply to dividend payments by a regulated investment company (RIT) or a real estate investment trust (REIT) in the United States. The higher rate limit also does not apply to a REIT, unless an individual beneficially owns less than 10% interest.

Article 10(4): Qualified governmental entities in the other Contracting State are granted full exemption from source tax on the dividends received beneficially by them, if they do not control the payer of the dividend.

Article 10(8) and 10(9): The source State may impose an additional branch profits tax on the dividend equivalent amount of the profits or income of a corporation resident in the other State, if (a) it has a permanent establishment in that State, or (b) it has income from immovable property taxed on a net basis under Article 6, or (c) its gains from the alienation of real property are taxed under US MC Article 13(1). The branch profits tax is limited to the lower withholding rate specified in Article 10(2) (a).

Article 11: Interest

OECD MC

While the dividends Article deals with corporate rights involving entrepreneurial risks, this Article considers payments for monies lent. It provides two separate rules for treaty relief on interest arising in a Contracting State and paid to a resident of the other Contracting State:

- Interest payments unconnected with a “permanent establishment” may be taxed as interest income in both the Contracting States (Article 11(1) & 11(2)).
- Interest payments made on a debt-claim effectively connected with a permanent establishment in a Contracting State are taxable under Article 7 as business profits of the permanent establishment. (Article 11(4)).

The Article grants shared taxing rights on the interest income, which arises in a Contracting State and is paid to a resident of the other Contracting State.²²¹ It may be taxed (non-exclusive) in both Contracting States. However, if the beneficial owner of the

²²⁰ US Model Technical Explanation (1996): Article 10, para. 140.

²²¹ Under Article 11(5), the interest is normally deemed to arise in the State of residence of the payer of the interest; See Chapter 4(7.2)).

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interest is a resident of the other Contracting State, the primary taxing right of the source State is limited to a maximum of 10% of the gross interest under the treaty.

The Commentary clarifies that the term “beneficial owner” is used in a wider sense as an anti-avoidance measure under the treaty. It excludes interest payments to an intermediary such as a nominee or agent, as well as conduit companies where the formal owner has very narrow rights in reality over the income, unless the beneficial owner is also a resident of the Contracting State of the recipient. They are resident but, as they do not own the income for tax purposes, are not liable to potential double taxation. The application of the limitation is settled by mutual agreement between the competent authorities.

Interest generally means the income or remuneration received for making the related capital available (i.e. making possible its use), subject to capital repayment. As used in this Article, it refers to “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” (Article 11(3)). It specifically includes income from government securities and income from bonds or debentures (including premiums and prizes). The interest on a participating (i.e. profit-sharing) or convertible bond is normally interest, unless the loan effectively shares the risks of the borrower’s business.²²²

The term “debt-claim” is not defined either in the MC or the Commentary, but a payment is not interest unless there is an underlying claim for monies lent.²²³ It is the payment for making capital available, no matter when the interest payment is made. Interest is deemed “paid” when funds are put at the disposal of the creditor as required by contract or by custom.²²⁴ All payments, which the issuer makes to the subscriber that exceed the face value of the financial instrument, are regarded as interest payments. According to the Commentary, the definition is exhaustive and, therefore, there should be no recourse to an interpretation under domestic law.²²⁵

The term “interest” excludes any item of income dealt with as a dividend under Article 10.²²⁶ Annuities and penalty charges for late payments are not regarded as interest under this Article. The income from non-traditional financial instruments with an underlying debt-claim (e.g. financial derivatives), which is purely hypothetical, is not interest.²²⁷ It also excludes profits from funds where the provider shares the entrepreneurial risks of the borrower’s business.

The provisions under Article 11(1) and (2) do not apply if the debt-claim is effectively connected as an asset of a permanent establishment in a Contracting State of a beneficial owner resident in the other Contracting State (Article 11(4)). In such cases, the income forms part of the business profits of the permanent establishment and is taxed on a net basis under Article 7. If it is not effectively connected, there is no force of attraction rule to tax it as the income of the permanent establishment.

²²² OECD Commentary: Article 11, para. 19; Klaus Vogel, *Double Taxation Conventions*, Article 11, m.no. 56.

²²³ Klaus Vogel, *Double Taxation Conventions*, Article 11, m.no. 56.

²²⁴ OECD Commentary: Article 11, para. 5; Klaus Vogel: *Double Taxation Conventions*, Article 11, m.no. 15.

²²⁵ OECD Commentary: Article 11, para. 21.

²²⁶ OECD Commentary: Article 11, para. 19.

²²⁷ OECD Commentary: Article 11, para. 21.1.

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Generally, the interest is deemed to arise in the State of residence of the payer of the interest (Article 11(5)). This source rule does not apply if the interest payment is incurred and borne by a permanent establishment situated in a Contracting State. In such cases, the source is the Contracting State where the permanent establishment is situated, irrespective of the residence of the payer. There must be “an obvious economic link between the loan interest and the permanent establishment”. The loan must be used and its costs borne, even if not necessarily paid, by the permanent establishment and not by the enterprise as a whole.²²⁸ This exception does not apply if the permanent establishment is located in a third State. The interest will then be deemed to arise in the State where the payer is resident.²²⁹

Article 11(6) denies the benefits under this Article on excessive or non-arm’s length interest paid under a “special relationship” between the payer and the beneficial owner or between both of them and another person. The provisions of the Article apply only to the arm’s length amount, and the excess payment is taxable separately under the domestic law (subject to other treaty provisions) of each Contracting State depending on the exact nature of the income. The Commentary clarifies that the special relationship involves a wider concept than the one used for an associated enterprise under Article 9. It includes “any community of interest as distinct from the legal relationship”, such as a relationship by blood or marriage. Unlike Article 9, the Article deals only with the taxation of interest in the hands of the lender, and not the determination of profits of the borrower. This paragraph permits the adjustment of the interest rate, but does not reclassify the loan as equity.²³⁰

The Article does not apply to interest arising in a third State, or to interest arising in a Contracting State that is attributable to a permanent establishment, which another enterprise of the same State has in the other Contracting State. In such cases, Article 21 applies.²³¹

OECD Observations or Reservations: Belgium, Canada, Hungary, Greece, Ireland, Italy, Mexico, Norway, Portugal, Slovak Republic, Spain, Turkey and the United States.²³²

Non-OECD Positions: Argentina, Brazil, Bulgaria, Estonia, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Thailand, Tunisia and Ukraine.

UN MC

The UN MC Article 11(2) allows the maximum concessional withholding tax rate limit for the beneficial owner of the interest to be determined by bilateral negotiations. The UN Commentary provides broad guidance on deciding the rate in treaty negotiations.²³³

Article 11(4) is extended to include interest income effectively connected to the permanent establishment through similar business activities under the limited force of attraction principle (UN MC Article 7(1)).

²²⁸ See Chapter 8(6.2).

²²⁹ OECD Commentary: Article 11, paras. 28–31.

²³⁰ OECD Commentary: Article 11, para. 32–36; Klaus Vogel, *Double Taxation Conventions*, Article 11, m.no. 109.

²³¹ OECD Commentary: Article 11, para. 6; Article 21, para. 4–5.

²³² OECD Commentary: Article 11, paras. 37–45.

²³³ UN Commentary: Article 11, paras. 11–18.

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US MC

There are several variations from the OECD MC:

Article 11(1): Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only (exclusive) in that other State (subject to certain exceptions under Article 11(3) and 11(5) below). A beneficial owner is any person resident in a Contracting State to whom that State attributes the payment for tax purposes.

Article 11(2): The Article text specifically includes all income taxed in the Contracting State in which the income arises as income from monies lent under the term “interest,” and excludes all income dealt with as dividends in Article 10.

Article 11(3): The provisions under Article 11(1) do not apply if the interest is attributable to a permanent establishment or a fixed base in a Contracting State of a beneficial owner who is a resident in the other Contracting State. In such situations, Article 7 applies. (Same as OECD MC Article 11(4)).

Article 11(5) (a): The treaty exemption in the source State is denied if the interest income is contingent on (i) the receipts, sales, income, profits or other cash-flow of the debtor or a related person; or (ii) any change in the value of any property of a debtor or related person; or (iii) any dividend, partnership distribution or similar payments made by the debtor to a related person. If the beneficial owner is a resident of the other State, the source tax rate on the interest is limited to the higher withholding rate specified in Article 10(2)(b).

Article 11(5)(b): Interest, which is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit (REMIC), may be taxed by each State under its domestic law.

Article 12: Royalties

OECD MC

The Article provides two separate rules for treaty relief on royalty income arising in a Contracting State and beneficially owned by a resident of the other Contracting State.

- Royalty payments unconnected with a “permanent establishment” are taxable only in the State of residence (Article 12(1)).
- Royalty payments made for a right or property effectively connected with a permanent establishment in a Contracting State are taxable under Article 7 as business profits of the permanent establishment (Article 12(3)).

Article 12(1) provides that the royalties arising in a Contracting State and paid beneficially to a resident of the other Contracting State shall be taxable only (exclusive) in the residence State of the beneficial owner. The Commentary clarifies that the term “beneficial owner” is used in a wider sense as an anti-avoidance measure under the treaty. It excludes nominees or agents, as well as conduit companies where the formal owner has very narrow rights in reality over the income, unless the beneficial owner is also a resident of the Contracting State of the recipient.²³⁴ They are resident but, as they do not own the income for tax purposes, are not liable to potential double taxation.²³⁵

²³⁴ OECD Commentary: Article 12, para. 4–6.

²³⁵ OECD Commentary: Article 12, para. 4; Klaus Vogel, *Double Taxation Conventions*, Preface to Articles 10–12, m.no. 11.

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Article 12(2) provides a treaty definition of the term “royalties” for purposes of this Article.²³⁶ It includes payments of any kind received as a consideration:

- for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films; or
- for the use of, or the right to use, any patent, trademark, design or model, plan, secret formula or process; or
- for information concerning industrial, commercial or scientific experience (“know-how”).

The Commentary clarifies that royalty payments could be either under a licence (use, right or information) or as compensation for the infringement of these rights. The licence may be exclusive or non-exclusive or specific for a geographical area. The rights do not necessarily have to be registered.

The word “use” implies that the rights must not amount to an outright assignment or sale of the intellectual property itself.

Know-how involves the transfer of existing unprotected specialist knowledge or information derived from experience, where the information is not publicly available.

The Commentary defines know-how as “all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; in as much as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique”. The transfer of know-how excludes the provision of services (e.g. consultancy or technical assistance). They are not royalties but business profits.²³⁷

The OECD MC was amended in 1992 to exclude the payments for the use of, or the right to use, industrial, commercial or scientific equipment, including containers, from this Article. Such lease rentals are taxable as business income (Article 7).²³⁸ Mineral royalties are taxable under the income from immovable property (Article 6). Software payments are royalties only when they represent payments for the exploitation of rights that belong to the copyright holder and, if infringed, would constitute a violation of the copyright (Article 12). Software payments for the personal or business use of programs and other digital products (e.g. images, sounds or text) that provide limited rights to enable the effective use of the program by the user are not royalties but business income from the sale of a copyrighted product (Article 7).²³⁹ The transfer of partial or complete rights may be taxable as capital gains (Article 13).²⁴⁰

The provisions under Article 12(1) do not apply if the royalties relate to a right or property, which is effectively connected with a permanent establishment in a Contracting State of a beneficial owner resident in the other Contracting State (Article 12(3)). In such cases, it forms part of the business profits of the permanent establishment and is taxed on a net basis

²³⁶ Klaus Vogel, *Double Taxation Conventions*, Article 12, m.no. 38; See Chapter 4(7.3).

²³⁷ OECD Commentary: Article 12, para. 11.

²³⁸ OECD Commentary: Article 12, para. 8–10.

²³⁹ See Chapter 8(2.3).

²⁴⁰ OECD Commentary: Article 12, paras. 12–17.

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under Article 7. If it is not effectively connected, there is no force of attraction rule to tax it as the income of the permanent establishment.

Article 12(4) denies the benefits under this Article on excessive or non-arm's length royalty paid under a "special relationship" between the payer and the beneficial owner. In such cases, the provisions of the Article apply only to the arm's length amount, and the excess payment is taxable separately under the domestic law of each Contracting State. The Commentary clarifies that only the adjustment of the amount of royalties is permitted. Royalties cannot be recharacterised for example as a contribution to equity capital. The Commentary also mentions that the special relationship involves a wider concept than the one used for the "associated enterprise" under Article 9, and includes "any community of interest as distinct from the legal relationship", such as a relationship by blood or marriage.²⁴¹

These taxing rights do not extend to royalties arising in a third State, or to royalties arising in a Contracting State but attributable to a permanent establishment that another enterprise of the same State has in the other Contracting State. In such cases, Article 21 applies.²⁴²

The Commentary Update 2003 also includes the recommendations made in the Report on Treaty Characterisation Issues Arising from E-Commerce.²⁴³ (See Chapter 8 (1.5(b)))

OECD Observations or Reservations: Australia, Belgium, Canada, Czech Republic, France, Greece, Hungary, Italy, Japan, Korea, Mexico, New Zealand, Poland, Portugal, Slovak Republic, Spain, Turkey and the United States.²⁴⁴

Several OECD Member States have reserved their right to tax royalties in the State of source.

Non-OECD Positions: Albania, Argentina, Belarus, Brazil, Bulgaria, China, Croatia, Estonia, Gabon, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Russia, Slovenia, South Africa, Thailand, Tunisia, Ukraine and Vietnam.

UN MC

The UN MC Article 12 allows the sharing of taxation rights by the Contracting States, similar to the UN MC Article on interest, as follows:

Article 12(1) and (2) provides that royalties may be taxed (non-exclusive) by the country where they arise and according to the laws of that State. If the recipient is the beneficial owner, the source withholding tax is limited to a reduced rate, as agreed through bilateral negotiations.²⁴⁵ The UN MC does not prescribe a maximum concessional withholding tax rate on gross royalties. The UN Commentary provides guidance notes for determination of the rate.²⁴⁶

241 OECD Commentary: Article 12, para. 22–26.

242 OECD Commentary: Article 12, para. 5.

243 OECD Commentary: Article 12, paras. 17.1–17.4.

244 OECD Commentary: Article 12, paras. 32–48.

245 UN Commentary: Article 12, para. 5.

246 UN Commentary: Article 12, paras. 8–11.

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Article 12(3) extends the definition of royalties to include the consideration for the use of, or the right to use (a) films or tapes used for radio or television broadcasting; and (b) industrial, commercial or scientific equipment. Moreover, the income from container leasing is also taxable as royalties. The UN Commentary refers to the OECD Commentary on Article 12 concerning software payments.²⁴⁷ It also mentions that literary copyrights include copyrights relating to international news.²⁴⁸

Under Article 12(4), the royalty income effectively connected to the permanent establishment through similar business activities is also taxed as business income under a limited force of attraction principle (UN MC Article 7(1)).

Under Article 12(5), the royalty is deemed to arise in the State of the payer, when the payer is a resident of that State. This source rule does not apply if the royalty payment is incurred and borne by a permanent establishment or fixed base situated in a Contracting State. In such cases, the source is the Contracting State where the permanent establishment is situated, irrespective of the residence of the payer. There must be an obvious economic link between the royalty payment and the permanent establishment or fixed base. The exception does not apply if the permanent establishment is located in a third State. The royalty income will then be deemed to arise in the State where the payer is resident.²⁴⁹

US MC

The Model treaty effectively follows the same taxing provisions as applicable to interest payments under the US MC Article 11. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only (exclusive) in that other State (Article 12(1)). A beneficial owner is any person resident in a Contracting State to whom that State attributes the payment for tax purposes.

The Article text mentions that the term “royalties” also includes the copyrights on other work, such as computer software, audio or videotapes or disks, and other means of image or sound reproduction. In addition, it includes the capital gains that are contingent on the productivity, use or sale of the property described in this paragraph (Article 12(2)).

The Technical Explanation excludes “shrink wrap” computer software as royalty income and regards it as business profit from the sale of a copyrighted article. A transfer of the rights in the object in which the copyright software is embodied (i.e. a program copy) is treated as capital gains. The term “royalties” does not include professional services, pure technical assistance, the payments received for after-sales service or the service provided under a guarantee. In limited cases, know-how may include technical information through technical or consultancy services, but not the general training of the user’s employees or the information developed especially for the user.²⁵⁰

²⁴⁷ UN Commentary: Article 12, para. 13.

²⁴⁸ UN Commentary: Article 12, para. 17.

²⁴⁹ See Chapter 8(3.3).

²⁵⁰ US Model Technical Explanation (1996): Article 12, paras. 175–183.

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Article 13: Capital Gains

OECD MC

As a rule under Article 13, the gains from the alienation of property are taxable only (exclusive) in the State in which the alienator is resident. The four exceptions to this rule are:

Article 13(1): The gains derived from immovable property may be taxed (nonexclusive) in the Contracting State in which it is situated. It may also be taxed in the State where the alienator is resident. This paragraph deals only with capital gains derived by a resident of a Contracting State from immovable property in the other Contracting State. It does not apply to property in a third State or in the State of residence (Article 13(5) applies). Immovable property is defined in Article 6.

Article 13(2): The gains from movable business property may be taxed (non-exclusive) in the other Contracting State, if it forms part of the business assets of a permanent establishment of an enterprise of a Contracting State in the other State, or if it is the permanent establishment itself. “Movable property” means all property other than immovable or real property, and includes intangible property, such as goodwill and licenses.

Article 13(3): The gains from the alienation of ships or aircraft operated in international traffic or from boats in inland waterways transport, and the related movable property, shall be taxable only (exclusive) in the Contracting State in which the place of effective management of the enterprise is situated (like Article 8). The Commentary Update 2003 clarifies that the paragraph applies only when the enterprise operates the boats, ships or aircraft for own transportation or on full charters.²⁵¹

Article 13(4): The gains from the alienation of shares in a company holding immovable property may be taxed (non-exclusive) in the State where the property is situated (as in paragraph 1), provided more than 50% of the value of the shares is derived directly or indirectly from such property. The Commentary mentions that the determination of the over 50% ratio should be based on the value of immovable property as a percentage of all the property owned by the company.²⁵²

Under Article 13(5), the gains from the alienation of any property, not referred to in the previous four paragraphs of the Article, shall be taxable only (exclusive) in the State of residence. Therefore, this paragraph includes the gains from the alienation of other movable private property and the gains derived in the alienator’s State of residence or in third States.²⁵³ The source State must exempt such gains.

The Article is worded broadly since there are wide variations in different countries on the rules governing the taxation of capital gains. The Article applies to all kinds of taxes levied by a Contracting State on capital gains from alienation of property.²⁵⁴ The OECD MC does not define alienation. The Commentary mentions that the words “alienation of property” are used to include the gains from a sale or exchange of property, a partial alienation, an

251 OECD Commentary: Article 13, para. 28.1.

252 OECD Commentary: Article 13, paras. 28.3–28.7.

253 Klaus Vogel, *Double Taxation Conventions*, Article 13, m.no. 91.

254 OECD Commentary: Article 13, para. 19.

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expropriation, a transfer for share exchange, a sale of a right, a gift or even a property transfer on death. There must be a transfer of assets resulting in an alienation or change in ownership.²⁵⁵

Generally, capital gains can only be taxed under a treaty by the country that has the right to tax the business profits derived from it. The Article does not give a State the right to tax capital gains if the right is not provided under its domestic law. Moreover, the OECD MC does not define gains, whether and when they should be taxed, or how they should be computed. Thus, how the Article should be applied is left to the domestic laws in each country.²⁵⁶

OECD Reservations: Australia, Denmark, Finland, France, Greece, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, New Zealand, Norway, Spain, Sweden, Turkey, the United Kingdom and the United States.²⁵⁷

Non-OECD Positions: Argentina, Brazil, Bulgaria, Israel, Morocco, Thailand, Estonia, Latvia, Lithuania and Vietnam.

UN MC

The UN Model includes additional gains under the treaty provisions, as follows:

Article 13(4) includes a special provision for the capital gains from the alienation of shares of a company, if its underlying assets consist directly or indirectly principally of immovable property. The gains from alienation of shares in such companies may be taxed in the Contracting State where such property is situated regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State. The term “principally” is defined as the value of such immovable property, as situated in the Contracting State, exceeding 50% of the value of all the assets owned by the company. This provision is now effectively contained under OECD MC Update 2003 as Article 13(4).

Under the UN MC 2001, this paragraph was extended to include the alienation of interest in a partnership, trust or estate if it owns directly or indirectly principally immovable property. This paragraph does not apply if the immovable property is used for its own business activities (e.g. a hotel), unless it is engaged in the business of management of immovable properties. Hence, the capital gains on sale on shares or interest in a qualifying property management company, partnership, trust or estate are taxable.²⁵⁸

Article 13(5) provides shared taxing rights on certain capital gains from the alienation of shares of a company, other than under Article 13(4). The State, in which the company is resident, may tax (non-exclusive) these gains, if the equity ownership exceeds a specified percentage shareholding (as agreed through bilateral negotiations).

²⁵⁵ OECD Commentary: Article 13, para. 5.

²⁵⁶ OECD Commentary: Article 13, para. 3–21; See Chapter 4(7.4).

²⁵⁷ OECD Commentary: Article 13, paras. 33-51.

²⁵⁸ UN Commentary: Article 13, para. 8.

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US MC

There are a few variations from the OECD MC. For example:

The gains from the alienation of ships, aircraft or containers operated or used in international traffic, and from related personal property, shall be taxable only (exclusive) in the State of residence of the enterprise (similar to US MC Article 8). Gains from a contingent sale of a patent, etc. are taxable under Article 12(2) as royalties.

Article 13(2) defines real property for the taxation of capital gains under this Article. It includes (a) property referred to in Article 6; (b) a United States real property interest including shares in US property companies (IRS Code Sec. 897); and (c) an equivalent interest in real property situated in the other Contracting State.

Article 14: Independent Personal Services

OECD MC

Note: This Article has been deleted under OECD MC Update 2000. Independent personal services and professional income are now covered under OECD MC Article 7 as business income. The comments below still apply to Article 14 in previously negotiated treaties under the OECD MC. The Article is retained under the UN MC and US MC.²⁵⁹

Income derived from professional services or other independent (e.g. outside an employment) activities shall be taxable (exclusive) only in the State of residence, unless there is a fixed base to perform such activities in the other State. If there is a fixed base in the other Contracting State, such income may be taxed (non-exclusive) in the host country to the extent that it is attributable to that fixed base. Therefore, the source State has taxing rights, but only if there is a centre of a fixed or a permanent character in that State.²⁶⁰ This Article excludes the taxation of directors' fees (Article 16) and artistes and sportsmen (Article 17).

The term "fixed base" is not defined, but it must be available regularly (not necessarily owned or used continually) to enable the person to perform his professional services or independent personal activities. It must be fixed in terms of time (i.e. non-temporary) and place (i.e. geographical location). A mere agent empowered to contract cannot form it.²⁶¹ The Article does not explicitly restrict the right of tax only to income from services performed in that State. However, since the person must be physically present to perform his personal services, generally the taxing rights of the source State would relate only to his services or activities performed in that State.

Although it is not identical to a permanent establishment of a business enterprise, a fixed base serves a similar function.²⁶² The concept of permanent establishment relates to commercial and industrial activities of an enterprise under Article 7. Article 14 applies to

²⁵⁹ Committee on Fiscal Affairs: Issues Related to Article 14 of the OECD Model Tax Convention (OECD, 2000); J.W.J. de Kort, Why Article 14 was deleted from the OECD Model Tax Convention (Intertax, March 2001) pp. 72–76; Edwin van der Bruggen, Developing Countries and the Removal of Article 14 from the OECD Model (IBFD Bulletin, December 2001) pp. 601–607.

²⁶⁰ OECD Commentary: Article 14, para. 4.

²⁶¹ Klaus Vogel, Double Taxation Conventions, Article 14, m.no. 27.

²⁶² Klaus Vogel, Double Taxation Conventions, Article 14, m.no. 23.

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the income from professional services or independent activities effectively connected with a fixed base.²⁶³ Unlike a permanent establishment where business must be actually carried on from a fixed place, there is no such requirement from a fixed base, which has only to be regularly available. A fixed base requires a lesser degree of permanence than a permanent establishment. The same principles of profit allocation and expense deductions should be followed as provided under paragraphs 2 and 3 of Article 7. The exceptions under Article 5(4) do not apply to Article 14.

Article 14(2) defines the term “professional services” to include “especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants”. The list is not exhaustive and includes both individuals and companies. The term “independent activities” refers to any service rendered by an individual who is not bound to any employer by a labour contract and who freely organises his own work.²⁶⁴ He must not be dependent either personally or economically on the payer, and he should carry on the activity bearing his own entrepreneurial risk and reward. Someone other than an employee bound under a master and servant relationship normally performs such services.

UN MC

The UN MC Article 14 applies only to income from professional services and independent activities. It grants non-exclusive (“may be”) taxing rights to the other Contracting State (i.e. source State) in the following two cases:²⁶⁵

- (a) If there is a fixed base regularly available for the performance of the activities, the income attributable to the fixed base may be taxed.
- (b) If the physical stay aggregates 183 days or more in any twelve-month period commencing or ending in the tax year, the income may be taxed even if there is no fixed base. However, only income derived from activities exercised or performed in that country may be taxed.²⁶⁶

The UN Commentary mentions that Article 14 applies to direct payments to an individual for independent personal services. UN MC Articles 5 and 7 cover the payments to an enterprise for similar services performed by the enterprise through its employees or other personnel.

US MC

The US Model treaty restricts this Article to individuals or groups of individuals (e.g. a partnership); the persons other than individuals are covered under Article 7. The US MC also limits the taxability under Article 14 to independent personal services performed in the source State.

Under Article 14 (1), a Contracting State has the exclusive taxing rights over the income derived by a resident individual from the performance of independent personal services,

²⁶³ Referred to in Articles 10(4), 11(4), 12(3), 13(2) and 21(2) prior to OECD MC Update 2000.

²⁶⁴ Gerard Colombe, IFA Cahiers Vol. 67B, General Report, 1982.

²⁶⁵ The third case under subparagraph (c) of Article 14(1) in the UN MC 1980 was deleted in the revised UN MC 2001. It allowed source taxation if the amount paid by a resident or a PE to a nonresident for independent personal services exceeded a certain amount.

²⁶⁶ UN Commentary: Article 14, paras. 3–8.

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unless he has a fixed base regularly available for performing his activities in the other Contracting State. If the individual has a fixed base regularly available for performing his activities in the other State that other State may tax the income attributable to the fixed base.

The US MC Article 14 (2) provides that the income taxable under this Article shall be determined on a net basis under the principles of Article 7(3).

Article 15: Income from Employment²⁶⁷

OECD MC:

The Article governs the taxing rights on income from employment other than specific instances of employment income that are dealt with separately under other Articles. Thus, the income must not fall under the provisions of the Articles applicable to directors' fees (Article 16), pensions (Article 18) and government service (Article 19). The Article also does not override Article 17, which is applicable to artistes and sportsmen.

The term "remuneration" used in this Article covers all forms of benefits in kind received in respect of employment income (other than pensions) and includes perquisites and fringe benefits, bonuses, allowances, social security payments, cash received and payments in kind. The Commentary Update 2005 now specifically includes stock options in this Article. It is irrelevant when and where it is paid. The remuneration also includes income derived from the other Contracting State or from sources in third States. Article 21 (other income) is not applicable to income from employment.²⁶⁸

Under Article 15, the taxing rights are allocated as follows:

The State of residence has the exclusive right to tax ("shall be taxable only") the salaries, wages and other similar remuneration derived by a resident of that Contracting State, unless the employment is exercised in the other Contracting State. The other Contracting State may (non-exclusive) also tax such remuneration to the extent that it is derived from the employment actually exercised by the individual in the other Contracting State. Although the term "exercised" is not defined in the treaty, the Commentary clarifies that employment is exercised in the place where the employee is physically present when performing the activities for which the employment is paid.²⁶⁹ Thus, this provision grants primary taxing rights on employment income to the State where the services are physically performed, i.e. State of activity. The Commentary Update 2005 reaffirms that the condition applies regardless of when that income may be paid to, credited to or otherwise definitely acquired by the employee. (Article 15(1))

The primary taxing right of the State of activity is denied and the State of residence retains, as an exception, its exclusive taxing right on the employment income derived in the other Contracting State, if all three of the following conditions are met (Article 15(2)).

The three conditions are:

- (a) the physical stay in the State of activity does not exceed 183 days in any 12-month period that begins or ends in the tax year concerned;

²⁶⁷ Under the OECD Update 2000, the title has been changed from "Dependent Personal Services" to "Income from Employment." This change does not apply to the UN and US MCs.

²⁶⁸ Klaus Vogel, *Double Taxation Conventions*, Article 15, m.no. 11.

²⁶⁹ OECD Commentary: Article 15, para. 1.

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- (b) the remuneration is paid by, or on behalf of, an employer who is not a resident in the State of activity; and
- (c) the remuneration is not borne by a permanent establishment that the employer has in the State of activity.²⁷⁰

The Commentary recommends that the days under Article 15 (2) (a) be based on the physical presence in the country, and not the duration of the activity. Days spent wholly outside the country are excluded. A part-stay during the day, however brief, would count as a day of presence. The physical stay in the source State need not be continuous or consist only of working days. For example, it would include the day of arrival and departure, Saturdays and Sundays, national holidays, vacation days spent inside the country of activity, days of sickness, short breaks like strikes and work stoppages, etc. It excludes holidays outside the country of activity and stops in transit.²⁷¹

Article 15 (2) (a) refers to a physical presence in any 12-month period commencing or ending in the fiscal year concerned. The paragraph applies to 12-month periods that either begin or end on the same date. Moreover, the Commentary Update 2005 clarifies that all possible periods of twelve consecutive months must be considered, even periods that overlap others to a certain extent. It is not necessary for the employee to be paid directly by the employer. The host entity or a third party on his behalf could pay the remuneration. In a fiscally transparent partnership, the terms “employer” and “resident” apply at the level of the partners.²⁷²

The Commentary mentions that the Contracting States may agree to interpret the term “employer” under Article 15 (2) (b) broadly in cases of “international hiring of labour” to ensure that the “substance over form” prevails.²⁷³ The person, who exercises the functions of the employer and bears the economic cost and risks of the employee’s remuneration, may then be taken as the employer despite the legal relationship.

In April 2004, the OECD Committee published a public discussion draft to re-examine the issue of economic versus legal employer under its 1985 Report. The draft proposes that the source State exemption should be denied in situations where either under the domestic law or according to the object or purpose of this Article,²⁷⁴ there is an employment relationship (contract of services), despite the formal contractual arrangement (contract for services). The proposals include several examples of situations not intended under this paragraph.²⁷⁵

As the term “not borne” is not defined, it leads to several questions of interpretation under Article 15(2) (c). The phrase “borne by” may follow its “natural meaning”, i.e. not in the

²⁷⁰ This condition extends the source tax exemption under Article 7 to the employees. They are not taxable unless there is a permanent establishment.

²⁷¹ OECD Commentary: Article 15, para. 5.

²⁷² OECD Commentary: Article 15, paras. 6.1–6.2.

²⁷³ OECD Commentary: Article 15, para. 8.

²⁷⁴ The latter criterion covers unintended situations where the services rendered by the employee are more integrated to the business of a resident enterprise than those of his formal employer. The draft mentions that “it would be contrary to the object and purpose (of the paragraph) to provide a tax exemption for what is in substance the ordinary work force of resident enterprises”.

²⁷⁵ Committee on Fiscal Affairs: Proposed Clarification of the Scope of Paragraph 2 of Article 15 of the Model Tax Convention (OECD, 2004). The changes have not yet been finalised and are currently not included in the 2005 Commentary Update.

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books of account of the permanent establishment.²⁷⁶ Alternatively, it could mean that the permanent establishment does not pay the amount physically, even if the payment is made by the head office and charged to the permanent establishment. It may also imply that the amount must not be claimed as a tax deduction by the permanent establishment.

Some treaties use the term “deducted” or “deductible” instead of “borne”. The Commentary Update 2000 clarified that the “proper test is whether the remuneration would be allowed as a deduction for tax purposes”. It mentions that the term should follow the underlying purpose of this Article. The fact that the employer has, or has not, actually deducted the amount is not conclusive. The proper test is whether the deduction otherwise available for the remuneration would be allocated to the permanent establishment under Article 7. The test will be met even where the amount is not deductible merely due to its nature, e.g. stock options.²⁷⁷

Article 15(3) deals with the employment income of the crew on ships or aircraft operated in international traffic or on board a boat engaged in inland waterways transport. Such remuneration is taxable in the State where the effective management of the enterprise is located (like Article 8).

The proposed Commentary Update 2005 includes the discussion on the complex tax issues arising on stock options granted to employees, and their recommended treatment under tax treaties.²⁷⁸

OECD Observations or Reservations: Denmark, Germany, Greece, Ireland, Norway, Sweden, Switzerland and the United Kingdom.²⁷⁹

Non-OECD Positions: Argentina, Latvia and Lithuania.

UN MC

Similar

US MC

Under US MC Article 15(2) (c), the reference to remuneration “borne by” a permanent establishment includes all expenses that are economically incurred even if they are not currently deductible for tax purposes. Therefore, the expenses may be capitalisable or deductible expenses. Moreover, the salaries paid by residents, who are tax-exempt, may be considered as borne by a permanent establishment even when they will be neither deductible nor capitalisable.²⁸⁰

²⁷⁶ *CIR v JFP Energy Inc* (1990) 12 NZTC 7176 (New Zealand): A US company was engaged in offshore drilling operations from a rig, which constituted a permanent establishment in New Zealand. The employees spent 28 days in New Zealand and 28 days in the United States. They were paid abroad by the US company, but no charge for the salary expense was booked by the branch in New Zealand. The NZ Court of Appeal held that the remuneration was not borne by the permanent establishment, and since the other conditions under the Article were met, the salary was not taxable in New Zealand.

²⁷⁷ OECD Commentary: Article 15, para. 7.

²⁷⁸ OECD Commentary Update 2005: Article 15, paras. 12–12.15; See Chapter 8(10.2) for details.

²⁷⁹ OECD Commentary: Article 15, paras. 13–21.

²⁸⁰ US Model Technical Explanation (1996): Article 15, para. 216.

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US MC Article 15(3) mentions that the employee “as a member of a regular complement” of a ship or aircraft operated in international traffic shall be taxable only (exclusive) in the State of residence of the employee. This paragraph does not apply to persons dealt with in Article 14 (independent personal services).²⁸¹

Article 16: Directors’ Fees

OECD MC

Directors’ fees and other similar payments (e.g. benefits in kind)²⁸² derived by a resident of a Contracting State as a member of the board of directors of a company resident in the other Contracting State may be taxed (non-exclusive) in the paying country where the company is resident. Thus, the State of the company’s residence has the primary taxing right as the source State.

Payments received by directors normally constitute either independent personal services (Article 7) or employment income (Article 15).²⁸³ This Article provides an exception for the remuneration paid to an individual or a legal person (e.g. a company) as a board member for the overall management or supervision of a company’s management.²⁸⁴ The amount may be paid either as a fixed amount or as a share of the company’s profits, or both. It may also be paid in kind. It does not matter where the services are performed. However, the Article does not cover fees received in any other capacity, for example as an employee, consultant or advisor, and excludes payments received for other services. Remuneration paid by a company resident in a third State would be taxable in the residence State of the director (Article 21 applies), unless it is taxable similarly under a tax treaty with that third State.

OECD Reservations: Belgium, Greece, Portugal and the United States.²⁸⁵

Non-OECD Positions: Albania, Bulgaria, Estonia, Latvia, Lithuania, Morocco, Slovenia and Thailand.

UN MC

The UN MC Article 16(2) grants additional (non-exclusive) taxing rights to the Contracting State, in which the company is resident, on remuneration paid to certain company officials who are resident in the other Contracting State. The remuneration paid to officials in top-level managerial positions is also taxable in the Contracting State of the paying company. The term “top-level managerial position” refers to positions that involve primary responsibility for the management and general direction of the affairs of the company, apart from the

281 US Model Technical Explanation (1996): Article 15, para. 217.

282 OECD Commentary: Article 16, para. 3.1; under the OECD Commentary Update 2005, similar provisions as under Article 15 apply to stock options granted to directors.

283 The domestic laws in several countries treat directors’ fees as income from employment (Examples: Canada, Italy, the Netherlands, Norway, Sweden, the United Kingdom).

284 Klaus Vogel, Double Taxation Conventions, Article 16, m.no. 11–12.

285 OECD Commentary: Article 16, paras. 4–7.

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activities of the directors. The term would include a person acting as both a director and a top-level manager.²⁸⁶

US MC

Under US MC Article 16, the directors' fees and other compensation for services derived by a resident of a Contracting State as a member of the board of directors of a company in the other Contracting State may be taxed (non-exclusive) in the company's State of residence. Unlike in the OECD MC, the Article limits this taxing right to fees received for services rendered in the company's State of residence.

Article 17: Artistes and Sportsmen

OECD MC

Article 17 grants non-exclusive ("may be taxed") taxing rights on the income derived directly or indirectly by a visiting artiste or sportsman, who is a resident of a Contracting State, to the other Contracting State where he exercises his personal activities as a performer ("State of performance"). It applies to his income either as an independent contractor, or as a dependent employee of another person or company or under any other arrangement. The provision applies regardless of the length of the stay and even if there is no permanent establishment. It is an exception to the normal treaty rules applicable to business profits or personal services under Articles 7 and 15.²⁸⁷

The taxing right of the State of performance under this Article is limited to the income which is attributable directly or indirectly to a public or live performance ("performance income") and does not normally extend to other activities or property rights, e.g. merchandise sales, royalties, cancellation fees, etc. The related income may also be taxable if there is a close link with an actual public performance or appearance in the State. For example, it may include appearance fees, award or prize money, share of gate receipts, sponsorship and advertising fees. Other Articles would apply if the income were not directly or indirectly attributable to a specific personal performance or event.²⁸⁸

The term "artiste" includes any person engaged as an entertainer, such as an actor in a theatre, motion picture, radio or television, or a musician. The Commentary clarifies that the Article is limited to entertainers performing in public, either directly or indirectly (via the media). It excludes persons engaged in artistic activities that do not involve public performances (e.g. painters, sculptors, photographers, writers and composers). Similarly, "behind the scene" administrative or support staff involved in the performance, such as producers, directors, cameramen, technical staff, coaches, road crews for a pop group, etc., are excluded. The Commentary specifically excludes payments to visiting conference speakers. The income received for arranging the appearance by the agent, manager, impresarios, etc. is also outside the scope of the Article.²⁸⁹

²⁸⁶ UN Commentary: Article 16.

²⁸⁷ Joel Nitikman, Article 17 of the OECD Model Treaty – An Anachronism (Intertax, August/September 2001) pp. 268–274.

²⁸⁸ OECD Commentary: Article 17, para. 9; Klaus Vogel, Double Taxation Conventions, Article 17, m.no. 10a.

²⁸⁹ OECD Commentary, Article 17, para. 3.

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The term “sportsmen” is not defined, but again the Commentary clarifies that it applies to the performance of persons engaged in games or sports held in public. Thus, if there is no audience, there is no tax under this Article. The term “sportsmen” includes participants in traditional athletic events, as well as in other sporting activities and tournaments, such as golfers, jockeys, tennis players, racing drivers and others. It would also include other “entertainment” type activities such as billiards and snooker, chess and bridge tournaments.²⁹⁰

The Article covers both professional and occasional or part-time paid activities, but excludes amateur performances that do not give rise to taxable income. The activities must be performed personally in public in the other Contracting State and, therefore, require physical presence. If there were no public appearances, the income would represent either royalties or income from personal services. In the case of mixed activities, the taxing rights may have to be split between the remuneration from live performance and other exploitation earnings from such a public performance, e.g. recordings.²⁹¹

Article 17(1) applies to the performance income derived directly and indirectly by a resident of a Contracting State from his personal activities exercised in the other Contracting State as an individual artiste or sportsman. Article 17(2) counters tax avoidance, when this income from the personal activities of an artiste or a sportsman in the State of performance accrues to “another person” (e.g. a person providing the services of the performer). The tax due from the artiste or sportsman under this Article may be recovered from the intermediary person by the State of performance, regardless of the other treaty provisions. This “look through” rule overrides the other provisions under the treaty.

The term “another person” includes legal entities (e.g. a “loan-out” or “rent-a-star” company, an orchestra, team, troupe, etc. or a management company), which provide the services of the performer or receive the income from the performance or appearance. Thus, the Article taxes both the performance income received by the artiste or sportsman and the profits of any legal entity that receives his performance income in the State of performance.²⁹² The Article also applies to the income derived by an artiste or sportsman employed by the government if the services performed by him are part of its business activities.²⁹³ The paragraph excludes other income of the employer from the performance but not related to the services of the performer.

The Commentary also mentions that the paragraph allows the State of performance to tax the “another person” as an intermediary if he is a resident in the other Contracting State, even if the performer is not a resident of that State. Alternatively, if the performer is a resident of the State of performance he may be taxed under the domestic law even when the intermediary is resident in a non-treaty third State. The intermediary and the performer do not have to be residents of the same Contracting State. The Commentary clarifies that

²⁹⁰ OECD Commentary: Article 17, paras. 5–6.

²⁹¹ Klaus Vogel, *Double Taxation Conventions*, Article 17, m.no. 20.

²⁹² Dick Molenaar and Harald Grams, *Rent-a-Star - The Purpose of Article 17(2) of the OECD Model (IBFD Bulletin, October 2002)* pp. 500–509.

²⁹³ OECD Commentary: Article 17, para. 13; Article 19, para. 6.

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the treaty does not prevent the use of general anti-avoidance rules under the domestic law in such cases.²⁹⁴

OECD Observations or Reservations: Canada, France, Switzerland and the United States.²⁹⁵

Non-OECD Positions: Philippines and Vietnam.

UN MC

Similar. However, instead of the word “sportsman” the Article uses the gender-neutral word “sportsperson”.

US MC

Like the OECD MC, the Article applies to all income connected with a public performance by an entertainer or sportsman. The Technical Explanation clarifies that the controlling factor to determine as to whether the income falls under this Article is “whether the income in question is predominantly attributable to the performance itself, or to other activities or property rights”.²⁹⁶

The US MC Article 17 has the following significant variations from the OECD MC:

Article 17(1): The income derived by an entertainer or sportsman may only be taxed by the other Contracting State if the gross receipts from such activities, including the expenses reimbursed or borne for him, exceed US\$ 20,000 (or equivalent in the currency of the other Contracting State) in a taxable year (this monetary exemption does not override US MC Articles 14 and 15).

Article 17(2): Where the income from the activities of an entertainer or a sportsman accrues to “another person”, that income may be taxed in the State where the activities are exercised. This provision does not apply if the entertainer or the sportsman, or any person related to him, does not share directly or indirectly in the receipts or profits of that “another person” in any manner (e.g. through deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions).²⁹⁷ The income is deemed to accrue to another person, if the other person has control over, or the right to receive, the gross income in respect of the services of the performer.²⁹⁸

294 OECD Commentary: Article 17, para 11; Committee on Fiscal Affairs: Taxation of Entertainers, Artistes and Sportsmen (OECD, 1987); Daniel Sandler, *The Taxation of International Entertainers and Athletes – All the World’s a Stage* (Kluwer Law International, 1995).

295 OECD Commentary: Article 17, paras. 15–20.

296 US Model Technical Explanation (1996): Article 17, para. 230.

297 US Model Technical Explanation (1996): Article 17, para. 237.

298 US Model Technical Explanation (1996): Article 17, para. 236.

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Article 18: Pensions

*OECD MC*²⁹⁹

This Article applies only to payments that are made under a past employment or service relationship with a private employer or government, unless the pension is covered by Article 19(2).³⁰⁰ The income from private pensions and other similar payments for past private employment services are taxable (exclusive) only in the State of residence of the individual pensioner.³⁰¹ The source State has no taxing rights on such payments. The place where the past employment was exercised and the residence of the payer do not affect the taxing rights under this Article.

The Article includes widows' and orphans' pensions and other similar payments, such as annuities paid in respect of past employment. Annuities paid in consideration of an alienation of property are excluded from Article 18.³⁰² It also excludes pension payments linked with the past earnings of independent personal services or as an agent of independent status.³⁰³ The Commentary leaves the tax treatment of lump sum payments received on retirement to bilateral negotiations.³⁰⁴

Alimony and social security benefits are excluded from this Article to the extent that they are not paid in consideration of past dependent personal services. Such social security benefits are treated as other income under Article 21, even if an employer has made the contributions, partly or fully, to the social security scheme. The Commentary suggests that countries may negotiate bilaterally to grant source taxation rights on social security benefits. The Commentary also suggests a provision, similar to US MC, to allow the tax deduction against the taxable income in the host country for the pension contributions paid in the home country by, or on behalf of, the expatriate employee.³⁰⁵

OECD Observations or Reservations: Australia, Belgium, Canada, Denmark, Finland, France, Greece, Ireland, Mexico, New Zealand, Norway, Portugal, Sweden, the United Kingdom and the United States.³⁰⁶

Non-OECD Positions: Brazil, Bulgaria, Gabon, Ivory Coast, Morocco, Romania, Russia, South Africa, Thailand, Tunisia and Ukraine.

299 The OECD Committee on Fiscal Affairs had published a public discussion draft in November 2003 to review the tax treaty issues arising from cross-border pensions. The final version of the comments has been included in the OECD Commentary Update 2005 under Article 18, paras. 1-69; See Chapter 8(10.3) for details.

300 Klaus Vogel, Double Taxation Conventions, Article 18, m.no. 14.

301 Under the domestic law, it could be taxable in the place where the fund is located, the residence of the payer, or the place of performance of the services to which the pension relates.

302 Klaus Vogel, Double Taxation Conventions, Article 18, m.no. 13.

303 Manfred Gunkel, The Taxation of Pensions (Intertax, 1992/12).

304 OECD Commentary: Article 18, para. 3.

305 OECD Commentary: Article 18, para. 4-37; the US MC provides for tax deductions on cross-border pension contributions under US MC Article 18(6).

306 OECD Commentary: Article 18, paras. 38-45.

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UN MC

The UN MC grants exclusive taxing rights to the paying State on public pensions and social security benefits under this Article. However, it offers two alternative methods for taxing private pensions for past employment services, as follows:

Article 18A: Alternative A gives the exclusive taxing rights on private pensions for past employment services to the Contracting State of the resident pensioner (same as OECD MC).

Article 18B: Alternative B provides that the taxing rights on private pensions for past employment services are taxable in the Contracting State of the resident pensioner. However, where the benefits are paid by a resident of, or a permanent establishment in, the other Contracting State, the amount may also be taxed (non-exclusive) in that State as the source State.

The UN Commentary clarifies that taxation at source means taxation at the place where the pension payments originated and not the place where the services were performed.³⁰⁷

US MC

The US MC Article 18 makes significant additions to the OECD MC. Besides private pensions, it provides the distributive rules for social security benefits and annuity receipts, alimony payments and child support income. In addition, it makes a provision for cross-border pension contributions and distributions. These additional provisions are as follows:

Article 18 (1): Private pension distribution and other similar remuneration for past employment services, whether paid as a periodic or a lump-sum amount to a beneficial owner resident in a Contracting State, shall be taxable only in his residence State. This taxing right is limited to the extent that the amount paid was not included before the pension distribution in the taxable income of the other State.³⁰⁸

Article 18 (2): Payments made under a social security or similar legislation of a Contracting State to a resident of the other State or to a US citizen are taxable only in the Contracting State making the payment.

Article 18 (3): Annuities (other than for past services rendered), which are derived and beneficially owned by an individual, who is a resident of a Contracting State, are taxable only in the State of residence of the recipient. Past service annuity is regarded as deferred compensation and is generally taxable under Article 15.

Article 18 (4): Alimony payments by a resident of a Contracting State to a resident of the other Contracting State are taxable only in the other State.

Article 18 (5): Child support payments (not covered in Article 18(4)) paid by a resident of a Contracting State to a resident of the other Contracting State are tax-exempt in both Contracting States.

Article 18 (6): Contributions to a recognised pension plan in a Contracting State made by, or on behalf of, an individual providing personal services in the other State, shall be deductible (or excludable) from his income in the State in which the services are performed.

³⁰⁷ UN Commentary: Article 18, para. 9.

³⁰⁸ US Model Technical Explanation (1996): Article 18, paras. 241–246.

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The employer's contributions shall also be a tax-deductible expense of the employer in the other State.

Any accrued benefits under the plan during the period will not be treated as the taxable income of the employee. Moreover, the income earned by the plan will be tax-exempt until it is distributed, and the distributions from the plan will not be taxable if they are contributed within a specified period into a qualifying plan in the other Contracting State.

These benefits are not available unless the individual was contributing to the plan (or a similar plan) in his home State before he arrived in the host State. Moreover, the competent authority of the host State must agree that the home pension plan corresponds to a plan recognised in the host State. Finally, the pension benefits of the home plan must not exceed the benefits granted in the host State to its residents on similar tax-approved plans.³⁰⁹

Article 19: Government Service

OECD MC

The Article covers salaries, wages and other similar remuneration (including benefits in kind) and pensions paid to individuals employed by the State itself or its political subdivision, or a local authority of a Contracting State. The Article also applies to government employees who are residents of a third State. It excludes persons rendering independent personal services to the government or public bodies, or deriving pensions related to such services. This Article does not override the provisions under Article 27 (members of diplomatic missions and consular posts).

Article 19 (1) gives exclusive ("shall be taxed") taxing rights on salaries, wages and other similar remuneration earned by an individual in government service to the Contracting State making the payment. The State of residence of the employee must exempt such income from tax unless it is the "paying" State. The place where the services are rendered is immaterial. As an exception, these taxing rights are given exclusively to the residence State of the individual employee if the services are rendered in that State, and the resident individual is a national of that State or, if he is a non-national, he did not become a resident solely for rendering the services.

Under 19 (2), a pension paid to an individual by, or provided out of funds created by, a Contracting State or its subdivision or authority, is also taxable exclusively in the "paying" State, if it is paid in respect of past services rendered by him to that State or subdivision or authority.³¹⁰ The other Contracting State must grant tax exemption, even if the pensioner is one of its residents. Again as an exception, the pension is taxable ("shall be") only in the other Contracting State (i.e. residence State) if the pensioner is both a resident and a national of that State.³¹¹

The above taxing rights apply to individuals who are or were engaged in functions of a government nature. They do not apply to the remuneration and pensions paid to government

309 US Model Technical Explanation (1996): Article 18, paras. 251–258.

310 OECD Commentary Update 2005: Article 19, paras. 5.1–5.2; the 2005 OECD amendments in the MC and the Commentary clarify that non-periodic payments (e.g. lump sum payments), which are paid in lieu of periodic pension payments, are covered under this paragraph.

311 Klaus Vogel, *Double Taxation Conventions*, Article 19, m.no. 40.

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employees for services rendered in connection with a business activity carried on by the government or its subdivision or authority in a Contracting State (Article 19 (3)). Such employees are taxed according to the appropriate provisions under Article 15 (employment income), Article 16 (directors' fees), Article 17 (artistes and sportsmen) or Article 18 (pensions).

OECD Reservations: Belgium, Canada, France, Norway and the United States.³¹²

Non-OECD Positions: Malaysia and Russia.

UN MC

The UN MC Article 19 corresponds to the OECD MC, as it existed before 1995. This Article applies to public employees working as artistes and sportsmen even when they are working on a business venture of a Contracting State or one of its sub-divisions.³¹³

US MC

The US MC Article 19 applies both to government employees and to independent contractors engaged by the government (unlike OECD MC), if they are paid from the public funds of a Contracting State or a political sub-division or a local authority. The payments must relate, directly or indirectly, to the functions or duties traditionally or solely carried on by a government. Therefore, it would not include functions commonly found in the private sector. The Article also applies to a government employee who is a resident of a third State.³¹⁴

Article 20: Students

OECD MC

This Article provides a special rule for tax exemption ("shall not be") in a Contracting State. The student or business apprentice is not taxed on qualifying overseas payments for the student's maintenance, education or training received in the Contracting State where he is studying or training. To qualify, the individual must be a resident of the other Contracting State immediately before his arrival and must be present in that State solely (or primarily) for education or training. The foreign payment may arise from sources in the other Contracting State or a third State, provided the ultimate payer is located outside the host State.³¹⁵

This provision is an exception to Article 1 of the treaty. The individual does not have to be a resident of one of the Contracting States during his stay to benefit from this treaty provision.³¹⁶ Moreover, he does not have to be a student or business apprentice in his home country before his arrival. Although the terms "student" and "business apprentice" are not defined, they would include individuals undergoing some kind of education or training.

³¹² OECD Commentary: Article 19, paras. 8–13.

³¹³ Klaus Vogel, Double Taxation Conventions, Article 19, m.no. 59a.

³¹⁴ US Model Technical Explanation (1996): Article 1, para. 10.

³¹⁵ Klaus Vogel, Double Taxation Conventions, Article 20, para. 11.

³¹⁶ Klaus Vogel, Double Taxation Conventions, Article 20, para. 14.

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They exclude persons who have completed their education or vocational training and are now pursuing knowledge in some specialist field.³¹⁷

Other overseas payments received by the individual will be taxable. For example, the Article does not cover overseas payments for the maintenance of his family or for other purposes. Other types of overseas income (e.g. interest income, salary, etc.) received will also be taxable even if the funds are used for purposes of his education or training. Moreover, for the purpose of this Article, payments made by or on behalf of a resident of a Contracting State or borne by a permanent establishment in that State are not considered to arise from sources outside that State.³¹⁸

OECD Reservations: Australia and New Zealand.³¹⁹

Non-OECD Positions: Albania, Brazil, Bulgaria, China, Estonia, Gabon, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Russia, Slovenia, Thailand, Tunisia and Vietnam.

UN MC

Similar. The Article also includes a business trainee. The paragraph 20 (2) in UN MC 1980 dealing with grants, scholarships and remuneration from employment was omitted in UN MC 2001.

US MC

The US MC Article 20 refers to payments from outside the State received by a student, apprentice or a business trainee undergoing full-time education at an accredited institution or full-time training. The payments are deemed to arise outside the State if the ultimate payer is not located in that State. The tax exemption is limited to the first year of stay only for an apprentice or business trainee (but not a student). An employee, who is sent by his employer to acquire further business skills or training, does not qualify as a student or business apprentice under this Article.³²⁰

Article 21: Other Income

OECD MC

Article 21 gives exclusive (“shall be taxable only”) taxing rights to the State of residence, if the income of a resident of a Contracting State, wherever arising, is “not dealt with” under the distributive rules in Articles 6 to 20.³²¹ The exclusive taxing rights apply even if the residence country does not tax the income.³²² The provisions are restricted to persons who

317 Klaus Vogel, Double Taxation Conventions, Article 20, m.no. 10.

318 OECD Commentary Update 2005: Article 20, para. 2.2.

319 OECD Commentary: Article 20, para. 3.

320 Philip Baker, Double Taxation Conventions and International Law, p. 343.

321 Examples: winnings from gambling, financial derivatives, covenants not to compete, punitive (not compensatory) damages, etc.

322 OECD Commentary: Article 21, para. 3.

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are residents of one or both Contracting States (Article 1), and to income, which is subject to taxes covered by the treaty (Article 2).

This Article provides a distributive rule for the residual income (“residual rule”) under the treaty. It includes items or types of income that are omitted and the sources of income that are not covered in the specific Articles. For example, most distributive Articles under the MC deal with taxing rights over income, which has a source in one Contracting State and is paid to a resident of the other Contracting State.

This Article covers income with a source in one Contracting State when paid to a resident of the same State. It also decides the taxing rights on income from a third State that is paid to a resident of one of the Contracting States (e.g. triangular cases).

The only exception to the residual rule is when such income is received by a resident of a Contracting State from an activity, which is effectively connected with his permanent establishment in the other Contracting State. The taxing rights on the income are then given to the State where the permanent establishment is located (Article 7 applies).³²³ This exception includes the income attributable to the permanent establishment that is sourced from third States. It also applies where the beneficiary and the payer are both residents of the same Contracting State and the income of the beneficiary is attributed to a permanent establishment in the other Contracting State. This exception does not apply to income from immovable property as the State of *Situs* always has the primary (non-exclusive) taxing right.³²⁴

The Commentary proposes additional provisions to deal with transactions involving non-traditional financial instruments (e.g. derivatives) between related parties. However, it makes no recommendations on taxation of such instruments in the MC as the matter is still under active study.³²⁵

Several bilateral treaties exclude this Article. In such cases, the domestic law, and not the treaty, is applicable.

OECD Reservations: Australia, Belgium,³²⁶ Canada, Finland, Ireland, Mexico, New Zealand, Portugal, Slovak Republic, Sweden, the United Kingdom and the United States.³²⁷

Non-OECD Positions: Albania, Argentina, Belarus, Brazil, Bulgaria, Estonia, Gabon, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Romania, Russia, Slovenia, South Africa, Thailand and Vietnam.

UN MC

The UN MC Article 21(3) provides for shared taxing rights over the residual income. The items of income not dealt with specifically in the treaty under Articles 6 to 20 may also be taxed (non-exclusive) in the other Contracting State. This shared right over the residuary income, which is granted to the other State, is limited to the income that arises or has a source in that State. The same exceptions as under the OECD MC apply.

³²³ Klaus Vogel, Double Taxation Conventions, Article 21, m.no. 32.

³²⁴ Alexander Rust, *Situs Principle v Permanent Establishment* (IBFD Bulletin, January 2002) pp. 15-18.

³²⁵ OECD Commentary: Article 21, paras. 7–12.

³²⁶ Belgium reserves its taxing right where the residence State does not exercise its exclusive taxing rights.

³²⁷ OECD Commentary: Article 21, paras. 13–17.

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US MC

Under the US MC Article 21, the exclusive taxing rights over the income, not dealt with in the other Articles (Articles 6 to 20), are assigned to the State of residence of the “beneficial owner” of the income. The Technical Explanation clarifies that an item of income is considered “dealt with” in another Article if it is of the type of income described in the Article and it has its source in a Contracting State.³²⁸ The same exceptions as under the OECD MC apply.

Article 22: Capital

OECD MC

Article 22 applies to taxes on capital from the possession or ownership of capital, and not to the income or the gains from capital. The Article is similar to Article 13 on capital gains. Under this Article, the State of residence has the exclusive taxing rights (“shall be taxed”) on all items of capital³²⁹ with the following exceptions:

- Immovable property owned by a resident of a Contracting State and situated in the other Contracting State may be taxed (“non-exclusive”) where situated.
- Movable property forming part of the business property (i.e. serves the business activities) of a permanent establishment of an enterprise of a resident in a Contracting State may be taxed (“non-exclusive”) in the other State where the permanent establishment is located.
- Capital represented by ships or aircraft in international traffic or boats engaged in inland waterways transport, and by movable property pertaining to their operation, shall be taxed only (“exclusive”) in the State where the place of effective management of the enterprise is situated.

The Commentary mentions that the Article does not apply to taxes on estates and inheritances and on gifts. These taxes are covered under a separate OECD Model Double Taxation Convention on Estates and Inheritances and on Gifts (1982).

OECD Reservations: Denmark, Finland, France, New Zealand, Norway, Portugal, Turkey, Spain, Sweden and Greece.³³⁰

Non-OECD Positions: Argentina, Bulgaria, China, Estonia, Malaysia, Thailand and Vietnam.

UN MC

The UN Model treaty leaves paragraph 4 of this Article on the taxation of capital to be decided by bilateral negotiations.

US MC

Article 22: The Article on Capital (OECD MC Article 22) is excluded since there are no federal capital taxes in the United States. The US MC Article 22 deals with the “Limitation

³²⁸ US Model Technical Explanation (1996): Article 21, para. 273.

³²⁹ This exclusive taxing rights of the State of residence applies to capital located in third States as well.

³³⁰ OECD Commentary: Article 22, paras. 9–14.

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on Benefits” under the treaty.³³¹ There is no similar Article under the OECD or UN Model treaties.

Under US MC Article 22 (1), a resident of a Contracting State is entitled to treaty benefits only to the extent provided in this Article. Article 22 (2) mentions that the following resident persons are entitled to treaty benefits:

- (a) Individuals: An individual resident in a Contracting State is entitled to treaty benefits.
- (b) Qualified governmental entity: A qualified governmental entity is entitled to treaty benefits.
- (c) Publicly-traded company or a subsidiary of a publicly-traded company:

A company qualifies for treaty benefits if all the shares in the class or classes of shares, which represent more than 50% of the voting power and value of the company, are regularly traded on a recognised stock exchange (as defined) in either Contracting State. Lower-tier subsidiaries of such publicly listed companies also qualify if the listed company owns, directly or indirectly, at least 50% of each class of their equity. In the case of indirect ownership, each intermediate owner must be a person entitled to the treaty benefits under this paragraph.

(d) Tax-exempt organisation: A tax-exempt organisation exclusively maintained for a religious, charitable, educational, scientific or similar purpose qualifies for treaty benefits as a resident. There is no requirement for a specified percentage of beneficiaries to be residents of the Contracting States.

(e) Pension fund: A tax-exempt organisation that provides pensions and other benefits to employees is entitled to treaty benefits. More than 50% of the beneficiaries, members or participants must be individuals who are tax residents of either Contracting State.

(f) A person other than an individual: This sub-paragraph provides a general twopart test based on ownership and base erosion for any form of legal entity that is a resident of a Contracting State. A person, other than an individual, is entitled to treaty benefits if it meets the following two requirements:

- (i) Ownership test – At least 50% of each class of shares or other beneficial interests in the person are owned, directly or indirectly, for at least half the number of days in a taxable year, by persons entitled to treaty benefits under subparagraphs (a) to (e) above, and
- (ii) Base erosion test – Less than 50% of the gross income of the person for the taxable year is paid or accrued, directly or indirectly, to nonresidents of either Contracting State (unless the payment is attributable to a permanent establishment in either State) as tax deductible expenses in his State of residence.

The US MC Article 22 (3) provides safe harbour rules for bona fide or genuine business activities of persons, who do not qualify under the US MC Article 22(2). This paragraph gives treaty benefits to a resident of the other Contracting State if he meets the following three requirements for any item of income derived from the other State:

- (i) The resident must be engaged in the active conduct of a trade or business in his State of residence. Investment business is not considered an active trade or business unless the

331 US Model Technical Explanation (1996): Article 22, paras. 281–329.

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activity is banking, insurance or securities business conducted by a bank, an insurance company or a registered securities dealer.

(ii) The income from the other State must be derived in connection with, or be incidental to, that trade or business. Income is incidental if it facilitates the conduct of the trade or business in the other State. The income is connected if the activity in the other State is in a line of business that forms a part of, or is complementary to, the trade or business.

(iii) The trade or business must be substantial (as defined),³³² in relation to the activity in the other State generating the income.

Article 22(4) allows the competent authority of the source State to grant treaty benefits, if a resident of the other Contracting State is not otherwise eligible.

Article 23: Elimination of Double Taxation

OECD MC

Article 23 deals with treaty relief from juridical double taxation where the same income or capital is taxed by more than one State under the treaty.³³³ The Model treaty provides for exclusive taxation in one of the Contracting States under several Articles.³³⁴ This exclusive right to tax is normally given to the State of residence, except in six cases.³³⁵ In other Articles, the taxing rights are not exclusive and are given to both States. Since both Contracting States may tax the same taxpayer on the same income or capital “in accordance with the provisions of the treaty”, relief is needed to avoid the double taxation. As the prior taxing rights remain with the source State, the relief provisions under this Article apply to the State of residence only and not to the State of source.³³⁶

The Article provides for the residence State to elect from two alternative methods, namely (i) the exemption method (Article 23A) and (ii) the credit method (Article 23B). The exemption method looks at the income while the credit method looks at the tax.³³⁷ A Contracting State may use a combination of the two methods. The treaty lets the domestic law and practice decide how each of the two methods should be applied.

The tax exemption is given with progression. The residence State retains the right to include the exempted amount for computing the tax to be imposed on the rest of the income or capital (Article 23A (3) and 23B (2)). The principle of progression applies to income or capital exempted under Article 23, as well as under other Articles in the treaty. As the residence State grants the exemption relief at the average tax rate and not the highest or lowest marginal rate, this relief may exceed or be lower than the actual tax paid in the source State.³³⁸

Under Article 23A, the residence State grants tax exemption with progression to a resident of a Contracting State on all items of income or capital, except dividend and interest income,

³³² The term “substantial” is defined in Article 22 (3) (c).

³³³ OECD Commentary: Article 23, para. 1.

³³⁴ See Chapter 3 (1.3).

³³⁵ Articles 8 (1) and 8 (2), 13 (3) and 22 (3) refer to the place of effective management, while Article 19 (1a) and 19 (2a) grants the taxing rights to the State which makes the payment.

³³⁶ OECD Commentary: Article 23, paras. 7–8.

³³⁷ OECD Commentary: Article 23, para. 17.

³³⁸ R. Doernberg and K. Raad, *The 1996 United States Model Income Tax Convention 1996*, p. 191.

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which may, in accordance with the Convention, be taxed by the other Contracting State. On dividends and interest income under Articles 10 and 11, it provides for ordinary credit relief. Thus, the State of residence tax-exempts other items of income or capital that are taxable in the State of source, irrespective of whether or not they are taxed by the other State under the domestic law.³³⁹

The credit method under Article 23B grants an ordinary credit to a resident of a Contracting State for the foreign taxes paid in the other Contracting State. The Commentary suggests that the credit given should be computed at the average tax rate on the total taxable income in the State of residence.³⁴⁰ The credit is allowed for the income tax only against income tax and for the capital tax only against capital tax. The OECD MC does not provide for indirect credit relief on dividend income (Article 10 (2)).

The residence State is required to give relief for the tax on the income or capital either through the exemption or credit method when the source State taxes an item of income or capital “in accordance with the provisions of the treaty”. However, double taxation (or double non-taxation) may still arise if the two Contracting States apply different treaty provisions on the same income or capital. Such situations could be due to either (a) conflicts of qualification (e.g. tax object) or attribution of income (e.g. tax payer) under their respective domestic laws, or (b) disagreements between the Contracting States on the facts or treaty interpretations. These cases do not normally present problems under the credit relief method since the residence State exercises its taxing rights in full or grants credit relief. However, under the exemption relief method they could lead to double non-taxation if the income has not been taxed by the source State (see Chapter 2(3.6)).

The Commentary Update 2000 has suggested the following approach to avoid double taxation and double non-taxation in such situations. It assumes that the objective of the treaty is not only to avoid double taxation but also to avoid double non-taxation. The new approach is summarised below:

- In the case of qualification or attribution conflicts, the residence State should accept the source State qualification and grant relief under this Article since the tax treatment in the source State is “in accordance with the provisions of the Convention”. If the source State exempts an item of income or capital under its domestic law even when it has the taxing right under the treaty, it has complied with the treaty provisions.

However, double non-taxation could arise due to the interaction of the treaty provisions with the domestic law. For example, when the domestic law in the source State taxes an item of income or taxpayer but the treaty as applied to the domestic classification of income denies it the right to tax. Under the Commentary 2000, the residence State is not obliged to grant the exemption on the presumption that the source State may not have taxed the item of income in accordance with the provisions of the Convention.³⁴¹

- In the case of disagreements between the Contracting States on the facts or on treaty interpretations, the Commentary considers that the above approach based on interpretation of Article 3(2) under the Commentary itself is not workable under the

³³⁹ OECD Commentary: Article 23, para. 34.

³⁴⁰ OECD Commentary: Article 23, m.no. 62; Klaus Vogel, *Double Taxation Conventions*, Article 23, m.no. 166.

³⁴¹ OECD Commentary: Article 23, paras. 32.1–32.7.

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exemption method and requires a change in the treaty itself.³⁴² In case of double taxation, the solution should be found through the mutual agreement procedure provided in Article 25 (3). For double non-taxation situations, the OECD MC Update 2000 has recommended an additional paragraph to this Article to modify partly the exemption method. The new paragraph (Article 23A (4)) mentions that the obligation of the State of residence to give exemption relief under paragraph 1 of Article 23A "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".³⁴³ Therefore, in such cases, the State of residence reserves the right to deny the exemption and tax even if the source State maintains it has granted the treaty benefits in accordance with the provisions of the treaty.³⁴⁴

OECD Observations or Reservations: The Netherlands, Portugal and Switzerland.³⁴⁵

The Netherlands agrees with the new approach in principle but would apply it only if the provisions were included in the treaty text either under a mutual agreement under Article 25 or as unilateral policy. Switzerland reserves its right not to apply it if the qualification conflict arose because of a subsequent change in the domestic law of the source State. Portugal has reserved its position on the new paragraph under Article 23A (4).

Non-OECD Positions: Albania, Argentina, Brazil, China, Ivory Coast, Malaysia, Morocco, South Africa, Thailand, Tunisia and Vietnam.

UN MC

The UN Commentary provides for investment incentives through tax sparing credits as a policy matter. It also gives a detailed description of the Ad Hoc Committee's debate on tax sparing. It mentions that many members from both developed and developing countries felt that sparing credits should be included in treaties between developed and developing countries, where the developed country used the credit method. However, a member from a developed country expressed the view that tax sparing credits were not an appropriate tool for promoting economic development. As a policy matter, countries remain free to adopt these investment incentives.³⁴⁶

US MC

The US MC Article 23 does not include the exemption method. It provides only for the credit method of treaty relief, as given under its domestic law. The US MC Article 23 (1)

³⁴² OECD Commentary: Article 23, paras. 56.1–56.3.

³⁴³ OECD MC: Article 23A para.4.

³⁴⁴ The above provisions introduced in 2000 are still not widely accepted or followed in many countries for several reasons (for country comments, read the general and national reports in 2004 IFA Cahiers Vol. 89A on Double Non-taxation).

³⁴⁵ OECD Commentary: Article 23, paras. 80–82.

³⁴⁶ UN Commentary: Article 23, paras. 1–12; the possible inclusion of a clause on tax sparing credits was discussed at the Ninth Meeting of the Ad Hoc Group of Experts in 1999 but was not included in the UN MC 2001.

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and 23 (2) grant direct credit to a citizen or a resident of a Contracting State for the income tax paid or accrued in the other Contracting State. Moreover, an indirect tax credit is given on dividend income received by a corporate shareholder in a Contracting State, if it owns at least 10% voting shares in a company resident in the other Contracting State. For the purposes of the foreign tax credit under this Article, the taxes listed under Article 2 are considered as income taxes.

US MC Article 23 (3) contains a special ordering rule when a US citizen is a resident in the other Contracting State. Besides the full tax liability in the State of residence, he is also taxable in the United States under US MC Article 1(4), as if the treaty did not exist. Thus, he is taxable in two jurisdictions on his worldwide income. This paragraph provides the rules for relieving the double taxation in the United States under such circumstances.³⁴⁷

Article 24: Non-discrimination

OECD MC

Article 24 ensures non-discrimination for the purposes of taxation of nationals and residents of the other Contracting State. The Article applies to “taxes of every kind and description” and not just taxes covered under Article 2 of the treaty (Article 24(6)). The detailed provisions mention:

(a) Discrimination of nationals:³⁴⁸ Article 24(1) provides for the non-discrimination of legal and natural persons on the grounds of nationality. It applies to taxation and related requirements imposed in a Contracting State on nationals of the other Contracting State. Unlike other treaty Articles, the provision overrides Article 1 and applies to the nationals of the other Contracting State, even if they are nonresidents of one or both States.

The nationals of the other State must be treated for tax purposes on par with the nationals of the Contracting State. Their tax treatment must not be other or more burdensome (i.e. must be the same) than that imposed under the domestic tax law on its own nationals in the same circumstances. The comparable tax treatment includes the basis of tax charge, the method of assessment, the tax rate and the compliance formalities under the domestic law,³⁴⁹ but does not extend to the benefits under the various double tax treaties. The comparison should be based on the tax treatment of a “notional” national to check if there is any discrimination.³⁵⁰ The term “other or more burdensome” refers to both the form and substance of taxation. The taxes levied cannot be unreasonable, irrelevant or arbitrary.³⁵¹ Moreover, the tax discrimination must not be justified by non-tax considerations.³⁵²

Under this paragraph, “in the same circumstances, in particular with respect to residence” implies that persons who are residents of the same State should not be treated differently

347 US Model Technical Explanation (1996): Article 23, paras. 330–341

348 The term “national” is defined in Article 3 (1) (g). It includes an individual who is a national of a Contracting State, and also any legal person, partnership or association deriving its status from the prevailing laws in a Contracting State.

349 OECD Commentary: Article 24, para. 10.

350 Philip Baker, *Double Taxation Conventions and International Tax Law*, p. 388.

351 Brian Arnold and Michael McIntyre, *International Tax Primer*, pp. 113–114.

352 Klaus Vogel, *Double Taxation Conventions*, Article 24, m.no. 37.

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for tax purposes solely due to their nationality.³⁵³ The Article forbids tax discrimination of residents when based on nationality only, but it does not prohibit discrimination against foreigners for other reasons. Nonresident foreigners are not in the same circumstances as resident nationals and foreigners. This paragraph, therefore, does not entitle them to claim the same tax treatment as given to residents of the taxing State. However, it does ensure that they are not treated differently from nonresident nationals of that State.³⁵⁴

Article 24 (2) extends similar tax protection to stateless persons, who are resident in a Contracting State. The term “stateless person” means an individual who is not considered a national by any State under its law.³⁵⁵ A stateless person in either Contracting State can invoke the non-discrimination provision. Unlike a national (who may be nonresident), a stateless person must be a resident in one of the two Contracting States. The Commentary excludes from this paragraph the special tax privileges granted by a State to its own public bodies or services and private institutions that are not-for-profit organisations.³⁵⁶

(b) Discrimination of permanent establishments: Article 24 (3) provides for non-discrimination of a permanent establishment of an enterprise. The permanent establishment that an enterprise of a Contracting State has in the other Contracting State “shall not be” less favourably taxed than an enterprise of the other Contracting State carrying on the same activities. Unlike Article 24 (1), this paragraph prohibits differential taxation, which is more onerous on the permanent establishment. It may, however, be the same or more favourable. There is no requirement that the tax treatment is not “other or more burdensome”, there is no reference to “any (taxation) requirements connected therewith”, and there is no comparison of nationals “in the same circumstances”.

The rule applies regardless of whether the permanent establishment is owned by a company or an individual. It involves a comparison with a domestic enterprise engaged in the same activities and located in the same State as the permanent establishment. The permanent establishment must be on an equal footing for tax purposes as a legally independent enterprise in that State. However, the Contracting State is not obliged to extend any preferential tax treatment, which is given to the residents of that State due to personal circumstances (e.g. personal allowances, reliefs and tax reductions), to the residents in the other State that own the permanent establishment. Moreover, the non-discrimination applies to taxation only (i.e. what must be paid in terms of money) and not to other procedural requirements.³⁵⁷

The Commentary discusses the need for non-discrimination or equal treatment of a permanent establishment in the following six areas:

- assessment of tax;
- special treatment of dividends received by permanent establishment;

³⁵³ OECD Commentary: Article 24, para. 4.

³⁵⁴ *Commissioner of Inland Revenue v United Dominions Trust Ltd* (1973) NZTC 61,028: A New Zealand resident company, which was owned 80% by a UK resident company, paid interest to its parent company. The interest was subject to a higher tax rate applicable to nonresidents. The NZ Court of Appeal held that the different tax treatment was justified due to its residence status.

³⁵⁵ Convention on the Status of Stateless Persons 1954, Article 1(1).

³⁵⁶ Kees van Raad, 1992 Additions to Articles 3(2) and 24 of the 1992 OECD Model and Commentary (Intertax 1992/12) pp. 674-675; OECD Commentary: Article 24, paras. 5–8.

³⁵⁷ Klaus Vogel, Double Taxation Conventions, Article 24, m.no. 121–126.

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- structure and rate of tax;
- withholding tax on dividends, interest and royalties by permanent establishment;
- credit for foreign tax; and
- extension to permanent establishment of the benefit of double tax treaties concluded with third countries.³⁵⁸

(c) Discrimination in expense deductions: Article 24 (4) provides for non-discrimination in expense deductions. Except for the adjustments on transactions between related persons under the treaty,³⁵⁹ an enterprise of a Contracting State is entitled to the same tax-deductible expenses for interest, royalties and other disbursements when the payments are paid to a resident of the other State, as is permitted for payments made to other residents of the same State under the same conditions. The term “other disbursements” is not defined. According to Vogel, it refers to all business payments that are made as consideration for the goods and services received.³⁶⁰

This paragraph protects the enterprise against any domestic legislation that discriminates on the tax deduction of business expenses when they are paid to nonresidents. Therefore, it prohibits any discriminatory tax treatment, which is applied only to nonresident creditors (to the exclusion of resident creditors). The same rule is provided for capital taxation on debts owed by an enterprise of one Contracting State to a resident of the other Contracting State.

(d) Discrimination of foreign ownership or control: Article 24 (5) prevents the tax discrimination of a resident enterprise, whose capital is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State. An enterprise resident in a Contracting State but owned or controlled by nonresidents “shall not” be subject to tax or any connected requirements that are other or more burdensome than a similar enterprise owned or controlled by residents of the taxing State.³⁶¹ Like Article 24(4), this paragraph protects a foreign-owned or foreign-controlled enterprise from tax discrimination in the Contracting State in which it is resident.

The objective is to prohibit tax discrimination due to the foreign capital ownership or control of an enterprise. It must be treated on par with a domestically owned enterprise, which is resident in the same State in similar circumstances. It does not prevent other forms of discrimination unconnected with the ownership or control by foreigners. The provision applies only to the enterprise and not to the persons owning or controlling it. Thus, it does not require the same tax treatment to be applied to foreign capital and domestic capital.³⁶²

The Commentary confirms that the request for additional information and the reversal of the burden of proof in transfer pricing cases does not amount to discrimination under this Article.³⁶³ Moreover, it does not prohibit thin capitalisation rules under the arm’s length principle.³⁶⁴

358 OECD Commentary: Article 24, Paras. 24–54.

359 See Articles 9(1), 11(6) and 12(4).

360 Klaus Vogel, *Double Taxation Conventions*, Article 24, m.no. 148.

361 Klaus Vogel, *Double Taxation Conventions*, Article 24, m.no. 166.

362 OECD Commentary: Article 24, para. 57.

363 OECD Commentary: Article 24, para. 59.

364 OECD Commentary: Article 24, para. 56.

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OECD Observations or Reservations: Australia, Canada, France, Germany, Greece, Ireland, Luxembourg, the Netherlands, New Zealand, Switzerland, the United Kingdom and the United States.³⁶⁵

Non-OECD Positions: Albania, Argentina, Brazil, Bulgaria, Estonia, Malaysia, Morocco, Philippines, Romania, Russia, Thailand, Tunisia, Ukraine and Vietnam.

UN MC

Similar

US MC

The US MC Article 24 includes several variations. For example:

- The Article under US MC does not cover stateless persons.
- As the saving clause of the US MC Article 1(4) does not apply to Article 24, it entitles a US citizen resident in the other Contracting State to claim benefits in the United States under this Article.
- The benefits of Article 24 (1) are given to nationals even if they do not qualify under US MC Article 22 (Limitation on Benefits). Moreover, it is sufficient that the tax imposed on the nationals of the other State is no more burdensome than that applicable to the State's own nationals in the same circumstances.
- As the United States taxes its citizens, whether resident or not, on their worldwide income, the paragraph uses the phrase "particularly with respect to taxation on worldwide income" instead of "in particular with respect to residence". It allows tax reliefs to US citizens, who are nonresident but are taxable on their worldwide income in the United States. These tax benefits do not have to be given to foreign nationals who are nonresident.³⁶⁶
- Article 24 (5) authorises the United States to impose a branch profits tax under US MC Article 10 (8) without violating the non-discrimination Article.

Article 25: Mutual Agreement Procedure

*OECD MC*³⁶⁷

The mutual agreement procedure is "a process of discussion between the competent authorities in which they seek to explore the possibility of a solution to the relevant problem that can be accepted by all concerned".³⁶⁸ As a tax treaty cannot affect the taxpayer adversely or impose additional taxes, the competent authority may, in principle, only give decisions that favour the taxpayer.

Article 25 provides for a mutual agreement procedure between the competent authorities in the Contracting States on treaty matters. It specifically refers to the following issues for

³⁶⁵ OECD Commentary: Article 24, paras. 61–72.

³⁶⁶ R.Doernberg and K.Raad, The 1996 US Model Income Tax Convention, Article 24, p. 204; Klaus Vogel, Double Taxation Conventions, Article 24, m.no. 38

³⁶⁷ The Committee on Fiscal Affairs is currently conducting a project to improve the effectiveness of the tax dispute resolution under this Article. It plans to produce a Manual on Effective Mutual Agreement Procedures (MEMAP). It is also reviewing alternative mechanisms, such as arbitration, expert opinion, mediation, etc. for resolving cross-border tax disputes. The project is expected to be completed by the end of 2006.

³⁶⁸ Committee on Fiscal Affairs: Mutual Agreement Report (OECD 1984) para. 98.

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resolution under this Article:

- Disputes affecting a taxpayer resident in a Contracting State due to taxation which is or is likely to be inconsistent with the treaty provisions (Article 25(1) and 25(2)).
- Difficulties relating to the interpretation or application of the tax treaty (Article 25(3)).
- Elimination of double taxation in cases not provided for in the tax treaty (Article 25(3)).

Article 25 (1) refers to dispute resolution in tax cases involving treaty non-compliance. The provision permits the affected taxpayer to present his case through the competent authority in his country of residence or nationality, irrespective of the remedies provided under the domestic law. The taxpayer is not obliged to exhaust the domestic remedies before commencing the mutual agreement procedure. The taxpayer must apply within three years.

The procedure is available to both tax residents and nonresident nationals of a Contracting State where a person considers that the actions of one or both the Contracting States have resulted, or will result, for him in taxation that is not in accordance with the treaty provisions. The taxation contrary to the treaty could arise due to (i) the incorrect interpretation or application of the treaty; (ii) the incorrect application of the domestic law if the treaty refers to it; or (iii) the incorrect analysis of the facts involved.³⁶⁹ There is no requirement to prove that double taxation has already occurred or will occur. Moreover, the actions, which have caused or may cause the treaty to be contravened, may be either acts of omission or commission.

Under Article 25(2), the competent authority of a Contracting State shall (i.e. is obliged to) try to seek a solution to a treaty dispute initially on its own, but only if it believes that the application is justified.³⁷⁰ If it cannot resolve the matter satisfactorily, it must then try to settle the treaty dispute by mutual agreement with the competent authority of the other Contracting State. Their endeavour should be to avoid or eliminate the tax contrary to the treaty. Although the Commentary suggests that the two authorities should act as quickly as possible, the matter is left with them. They have no obligation to agree and there is no time limit. However, any agreement reached by them can be carried out despite any time limits under the domestic law of the Contracting States.

Under Article 25(3), the competent authorities of the Contracting States are required to make efforts to resolve difficulties or doubts relating to the interpretation or application of a tax treaty, and to consult with each other to eliminate double taxation in situations not covered by the treaty. The Commentary makes the mutual agreement on treaty interpretation or application issues “binding on administrations as long as the competent authorities do not attempt to modify or rescind the mutual agreement”.³⁷¹

Generally, they are binding on the tax authorities to the extent that the treaty, the domestic law or judicial decisions permit them. However, they do not bind the Courts³⁷² and, therefore,

³⁶⁹ Klaus Vogel, *Double Taxation Conventions*, Article 25, m.no. 35.

³⁷⁰ The competent authority can justify its refusal to refer a case to a mutual agreement procedure for a wide range of reasons. (See Philip Baker: *Double Taxation Conventions and International Tax Law*, Article 25, para. 6)

³⁷¹ OECD Commentary: Article 25, para. 36.

³⁷² *IRC v Commerzbank AG* (1991)(UK): in the this case, the Court held that the decisions of a competent authority were not binding under English law.

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the taxpayer.³⁷³ Under the Vienna Convention on the Law of Treaties, they may be considered as subsequent agreement or practice when interpreting the treaty (VCLT Article 31(3)).³⁷⁴ Such an agreement under Article 25(3) can amend the treaty, if it is permitted under the constitutional law.

The Commentary mentions that the competent authorities can use the mutual agreement procedure:

- to complete or clarify the definition where a term has been incompletely or ambiguously defined in a treaty;
- to settle any difficulties that may emerge from a new system of taxation where the domestic laws have been changed by either treaty party; or
- to decide “whether, and if so under what conditions, interest may be treated as dividend under the 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.”³⁷⁵ The Commentary also suggests the use of the mutual agreement procedure in disputes on transfer pricing issues.³⁷⁶

Article 25(4) empowers the competent authorities to communicate, directly or by other appropriate methods (including through a joint commission), to reach an agreement on tax issues. There is only an obligation or duty to negotiate and use the best efforts, but not to achieve a result.³⁷⁷ They are not required to agree, even in cases of double taxation.

There are also additional procedural problems for the taxpayer.³⁷⁸ The decisions under the mutual agreement procedure only involve the two competent authorities. The taxpayer has a right to make representations or to be helped by a counsel, but he has no access to the documents relating to the case and is not entitled to join in the consultation process. There is no specific requirement for the competent authority to publish the results of the procedures. However, the Article does establish a useful process of voluntary negotiation for resolving specific and general problems involving double taxation that could be helpful to the taxpayer.³⁷⁹

The Commentary also contains notes on interaction of the mutual agreement procedure with dispute resolution under the General Agreement on Trade in Services.³⁸⁰

OECD Observations or Reservations: Belgium, Canada, Greece, Ireland, Italy, Mexico, Portugal, Slovak Republic, Spain, Switzerland, Turkey and the United Kingdom.³⁸¹

Non-OECD Positions: Brazil, China, Malaysia, Philippines, Russia, Thailand, Tunisia and Ukraine.

373 Klaus Vogel, *Double Taxation Conventions*, Article 25, m.no. 105.

374 Philip Baker, *Double Taxation Conventions and International Tax Law*, Article 25, para. 18.

375 OECD MC Commentary: Article 25, para. 34.

376 OECD MC Commentary: Article 9, para. 11.

377 OECD Commentary: Article 25, para. 26.

378 Philip Baker, *Double Taxation Conventions and International Tax Law*, Article 25, paras. 27–30.

379 Karl Koch, IFA Cahiers Vol. 66A, General Report, 1981; John F. Avery Jones et al, *The Legal Nature of Mutual Agreement Procedure* (*British Tax Review*, 1979); Arvid Skaar, *The Legal Nature of Mutual Agreements under Tax Treaties* (*Tax Analysts*, December 21, 1992).

380 OECD Commentary: Article 25, paras. 44.1–44.7.

381 OECD Commentary: Article 25, paras. 49–55.

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UN MC

The UN MC Article 25(4) also requires the competent authorities to develop appropriate bilateral procedures, conditions, methods and techniques through consultations to implement the mutual agreement procedure under this Article. They may devise appropriate unilateral means to facilitate these bilateral actions.

The UN Commentary also includes additional guidance under “Other issues” covering (a) information on adjustments, (b) invoking consultation process with competent authority, (c) correlative adjustments, (d) publications of competent authority procedure and determinations, (e) procedures to implement adjustments and (f) unilateral procedures.³⁸²

US MC

The US MC Article 25 provides wider powers to the competent authority of each Contracting State. In particular:

Article 25 (1): There is no time limit (OECD MC: 3 years) for a taxpayer to present his claim for a tax refund to the competent authorities. Moreover, he can present his case to the authority of either Contracting State.

Article 25 (2): Assessment and collection procedures must be suspended during the mutual agreement proceedings.

Article 25 (3): The paragraph provides an illustrative list of tax issues that the competent authorities may take up for resolution under the mutual agreement procedure.

Article 25 (4): The competent authorities may agree to increases in any specific dollar amount referred to in the treaty (e.g. Article 17).

Under US MC Article 1(5)(a), Article 25 is not subject to the saving clause (Article 1(4)) and, therefore, its benefits are available to US citizens and permanent residents. Moreover, as Article 25 applies to persons, and not residents, its benefits are available to residents even if other treaty benefits are denied under Article 22 (Limitation on Benefits).³⁸³

Article 26: Exchange of Information

OECD MC³⁸⁴

Article 26 deals with the international exchange of information between the tax authorities of Contracting States. Since international law does not allow a State to conduct a tax investigation in another State without its consent, this Article empowers both Contracting States to exchange information required under the tax treaties and the domestic tax laws. Its purpose is wider than mere tax compliance; it is also meant to counter tax evasion and avoidance.³⁸⁵ The Article excludes legal and administrative assistance in tax enforcement or in the collection of taxes.³⁸⁶

³⁸² UN Commentary: Article 25, paras. 10–36.

³⁸³ US Model Technical Explanation (1996): Article 25, para. 382.

³⁸⁴ This Article and its Commentary were amended in June 2004. The write-up incorporates some of the major changes and recommendations. According to the 2004 Commentary, these changes are consistent with the 2002 Model Agreement on Exchange of Information in Tax Matters, which was developed by the OECD jointly with a number of non-Member economies committed to the principles of transparency and effective exchange of information (See Chapter 6 (7.1)). The revised Article and the Commentary are included in the OECD MC Update 2005 and its Commentary.

³⁸⁵ Klaus Vogel, *Double Taxation Conventions*, Article 26, m.no. 18.

³⁸⁶ OECD Commentary: Article 26, para. 3 (now covered in Article 27).

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OECD MC Articles 1 and 2 do not restrict the scope of this Article. Thus, the authorities can also exchange tax information on nonresidents (and non-nationals) and even request information on indirect taxes.³⁸⁷

Only the competent authorities of the Contracting States are entitled to information under this Article. A Contracting State cannot apply this provision to obtain such information from within the other Contracting State through other means.

Under Article 26(1), the competent authorities of the two Contracting States shall (i.e. are obliged to) supply each other with the information foreseeably relevant either for carrying out the provisions under the tax treaty or for the administration or enforcement of the domestic laws of both Contracting States concerning the taxes of every kind and description, provided they are not contrary to the treaty provisions. The exchange of information is not restricted by Articles 1 and 2.

The Commentary confirms that foreseeable relevance provides for information to be exchanged to the widest possible extent but fishing expeditions or request for information not relevant to the tax affairs of a taxpayer are not allowed.³⁸⁸ The information may be exchanged on request, automatically (or any combination of them) as a matter of course, or spontaneously if one State believes it might be of interest to the other State. Moreover, the Contracting States may use other techniques such as simultaneous examinations, tax examinations abroad and industry-wide exchange of information.³⁸⁹ The manner of the exchange can be decided mutually by the competent authorities of the Contracting States.

Article 26(2) provides for confidentiality of the information exchanged. The information received must be kept secret on a basis consistent with the domestic laws of the requesting State. The confidentiality rules apply to all kinds of information whether provided in a request or transmitted in response to a request.

The information may only be revealed to persons and authorities (including Courts and administrative bodies), who need to know for the tax assessment, collection, enforcement, prosecution or appeal in relation to the taxes covered by this Article, and to their oversight bodies.³⁹⁰ All such persons or authorities must use the information only for purposes permitted under this Article. The information may, however, be disclosed by them in public Court proceedings or in judicial decisions.³⁹¹

The Commentary provides that the information may also be communicated to the taxpayer, his proxy or to the witnesses.³⁹² There is no obligation to inform the taxpayer. In cases where the requesting State is required to notify the taxpayer under its domestic law of a proposed information exchange, it should inform the treaty partners in writing of this requirement and of its consequences when the treaty is concluded and whenever the rules

³⁸⁷ OECD Commentary: Article 26, paras. 11.1–11.2.

³⁸⁸ OECD Commentary: Article 26, para. 5.

³⁸⁹ OECD Commentary: Article 26, para 9.1.

³⁹⁰ The confidentiality rules in Article 26 have been changed under the 2005 Update to permit disclosure of information to oversight authorities. Oversight authorities are authorities that supervise tax administration and enforcement authorities as part of the general administration of the government of a Contracting State.

³⁹¹ OECD Commentary: Article 26, para. 11–13.

³⁹² OECD Commentary: Article 26, para. 12.

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are modified. Any requirement to notify the taxpayer should not prevent or unduly delay effective exchange of information.³⁹³

Article 26(3) places certain restrictions on the exchange of information, as follows:³⁹⁴

- (a) A Contracting State is not obliged to take administrative measures that go beyond the laws and administrative practice of either its own or the other Contracting State. Therefore, the request for information must comply with the laws and administrative practices of both States. Administrative measures are acts that are generated by the request for information.
- (b) A Contracting State is not obliged to supply information, which is not obtainable under the laws or in the normal course of administration of either its own or the other Contracting State. Normal course of administration implies that either the authorities have the information or they can obtain it through the normal procedure of tax administration, including special investigations or special examinations.

Since a requesting State cannot demand information that is neither permitted nor obtainable in its own country, the Commentary clarifies that a Contracting State cannot take advantage of the information system of the other Contracting State if it is wider than its own. This principle of reciprocity should not be applied where the legal system or administrative practice of only one country provides for a specific procedure, e.g. a ruling regime.³⁹⁵ Unless otherwise agreed, the other Contracting State can assume that the requested information could be obtained by the requesting State in similar situations.³⁹⁶

- (c) There is no obligation to supply any information, which would reveal a trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy.³⁹⁷ The Commentary clarifies that the secrets mentioned should not be defined in too wide a sense, and the requested State “should carefully weigh if the interests of the taxpayer really justify its application”.³⁹⁸ The 2005 Commentary Update adds that the confidentiality rules under Article 26(2) and the domestic laws and practices of the requesting State may provide adequate protection against adverse consequences of such an information exchange. Generally, financial information required for tax purposes is unlikely to require disclosure of sensitive technical information. Where such information might reveal a trade, business or other secret, it can be excised from the documents before the information is exchanged.³⁹⁹

The proposed 2005 Commentary Update also suggests that that the non-disclosure by lawyers of confidential communications under client privilege should be narrowly defined if it hampers effective exchange of information. Such protection does not attach to documents or records held by them to avoid disclosure under the law, and their client communications are only confidential in their legal capacity. Moreover, any information on the identity of a person as a director or beneficial owner of a company is usually not protected as confidential

³⁹³ OECD Commentary: Article 26, paras. 14–15.

³⁹⁴ OECD Commentary: Article 26, para. 14–19.5.

³⁹⁵ OECD Commentary: Article 26, paras. 15–15.1.

³⁹⁶ OECD Commentary: Article 26, para. 18.1.

³⁹⁷ The English law defines trade secret to include a wide range of confidential information including processes, formulae, customer information, plans and drawings.

³⁹⁸ OECD Commentary: Article 26, para. 19.

³⁹⁹ OECD Commentary: Article 26, para. 19.1–19.2.

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information. Finally, any claim by lawyers for client privilege should be based solely on the laws of the Contracting State where it arises.⁴⁰⁰

The proposed 2005 changes also include two new paragraphs under this Article:

(i) Article 26(4): This paragraph prevents “domestic tax interest” requirements from hindering exchange of information. A domestic tax interest requirement refers to laws or practices that would prohibit one treaty partner from obtaining or exchanging requested information unless the other treaty partner had an interest in such information for its own tax purposes. The new paragraph clarifies that Contracting States should obtain and exchange information irrespective of whether they also need the information for their own tax purposes. This obligation is subject to the limitations under Article 26(3) above.

The Commentary mentions that the Contracting States should use their “information gathering measures” even when they are required solely to provide information to the other Contracting State. These measures refer to the laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information.⁴⁰¹

(ii) Article 26(5): This paragraph mentions that the provisions of paragraph 3 cannot be used by a Contracting State to decline the supply of information held by banks, other financial institutions, nominees, agents and fiduciaries or because it relates to ownership interests in a person. According to the Commentary, although this addition merely reflects current practice its inclusion explicitly overrides the use of Article 26 (3) by a Contracting State to deny information on grounds of bank secrecy. Moreover, information held in a fiduciary capacity cannot be withheld under its domestic law as a “professional secret”. The paragraph does not prevent the use of paragraph 3 when the refusal is 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 interest in a person.⁴⁰²

OECD Observations or Reservations: Austria, Belgium, Greece, Japan, Luxembourg and Switzerland.⁴⁰³

Austria, Belgium, Luxembourg and Switzerland have expressed their Reservations on the new paragraph 5 of this Article.

Non-OECD Positions: Brazil, Malaysia, Thailand and Morocco.

UN MC

The Article 26(1) under UN MC differs from the OECD MC in the following respects:⁴⁰⁴

- It mentions that the exchange of information may also help to prevent tax fraud or tax evasion, provided the taxation involved is not contrary to the Convention.
- Like the OECD MC, the exchange of information is not restricted to residents under Article 1 but UN MC is limited to taxes covered under Article 2.

400 OECD Commentary: Article 26, para. 19.3-19.4.

401 OECD Commentary: Article 26, paras. 19.6-19.8.

402 OECD Commentary: Article 26, paras. 19.10-19.15.

403 OECD Commentary: Article 26, paras. 20-26.

404 The UN MC Article 26 does not include the proposed changes under the OECD MC update 2005.

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- The restriction on disclosure of information only to persons or authorities (including courts and administrative bodies) applies only if it is originally regarded as secret by the transmitting State.
- The Article requires that the competent authorities develop appropriate conditions, methods and techniques for the exchange of information on tax compliance and tax avoidance matters through mutual consultations. The UN MC Commentary includes suggested guidelines for carrying out an appropriate exchange of information.⁴⁰⁵
- The exchange of information includes the exchange of documents.⁴⁰⁶

The UN Commentary also includes a suggested outline on “Assistance in Recovery” of taxes for consideration during bilateral negotiations. (Similar to Article 27 introduced under OECD MC Update 2003).

US MC

The US MC Article 26 contains the following significant variations:

Article 26(1): The US MC provides that persons and authorities that are involved in the oversight of various tax functions can also have access to the exchanged information.

Article 26(3): This paragraph specifically grants the competent authority of the requested State the authority “to obtain and provide information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity, or respecting interests in a person, including (an interest through ownership of) bearer shares, regardless of any laws and practices of the requested State” Moreover, if the information is requested by a Contracting State under this Article, the other Contracting State must obtain the information as if it was dealing with its own taxes. It must also provide the documentary evidence, as specifically requested, that can be obtained under its own laws and internal administrative practices on tax matters.

Article 26(4): This paragraph obliges each Contracting State to try to collect the taxes on behalf of the other Contracting State where persons who are not entitled to the benefits enjoy the treaty reliefs. The paragraph does not impose on either Contracting State any obligation contrary to its sovereignty, security or public policy.

Article 26(6): This paragraph obliges the competent authorities of the requested State to allow the representatives of the requesting State to interview individuals and to examine books and records in the other State with the consent of the persons subject to examination.

Article 27: Assistance in the Collection of Taxes

OECD MC

The OECD MC Update 2003 includes an optional Article 27 for Contracting States to provide comprehensive assistance to each other in the collection of taxes. The competent authorities of the two Contracting States can decide the detailed procedures, including documentation, cost-sharing arrangements, time limits, etc. The Contracting States can also agree to restrict the application of this Article.⁴⁰⁷

405 UN Commentary: Article 26, paras. 6–29.

406 UN Commentary: Article 26, para. 5.

407 OECD Commentary: Article 27, paras. 6–9.

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Article 27(1) mentions that the Contracting States shall (i.e. are obliged to) assist in collecting their mutual revenue claims. Article 27(2) defines the term “revenue claim” as “an amount owed in respect of taxes of any kind and description imposed on behalf of a Contracting State or of their political subdivisions or local authorities”. As the assistance is not restricted by Articles 1 and 2, it may include all kind of taxes, as well as related interest, penalties and collection costs, and apply even to nonresidents. The only restriction is that the tax must not be contrary to the tax treaty or any other agreement between the Contracting States and must comply with the laws of both countries.

Article 27(3) covers the conditions under which a competent authority can request for assistance. To qualify the requesting State must have the right to collect the revenue claim and the taxpayer must have no right to prevent such collection under its domestic law. The requested State is obliged to collect the revenue claim as if it was its own claim, provided the request complies with the enforcement and collection laws applicable to its own taxes. Therefore, it will not be possible for the requested State to provide assistance if restricted by its laws. The Commentary provides an alternative wording for the treaty to allow them to collect solely under the domestic law of the requesting State in such cases.⁴⁰⁸

Article 27(4) extends the mutual assistance to safeguard the collection rights when the revenue claims are not enforceable or when the debtor has the right to prevent their collection through conservancy measures (e.g. freezing of assets), if permitted under its laws. These measures guarantee that the assets will still be available when the collection takes place.

Article 27(5) ensures that the time limits under the domestic law of the requested State shall not apply to assistance requests made by the other State, provided they are enforceable in the requesting State. Moreover, the revenue claims of the requesting State shall not have any priority over any claims of the requested State. The priorities to which this rule applies are only those that are specific to unpaid taxes; it would not apply, for instance, to a priority arising from civil law under which an older debt-claim has priority over a newer one.⁴⁰⁹

Under Article 27(6), no legal or administrative action can be brought before the requested State’s courts and administrative bodies in respect of the existence, validity or the amount of a revenue claim of the requesting State.

Article 27(7) mentions that the requesting State must inform the requested State promptly if the revenue claim ceases to qualify under paragraphs 3 and 4 of the Article, and also suspend or withdraw its request at the option of the requested State.

Article 27(8) limits the rights of the requesting State in certain cases. Under this paragraph, the requested State is not obliged:

- To carry out administrative measures against the laws and administrative practices of either Contracting State;
- To carry out measures which would be contrary to public policy (*ordre public*);

⁴⁰⁸ OECD Commentary: Article 27, para. 16.

⁴⁰⁹ OECD Commentary: Article 27, para. 27.

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- To satisfy the request if the requesting State has not pursued all reasonable measures of collection or conservancy under its laws or administrative practices;
- To reject the request for practical considerations where the administrative or financial costs exceed the benefits under the revenue claim.

UN MC

This Article is excluded.

US MC

This Article is excluded.

Article 28: Members of Diplomatic Missions and Consular Posts

OECD MC

The OECD MC does not take precedence over or affect the tax privileges granted to the members of diplomatic missions and consulates. Article 27 ensures that they receive under the tax treaty “no less favourable treatment than that to which they are entitled under international law or under special international agreements”.⁴¹⁰ Many OECD countries provide under their domestic law that diplomats retain their tax residence at home when posted overseas. The Commentary suggests that provisions be bilaterally negotiated to avoid any unintended tax reliefs in the sending State.

The members of a diplomatic mission under the Vienna Convention on Diplomatic Relations are the members of the diplomatic staff and other personnel of the mission. Diplomatic agents and their families are generally exempt from tax in the receiving State, with certain exceptions. Consular agents and other mission staff are only tax-exempt provided they are neither nationals nor permanent residents. The term “permanent resident” includes all locally employed members of the staff. The honorary consular officers are normally entitled to tax exemption for reimbursement of expenses only.⁴¹¹

Article 28 does not independently provide any tax benefits to diplomatic agents and consular officers but it ensures that in the case of a conflict, the tax rules under the international law or other agreements prevail. The treaty provisions apply to income not protected under the international law or agreements.

UN MC (Article 27)

Similar

US MC (Article 27)⁴¹²

Similar

⁴¹⁰ Similar rule applies to tax privileges under international law given to certain international organisations (e.g. United Nations) and their personnel.

⁴¹¹ OECD Commentary: Article 28, para. 5; Klaus Vogel, *Double Taxation Conventions*, Article 27, m.no. 11–20.

⁴¹² The Article is titled “Diplomatic Agents and Consular Officers”.

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Article 29: Territorial Extension⁴¹³

OECD MC

This Article is used by countries with overseas territories or with responsibility for the international relations of other territories or States. It permits a Contracting State to extend the negotiated treaty, in full or in part, at any time through necessary constitutional steps to its overseas territories. Under Article 29(1), a tax treaty may be extended to overseas territories or other States provided its taxes are substantially similar in character to those to which the treaty applies. These taxes may be imposed by the other territory or State or by the Contracting State itself.⁴¹⁴ If included under this Article, the termination of the treaty under Article 30 also applies to such territories or States (Article 29(2)).

Non-OECD Positions: China and Thailand.

UN MC

This Article is excluded.

US MC

This Article is excluded.

Article 30: Entry into Force

OECD MC

This Article mentions that the two Contracting States must ratify the treaty according to their respective constitutional laws. The treaty comes into force when they exchange the instruments of ratification. It also specifies the dates when the various provisions under the treaty become effective in each State. A treaty provision may apply retrospectively and the dates may vary with the type of tax and how it is applied. A renegotiated treaty may give details of when the previous treaty will be cancelled, and provide for transitional provisions.

UN MC (Article 28)

Similar

US MC (Article 28)

US MC Article 28(1) only requires notification by each Contracting State that the ratification procedures have been complied with. Under The US MC Article 28(2), the treaty enters into force on the date when the later of the two notifications is received. The treaty provisions take effect as follows:

- withholding taxes – the first day of the second month following the date when the treaty comes into force.
- other taxes – the first taxable year beginning on or after January 1 following the date when the treaty comes into force.

⁴¹³ This Article does not exist in the UN and US Model Conventions.

⁴¹⁴ Klaus Vogel, *Double Taxation Conventions*, Article 28, m.no. 6.

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Article 31: Termination

OECD MC

Article 31 grants each Contracting State the option to cancel the treaty after a certain year (as specified) by giving a notice of termination through the diplomatic channels at least six months before the end of a calendar year. This Article suggests that it should be provided when the treaty provisions would cease to have effect in each State.

UN MC(Article 29)

Similar

US MC (Article 29)

Under the US MC Article 29, the termination notice can be given at any time by either Contracting State. The Article specifies the dates on which the treaty provisions cease to have effect, as follows:

- withholding taxes – six months after the date when the notice was given.
- other taxes – the taxable periods beginning after the expiry of the six-month period from the date of the notice.

5. BILATERAL TAX TREATIES

Nearly all tax treaties are bilaterally negotiated arrangements,⁴¹⁵ based on the relative bargaining strengths and peculiarities of the domestic tax systems in each Contracting State and the underlying economic relationships.⁴¹⁶ Therefore, despite the common internationally accepted Models, tax treaties vary widely due to modifications agreed by the Contracting States. Unlike the negotiated tax treaties, the MC and its Commentaries are not legally binding.

The negotiated tax treaties usually make little or no variation in the wording of certain Articles, such as Article 1 (personal scope), Article 6 (immovable property income), Article 9 (adjustment of transfer prices), Article 16 (directors' fees), Article 21 (other income) and Article 28 (diplomats, etc.). Other Articles often contain local variations in detail but not substance. They include Article 2 (taxes covered), Article 3 (definitions), Article 23 (elimination of double taxation) and Article 30 and 31 (commencement and termination). The Article that often varies significantly from the Model is Article 12 (royalties). Article 22 (capital) and Article 29 (territorial extension) are frequently omitted.⁴¹⁷

⁴¹⁵ See Chapter 2(6) for a review of selected multilateral treaties.

⁴¹⁶ Philip Baker, *Double Taxation Agreements and International Tax Law*, pp. 5–12.

⁴¹⁷ John S Phillips, *International Tax Treaty Networks – Introduction to the OECD Model* (E.S.C. International Limited, 1995) p. 13.

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CHAPTER 4

IMPACT OF DOMESTIC TAX SYSTEMS

Note: The purpose of this chapter is to review some of the key principles of domestic tax systems that affect international taxation of companies. It is based on secondary data sources and is not a detailed or comprehensive description. With constantly changing tax laws and practices, it is not possible to guarantee the accuracy of the data.

1. INTRODUCTION

1.1. General

As early as 1776, Adam Smith prescribed the four principles of taxation in his book on the “Wealth of Nations” as follows:

- (a) Equity: the tax payable should accord with the ability to pay, or the taxable capacity.
- (b) Certainty: the taxpayer should know exactly what is being taxed, how much he has to pay, and how and when he has to pay it. The law should be clear and unambiguous and the interpretation of it should be readily available.
- (c) Convenience: the tax should be payable in a manner and at a time convenient to the taxpayer.
- (d) Economy: the enforcement and collection costs should be reasonable and proportionate to the receipts.

Within these fundamental canons of taxation, the domestic tax systems in different countries vary widely to suit their economic, social and political needs. Under these systems, the tax laws and practices define the taxpayer, decide the tax scope, set the tax rate and determine the tax base. They provide answers to questions like:

- What taxing powers exist under the domestic law? Who is liable to tax? What income is taxable or tax-exempt? What are the applicable tax rates? When is the entity tax resident or non-resident under the domestic tax rules? What are the special tax rules affecting nonresidents or foreigners?
- How should the taxable income be computed? What are the rules for revenue recognition? What expenses are deductible? What expenses are disallowed? What incentives and allowances or exemptions are available? What accounting policies are acceptable for tax purposes? What exchange gains and losses are allowed for tax purposes?
- How are the tax losses treated? How long can they be carried forward? Can they be carried back? Is there a provision for tax consolidation? Are there separate rules for capital transactions? Can the losses be transferred on acquisitions or mergers?

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- What are the tax compliance and withholding requirements? When is the tax payable? Can the tax be deferred? Do the tax authorities give advance rulings on a pre or post transaction basis? How is tax compliance enforced?
- How is double tax relieved unilaterally under domestic law? How are the relief provisions under the domestic law and tax treaties applied? What are the rules for computing foreign tax credits?
- How does the tax treaty modify the domestic tax law? Does the treaty override domestic law? Are the benefits under the domestic law more beneficial than the treaty benefits? How does domestic law assist in treaty interpretation?

Thus, the role of the domestic tax system in a country is very wide. It governs all matters regarding how and in whose hands an item of income is taxed. The tax treaties can only limit its scope. They cannot expand it. Domestic law alone decides the connecting factors, namely: Who can be taxed? Or “Tax subject”.

What can each tax? Or “Tax object”.

The study of international taxation, therefore, requires the knowledge of domestic tax laws of more than one country as well as how they are applied in each country.

1.2. Connecting Factors

A State can only tax a person who has some connection with that country under its domestic law. Without this connection, a tax jurisdiction cannot exercise its taxing rights.¹ In addition, there must be some connection between the tax jurisdiction and (a) a taxable person (“tax subject”) and (b) a taxable event (“tax object”) for a tax liability to arise. There can be no tax due on a tax object unless there is a tax subject who is liable to pay the tax. Moreover, a person may be liable to tax but would pay no taxes unless there is a tax object, i.e. taxable income.

Generally, the tax laws impose a tax on tax subjects or persons (natural or legal) under the “charging provision”. However, it is not imposed on all persons, but only on persons who have taxable objects or income for the relevant tax period. Some countries levy the tax on tax objects or taxable income of persons. In such cases, the domestic law has an additional provision that requires a tax subject to pay the tax.²

The connecting factors are generally based on residence, nationality or the domicile of the taxpayer for the tax subject, and on the source rules over the income or gain for the tax object. Other factors that can create a connecting factor include the situs of the transaction or asset, the nature of the transaction or business operation, or the character of the payment.

1.3. Resident v Nonresident

There are two main categories of tax subjects:

- Residents: they are taxable on their worldwide income (“unlimited or full liability”); and
- Nonresidents: they are only taxable on the income and gains within the country (“limited liability”).

¹ See Chapter 2(1.3).

² Lee Burns and Richard Krever, *Individual Income Tax (Tax Law Design and Drafting, 2000)* p. 500.

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Normally, countries tax both residents and nonresidents on the domestic-source income derived from their tax jurisdiction. Tax residence rules extend the taxation of residents to foreign-source income (“residence based taxation”). As an exception, certain countries follow the territorial tax regime and do not tax the foreign-source income of residents. In such countries, the tax residence becomes largely irrelevant, except for treaty purposes.

A tax resident is defined under the domestic tax rules. By definition, a person who is not a tax resident under the domestic law is a nonresident. A nonresident normally pays tax on the income (actual or deemed) derived from that country only. His tax liability is limited to tax on the income derived, arising or accruing from domestic sources (“source based taxation”).

Nonresidents may also be treated differently from residents in other respects.³ For example:

(i) They may be taxed on a different basis from residents, e.g. higher or lower tax rate or base, no personal allowances or rebates, final fixed or flat tax, deemed profit basis, etc.

(ii) They may be required to pay additional taxes compared to a resident in the same circumstances, e.g. branch profits tax.

(iii) They may be exempt from taxes that residents would pay, e.g. no tax on certain interest or portfolio investments.

They may be subject to more rigorous tax withholding and compliance rules due to the practical difficulties in enforcing the tax laws on them.

(v) Since tax treaties only apply to residents of a Contracting State, they cannot claim treaty benefits.

In some countries, nonresidents are also taxed on foreign-source income remitted or received by them (Examples: Bangladesh, India, Israel, Jamaica, Malta, Singapore and Trinidad and Tobago). There are also a few jurisdictions that treat a nonresident branch registered or operating in their country as a resident entity and tax it on its worldwide income (Examples: Argentina, Bulgaria, Ghana, Hungary, Mexico, Sri Lanka, Thailand, Taiwan, Tunisia, Ukraine).

Thus, the residence status is critical for tax purposes. Besides the scope of taxation, it usually affects the tax allowances and deductions, and subjects the taxpayer to special tax compliance rules. Moreover, only a person, who is a tax resident of a Contracting State, qualifies for treaty benefits.

1.4. Full v Limited Taxation

The reason given for residence as a basis for worldwide tax is that a person is expected to contribute for the privilege and the protection that the country of residence provides him. A few countries also tax the worldwide income of their citizens, regardless of their tax residence. In their case, the diplomatic protection and the privileges that are provided by the

³ J.S. Phillips and M.H. Collins, IFA Cahiers Vol. 70A, General Report, 1985, pp. 52–55.

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country of citizenship are the reasons for taxing them. (Examples: Ecuador, South Korea, Liberia, the United States).

There are exceptions to the worldwide taxation of residents, such as:

(a) Nil tax regime

There are several countries, which do not impose direct taxes on income. For example:

Personal tax: Andorra, Anguilla, Antigua and Barbuda, Bahamas, Bahrain, Bermuda, Brunei, Cayman Islands, Cook Islands, French Polynesia, Kuwait, Maldives, Monaco, Nauru, Nevis, Oman, Paraguay, Qatar, Saudi Arabia, Seychelles, Turks and Caicos Islands, St Kitts and Nevis, the United Arab Emirates, Uruguay (except agricultural income), Vanuatu.

Corporate tax: Anguilla, Bahamas, Bahrain (except oil companies), Bermuda, Cayman Islands, Kuwait (local owned), Maldives (except bank profits), Nauru, Nevis, Qatar (local owned), Saudi Arabia (local owned), Turks & Caicos Islands, the United Arab Emirates (except oil and gas companies and foreign banks), Vanuatu.

(b) Territorial regime

(i) Full territoriality: The countries, which follow the full territorial tax regime, tax their residents only on the taxable objects sourced or deemed sourced in their jurisdiction. Country examples include:

Personal tax: Bolivia, Botswana, Cambodia, Costa Rica, Djibouti, Dominican Republic, Ecuador (non-nationals), El Salvador, Ghana, Guatemala, Guyana (earned income) Hong Kong, Iran (non-nationals), Jordan, Lebanon, Lesotho, Macau, Malawi, Malaysia, Mauritius, Mozambique, Namibia, Nicaragua, Panama, Philippines (non-nationals), Singapore, Swaziland, Taiwan, Thailand, Zambia, Zimbabwe.

Corporate tax: Albania, Brunei, Bolivia, Botswana, Cambodia, Cameroon, Congo, Costa Rica, Dominican Republic, Djibouti, El Salvador, France, Gabon, Guatemala, Guinea, Hong Kong, Ivory Coast, Jordan, Kenya, Malawi, Lebanon, Lesotho, Libya, Macau, Malaysia, Monaco, Morocco, Mozambique, Namibia, Nicaragua, Oman, Panama, Paraguay, Qatar, Senegal, Seychelles, Singapore, South Africa (pre 2001), Swaziland, Uruguay, Zimbabwe.

(ii) Partial territoriality: Some countries apply a partial territorial tax regime on individuals, who are resident but not ordinarily resident. They may not be taxed on all or certain foreign-source income, unless they are ordinarily resident. Ordinary residence denotes residence in a place with some degree of continuity and permanence due to a social or economic attachment. It is defined as “a man’s abode in a particular place or country as part of the regular order of his life for the time being (whether short or long) adopted voluntarily or for a settled purpose”.⁴

⁴ *Levene v CIR* (1928) 13 TC 486 (UK).

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Examples: British Virgin Islands, Cyprus, Guernsey, Guyana (unearned income), India, Japan (non-permanent resident), Jersey, Lesotho, Malta, St Lucia, the United Kingdom, Zimbabwe.

(c) Received or remittance regime

(i) Some countries that follow the full territorial regime also tax certain or all the foreign-source income that is received by, or remitted to, residents.

Examples: Ghana, Guyana (earned income), Lesotho, Malaysia, Mauritius, Singapore, Thailand, Zambia.

(ii) Resident and ordinarily resident individuals, who are not domiciled under common law in certain countries, are taxed on their foreign-source income on a received or remittance basis.

Examples: Barbados, British Virgin Islands, Cyprus, Guyana, Ireland, Malta, Trinidad and Tobago, the United Kingdom.

Some countries make a distinction between received and remitted income. The term “receipt” implies “to take possession of”, while “remitted” requires a transfer of the foreign income. As a person can only receive the income once, the place of first receipt applies. Once the income is received then it moves merely as a transfer of money or remittance. Thus, an overseas receipt is a remittance when it is transferred to a domestic bank account from an overseas account of the taxpayer.⁵ A remittance may be actual or constructive if the foreign funds are used to meet the liabilities incurred in the country of residence.

2. TAX RESIDENCE OR FISCAL DOMICILE

2.1. General

The residence rules are either given in the domestic tax law, or defined by practice, or by court decisions. Since each country has its own rules, the tax residence rules may conflict. As a result, a person could be “dual resident” and, therefore, taxable in two or more countries on the same income under the respective domestic laws. Alternatively, it is possible for a person not to be resident in any tax jurisdiction, if he does not fulfil the essential residence requirements. He may then be taxable under the “source based taxation” rules only on the income that he derives from each country.

Separate residence rules usually apply to natural persons (e.g. individuals) and legal persons (e.g. companies).

2.2. Residence of Individuals

2.2.1. General

The tax residence of individuals is normally decided on factors that can be determined by external observation. Generally, it is based either on (a) the “physical presence” in the

⁵ *Saiyid Ali v Crown* ITC 402 (India); *Keshav Mills v CIT* 23 ITR 230 (India).

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country or (b) the “facts and circumstances” that prove residence in a country. Unlike the former test, which is objective and relatively easy to apply, “facts and circumstances”, such as a permanent home, habitual abode, life style, etc., tend to be more subjective. More than one residence test is applied in several jurisdictions.

(a) Physical presence test

The decisive factor is the physical presence for more than a specified number of days (generally 183 days or six months) in the fiscal year, or a 12-month period, or over a period of preceding years. The 1992 OECD Report noted variations in the practices followed by its members.⁶ Many countries use the actual “days of physical presence” method. Some of them prefer the “duration of activity” method or the period of the activity (Examples: France, Germany, Greece, Italy, Luxembourg, Netherlands, Spain).

Moreover, what is defined under the domestic law as a day’s presence varies widely. For example, several countries include part of the day as a day in the calculation; some require presence at midnight (Example: Ireland); some of them even use an hourly basis.⁷ Therefore, the period may be computed on the aggregation of part-stays in a day, or even a minute’s stay may count as a full day.

Wide differences exist on the treatment of holidays and vacations, the stays abroad during periods of sickness and short breaks, transit stops, etc. For example, the United States excludes the time spent in the country while in transit, if it is less than 24 hours, when travelling between two points outside the States. Some countries (Examples: Austria, Ireland, the United Kingdom) exclude the days of arrival and departure, while others (Example: the United States) include both days. Days of arrival are not taken into account but days of departure are when calculating an individual’s residency status in Russia.

While some countries use the period of physical presence as the sole test, many countries apply it as one of the factors to decide on tax residence. There are also countries that do not use this test. For example:

- The period of physical presence is the decisive factor for tax residence.
Examples: Azerbaijan, Bangladesh, Barbados, Bolivia, Botswana, British Virgin Islands, Colombia, Cyprus, Dominican Republic, Ecuador, El Salvador, Guam, Guernsey, Honduras, India, Isle of Man, Kazakhstan, Malaysia, Mauritius, Pakistan, Russia, Singapore, Solomon Islands, Sri Lanka, Sweden, Thailand, Trinidad and Tobago, Ukraine, Venezuela, Vietnam, Yemen.
- The physical presence is only one of the criteria for tax residence.
Examples: Antigua, Argentina, Australia, Austria, Bulgaria, Canada, Chile, China, Congo, Costa Rica, Croatia, Czech Republic, Denmark, Egypt, Estonia, Faroes Islands, Fiji, Finland, Germany, Ghana, Gibraltar, Greece, Guyana, Hungary, Indonesia, Iran, Ireland, Israel, Jamaica, Japan, Jersey, Kenya, Korea, Laos, Latvia, Lithuania, Malta, Mexico, Morocco, Mozambique, New Caledonia, New Zealand, Nigeria, Norway, Papua, Peru,

⁶ Committee on Fiscal Affairs: 183 Day Rule (OECD, 1992).

⁷ US counts a part of a day as a day of presence. UK allows fractions of a day under the legal decision in *CIR v Wilkie* (1951), 32 TC 495 (UK).

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Philippines, Poland, Portugal, Puerto Rico, Romania, St Lucia, Senegal, Slovak Republic, South Africa, Spain, Switzerland, Taiwan, Tanzania, Tunisia, Turkey, Uganda, the United Kingdom, the United States, Uzbekistan, Zambia, Zimbabwe.

- The physical stay does not affect the tax residence.
Examples: Belgium, Brazil, Cameroon, France, Gabon, Guatemala, Italy, Ivory Coast, Liechtenstein, Luxembourg, Mexico, Netherlands, Netherlands Antilles, Slovenia.

(b) Facts and circumstances test

The facts and circumstances of the stay in a country are often used to determine the tax residence of individuals. They include considerations such as the centre of vital interests, family ties, retention of a house or availability of living accommodation, residence of the family, etc. These rules vary widely.⁸ Under this test, the tax authorities examine a variety of factors, such as:

- Residence or home available: Residence implies a permanent dwelling place. Residence or home available refers to any property that the taxpayer has for his effective use in a permanent way. The intention to stay is not relevant. This “home test” may include holiday apartments but not hotel rooms unless they are rented permanently. Examples: Austria, Barbados, Cameroon, Congo, Croatia, Gabon, Guernsey, Guinea, Germany, Hungary, Iran, Isle of Man, Israel, Italy, Ivory Coast, Jamaica, Jersey, Kenya, South Korea, Mexico, Morocco, New Zealand, Norway, Portugal, Slovenia, Tanzania, Uganda.
- Economic, social or family ties (“centre of vital interests”): this test is subjective and determines the residence from the taxpayer’s way of life and his family, social, political and cultural links with a country. It is broader than just the place where he resides or stays for any period, or has a home. In some countries, the “centre of family interests” is the location of the family home or the place where the person and his family normally live. Examples: Argentina, Australia, Belgium, Bulgaria, Cameroon, Canada, Chile, France, Greece, Israel, Italy, Japan, Luxembourg, Morocco, Netherlands Antilles, New Caledonia, New Zealand, Puerto Rico, Spain, Suriname, Switzerland, Zimbabwe.
- Permanent or principal residence, or habitual, usual or customary place of abode: this test usually refers to the country where an individual physically stays or normally lives. Habitual abode is more than the place where an individual “stays more frequently” within a short time period, say a tax year.⁹ The term “permanent”, “principal”, “habitual”, “normal”, “usual”, or “customary” would suggest that the individual resides there on a non-temporary basis or is ordinarily resident. Examples: Australia, Austria, Belgium, Botswana, Cambodia, Cameroon, Chile, China, Congo, Czech Republic, Denmark, Estonia, Fiji, Finland, France, Germany, Ghana, Gibraltar, Guyana, Hungary, Israel, Italy, Ivory Coast, Japan, Kenya, Latvia, Liechtenstein, Luxembourg, Malta, New Zealand,

⁸ Examples: economic and social links (Netherlands), a home or habitual place of residence (Germany), home or principal place of residence (France), habitual residence (Portugal), main residence (Belgium), normal abode (Luxembourg), centre of living (Japan), family and social ties (Canada), regular visits (Netherlands), expected period of stay or type of employment (the United Kingdom).

⁹ Klaus Vogel, Double Taxation Conventions, Article 4, m.no. 78.

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- Papua, Philippines, Poland, Portugal, Romania, Senegal, Singapore, Slovak Republic, South Africa, Taiwan, Tanzania, Turkey, the United Kingdom.
- Intention to reside permanently: the intention to reside permanently, or not on a temporary basis, is used by several countries. Examples: Barbados, Chile, Ghana, Greece, Guyana, Indonesia, Ireland, Japan, Luxembourg, Norway, Philippines, Singapore, Turkey, the United Kingdom, Zambia, Zimbabwe.
 - Official registration: some countries regard persons whose names are in their population registers (e.g. for voting purposes) as tax residents. Examples: Belgium, Italy, Netherlands.
 - Nationality: the citizenship can affect the residence status in certain circumstances. Examples: Argentina, Botswana, Bolivia, Brazil, Bulgaria, Chile, Ecuador, Iran, Latvia, Liberia, Lesotho, Nigeria, Panama, Peru, Philippines, South Korea, the United States.
 - Immigration status: the immigration or residence visa can influence the residence status. The visa status may reflect the intention to reside permanently in a country. Examples: Australia, Brazil, British Virgin Islands, Canada, Israel, the United States.

2.2.2. Country Examples

Australia

A person is a resident if (i) he resides in Australia within the ordinary meaning of the word (“residence test”), or (ii) he is domiciled under the common law in Australia and does not have a permanent place of abode outside Australia, or (iii) he stays in Australia for more than 182 days in a tax year (subject to the exception when his usual place of abode is outside Australia and he has no intention of becoming an Australian resident), or (iv) he is a member, or an eligible employee or a spouse or a minor child of a member of a qualified superannuation scheme.

The residence test considers factors like physical presence, citizenship or nationality, economic and personal ties, and the maintenance of an abode in another country. It is difficult for an individual to demonstrate that they are no longer a resident of Australia if they retain ties in Australia. This is particularly the case for those working abroad for shorter contracts, where it is not clear that a home has been established in the foreign country.

Individuals, who intend to stay for over two years or as immigrants in Australia, are considered as Australian tax residents.

Belgium

An individual is a tax resident if he is (i) domiciled in Belgium or (ii) has his centre of economic interests in Belgium. Unless otherwise evidenced, an individual is deemed to be domiciled and have his centre of economic interests in Belgium when he is registered in the national civil register. The centre of economic interests is the place from which a person plans and manages his investments and assets or derives most of his income, irrespective of where the assets are situated. For tax purposes, the domicile is, according to the case law, the place where an individual continuously and effectively resides, where his household is located and where he has his centre of vital interests. Married taxpayers are deemed to

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have their tax residence where their household is located, i.e. the family home and centre of family life.

Brazil

A citizen is deemed to be a tax resident unless he leaves the country on a permanent basis. The tax residence for foreigners is based on the type of visa. Besides a tourist visa, a visa can be a temporary (two years) or a permanent visa. A foreigner is considered a tax resident from the date of arrival if he enters the country on a temporary or permanent visa. However, a temporary visa holder, who is not under a labour contract with a Brazilian company, is considered as a resident only if he remains in Brazil for more than 183 days during a 12-month period. A permanent visa is required for a foreigner to hold a managerial position or directorship in a Brazilian company.

Canada

There is no statutory definition of a tax resident for an individual. An individual may be resident, part-year resident or nonresident. An individual is deemed resident for the whole year if he “sojourns” or stays temporarily in Canada for at least 183 days in a calendar year. Residence may also be based on facts and circumstances. The tax authorities (the “Canada Revenue Agency”) consider an individual as a tax resident if Canada is the place where he regularly, normally, or customarily lives in the settled routine of his life. The Agency takes into consideration his links or nexus with Canada, such as family members and dependants in Canada, the dwelling place, social and economic ties, home available for use, ownership of property, immigration status, intention to return to Canada, etc. To be nonresident, an individual must sever his ties in Canada and establish residential ties in another country. Canada imposes a departure tax on persons ceasing to be residents of Canada.

China

The residence of individuals depends on their domicile and habitual abode in China. Individuals resident in China for more than one year are generally taxed on their worldwide income. However, if the stay is intended to be less than five years, individuals may get special approval to pay tax on a limited category of non-Chinese sourced income. If their stay is less than one year, they are only taxed on their Chinese-source income as nonresidents. In calculating the one-year, temporary absences of less than 30 days at a time or up to 90 days in total are not excluded.

Denmark

An individual is resident if he either resides habitually in Denmark or stays six months or more continuously (ignoring short stays abroad) in the country.

Finland

An individual is resident in Finland if he has a permanent home in Finland or stays in Finland continuously (excluding short breaks) for six months. After emigration, a Finnish citizen

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remains a tax resident for three years unless he can prove that he has broken all essential ties with the country (3-year rule).

France

An individual is a tax resident in France if (i) his home or principal abode is in France, or (ii) he is engaged in a professional activity in France (unless it is ancillary to foreign-source activities), or (iii) the centre of his economic interests is in France, or (iv) his stay in France exceeds 183 days in a calendar year. The home is defined as the habitual residence where his family usually lives, even if he is abroad for long periods during the year. The abode test is based on the length of the physical presence in France. The professional activities may be carried on either as a self-employed person with a fixed base or as an employed individual. The economic interests test involves the place where the individual owns assets or receives investment income to support his lifestyle, or derives most of his income, or manages his work.¹⁰

Germany

An individual is a tax resident if he has a domicile or habitual place of abode in Germany. An individual has a domicile if he has permanent accommodation available (i.e. at his disposal) in Germany. Habitual abode is presumed when the physical stay exceeds six months (short absences are ignored) continuously in a calendar year or over two calendar years. A nonresident individual may elect to be taxed as a resident if at least 90% of his worldwide income is taxable in Germany, or if his income, not subject to German taxation, does not exceed EUR 6,136.

India

In India, the residence rules are codified in the domestic law. A person is a resident only if he is physically present for 182 days or more in a tax year, or has stayed for at least 60 days¹¹ in the present tax year and 365 days or more in the previous four years. An individual who is resident and ordinarily resident is taxed on his worldwide income. A person is not ordinarily resident if he is nonresident for nine out of the ten previous tax years and the physical stay in India within the past seven fiscal years totals 730 days or more. If a resident is not ordinarily resident, he only pays Indian taxes on domestic-source income, and on foreign source income received in India.

Ireland

To be a resident, an individual must (a) spend either (i) 183 days or more in a tax year in Ireland, or (ii) 280 days or more over two consecutive tax years and spend more than 30 days in each year in Ireland, or (b) elect to become a tax resident for the tax year in which he comes to Ireland with the intention to reside permanently. An individual is treated as

¹⁰ Philippe Juillard: Towards a New Definition of Tax Residence in France (IBFD Bulletin, April 1996); Oliver Delattre: The Tax Residence of Individuals in France (European Taxation, 1999 No. 6).

¹¹ This period is extended to 182 days for persons of Indian origin living abroad.

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resident for the full tax year in the year of arrival or departure. A day counts for residence purposes only if the person is present in Ireland at midnight.¹² An individual must be a resident for three successive years to become ordinarily resident in year four. He ceases to be ordinarily resident if he is not resident for three consecutive years.¹³

Israel¹⁴

An individual is resident if his “centre of life” is in Israel. The centre of life includes the permanent home of the individual, the actual place of abode, the place of his occupation or permanent employment, the location of “active and material financial interests” and the place of associations and organisations of which the taxpayer is an active member. The mere passive ownership of financial investments or an inactive membership of an organisation is not adequate. It is presumed that an individual is resident if he stays at least 183 days in Israel or spends 30 days or more in Israel during the tax year and 425 days or more during the current and previous two tax years.

Immigrants and returning residents are tax-exempt on their foreign source income for five years after becoming a resident. They are also exempt from capital gains tax for ten years on the sale of assets owned prior to their immigration. The period is three years for returning residents. An exit tax is applicable on emigration.

Italy

An individual is a tax resident if he (i) is registered in the Italian population records for more than half the tax year, or (ii) has his centre of personal and economic interests in Italy, or (iii) has his habitual abode in Italy. Italians emigrating to low or nil tax jurisdictions remain tax residents unless they can show that they are not resident in Italy.

Japan

A resident person is either a permanent or a non-permanent resident depending on his domicile, the intention to reside permanently in Japan, or the period of his stay. The domicile is defined as the place in which a person has the base and centre of his life. A person, who is domiciled in Japan or has stayed continuously in Japan for more than five years, is a permanent resident. A person, who is non-domiciled in Japan and has no intention to reside permanently, is treated as a non-permanent resident. A nonresident is an individual who has not established a domicile in Japan and has resided in Japan for less than one year.¹⁵

¹² *Cesena Sulphur Co. v Nicholson* 1 TC 88, 103 (1876) (UK): An individual is present “where he sleeps and lives.”

¹³ Resident, ordinarily resident and domiciled (common law) individuals are taxed on their worldwide income. If resident but not domiciled, they pay tax on domestic-source income and remittances of foreign-source income only. Nonresident individuals who are ordinarily resident pay tax on worldwide income other than from employment, trade or profession exercised wholly outside Ireland. Nonresidents who are neither ordinarily resident nor domiciled pay tax on domestic-source employment only if their remuneration is paid in Ireland.

¹⁴ As from 2003, Israeli residents are taxed on a worldwide basis (previously territorial basis). Nonresidents are taxed on their Israeli source income only; no tax is levied on their foreign income received in Israel.

¹⁵ Permanent residents pay tax on their worldwide income. Nonresidents are taxed on Japanese source income only. A non-permanent resident is taxed on Japanese source income and on foreign-source income paid in, or remitted to, Japan. A foreigner on a short assignment up to a year in Japan is usually considered a non-permanent resident (not nonresident).

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Luxembourg

An individual is tax resident if his domicile or customary place of residence is in Luxembourg. A place of domicile is the place where a person has accommodation that he intends to retain and use on a non-temporary basis. Customary place of abode exists if he is present in Luxembourg for at least six months.

Mexico

An individual is resident if he has a home in Mexico. To be nonresident, a former resident must stay abroad for more than 183 days in a calendar year and acquire tax residency overseas.

Netherlands

The tax residence is based on the place where the individual usually lives, but the facts and circumstances are also considered. A person is a resident if his centre of personal and economic interests is based in the Netherlands. The relevant factors include a home, duration of stay, family ties and economic factors linking him with the country. Various judicial decisions suggest that the place where the family resides is a key factor in determining the tax residence. Temporary absences will not make him nonresident, whereas a short assignment in the Netherlands will not make him a tax resident. If a person settles in the Netherlands with his family for employment purposes, he is deemed to be a tax resident.

New Zealand

An individual is a tax resident if he (i) is physically present for 183 days or more in any 12-month period, or (ii) has a permanent place of abode in New Zealand, despite having a place of abode abroad. A part of a day is counted as a whole day.

The term “permanent place of abode” refers to the centre of an individual’s domestic life, and not simply a physical place of residence. The tax authorities consider the facts and circumstances of the stay. The main determining factors include the length of time spent in New Zealand, accommodation arrangements (whether rented or purchased, or an overseas home is retained), type of employment (temporary or permanent), length of the stay in the home country, financial and family ties, children’s education, where annual holidays are taken, social welfare benefits, etc. An individual ceases to be a resident if he is absent for more than 325 days in any period of 12 months, and does not maintain a permanent place of abode during that period in New Zealand.

Norway

An individual is a tax resident if he stays in Norway in aggregate more than either (a) 183 days during a 12-month period, or (b) 270 days during a 36-month period.¹⁶ A previously resident individual remains tax resident as long as he has a permanent home at his disposal in Norway for himself and his family and his stays in Norway exceed 61 days during the calendar tax year.

¹⁶ The person is considered as tax resident after he fulfils either condition, and not from the beginning of the stay.

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As from 2004, a domiciled person remains resident even if (a) he is absent for four years or more, or (b) he is a tax resident in a comparably taxed country overseas. A resident may claim tax exemption on his foreign salary if he stays abroad because of his employment for at least twelve months. This tax exemption does not apply if the salary can only be taxed in Norway under a tax treaty.

Peru

A Peruvian citizen is a tax resident if he is domiciled (i.e. permanently resident) in the country. A foreign individual is a resident only after a continuous stay in Peru of at least two years, or at his request after an initial stay of six months in the country. Temporary absences up to 90 days in each year are ignored. The tax domicile is lost after two years of residence abroad, or when the individual obtains a foreign resident visa or a contract to work abroad for at least one year. A returning citizen becomes a resident again unless his stay is less than six months in the year of his return.

Portugal

An individual is a tax resident if (i) his physical stay exceeds 183 days in a calendar year, or (ii) he visits Portugal for a shorter period but has a permanent or habitual residence or dwelling place on December 31 of that year, or (iii) he is a crew member of a ship or aircraft operated by a resident legal entity on that day. A Portuguese citizen remains resident for four years if he emigrates to a listed tax haven, unless the main purpose is not tax avoidance.

Russia

Individuals are tax resident in Russia if they are present within the Russian Federation for at least 183 days in a tax year.

Singapore

An individual is a tax resident if (i) he is physically present or exercises employment (other than as a director of a company) in Singapore for 183 days or more in a tax year, or (ii) he resides in Singapore (i.e. he has settled or intends to settle in Singapore). If an individual is physically present or working in Singapore for three consecutive years or more, he is deemed resident for all the years, even if his stay is less than 183 days in the first or last tax year of stay.¹⁷

In 2003, Singapore introduced the Not Ordinarily Resident (NOR) Taxpayer scheme to tax-exempt remittance of foreign income previously earned by individuals who were not tax resident in the previous three years. The NOR scheme is valid for five years.

¹⁷ Only residents are entitled to claim personal tax relief. A non-resident (other than a director) is taxed on his employment income at a flat rate of 15% or the progressive personal tax rates varying from nil to 22%, whichever is higher. On other income, the tax is imposed at the 22% rate.

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South Africa

As from the tax year beginning March 2001, South Africa taxes resident individuals on their worldwide income. An individual is resident if either (i) he is ordinarily resident in South Africa or (ii) he meets the “physical presence” test.

A person is ordinarily resident in a country where his most fixed or settled residence is located. It is the country to which he normally returns (i.e. his real home). The physical presence test requires a person to spend (a) more than 91 days during the current tax year and in each of the previous three tax years, and (b) more than 549 days in aggregate during the previous three years.

Under the physical presence test, an individual would become resident from year four. Immigrants into South Africa are tax residents from the day of arrival in South Africa. An individual must stay abroad for a continuous period of 330 days immediately after leaving South Africa to claim non-residency under the physical presence test. He will be deemed nonresident from the day on which he left the country.¹⁸

A person deemed as nonresident in the other contracting state under the tie-breaker (Article 4(2)) of the treaty is treated as nonresident under the domestic law as well.

Spain

An individual is a tax resident if either (i) his physical stay exceeds 183 days in a calendar year, or (ii) the main centre of his professional or business activities or economic interests is based in Spain. A married person may be deemed resident if his family reside in Spain. Temporary absences are ignored, unless the individual is habitually resident in another country for more than 183 days in a calendar year. Tax residence can be changed during the year but an individual can only be resident in one country in a given year. Spanish nationals who emigrate to a listed tax haven under Royal Decree 1841/1991 remain tax resident for four subsequent years.

Sweden

An individual is tax resident if either he has his principal home in Sweden or stays in Sweden continuously for at least six months. Swedish nationals and foreigners who have been resident in Sweden for previous ten years are deemed resident for five years after they emigrate, unless they do not maintain essential ties with Sweden (“five-year rule”).

Switzerland

An individual is resident if he (i) works in Switzerland temporarily for more than 30 days in a year or (ii) intends to stay for at least 90 days in a year or (iii) takes up permanent residence in Switzerland. The intention to stay is based on the centre of personal and business interests in Switzerland.

¹⁸ A resident individual who stays out of South Africa for an aggregate period exceeding 183 full days in any 12-month period commencing or ending in an assessment year of which there is continuous period of at least 60 days, and works abroad during that period will not be taxed on his foreign employment income for that tax year.

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United Kingdom

There is no statutory definition of residence. It is based upon a mixture of statutes, case laws and tax practices. A person may be either a resident or ordinarily resident or both.

(a) A person is a resident in a tax year if he satisfies one of the following requirements:

(i) He intends to stay as a temporary visitor (less than two years) and his physical presence exceeds an aggregate of 183 days or more in that year. If the stay is likely to last for two years or more, the individual is a resident from the date of arrival.

(ii) If the annual visits to the United Kingdom average 91 days or more over four consecutive tax years, he is resident from the fifth year. If the visits are planned, the individual may be regarded as resident from the start of the visits.

(b) A person is ordinarily resident, if he intends to reside or resides habitually in the United Kingdom. The ordinary residence depends on the intention when entering the country, the type of accommodation (permanent or temporary) and the actual period of his stay. He is ordinarily resident from the date of arrival if he intends to stay in the country for three years or more. Otherwise, he is ordinarily resident in the tax year after the three-year period in the country is over, provided he lives in temporary accommodation. A person will also be ordinarily resident if he makes annual visits to the United Kingdom averaging three months or more over a four-year period.¹⁹

United States

All US citizens and permanent resident aliens (“green card holders”) are treated as tax residents, regardless of their actual residence. In addition, an individual is a resident, if he is physically present for either (i) 183 days or more in a calendar year, or (ii) spends at least 31 days in a calendar year and 183 days based on a weighted average over a three-year period (“substantial presence test”). The presence is based on the physical stay at any time during the day. A resident individual is taxed on his worldwide income. The “substantial presence test” does not apply if the presence is less than 183 days in the current year, and the individual has a “tax home” (as defined) with which he has a closer connection in a foreign country. There are also exceptions to this test for foreign government officials, teachers, trainees, students, professional athletes, persons in transit for less than 24 hours, etc.

2.3. Residence of Companies

2.3.1. General

Companies can have a variety of connecting factors for their tax residence. For example, the tax residence can be based on their place of incorporation or registered office, or the place of residence of shareholders, directors or managers, or the place of management or

¹⁹ An individual who is resident, ordinarily resident and domiciled pays tax on his worldwide income. Non-domiciled or not ordinarily resident individuals are liable to tax on their UK source income and remittances of foreign income. Nonresidents pay tax only on their earnings derived from duties performed in the United Kingdom. The Inland Revenue is reviewing the current tax treatment of non-domiciled UK resident individuals.

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administration. Most commonly, it is decided by either (i) the place of incorporation or legal seat, or (ii) the location of management or real seat.

In the former case, the status is determined by the country of incorporation or registration, or where its legal or statutory seat (“registered address or office”) is located under the country’s civil or commercial law. Generally, the legal or statutory seat is also the country of incorporation. However, the statutory seat may or may not be at the same place as the real or effective seat, i.e. the location of management or the place where the central administration is located. Since a company can be incorporated and have its legal seat abroad, and still be effectively managed in the country, several jurisdictions use both criteria. Some countries also apply multiple tests. For example, Suriname determines the corporate residence based on the following factors:

- the place where central management is located;
- the place where its statutory seat is located;
- the place where its business is conducted;
- the place where its general meeting of shareholders is held; and
- the place where its books and records are maintained.

Tax residence based on incorporation or legal seat is fairly obvious. The criteria relating to the location of management, however, are not so clear. The definition of management varies widely under the domestic law and practices in different countries. For example, the management could be defined as management and control (“policy making”) or operational management (“policy execution”). The head office could be the registered office (“legal head office”) or the principal place of control or operational management (“administrative head office”). Some countries use the place of principal activity to indicate the place where the business is managed.

Generally, central management and control signify the ultimate level of policy decision-making or superior control (e.g. board of directors), while operational management denotes day-to-day management of the business (e.g. top-level executives). Day-to-day management deals with administrative tasks. The principle of central or superior management is used in several countries (Examples: Australia, British Virgin Islands, Canada, Hong Kong, Isle of Man, Israel, Jersey, Malaysia, New Zealand, Norway, Portugal, Singapore, Sri Lanka, the United Kingdom). The decision in the *De Beers* case of 1906 is still applied.²⁰

The place of management or effective management is also used to decide the tax residence in many countries. For example, in Austria, Denmark, the Netherlands and Spain it means operational or day-to-day management. New Zealand defines effective management as practical day-to-day management, irrespective of where the overriding control or superior management is exercised. Switzerland defines effective management as either the place of

²⁰ *De Beers Consolidated Mines Limited v Howe (Surveyor of Taxes)* AC 455 (1906)(UK). In this case, the judge held: “a company resides for the purposes of income tax where its real business is carried on. . . I regard that as the true rule; and the real business is carried on where the central management and control actually abides”. The decision refers to the place where the de facto control is exercised and “real business” is, in fact, conducted. “Management and control” is considered a composite test. It does not imply either day-to-day management of the business by executives or control by shareholders through their voting power. This management and control should be central (i.e. highest level of control) to the business as a whole. See Robert Couzin, *Corporate Residence and International Taxation* (IBFD Publications, 2002) pp. 38–47.

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day-to-day activities or the place where the management decisions are taken. In Germany, a place of management is the place where management actually makes its important policy decisions. It is the centre of top level management. A place where a business is merely supervised would not qualify.

Dual tax residence can arise if (a) the same criterion leads to residence in both countries; (b) the two countries interpret the same criterion differently; or (c) the two countries use different criteria. The definitions of corporate tax residence under domestic tax laws may satisfy the residence requirements in more than one country. A common reason for dual residence is incorporation in one country, and management and control in another country. For example, an overseas branch may satisfy the location of management criteria and decide the tax residence of the company.

In the UK case of *Swedish Central Railway Co.*,²¹ the Court held that a company may have two residences under a single criterion, namely the central management and control. Unlike the *De Beers* case, this company was incorporated in the United Kingdom. The Court held that the company was also resident in the United Kingdom since it conducted “vital organic operations incidental to its existence as a company” such as keeping its statutory records, having a bank account and being audited, besides its English incorporation.

This ruling differed from the decision in a later case where the *De Beers* decision was followed for a UK incorporated company. In the *Egyptian Delta Land* case,²² the company was held not to be UK resident since the administrative functions performed were considered insufficient to result in the central management and control being exercised in the United Kingdom. The English company carried on its entire business operations abroad. The judge also mentioned that corporate residence must relate to the corporate business and not to acts of corporate administration.²³

The issue of dual residence was also considered in the United Kingdom in the 1950s. In the *Union Corporation* case, the Court of Appeal gave its view that the company could have split central management and control if the superior or directing authority was found in both countries.²⁴ It concurred with the view of the Australian Court in *Koitaki Rubber v FCT*,²⁵ that a company may be dual resident where the

²¹ *Swedish Central Railway Company Limited v Thompson (Inspector of Taxes)* (1923–25) 9 TC 342 (UK): The company was incorporated in England in 1870 to construct a railway in Sweden. After the construction period, the articles of the company were amended and the management and control moved to Sweden. The company earned income from leasing the railway. The directors and shareholders held their meetings in Sweden and dividends were paid there, but the company’s bank account and the company seat were located in England, and share transfers were done in the United Kingdom.

²² *Todd (Inspector of taxes) v Egyptian Delta Land and Investment Company Limited* (1926–28) 14 TC 119 (UK): Although the company was UK incorporated, all the English directors resigned in 1907 and were replaced by Egyptian residents, all its meetings were conducted in Egypt, the seal was transferred to Cairo along with the minute books and the books of accounts, and the shareholders’ register and meetings were held in Egypt.

²³ Robert Couzin, *Corporate Residence and International Taxation*, pp. 51–55.

²⁴ *Union Corporation Ltd v Inland Revenue Commissioners Cases* [1952] 1 ALL ER 646 (UK): *Union Corporation*, a South African company, had 16 subsidiaries with the head office in South Africa. Three of the companies were managed from England. The majority of the directors resided in England but the board meetings were held in South Africa.

²⁵ *Koitaki Para Rubber Estates Limited v Federal Commissioner of Taxation* (1941) 64 CLR 15, 241 (Australia).

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central authority is divided. In Canada, the Courts have held that, except in very unusual circumstances, a corporation may only have its central management and control in a single jurisdiction.

Dual fiscal residence does not only occur when the criterion of incorporation and the test of central management and control are used simultaneously. As mentioned above, residence may also be based on other tests. A company incorporated under foreign law that carries on business in Australia and has its voting power controlled by shareholders who are residents of Australia may be dual resident. These conflicting rules under the domestic tax law lead to companies that are tax resident in more than one tax jurisdiction or not resident in any jurisdiction. The OECD MC Article 4(3) provides a tie-breaker based on the place of effective management for dual resident companies.

The term “effective management” in the Model treaty is now defined in the OECD Commentary Update 2000. (See Chapter 3(4-Article 4)) The Commentary mentions that it is “the place where key management and commercial decisions that are necessary for the conduct of the entity’s business are in substance made”. Moreover “the place of effective management will ordinarily be the place where the most senior person or group of persons (for example, a board of directors) makes its decisions”, and “the place where the actions to be taken by the entity as a whole are determined”. Thus, it should normally be the location where the top management, in fact, makes key decisions affecting the entity as a whole.²⁶

The relevant consideration is the place where the key management and commercial decisions are made. Although the place of effective management will ordinarily be based at the place where the directors’ meetings are held, in certain situations these strategic decisions may be exercised by others. In these cases, the key management and commercial decisions may be made in one place, but formally finalised somewhere else by the board or by another person or group of persons.

The OECD Committee on Fiscal Affairs has currently issued two proposals, as follows:²⁷

(a) In the first proposal it has refined the concept of “the place of effective management” by expanding the Commentary explanations as to how the concept should be interpreted. It suggests that when key decisions are made in one State but formally finalised in another State the place of effective management should be decided as follows:

- If decisions are formally finalised at board meetings held in the other State, the State where the management and commercial decisions are made in substance.
- If the decisions are made by a controlling interest holder (e.g. a parent company or associated enterprise), the State where these key decisions are made by that person.
- Where the board of directors routinely approves commercial and strategic decisions of its executive officers, the State where these executives perform their functions.

(b) In the second proposal, there is a revised paragraph 4(3) in the Model treaty using four hierarchical rules that apply in succession (similar to paragraph 4(2) for individuals). The first test is the State where the effective management is situated. As a second test,

²⁶ OECD Commentary: Article 4, paras 21–24.

²⁷ See Discussion Paper on “Place of Effective Management as a Tie Breaker Rule” (OECD, February 2001) and the subsequent draft proposals issued in May 2003; See also John F. Avery Jones, Place of Effective Management as a Residence Tie Breaker (IBFD Bulletin, January 2005) pp. 20–24.

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the current proposal offers three different options to determine the place of effective management. These options refer to (i) the State with closer economic relations, (ii) the State where business activities are primarily carried on and (iii) the State where senior executive decisions are primarily taken. Failing this test, the place of effective management is determined by the State from which it derives its legal status. If this test also fails, it is finally determined through mutual agreement between the competent authorities of the Contracting States.

These proposals have not yet been finalised by the OECD Committee on Fiscal Affairs.

Some examples of the corporate residence rules used by various countries are given below:

(a) Incorporation or legal seat

- Incorporation or registration is the sole decisive factor: Antigua, Argentina, Bolivia, Bulgaria, Cameroon, Chile, Colombia, Congo, Costa Rica, Ecuador, Egypt, El Salvador, Estonia, Faeroes Islands, Finland, France, Gabon, Greece, Guatemala, Honduras, Hungary, Iran, Ivory Coast, Latvia, Lithuania, Macao, Mozambique, Myanmar, Namibia, Netherlands Antilles, Nicaragua, Nigeria, Panama, Peru, Philippines, Puerto Rico, Russia, San Marino, Senegal, Slovak Republic, Slovenia, Sweden, Taiwan, Ukraine, the United States, Uzbekistan, Yugoslavia, Zimbabwe.
- Incorporation or registration is one of the criteria: Australia, Austria, Barbados, Belgium, Belize, Botswana, Brazil, Brunei, Cambodia, Canada, Czech Republic, Denmark, Dominican Republic, Fiji, Germany, Guernsey, Iceland, India, Indonesia, Ireland, Isle of Man, Israel, Italy, Jamaica, Japan, Jersey, Kazakhstan, Kenya, Lebanon, Liechtenstein, Lesotho, Luxembourg, Malta, Mauritius, Mexico, Myanmar, Netherlands, New Zealand, Norway, Pakistan, Papua New Guinea, Poland, Portugal, Romania, St. Lucia, Saudi Arabia, Solomon Islands, South Korea, Suriname, Spain, Sri Lanka, South Africa, Spain, Switzerland, Tanzania, Thailand, Turkey, Uganda, the United Kingdom, Venezuela, Yemen, Zambia.

(b) Location of management or real seat

- Location of management is the sole decisive factor: Bahamas, Bangladesh, Barbados, Botswana, British Virgin Islands, Cyprus, Gibraltar, Ghana, Grenada, Guyana, Hong Kong, Malaysia, Montserrat, Paraguay, Singapore, Swaziland.
- Management and/or control is one of the criteria: Australia (superior directing management), Austria (effective top management), Belgium (de facto management), Brunei (de facto control), Belize (central management and control), Canada (central mind and management), Denmark (effective management), Dominican Republic, Egypt (central management), Fiji (practical management), France (effective management), Germany (day-to-day management), Honduras, Ireland, India, (wholly managed and controlled), Isle of Man, Israel, Italy, Jamaica, Jersey, Kazakhstan (governing body), Kenya (management and control), Lesotho (management and control), Liechtenstein (effective management), Luxembourg, Malta (management and control), Mauritius, Mexico, Netherlands (effective management and control), New Caledonia, New Zealand (centre of management), Norway, Papua New Guinea, Pakistan (wholly managed and controlled), Poland (seat of management), Portugal (effective management control),

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South Africa (effective management), Spain (place of administration), Sri Lanka (management and control), Suriname, Switzerland (effective or day-to-day management), Tanzania (management and control), Trinidad and Tobago, Turkey, the United Kingdom, Yemen (wholly managed and controlled), Zambia, Zimbabwe.

(c) Other criteria

- Head office or main office: Belgium, Brazil, China, Greece, Indonesia, Italy, Japan, Luxembourg, Mexico, Mozambique, Netherlands, New Zealand, Norway, Poland, Portugal, Romania, Saudi Arabia, South Korea, Sri Lanka, Spain, Taiwan, Tunisia, Turkey. In certain countries, the location of head office is the sole factor that determines the tax residence (Examples: Brazil, South Korea).
- Principal activity: Cambodia, Ghana, Israel, Italy, Tunisia, Mexico, Netherlands, Suriname, Uganda, Uruguay.
- Nationality or tax residence of controlling shareholders or directors: Australia, Fiji, Guernsey, Lebanon, New Zealand, Papua New Guinea, Solomon Islands, Spain, Sweden.

As mentioned, the definition of management or effective management could be either central management and control or operational management, or both. The other criteria also use some measure of management or control. Several countries require that the locally incorporated companies must have their management in the country.

2.3.2. Country Examples

Australia

A company is tax resident in Australia if (i) it is incorporated in Australia, or (ii) it carries on business in Australia with either the central management and control in Australia or the voting control by resident shareholders. Central management and control is more than day-to-day operational control. It represents the place where the real business of the company is conducted and the policy decisions are taken, i.e. the location of superior directing authority.²⁸ Generally, it would be the place where the directors' meetings, or sometimes even the shareholders' meetings, are held. What matters is the place of effective business direction, and not the legal form.²⁹

Belgium

A company is tax resident if its registered office ("*siège social*"), or the principal establishment, or the seat of management is in Belgium, and it is engaged in profit-making activities. In practice, the tax residence follows the place of de facto or effective management. It is the place where the meetings of the board of directors are held, the accounting functions are performed and the company records kept, the managers' offices are located, etc.³⁰

²⁸ *Malayan Shipping Co. Ltd v Federal Commissioners of Taxation* (1946) 71 CLR 156; In this case, the Court held that the company was resident in Australia since the managing director exercised complete management and control from Australia even though the trading operations were conducted wholly abroad.

²⁹ *Koitaki Para Rubber Estates v Federal Commissioners of Taxation* (1941) 64 C.I.R. 15, 241 (Australia): This case listed several factors as affecting corporate residence, such as the tax domicile of the company directors, the place of the board meetings, and the place where the company's general policy is developed.

³⁰ A company with its statutory or legal seat in Belgium, but the place of effective management or real seat outside Belgium will still be treated as resident since the three abovementioned criteria are alternative.

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Brazil

The tax residence follows the location of the head office. Under Brazilian civil law, a domestic company must be incorporated and have its administrative head office in Brazil. The head office is the place where the management exercises its duties, either at the level of the board of directors or at the administrative level, or as defined by its bylaws. A company with its head office abroad is nonresident.

Canada

A company is tax resident in Canada if it is either incorporated in Canada, or if the central management and control (“mind and management”) is in Canada. It does not depend on the day-to-day management or principal business or residence of shareholders. It is generally based on the place where the directors meet to manage the affairs.³¹

Denmark

Tax residence in Denmark is based on either incorporation and registration or management and control. The latter is defined as the actual place of day-to-day management and head office activities. It does not necessarily depend on the place where the supervisory board of directors exercises the general strategic management and stewardship functions or where the annual meetings of the company are held.³²

Finland

A company is tax resident if it is incorporated under Finnish law and registered in Finland.

France

A company is tax resident in France if it is incorporated in France, or it has its registered address (“*siège social*”) in France. The *siège social* is stated in the articles of registration and denotes the right to occupy the office premises at the registered address. The business must be managed and operated from the location. It is, therefore, the place where the company has its main establishment, its managerial and administrative personnel and its place of effective management. Generally, both legal and effective seats would be located in the same State.

Germany

A company is tax resident if its statutory seat (or registered address), or its place of management is in Germany. A German incorporated company must have its place of management in Germany. It is the centre from which the activities are actually directed by the directors. Based on judicial decisions, it is the place of the day-to-day management where the usual business activities and the organisational measures necessary for the ordinary

³¹ Jack Bernstein, Residence of Corporations for Canadian Tax (IBFD Bulletin, April 1998).

³² Danish companies will often have a supervisory board and a management board. The management board is responsible for the day-to-day running of the company and, generally, it is their location that will decide the tax residence. However, if the shareholder or any other person is de facto making the daily management decisions, then that will become the decisive factor.

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administration of the company are executed. A foreign company managed and controlled in Germany would be taxed as a corporation.

India

A company is tax resident in India if it is either incorporated in India, or wholly managed and controlled in India.

Ireland

The tax residence of a company is based on (i) central management and control, or (ii) incorporation in Ireland. The central management and control is the place where the ultimate directing authority of the company is exercised. Normally, it will be the place where the directors' meetings are held and the fundamental policy and business decisions are taken. The directors should supervise and guide the company's policies, and they must be the highest decision-making authority.

Until 1999, the central management and control was the sole basis for corporate residence. Incorporation is an additional test of tax residence in Ireland. This provision does not apply in certain circumstances. To be nonresident, an Irish incorporated company (or a related company) must actively trade in Ireland and be either ultimately controlled by persons resident in the European Union or a treaty country, or be traded actively on a recognised stock exchange. Alternatively, the company must be deemed as a nonresident company under the tie-breaker clause in a treaty with Ireland.³³

Israel

A company is defined as resident if either (i) it is incorporated in Israel, or (ii) its business is controlled and managed in Israel. The definition includes a "foreign professional corporation" established by residents to provide the same services abroad as those they provide in Israel.

Italy

Tax residence of companies is based on (i) the legal seat (i.e. registered office) or (ii) the administrative headquarters ("place of central management"), or (iii) the place where the principal business activities are performed. Therefore, a company is resident if it is incorporated in Italy, or administered in Italy, or has its principal activities in Italy.

Japan

A company is tax resident, if (i) it is incorporated in Japan, or (ii) if incorporated abroad it has its headquarters (registered office) or principal office in Japan. A company incorporated in Japan must have either its headquarters (Commercial Code) or its registered principal office (Civil Code) in Japan. The place of effective management or management and control is not relevant.

³³ Mary Walsh, Ireland's 1999 Finance Bill Changes Corporate Residence Rules (Tax Analysts, February 22, 1999).

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Luxembourg

A company is resident if its registered office (i.e. legal seat) or principal place of management is in Luxembourg.

Mexico

A company is tax resident if either it is incorporated in Mexico, or its administration or principal place of management is located in Mexico. The administration or place of management is deemed to be located in Mexico if (i) the shareholders' or board meetings are held in Mexico; or (ii) the individuals that make day-to-day management, control or administrative decisions for the legal entity are tax resident in Mexico or have their offices in Mexico; or (iii) the entity has an office in Mexico at which the administration or control of the entity is carried out; or (iv) the accounting records are maintained in Mexico.

Netherlands

The determining factor of tax residence for companies is incorporation or based on facts and circumstances. A Dutch incorporated company is always deemed to be a tax resident and generally it must have its seat or domicile (registered office) in the Netherlands under its statutes. The Netherlands applies the real seat or "management test" for foreign companies. Their tax residence is determined "according to the circumstances". The key factor is the place where the day-to-day management meets normally, performs its management functions and takes decisions. Other factors may be used to provide supportive evidence of this place of management. They include the location of board meetings, main offices, shareholders' meetings, the currency or the place where the corporate records are kept and financial accounts prepared, etc.³⁴

New Zealand

A company is tax resident if (i) it is incorporated in New Zealand, or (ii) it has its head office in New Zealand, or (iii) it has its centre of management (e.g. where the company as a whole is managed from on a day-to-day basis) in New Zealand, or (iv) the control by the directors is exercised in New Zealand. The head office would generally be at the place where the real business of the company is carried on, or where its central management, administration and control take place.

Norway

The corporate tax residence is based on (i) incorporation or registration, or (ii) the effective place of central management and control in Norway. The place of central management is usually where the board meetings are held. Normally, the place of management is the same as the place of incorporation and the place of registration. A company incorporated in Norway must have its principal place of business or central management in Norway under its statutes.

³⁴ If a company is only a resident of the Netherlands because of its incorporation under Dutch law, a number of provisions of the Dutch Corporate Income Tax Act of 1969 are not applicable to those companies (e.g. the provisions regarding the participation exemption and the fiscal unity).

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Portugal

The corporate tax residence is based on its head office (“legal seat”) or the place of effective management.

Russia

Legal entities established under Russian law are taxed on their worldwide income effectively as resident corporations.

Singapore

A company is tax resident only if its management and control is exercised in Singapore. It is the place where the directors habitually meet and exercise superior control. The location of its trading activities or physical operations is not necessarily the place of management and control. The location of incorporation does not affect the tax residence of a company.

South Africa

A company is resident if (i) it is incorporated in South Africa, or (ii) if it has its place of effective management in South Africa.

South Korea

A company is either domestic or foreign. A domestic company has its principal office or head office in South Korea.

Spain

A company is tax resident if (i) it is established or incorporated under Spanish law, or (ii) it has its legal headquarters or registered office in Spain, or (iii) its place of effective management is in Spain. Effective management is defined as the place where the administration and management (e.g. general contractual activity and main accounting) are actually conducted. In doubtful cases, the residence is decided by the location of the most valuable capital assets. An exit tax based on a deemed sale of all Spanish assets is levied when a company ceases to be resident unless it maintains a branch in Spain, to which the assets are allocated.

Sweden

A company is tax resident if it is incorporated and registered in Sweden.

Switzerland

A company is tax resident if it is (i) domiciled in Switzerland under its statutes or (ii) effectively managed and controlled in Switzerland. A domestic company incorporated, organised or registered in the commercial register in Switzerland is domiciled under the tax laws. A foreign company is tax resident if it is effectively managed and controlled

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from within Switzerland. The place of effective management may be either the place where important decisions are taken, or the place of day-to-day management.³⁵

Thailand

A company is tax resident if (i) it is incorporated in Thailand or (ii) it carries on business in Thailand as a foreign company. The “carrying on business” includes the presence of an employee, representative or other persons to derive income or gains in Thailand.

Turkey

A company is tax resident if it (i) has its legal seat or business headquarters under its statutes or (ii) the place of central management in Turkey. The place of management refers to the highest level of management (i.e. policy-making management).

United Kingdom

A company is tax resident if it is (i) incorporated in the United Kingdom or (ii) the central management and control is based in the United Kingdom. The United Kingdom still follows the old De Beers decision to determine the place of central management and control.³⁶ Thus, the test of control is determined by whoever exercises “superior and directing authority”. Control does not demand any minimum standard of active involvement, e.g. it could be passive oversight. The place where the board of directors meets is important but not conclusive.³⁷

The UK Inland Revenue has clarified that a foreign company may become tax resident if the central or overriding management and control is deemed to be in the United Kingdom. The tax authorities would look at factors such as:

- where the highest level of control is exercised;
- where the actual management control is exercised (e.g. the use of shadow directors);
- where the directors have board meetings;
- where the decision making processes and management meetings take place; or
- where the controlling individual/s or shareholder/s exercise their powers.³⁸

³⁵ A decision of the Swiss Federal Supreme Court on December 4, 2003 held that the place “where the managing bodies are located, the place where the management operations are carried out and where the company documents are kept”. If activities are carried out in several locations, it is where the activities are predominantly carried out. It is not necessarily the place where the director or shareholders meet or reside.

³⁶ *De Beers Consolidated Mines Limited v Howe (Surveyor of Taxes)* AC 455 (1906) (UK): De Beers was a South African company with its head office and all the mining operations in South Africa. The general meetings were also held there. The UK House of Lords held that the directors’ meetings in London are the meetings where the real control was always exercised in practically all the important business of the company except the mining operations. The Court rejected the tax residence based on the country of incorporation or registration. It also applied an analogy of an individual’s residence. It said, “A company cannot eat or sleep, but it can keep house and do business. We ought, therefore, to see where it really keeps house and does business”.

³⁷ In *Bullock v Unit Construction Co.* [1960] AC 351 (UK), a UK company had three subsidiaries in Kenya that were de facto managed and controlled by the parent company in the United Kingdom. They were held to be resident in the United Kingdom. The Court considered the residence as the place where the management decisions were actually (i.e. effectively) taken and not where their directors formally approved the decisions.

³⁸ UK Statement of Practice 6/1983 now updated by SP 1/90.

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United States

Corporate taxation in the United States depends on whether a company is domestic or foreign, based on its place of incorporation. A company is domestic if it is incorporated under the laws of any of the states in the United States or the District of Columbia. Tax residence is unaffected by the place of management and control.

2.4. Residence of Other Entities

For legal entities that are unincorporated businesses, residence is generally determined under either a place-of-organisation test or a place-of-management test. However, unlike corporations they may or may not be treated as separate legal and taxable persons. Determining the residence of a partnership may also be difficult because of the informality with which a partnership can be established. Similar problems arise when determining the residence of trusts.

Generally, corporate residence rules apply to business organisations that operate as companies, e.g. partnerships limited by shares, limited liability companies, trust companies and co-operative societies. Special rules apply to the residence of general partnerships. Some countries treat them as a separate taxable entity, whereas in other jurisdictions they are fiscally transparent. Where partnerships are treated as companies, generally their tax residence is based under the corporate rules. In jurisdictions where partnerships are fiscally transparent entities, the tax residence follows the residence of the partners (individual or corporate).³⁹ (See Chapter 8(7))

The residence of trusts is not so clear. It may be determined by the residence of the majority of the trustees or the place of management or administration of the trust, or the place where it is organised. However, it could also be based on the location of the trust assets, the residence of the beneficiaries or the residence of the settlor or grantor.⁴⁰ For example, a trust is resident in Australia if a trustee is resident or the central management and control of the trust is in Australia. In the United Kingdom, for a trust to be resident the trustees must be resident, but if the majority of trustees are nonresident and the general trust management is carried out abroad it is treated as nonresident. The residence of the trust in Canada is based on the place of superior management and control. (See Chapter 8(9))

A branch or permanent establishment does not have a separate legal existence and normally retains the same tax residence as its head office. However, if the location of management is based at the branch, it could satisfy the residence requirements in certain jurisdictions. In such cases, the company may become resident at the location of the branch. (See Chapter 5(2.3))

³⁹ Some countries do not permit non-individuals as partners (Examples: Italy, Switzerland).

⁴⁰ A. Esson and V. Thuronyi, *Fiscal Transparency (Tax Law Design and Drafting, 2000)* pp. 961–965; Philip Baker, *Double Taxation Conventions (Sweet & Maxwell, 2003)* pp. 1B 17–31.

2.5. Domicile under Common Law

The term “domicile” is used in several countries.⁴¹ This concept of domicile under the common law differs from the term as used in civil law countries, where it usually refers to the place of permanent residence or home.

Domicile under common law is difficult to define. An old UK case law held that “a place is properly the domicile of a person in which his habitation is fixed without any present intention of removing therefrom”.⁴² Thus, the term “domicile” signifies a permanent home or place where a person is a permanent resident with the intention of remaining there for an indefinite period “unless and until something (which is unexpected or the happening of which is uncertain) shall occur to induce him to adopt some other permanent home”.⁴³ Once established the domicile can continue even if the person is away for a long period as long as the intention remains of returning to the domicile as a permanent residence.⁴⁴ Therefore, it implies a permanent home or residence and “if that was not intelligible by itself no illustration could help to make it intelligible”.⁴⁵

Two elements are necessary for the existence of domicile under common law, namely (i) a residence of a particular kind, and (ii) an intention of a particular kind. The residence must answer “a qualitative as well as a quantitative test”. The person must reside in the country where he takes up residence and must intend to stay there permanently. There must be a fixed intention at that relevant time to regard the place of residence or settlement as the permanent home forever.

Everyone must have a domicile. One cannot be without a domicile and a person can be domiciled only in one place at any time. An individual acquires the domicile of the father as his domicile of origin at birth. It does not depend on the father’s nationality, the country where he was born or the country of residence of the parents. A posthumous or illegitimate child follows the domicile of the mother. A foundling has his domicile in the country in which he was found. The domicile of origin stays with the person until abandoned by him for a domicile of choice.

A person can adopt a domicile of choice by the combination of residence and the intention of permanent or indefinite residence, but not otherwise. The domicile of choice continues until the former domicile is resumed or another is acquired. A person can give up his domicile of choice by not residing there and not intending to reside there permanently or indefinitely. Since a person cannot be without a domicile nor have more than one domicile, he then either acquires a new domicile of choice, or he reverts to the domicile of origin.

The third kind of domicile is the domicile of dependency. A domicile of a dependent person follows the domicile of the person on whom he is legally dependent. For example,

41 Many British Commonwealth countries give certain tax concessions to non-domiciled individuals, whose foreign income and gains may be taxed only on a remittance or received basis.

42 *Craignish v Craignish* (1892) 2 Ch. 180 (UK).

43 E.I. Sykes and M.C. Pryles, *Australian Private International Law* (The Law Book Company Ltd., 1987) pp. 314–315.

44 Ramon J. Jeffery, *The Impact of State Sovereignty on Global Trade and International Taxation* (Kluwer Law International, 1999) pp. 50–51.

45 Lord Cranworth in *Whicker v Hume* 7 H.L.C. (1859) (UK).

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an adopted child takes up the domicile of the adopting parents, while the domicile of the wife is that of her husband. In the United Kingdom, a wife acquired the husband's domicile if married before January 1, 1974. If married after that date, her domicile status is dependent on her origin or choice.

3. SOURCE OF INCOME OR GAIN

3.1. General

The connecting factors for the tax objects are the source rules. The source rules identify (a) where the income arises and (b) which country has the taxing rights over it. A country has the source taxing right only if there is an economic connection between a particular item of income and the country as a taxing jurisdiction. To be effective, the source rules should enable the tax jurisdiction to identify the income and its recipient, to quantify it and to enforce its taxing rights.⁴⁶

Each country has its own rules ("basic source rules") under the domestic law to decide where the income arises for taxation purposes. They are normally based on the location of the economic activity that generates the income, i.e. where the profits accrue or arise. In many cases, the domestic tax practice rather than the specific statutory rules determines the source. Very broadly, any income derived from the activities carried on within a country is sourced in that country.

For example, the location of real or immovable property generally determines its income source. The source of personal services is usually the country where they are physically performed or where they are used. Active business income follows the place of operations from which the profits in substance arise. Passive income, such as interest, royalties and dividends, is usually (but not always) sourced in the country of the payer. Certain passive income may be treated as active if it is effectively connected with a business activity in a State.

The taxing rights are largely dictated by the country's ability to enforce its tax laws (i.e. enforceability) and the principle of reciprocal sharing of tax revenues by nations (i.e. reciprocity).⁴⁷ Under the public international law, every country has the primary right to tax the income arising or derived from an economic attachment or territorial link with that country (i.e. domestic-source income). Therefore, a nonresident person is liable to pay a tax for the privilege of earning the income from a source in the host country. This taxing right does not extend to non-domestic source income (i.e. foreign-source income) derived from other countries. Whether an income should be treated as domestic or foreign-source for tax purposes is determined under the domestic law and practice ("taxing source rules").

Generally, the income is classified by the type or nature of income before the source rules are applied. The rules that classify or characterise various items of income affect the

⁴⁶ *Nathan v Federal Commissioner of Taxation*, (1918) 25 CLR 183; 24 ALR 286 (Australia): Source is not a legal concept but something which a practical man would regard as a real source of income and the ascertaining of the actual source is a practical, hard matter of fact.

⁴⁷ Richard J. Vann, *International Aspects of Income Tax* (Tax Law Design and Drafting, 2000) pp. 729–737.

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applicable source rules on that income. They can change the basic source assigned to an item of income and the related taxing rights. For example, a sale of computer software may be classified as business or service income, sale of a copyright or know-how, or a sale of a capital asset. Depending on the category, the basic source would change and the right to tax could be affected.

3.2. Basic Source Rules

The basic source or origin rules vary widely, depending on the nature or character of the income. For example, intangible property rights are usually sourced either at the place where they are used or where the payer is resident. In a sale of tangible goods, the source is generally the place where the ownership changes or title passes. It is usually the country of residence of the seller. However, these rules may specify the source as where the title passes, where the contract is signed, where the delivery takes place, or where the payment is made. Several jurisdictions regard income as sourced where the contractual offer is accepted.

The income from an overseas sale transaction may also have a taxable source in the importing country. In the United States, the production and selling profits may be split on cross-border transactions involving manufactured goods.⁴⁸ In Canada, a person is deemed to carry on a business and may be taxable if he or his agent solicits orders or offers anything for sale.

The source of service income is usually, but not always, the place where it is performed. The source may also be the residence State of the payer, or the place where the services are used, or where the payment is received. Occasionally, the source may depend on where the person is employed or the services are performed. For example:

- In Australia, the source rule for employment income can be either the place where the service is performed, or the place of the contract of employment or the place where the payment is made.
- In Ireland, if the employment contract of a non-domiciled employee is negotiated and accepted abroad and the payments under it are made into a foreign bank account, the employment income is considered foreign-source even for work done in Ireland. It is taxed on a remittance basis.

National rules vary, depending on how source is defined. For example, a dividend distributed by a company may be deemed to have its source in the country of residence of the company distributing the dividend, or in the country or countries from which the company has derived its profits. Another example is royalty, which may be deemed to have its source in the place where the underlying contract was signed, or in the place

⁴⁸ The title passage rule in the United States applies to traded inventory and certain depreciable personal property. In other cases, the sales income is deemed to arise in the seller's country of residence, unless either (i) substantial sales activity is carried out in the country where the sale is made or (ii) the goods are sold for the use, consumption or disposition in the other country, and at least a significant amount of activity is carried out through a fixed place of business in that country. (See Klaus Vogel, *Worldwide v Source Taxation of Income – Intertax 1988/8–9*, p. 225).

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where any activities giving rise to the royalty were performed, or where the payer is resident.

Thus, there are wide variations in the basic source rules applied under the domestic law by various jurisdictions. It is, therefore, difficult to provide a single set of source or origin rules that is followed globally. Some commonly used source rules for various types or categories of income include:

- (a) Sale of tangible goods or services
 - where the title passes
 - where the payment is received or delivery made
 - where the commercial cycle is completed
 - where the sales contracts are concluded
 - where the business is carried on (OECD MC Art. 7)
- (b) Sale of employment services
 - where the service is performed or rendered (OECD MC Art. 15)
 - where the results of the service are used
 - where the payer is resident
 - where the payment is received
 - where the service contract is made
 - where the related sale takes place
- (c) Dividend income
 - where the paying company is resident (OECD MC Art.10)
 - where the underlying profits are sourced
 - where the shares are registered
- (d) Interest income⁴⁹
 - where the payer is resident (OECD MC Art. 11)
 - where the debtor is resident
 - where the loan contract is entered
 - where the money is lent
 - where the borrowed funds are used (OECD MC Art. 11)
 - where the income arises from which it is paid
 - where the debt can be enforced
 - where the collateralised assets are located
 - where the interest is remitted from
- (e) Royalty income
 - where the payer is resident (UN MC Art. 12)
 - where the intangible rights are used
 - where the inventor resides
 - where the intangible rights are registered

⁴⁹ *Westminster Bank Executor & Trustee Co. (Channel Islands) Ltd. v National Bank of Greece SA* (1970) 46 TC 472 (UK): interest is sourced in the United Kingdom if there is sufficient nexus. The relevant factors include the place where the debt claim can be enforced, the place where the interest is paid, the source from which the debt is paid, how the debt is secured, the currency of the debt, the governing law of the agreement, etc.

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- where the intangible rights are transferable
- where the agreement is made
- (f) Equipment/movable property rentals
 - where the permanent establishment is situated (OECD MC Art. 7)
 - where the assets are physically located
 - where the payer is resident
 - where the assets are used
- (g) Income from real/immovable property
 - where situated (OECD MC Art. 6)
- (h) Capital gains
 - immovable or real property: where situated (OECD MC Art. 13)
 - shares and securities: where registered
 - ships and aircraft: where the effective management situated (OECD MC Art. 13)
 - goodwill: where the trade, business or profession is carried out
 - copyrights, franchises, rights and licenses: where the rights are exercisable or used
 - judgment debt: where the judgment is recorded
 - gains other than from immovable property, ships and aircraft and permanent establishment: the state of residence (OECD MC Art. 13).
- (i) Income from agriculture
 - where the asset generating the income is located.

In tax treaties, the source of income is usually referred to in an indirect manner. For example, the dividend Article in the OECD MC applies to “dividends paid by a company which is a resident of a Contracting State.” In this case, it is only by implication that one may conclude that the company’s residence determines the source of the dividend. The dividend Article prevents tax on a dividend in a Contracting State only because the company’s profits are derived from that State.

3.3. Taxing Source Rules

The taxing source rules decide whether the income is domestic or foreign-source. These rules serve two basic purposes. Firstly, they specify the connecting factors for the taxability of the income by the host country. Secondly, they affect the credit given by the home country for the taxes paid abroad on the foreign-source income. Thus, the taxing source rules decide the taxability of nonresident taxpayers in the source State, and their right to receive foreign tax credits on such taxes in their residence State.

Most countries combine the taxing source rules with the basic source or origin rules under their domestic law. As an exception, the United States defines the taxing source rules separately from the basic rules for the different items of income and expenses. It is, therefore, possible to either modify the categories of taxable income or vary the source or origin from domestic to foreign (or vice versa) by a change in the domestic law. Any change in these rules can effectively change the taxability of the income.⁵⁰

⁵⁰ Robert J. Patrick, IFA Cahiers Vol. 65B, General Report, 1980, pp. 15–18; J.S. Phillips and M.H. Collins, IFA Cahiers Vol. 70A, General Report, 1985, pp. 23–26.

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As mentioned, the taxing source rules normally refer to the income derived from the assets within a country or from the activities carried on within a country. This distinction is not always maintained. Countries that follow the territorial tax regime often treat certain foreign-source income as deemed domestic-source income. Similarly, certain countries tax foreign-source income of nonresidents under a deemed-source provision. For example:

(a) Deeming provisions in countries with the territorial tax regime may extend their taxing rights over certain foreign-source income. For example, the following foreign-source income is deemed as domestic-source in Namibia: foreign interest income, foreign income derived from a domestic trading activity, and royalty and similar payments for the use of intellectual property in Namibia.

(b) Several countries with the worldwide tax regime have extended their source rules to tax certain foreign-source income of nonresidents.

- The United States taxes foreign income as US source if there is a nexus with a trade or business conducted in the United States. Prior to 2005, a pro rata share of the dividends paid by a foreign corporation was treated as US source, if 25% or more of its gross income in the three preceding years was effectively connected with a trade or business in the United States. On the other hand, interest and dividends from a domestic company may be treated as foreign-source income if at least 80% of the gross income during the previous three years was active foreign business income.
- India treats certain overseas income of nonresidents as taxable under its deeming provisions. They are deemed to accrue or arise in India. For example, foreign income is subject to tax if it is derived directly or indirectly through, or from, a “business connection” in India.⁵¹ Foreign interest, royalties and technical services for use in India are deemed to arise in India, if an Indian tax resident pays them to nonresidents.
- The income from unconnected activities undertaken by a nonresident entity may be taxable as business income under a “force of attraction” principle, if it has a branch in that country (Example: Japan, India, Indonesia, Latvia, the United States). This principle usually involves an independent set of source rules.⁵²

3.4. Conflicts in Source Rules

As not all countries follow the same source rules, double taxation arises when they conflict. For example, the rental income may be taxed in the State where the immovable asset is situated and in the place where the contract is entered. Personal services may be taxed in the place where they are physically performed and in the residence State of the payer.

⁵¹ Similar provisions exist in several countries. (Examples: India, Indonesia, Malaysia, Portugal, Singapore, the United States); Har Govind, *Business Connection and Permanent Establishment* (IBFD Asia and Pacific Bulletin, August 2001).

⁵² Hugh Ault, *Comparative Income Taxation* (2004), pp. 395–415.

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Similarly, technical services performed at home may be taxable at home and in another country if paid by, or used in, that country.

Thus, two or more jurisdictions may tax the same income as sourced in their country. Moreover, the residence State may refuse to grant relief for the foreign taxes paid due to source conflicts. Many of these conflicts are minimised through the explicit or implicit rules agreed under the source and assignment rules in tax treaties. The treaties classify or characterise the items of income, provide the basic source rules, and then assign the taxing rights to one or both Contracting States.

As the treaty rules normally override domestic law, they are de facto source rules. However, they do not avoid all source conflicts. For example, a treaty usually leaves the characterisation of income to the domestic law. As a result, two States may classify the same income or capital differently and apply different treaty provisions. For example, equipment rentals may be classified as royalties in the source state and business income in the residence State. Similarly, loan interest paid to a partner may be treated as interest in one State and a share of partnership profits in the other State. These conflicts of qualification (i.e. classification) often lead to double taxation or double non-taxation even when both Contracting States have acted in accordance with the treaty provisions.⁵³

When the taxable profits of an enterprise are shared between the Contracting States, the domestic-source rules also govern the expense apportionment methods. For example, they decide the calculation of the attributable profits of a branch as a permanent establishment in the host State. The use of conflicting expense allocation or attribution rules in various jurisdictions could again lead to double taxation or double non-taxation.

Finally, the domestic rules affect the foreign tax credit calculations in the residence State. The relief is calculated on the foreign income, net of related expenses, as computed under its domestic tax rules. These rules vary. The allocation of additional costs (either as specific costs or as a proportion of general overheads) in the residence State to the foreign-source income could reduce the foreign tax credit. Double taxation would arise unless they are also allowed as expense deductions in the host country.

4. BASIS OF TAX COMPUTATION

4.1. General

The taxable income or tax base and the tax rate determine the tax liability for the tax period. The tax base is computed by deducting the related costs incurred in the acquisition of the earnings from the gross revenues. The tax rate is then applied to this chargeable profit. A change in either the rate or the base affects the tax payable. The effective tax rate is defined as the actual tax payable as a percentage of the total pre-tax income (not taxable income).

⁵³ See Chapter 2(3.6).

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Although the tax liability is a combination of the tax base and the tax rate, their definitions vary widely.

The domestic tax systems in the world may be grouped into eight broad families of income tax laws.⁵⁴ Under these systems, certain countries have a single tax system for all taxpayers (“global system”), while other countries provide separate tax laws for different taxpayers and different items of income (“schedular system”). Many of them follow a hybrid system, which contains the characteristics of both methods.

Thus, some jurisdictions apply a global system with a single comprehensive definition of income for all taxpayers, and subject them to the same tax rate structure irrespective of the nature of the income. Other jurisdictions classify the taxable income into a number of broad categories under a schedular system. The schedules split the tax base into particular categories often with different tax rates for each class of taxpayer and/or income. The tax rules may also differ for different taxpayers (e.g. individuals or companies), and for different classes (e.g. business, investment or employment income) and types (e.g. dividends, interest, royalties, etc) of income.

Certain countries define their tax base under the global system (Examples: Australia, Colombia, the United States), while others follow the schedular system (Examples: France, Germany, India, Italy, Japan, Spain, the United Kingdom). Often, a combination of the two systems is used. Under a composite system, the income in each schedule is computed separately and then a global tax rate is applied on the total income. The use of withholding tax on passive income has led to a partial use of the schedular system in countries, which follow the global system.⁵⁵

Broadly, common law countries follow the schedular system while civil law countries prefer the global system.⁵⁶ The main difference between the two legal systems is that while civil law relies on statutes or enacted legislation, the common law accepts uncodified law based on past judicial decisions or judge-made law. The legal system also affects the tax computations. While common law countries generally tax the accounting profits, civil law countries compute the taxable income on the difference in the balance sheets (as adjusted for dividends) at the beginning and end of the period. Moreover, the countries that use the global system normally do not tax capital gains separately. Both are taken as part of the aggregate taxable income or profits.

4.2. Tax Rate

Tax rates and the way they are applied also vary between countries. Some of the tax rate systems in use are:

(a) Flat rate or fixed percentage of taxable income: Under the flat rate system, the tax is levied as a fixed percentage of income (also called proportional rate). Different rates

⁵⁴ There are eight groups of countries based on common characteristics, namely British, American, French, Latin American, East European (i.e. transition countries), Northern European, Southern European and Miscellaneous. (See Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International, 2003) pp. 23–44.

⁵⁵ Lee Burns and Richard Krever, *Individual Income Tax* (Tax Law Design and Drafting, 2000) pp. 495–500.

⁵⁶ Victor Thuronyi, *Comparative Tax Law* (Kluwer Law International, 2003) pp. 45–59.

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may apply depending on the character of the income, the type of activity or the nature of ownership. In some countries, the taxable income below a certain minimum level or capital base is subject to a lower tax rate.⁵⁷ For example, the United Kingdom applies a lower “small income” rate of 19% if the taxable profit of a company is less than UK£300,000, with a tapered relief up to UK£1,500,000. Japan applies a flat rate of 30% to companies with a capital over JPY 100 million, while small and medium-sized companies pay 22% on the first JPY 8 million of taxable income. A federal tax rate of 12% applies to small private companies in Canada on the first Can. \$300,000 of active business income.

(b) Progressive rates or an increase in tax rates at higher slabs: Progressive tax rates or a higher rate as taxable income increases are commonly used for personal taxes to maintain the vertical equity based on the ability to pay. Certain countries also compute their corporate taxes on a progressive tax system.⁵⁸ The tax levied on the higher income may be either at the higher rate on the entire income, or only on the excess over the next lower income bracket. Under the latter method, the effective tax rate is less than the marginal tax rate on the top income slab.

Some countries allow the taxpayer to elect the lower of either the tax payable at the marginal rate applied to the total taxable income, or the tax due on the previous tax bracket plus the income in excess of this bracket (Examples: Kuwait, Qatar, Taiwan). A few countries use a hybrid method, where certain income brackets or “slabs” are taxed at a progressive rate on the excess, while other slabs have a flat rate for the entire income (Examples: Luxembourg, the United States).

(c) Degrressive rates, or decreases in tax rates, at higher income levels: The higher income slabs are taxed at a lower tax rate. The degressive method is very rarely used.

(d) Tax-exempt or nil taxation: Many countries exempt (partly or fully) the income from approved business activities or geographical areas. Normally, the preferential tax rates apply as incentives for foreign capital, employment generation or technology transfers. Export earnings are partly or fully tax-exempt or taxed at concessional rates in several countries. Tax-exemption may also be given to certain types of income, e.g. charities, mutual funds, windfall gain, income of diplomats, etc. A taxpayer remains liable to tax, although he is not subject to tax. These situations differ from tax-free jurisdictions that do not impose any tax on income. Normally, no deduction is given for expenses when the related income is tax-exempt.

(e) Surtaxes or surcharges: Income or corporate tax may contain additional tax levies (as a surtax or surcharge) that are computed either as a separate tax,⁵⁹ or as a percentage of

⁵⁷ Examples: Belgium, Bulgaria, Canada, Costa Rica, France, Honduras, Japan, Latvia, Luxembourg, Netherlands, Nigeria, Panama, South Africa, South Korea, Spain, the United Kingdom.

⁵⁸ Examples: Aruba, Cyprus, Honduras, Indonesia, Iran, Ireland, Korea, Kuwait, Luxembourg, Macau, Myanmar, Oman, Netherlands Antilles, Puerto Rico, Qatar, Saudi Arabia, Seychelles, Taiwan, the United States, Venezuela.

⁵⁹ Brazil levies a 9% social contribution tax (non-deductible); Bulgaria levies a 10% municipal tax; China levies a 3% local corporate income tax; Egypt levies 2% development duty on annual taxable income over LE 18,000; Germany a municipal trade tax from 13% to 20.5% (deductible expense); Italy adds a local income tax (IRAP) at 4.25%; Japan levies 5% to 10.08% enterprise tax (deductible); Jordan a 1% university tax; Libya a 2%–4% Jihad tax; Russia levies regional taxes (up to 19%); Swiss cantonal taxes (varying rates).

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the corporate tax.⁶⁰ They are generally imposed as short-term supplements to the national taxes, or as local or municipal taxes. Some countries treat the surtax or surcharge for local or municipal taxes as a tax-deductible expense for corporate tax.⁶¹ Other countries adjust the tax base for local taxes. For example, Canada grants 10% federal rate abatement on the taxable income subject to provincial taxes. The United States calculates the US state taxes on the profits, net of federal tax.

(f) Taxes on capital or wealth tax: Several countries impose a capital tax, which is based on the net worth or assets employed by a company.⁶² For example, large Canadian corporations with capital over Can \$50 million pay a creditable federal capital tax (“large corporations tax”). In many Latin American countries, the net worth tax is deemed as an alternative minimum tax, and the amount is creditable against the regular corporate tax liability.⁶³ Mexico imposes a minimum tax of 1.8% on net assets (“TNA”).

Several countries impose a wealth or net worth tax on individuals.⁶⁴ For example, France imposes a tax on individual wealth over EUR 15 million at rates up to 1.8%. Spain levies wealth tax at rates up to 2.5%. India charges a 1% tax on taxable wealth over INR 1.5 million. Pakistan, Saudi Arabia and Yemen impose a *zakat* or Islamic wealth tax.

Certain countries levy a capital duty on new or additional contributions to the capital of companies. (Examples: Austria (1%), Belgium (0.5%), Ireland (0.5%), Luxembourg (1%), Liechtenstein (1%), the Netherlands (0.55%), Spain (1%), Switzerland (1%), Taiwan (0.025%), Uruguay (1%)). This duty is not normally creditable for tax purposes.

(g) Presumptive taxes:⁶⁵ Several countries impose a presumptive tax in situations where the taxable income cannot easily be ascertained or computed.⁶⁶ It involves the use of indirect means to ascertain the tax, which is then presumed as payable. The reasons for its use vary. It may be to curb tax evasion or avoidance, or to reduce the compliance costs particularly on low turnover or income groups. The tax is often levied on deemed income or profits from certain sources. It is collected either on assessment or by a withholding tax when the amount is paid. It may be levied under the domestic law or at the discretion of the tax authorities, and may or may not be rebuttable by the taxpayer. The method provides a convenient tax assessment and collection mechanism, but it could be an incentive to pay a fixed (and lower) tax, irrespective of the actual tax liability.

The presumptive methods vary from the use of a minimum tax under the law to income estimation by the tax authorities. In many cases, it is computed as a percentage of the

60 Examples: Belgium, Botswana, Brazil, Cameroon, Canada, France, Germany, Honduras, India, Japan, Luxembourg, Portugal, South Korea, Turkey.

61 Examples: Bulgarian municipal tax, Germany municipal trade tax, Japanese enterprise tax, Luxembourg municipal tax.

62 Examples: Canada, Finland, Greece, Iceland, India, Jamaica, Japan, Lebanon, Liechtenstein, Luxembourg, Mexico, Russia, Saudi Arabia, Switzerland, Uruguay.

63 Examples: Costa Rica, Colombia, Guatemala, Honduras, Mexico, Peru, Venezuela.

64 Examples: Bangladesh, Finland, France, Germany, Guyana, Italy, India, Israel, Liechtenstein, Luxembourg, Netherlands, Norway, Pakistan, Saudi Arabia, Spain, Suriname, Sweden, Switzerland, Thailand, Uruguay, Yemen.

65 IFA Seminar Series: Presumptive Income Taxation (Kluwer Law International, 1998); Victor Thuronyi, Presumptive Taxation (Tax Law Design and Drafting, 2000) pp. 401–433.

66 Examples: Argentina, Bangladesh, Brazil, Dominican Republic, Guatemala, India, Mexico, Morocco, Pakistan, Portugal, Saudi Arabia, Switzerland.

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assets, gross revenue or deemed profits. For example, the Dominican Republic levies a presumptive tax on the deemed income of companies engaged in insurance, transportation, film distribution and communications. Guatemala charges nonresident transport companies a final tax at 5% of gross revenues. Saudi Arabia imposes tax on a deemed profit of 15% of gross revenues, if no financial statements are presented. Similarly, Russia applies a notional margin of 20% of expenses, if the tax authorities are unable to determine the profit of a permanent establishment or branch.

Certain jurisdictions apply a presumptive tax on the deemed revenues earned by foreign airlines and shipping companies (Examples: Bangladesh, India, Iran, Pakistan, Peru). Similar deemed taxation is often applied on the gross receipts of nonresidents from oil-related activities. Construction, assembly and similar projects are subject to a final withholding tax on payments to nonresidents in Pakistan. Hungary taxes unregistered branches of foreign companies, either on their net profits or at 12% of expenses, whichever is higher. Several countries impose a tonnage tax as an alternative to regular corporate income tax on profits for shipping activities.⁶⁷

Presumptive tax is also applied to individual taxpayers. In some countries, it is based on “outward signs of lifestyle”. For example, Switzerland allows individuals to elect for a lump-sum tax based on expenses (i.e. standard of living) rather than on the actual taxable income.⁶⁸ Austria grants various tax exemptions to qualifying foreigners taking up Austrian residence.⁶⁹ France taxes nonresident individuals on their French source income on a lump-sum basis. The amount is equal to three times the market rental value of their property in France, provided it is owned for at least a year.

(h) Minimum alternative tax: Many countries charge a minimum annual tax based on the profits, gross revenues or net worth of the taxpayer.⁷⁰ The taxpayer is liable to pay a minimum alternative tax, if the computed tax liability is less than this figure. In certain jurisdictions, the excess over the actual tax liability may be used to offset current or future corporate tax over an indefinite or specified period.⁷¹ Special rules often apply for the start-up years of operations.

The minimum tax may be either a presumptive tax or a requirement that the tax allowances and deductions do not reduce the tax payable below a minimum figure (Examples: India, the United States). For example, Nigeria applies a minimum tax on companies based on the highest amount computed on specified percentages of gross profits, net assets, paid-up capital or turnover. India levies it at 7.5% of book profits. In Colombia, it is based on 6%

⁶⁷ Examples: Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, India, Ireland, Latvia, Netherlands, Norway, Spain, the United Kingdom.

⁶⁸ Xavier Oberson and Howard R. Hull, Switzerland in *International Tax Law* (IBFD Publications, 1996) pp. 42–46.

⁶⁹ The Austrian Minister of Finance is empowered to grant special tax treatment to foreigners who have not resided in Austria during the preceding 10 years, and whose professional activities are beneficial to Austria. If such individuals do not earn any income whatsoever in Austria, they may be entirely exempt from Austrian taxation. As with Switzerland, they benefit from the provisions of Austria’s double tax treaty network.

⁷⁰ Examples: Austria, Argentina, Cameroon, Colombia, Congo, Costa Rica, France, French Polynesia, Gabon, Guatemala, Guinea, Guyana, Honduras, India, Italy, Ivory Coast, Korea, Laos, Mexico, Morocco, Nigeria, Pakistan, Peru, Philippines, Puerto Rico, Senegal, Tunisia, Turkey, the United States, Venezuela.

⁷¹ Examples: Argentina (ten years), France (two years), the United States (indefinite).

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of net equity. Pakistan imposes a minimum income tax at 0.5% of gross revenues. France levies a minimum corporate tax based on turnover. Senegal imposes a minimum tax of FCFA 500,000 (FCFA 1,000,000 if the turnover exceeds FCFA 500 million). Tunisia has a minimum tax payable of TD 2,000 or 0.5% of turnover, if higher. In Morocco, the minimum tax is the greater of DH 1,500 or 0.5% of the annual turnover. The minimum corporate tax is 2% of gross income in the Philippines.

Certain countries also apply an alternative minimum tax on individuals (Examples: Canada, South Korea, the United States).

(i) Higher tax rate on undistributed or distributed profits: Several countries impose additional taxes either to reduce or raise the level of profit distributions.

Examples to discourage profit distributions:

- Argentina imposes a final withholding tax of 35% on the excess, if any, of the dividend payment or branch remittances over retained taxable profits of the company.
- In India, domestic companies pay an additional 12.5% tax (plus surcharge) on distributed profits.
- Liechtenstein levies a surcharge of up to 5% if the dividend distribution exceeds 8% of taxable capital.
- Norway provides a deferred tax regime for shipping companies and levies the tax only when they distribute the profits.⁷²
- South Africa taxes corporate income at 30% rate; the companies also pay a secondary tax at 12.5% on the dividend distributions.

Examples to encourage profit distributions:

- Germany taxed undistributed profits at 40% and imposed a lower rate of 30% on distributed profits of companies through a 10% tax refund (pre 2001).
- Panama imposes a deemed dividend tax of 4% of the net profits if no dividends are declared during the year.

Some countries levy an additional tax on the retained earnings of closely held companies, unless they can justify the profit retentions on commercial considerations (Examples: India, Ireland, Philippines, South Korea, Taiwan, the United Kingdom, the United States). The controlling interest in such companies allows them to defer the payment of dividends and avoid the tax liability due on the shareholders of the company. For example, the Philippines levies an “improperly accumulated earnings tax” of 10% if a company (with certain exceptions) accumulates profits and does not distribute them to the shareholders. In Taiwan, a company must pay a 10% tax on the retained profits if its undistributed earnings exceed 100% (200% for government-approved industries) of the issued share capital.

(j) Special tax rates: Some examples of special taxes and tax rates include:

- Australia, India and New Zealand impose a separate “fringe benefits tax” on the employer for various non-cash perquisites given to employees.

⁷² A similar tax regime has been introduced by the United Kingdom for small taxpaying companies. The first UK£10,000 is tax-free but subject to 19% tax on distribution.

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- Estonia taxes only income that is distributed. The distribution tax is levied on the gross amount of the distribution of certain specified payments.⁷³
- Liechtenstein levies a graduated rate varying from 7.5% to 15% based on the company's return on net worth.
- Norway imposes an "active shareholder tax" if resident shareholders own two-thirds of the shares and actively participate in the company's business. The company may reimburse the tax as a non-deductible expense.

Higher tax rates than the regular corporate rate may also be applied in other special cases. Bangladesh levies a higher tax rate on unlisted and nonresident companies. Bulgaria taxes commercial banks at a 50% rate. India taxes the profits of branches of foreign companies at a higher 40% rate. A company incorporated in the Solomon Islands is taxed at a 35% rate, while foreign companies, even if they are resident in the Islands, pay a higher 50% rate. Special tax rates apply to gold mining companies in South Africa. Similar higher rates are often applied in the case of income from oil exploration and production in several countries.⁷⁴

Many countries encourage foreign investments through lower tax rates.⁷⁵ For example:

- China grants reduced tax rates for foreign investments located in the Special Economic Zones and Coastal Open Economic Regions.
- Israel levies a lower tax rate on approved enterprises depending on the level of foreign ownership.
- Singapore offers a concessional tax rate on a wide range of approved business activities.
- Vietnam provides lower rates for foreign-owned companies based on the type of business activity, export commitment, employment level, technology considerations, etc.

4.3. Tax Base

4.3.1. General

The charging provision under the domestic law specifies (i) the person liable to tax, (ii) the tax period to which the charge relates since the tax is imposed by reference to a period, (iii) the taxable income or the tax base, and (iv) how the tax payable should be calculated. The charging provision applies to the taxable income or tax base and not to the gross income. Moreover, it excludes any income exempt from taxes.⁷⁶

The tax base is affected by how the taxable income is computed. As mentioned earlier, some countries follow a global tax approach, under which they apply the same tax rules and the same tax rate to all categories of income, while other countries use a schedular system. The latter system classifies the income by broad categories or schedules under different heads of income, computes taxable income differently for each schedule and usually

⁷³ Distribution tax based on the grossed-up amount is levied on payments of dividends, employee fringe benefits, gifts and non-business expenses, and transfer pricing adjustments. Retained income is not taxable.

⁷⁴ Examples: Albania, Bangladesh, India, Egypt, Ghana, Malaysia, Norway, Papua, Tanzania, South Africa, Vietnam.

⁷⁵ Examples: China, Cyprus, Dominican Republic, Egypt, Ireland, Israel, Korea, Lithuania, Mauritius, Monaco, Oman, Nigeria, Philippines, Singapore, Sri Lanka, Tanzania, Vietnam, Yugoslavia.

⁷⁶ Lee Burns and Richard Krever, *Individual Income Tax (Tax Law Design and Drafting, 2000)* pp. 500–501.

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subjects them to different tax rates. In practice, all global systems contain some schedular elements and vice versa. Most tax systems lie somewhere between the schedular and global systems.⁷⁷

Under the schedular system, the total income is often split between active income and passive or capital income. Income from capital includes income from passive investments such as rentals from immovable property, dividends from shares in a company, interest from loans and bonds, rental payments from leasing of property, capital gains, etc. It differs from active income, such as business income (manufacture, trading, provision of services, etc.), employment income (i.e. from labour) or income from independent personal services. Generally, lower tax rates are levied on unearned income while earned income from business or employment income is taxed at higher progressive tax rates.

4.3.2. Tax Period

The charging provisions impose tax only on the persons who have taxable income for the relevant tax period. As income tax is imposed on a periodic basis, the tax base is affected by the rules relating to the fiscal or tax year. These rules vary widely. For example, some countries insist on a statutory tax year for corporate tax purposes. The calendar year must be used as the statutory tax year in many jurisdictions.⁷⁸ A few countries have specified fiscal year-ends.⁷⁹ Others require the financial or accounting year to be used for tax purposes.⁸⁰ Many countries allow the taxpayer to select any 12-month accounting period as the tax year, either with or without prior approval from the tax authorities.⁸¹ Finally, there are a few countries that base the tax year on the financial accounts for the year, which had ended in the previous tax year (Examples: Fiji, India, Isle of Man, Malta, Mauritius, Singapore, Sweden).

⁷⁷ Lee Burns and Richard Krever, *Individual Income Tax (Tax Law Design and Drafting, 2000)* p. 497.

⁷⁸ Calendar year-end: Albania, Angola, Austria, Azerbaijan, Barbados, Brazil, Brunei, Bulgaria, Chile, China, Colombia, Congo, Indonesia, Ireland, Ivory Coast, Croatia, Cyprus, Czech Republic, Ecuador, Estonia, Fiji, Germany, Greece, Ghana, Guernsey, Guyana, Hungary, Iceland, Indonesia, Ireland, Israel, Jamaica, Jersey, Kazakhstan, Kuwait, Lebanon, Lithuania, Luxembourg, Macao, Macedonia, Malaysia, Malta, Mexico, Mozambique, Netherlands, Netherlands Antilles, Nigeria, Norway, Oman, Panama, Papua New Guinea, Peru, Philippines, Portugal, Qatar, Romania, Russia, Senegal, Seychelles, Singapore, Slovak Republic, Slovenia, Solomon Islands, Syria, Taiwan, Trinidad and Tobago, Tunisia, Uzbekistan, Vietnam, Yugoslavia, Zimbabwe.

⁷⁹ Examples: February 28 – Namibia, South Africa; March 31 – Denmark, Hong Kong, India, Indonesia, Myanmar, New Zealand, Sri Lanka, the United Kingdom, Zambia; April 30 – Egypt; June 30 – Australia, Bangladesh, Botswana, Cameroon, Guatemala, Greece, Malawi, Mauritius, Nicaragua, Pakistan, Swaziland, Uganda; September 30 – Costa Rica; Sweden allows an option of four year-end dates.

⁸⁰ Examples: Argentina, Canada, Denmark, Finland, France, Hong Kong, Italy, Japan, Kenya, Korea, Monaco, Morocco, Netherlands, Poland, Saudi Arabia, South Africa, Spain, Tanzania, Thailand, Turkey, the United States, Yemen.

⁸¹ Financial accounts year-end:

With approval – Australia, Austria, Czech Republic, Germany, Greece, Guyana, Indonesia, Israel, Jamaica, New Zealand, Lebanon, Lithuania, Malta, Mauritius, Namibia, Norway, Pakistan, Panama, Portugal, Qatar, Sri Lanka, Sweden, Taiwan, the United States, Vietnam, Zambia. Sweden allows accounts ending at April, June, August or December month-ends.

Without approval – Barbados, Belgium, Barbados, Brunei, Cambodia, Canada, Denmark, Djibouti, Fiji, Germany, Ghana, Korea, Oman, Latvia, Lesotho, Liechtenstein, Luxembourg, Malaysia, Netherlands, New Zealand, Nigeria, Papua New Guinea, Philippines, Saudi Arabia, Singapore, Solomon Islands, South Africa, Switzerland, Syria, Trinidad and Tobago, the United Kingdom, the United States, Zimbabwe.

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4.3.3. Timing Rules

The tax base may be computed on the cash or accrual basis of accounting, or some combination thereof. Under the “cash method”, the income is taken into account when the taxpayer has unrestricted access, directly or indirectly, to the money or the property involved. Similarly, expense deductions are given when the payee has unrestricted access to the funds.

The timing rules allocate the income and expenses of the taxpayer to tax periods. The rules usually vary for different taxpayers and for different items of income and expenses. The tax accounts for business income generally follow the accrual method where the income earned during the accounting period and the related expenses are matched. Several countries allow the cash basis for small businesses, employment income or individuals.⁸²

4.3.4. Tax Accounts

Countries follow different approaches when preparing their accounts. Moreover, the rules differ depending on their purpose. The three main types of accounts are:

- **Commercial accounts:** These financial statements are usually prepared to determine the profit of each entity under local generally accepted accounting principles (GAAP) in a country.⁸³ The rules normally form part of the country’s commercial or company law to protect the rights of shareholders and creditors. One of their key principles is the “prudence” principle, i.e. to provide for all future losses and recognise profits only when they have been earned.
- **Capital market statements:** Usually entities listed on a stock exchange are required to submit accounts under prescribed accounting and reporting standards as information to, and for protection of, investors (and other stakeholders). The guiding principle is “fair presentation” or “true and fair view”. The listed holding companies are often required to submit their consolidated worldwide results.⁸⁴
- **Tax accounts:** These accounts are prepared to determine the tax payable for a given tax period. Specific rules are used to determine the tax liability. The rules vary widely and are generally given in the domestic tax law of each jurisdiction. These rules may not be based on fiscal considerations only. They often reflect other economic, and even social and political, objectives. Taxation is used widely as an instrument of domestic public policy by countries.

These different accounts serve different purposes, have different objectives and are based on different principles. For example, commercial and capital market statements look at a group of companies as a single global economic entity, whereas tax accounts are normally based on a separate domestic legal entity. Moreover, tax rules are often designed to influence the behaviour of taxpayers by granting them incentives or using disincentives for non-fiscal reasons.

⁸² Lee Burns and Richard Krever, *Individual Income Tax (Tax Law Design and Drafting, 2000)* pp. 534–537.

⁸³ Inflation-adjusted accounts may also be prepared in countries that experience high inflation rates, e.g. in certain countries in South America.

⁸⁴ Consolidated accounts for tax purposes differ from consolidated financial statements. Very few countries permit worldwide tax consolidation; See Chapter 4(5.5) and Chapter 5(6).

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Some of the other significant differences in tax accounts include (a) the realisation principle, which enables taxes to be paid only when funds are realised or available, (b) the equity principle, which ensures that taxes payable are fairly imposed on different classes of taxpayers, and (c) the timing rules that govern the recognition of income and expenses, loss carryovers from other years and other tax rules.

The underlying principles of financial accounting are not always compatible with the basic principles and practices used in the field of taxation.

Therefore, the taxable profit, as computed in the tax accounts, is usually not the same as the commercial profits, as shown in the financial statements. The financial or commercial profits are determined under generally accepted accounting principles or commercial code.⁸⁵ The tax base is computed either independently under the tax rules or based on adjusted financial accounts under the tax code.⁸⁶

The two methods, which are commonly used for computing the tax accounts of companies, are:⁸⁷

(i) Gross income less allowable deductions (“tax rules”)

This method does not rely on the financial or commercial statements. It uses the financial data and adjusts them, as appropriate, to meet the differing objectives of the tax accounts. Both the gross taxable income and the allowable expenses are defined under the domestic tax law. Thus, the same books of accounts as the financial statements are used for tax accounting, but the special tax rules significantly modify the accounting principles.⁸⁸

In a few countries, the taxable profit is calculated under the principles of “sound business practice”, as defined in their tax rules.⁸⁹ These principles differ from the financial accounting rules. Although in practice the differences may not appear to be significant, the taxable profits are not necessarily based on the financial statements and may differ. For example, the rules may not allow a deduction for unrealised losses even when there is a strong probability that they will be incurred and the amount can be quantified.⁹⁰

(ii) Accounting profit (“accounting rules”)

Taxable profits are based on the accounting profits in the financial statements, as adjusted under specific tax rules. The accounting profits are taken either as a change in net worth in the balance sheet or from the profit and loss account.

Under the net worth approach, the book and tax income are closely linked. The tax accounts accept the value of the assets and liabilities stated in the commercial balance sheet. The taxable profit is the difference in the shareholders’ funds reported in the opening

⁸⁵ Hugh Ault, *Comparative Income Taxation* (Kluwer Law International, 2004), pp. 243–250.

⁸⁶ ICC Policy Statement: Important Differences between Taxation and Accounting Rules.

⁸⁷ Charles J. Berg, IFA Cahiers Vol. 62B, General Report, 1977.

⁸⁸ Examples: Australia, Azerbaijan, Brunei, Colombia, Fiji, Greece, Indonesia, Japan, Jordan, Kazakhstan, Korea, Liechtenstein, Lithuania, Namibia, Netherlands, Netherlands Antilles, New Zealand, Papua New Guinea, Panama, Peru, Qatar, Romania, Russia, South Africa, Suriname, Turkey, Ukraine, the United States, Yugoslavia, Zimbabwe.

⁸⁹ Examples: Namibia, Netherlands, Netherlands Antilles, Suriname.

⁹⁰ Peter Essers, *The Relationship between Fiscal and Commercial Accounts in the Netherlands – Fiscal versus Commercial Profit Accounting in the Netherlands, France and Germany* (IBFD Publications, 1996).

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and closing balance sheets, as adjusted for capital contributions and dividends payments. This method is used in many civil law jurisdictions.⁹¹ Under the profit and loss approach, the accounting profit in the financial statements forms the starting point for the tax computations. This income is adjusted as required by statute, judicial decisions and/or revenue practices. Several countries use this method.⁹²

Tax rules in countries often provide for the deferral of tax on certain items of income or expense. They are recognised for book purposes in a particular year but are included for tax purposes in a different year. These tax adjustments create timing differences in tax payments or a “deferred tax liability”. Some examples of tax deferral include:

- the income or payment of tax is spread over several years to prevent hardship, especially in cases where a taxpayer’s income is very high in a particular year.
- additional or accelerated depreciation allowances are granted on business assets to encourage investment by reducing the taxable income of earlier years with a corresponding increase in later years.
- rollover relief allows deferral of capital gains tax liability.

A few countries require the tax computation to be based on inflation-adjusted accounts.⁹³ Some countries also demand that the accounts be audited for tax purposes.⁹⁴

The extent of the adjustments required in the commercial accounts to arrive at the taxable profits varies. In some countries, the financial and tax accounts are virtually identical since the accounting practices are largely influenced by the tax rules.⁹⁵ Certain countries prepare the financial statements independently of the tax rules and, therefore, require significant adjustments under their tax laws to compute the taxable profits.⁹⁶ There are also countries that prepare the financial statements under the accounting principles and standards but need few adjustments to meet the tax requirements.⁹⁷ Finally, many countries adhere to the form of the transaction in the determination of the taxable income, while others look at the substance and adjust the accounts accordingly for tax purposes.

4.3.5. Other Issues

The tax base is affected by several other factors, such as accounting policies, exempt income, special tax allowances or disallowances, non-deductible or limited-deduction expenses,

⁹¹ Examples: France, Germany, Luxembourg, Norway, Spain.

⁹² Examples: Angola, Argentina, Austria, Bangladesh, Barbados, Belgium, Bolivia, Botswana, Bulgaria, Cameroon, Canada, Chile, China, Congo, Costa Rica, Croatia, Cyprus, Czech Republic, Denmark, Dominican Republic, Djibouti, Ecuador, Egypt, Estonia, Finland, Gabon, Ghana, Gibraltar, Guatemala, Guernsey, Guinea, Guyana, Hong Kong, Hungary, Iceland, India, Ireland, Isle of Man, Israel, Italy, Ivory Coast, Jamaica, Jersey, Kenya, Kuwait, Latvia, Lebanon, Lesotho, Macau, Macedonia, Malaysia, Malta, Mauritius, Mexico, Monaco, Morocco, Mozambique, Myanmar, Nicaragua, Nigeria, Norway, Oman, Pakistan, Paraguay, Philippines, Poland, Portugal, Puerto Rico, Saudi Arabia, Seychelles, Senegal, Singapore, Slovak Republic, Slovenia, Solomon Islands, Sri Lanka, Sweden, Switzerland, Taiwan, Tanzania, Thailand, Trinidad and Tobago, Tunisia, Uganda, the United Kingdom, Uruguay, Uzbekistan, Venezuela, Vietnam, Yemen, Zambia.

⁹³ Examples: Chile, Colombia, Ecuador, Iceland, Israel, Mexico, Peru, Uruguay, Venezuela.

⁹⁴ Examples: India, Malaysia, Malta, Pakistan, Saudi Arabia, Singapore, Thailand, Yemen.

⁹⁵ Examples: Finland, Norway, Russia, Spain, Sweden, Switzerland.

⁹⁶ Examples: Bangladesh, Barbados, British Virgin Islands, Cyprus, Denmark, Gibraltar, India, Ireland, Isle of Man, Malaysia, Pakistan, Singapore, Sri Lanka, Trinidad and Tobago, the United Kingdom, Zambia.

⁹⁷ Examples: Belgium, France, Germany, Greece, Italy, Luxembourg, Portugal, Spain.

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losses brought forward, etc.⁹⁸ Different countries follow different accounting principles for tax purposes, allow or disallow different deductions and grant different tax incentives and exemptions.

As mentioned above, the adjustments to the commercial accounts may be permanent or just create a timing difference when certain expenses are deductible for book purposes but not tax purposes, and vice versa. Some of these issues are described in the following sub-sections.

4.4. Accounting Policies

Although they are not binding, the Courts usually accept that the financial statements prepared according to the generally accepted accounting principles give a true statement of the commercial profits for the relevant period. The tax rules do not always follow the same accounting policies as used for financial reporting purposes. Differing accounting policies can and do affect the tax computations, and the taxable profits. Some general accounting policies that have a significant impact on the tax base relate to inventory valuation, depreciation policies, lease accounting and treatment of foreign exchange gains and losses.

4.4.1. Inventory Valuation

(a) The inventory valuation rules acceptable for tax purposes by countries vary widely. For example:

- Lower of cost or market value:⁹⁹ Austria, Belgium, Brazil, Cameroon, Canada, Congo, Denmark, Egypt, Fiji, France, Gabon, Germany, Greece, Guatemala, Guinea, Israel, Italy, Ivory Coast, Japan, South Korea, Luxembourg, Monaco, Netherlands, Philippines, Portugal, Puerto Rico, Senegal, Switzerland, Thailand, Trinidad and Tobago, Taiwan, the United States, Yemen.
- Lower of cost or net realisable value: Botswana, Czech Republic, Hong Kong, Iceland, Ireland, Kuwait, Lebanon, Malaysia, Malta, Pakistan, Singapore, South Africa, Sri Lanka, Tanzania, Uganda, the United Kingdom.
- Lower of cost, market value or replacement value: Australia, Finland,¹⁰⁰ India, South Korea, Mauritius, Mozambique, Papua New Guinea, New Zealand, Uruguay.
- Inflation-adjusted cost: Chile, Colombia, Ecuador, Israel, Mexico, Peru, Venezuela.
- Historic cost only: China, Japan, New Zealand, Norway, Spain, Sweden, Tunisia
- Any acceptable basis used consistently (no rules specified): Angola, Bangladesh, British Virgin Islands, Bulgaria, Djibouti, Gibraltar, Libya, Mozambique, Nigeria, Oman.

⁹⁸ Lee Burns and Richard Krever, *Taxation of Income from Business and Investment (Tax Law Design and Drafting, 2000)* pp. 673–681.

⁹⁹ The term “market value” usually represents the fair selling price in the taxpayer’s trading market. It resembles more closely the term “net realisable value” or the estimated selling price less any cost of completion and disposal. It differs from the term “market” defined in US accounting principles as the current replacement cost by purchase or reproduction.

¹⁰⁰ Finland permits the use of net sales value on the last day of the accounting year.

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(b) The term “cost” normally includes the related expenses and charges directly and indirectly incurred in bringing the asset to its present condition and location. However, this definition is not followed in all countries. While certain countries require that the inventory costs must be based on full absorption costing (i.e. direct and indirect production overheads),¹⁰¹ some countries only accept direct costing (i.e. the sum of direct material, direct labour and variable factory overhead costs).¹⁰² In the United Kingdom, the Courts give the option to the taxpayer to use either the full absorption or direct costing method.¹⁰³

In Brazil, unless an integrated costing system is in place, the finished goods are valued at 70% of the highest sales price, and work-in-progress at 80% of the finished goods cost or at 150% of the highest material content. Argentina values them at the cost price during the last two months of the financial year. Portugal accepts any approved valuation, including standard costs, and allows the use of the sales price less a normal gross profit margin for inventory valuation. Mexico allows the deduction of the actual costs incurred on purchased materials, labour and overheads, instead of the normal cost of sales for computing net profits.

(c) The method of computing the cost of inventory also varies. Many countries permit either the actual cost or the average cost for inventory valuation on the first-in, first-out basis. Several of them also allow the last-in, first-out method,¹⁰⁴ while others specifically forbid its use.¹⁰⁵ In many countries, any acceptable method may be used, provided it is applied consistently over time. For example, Japan and South Korea allow a wide range of inventory costing methods, provided it is reported to the tax office. If it is not reported, Japan accepts the most recent purchase method, while the first-in, first-out method is permitted in South Korea. Base stock method is allowed in the Netherlands, but not the replacement cost method.

(d) Generally, the tax authorities insist that any changes in the valuation method must be made only with their prior approval. In Panama, once a method is adopted, it cannot be changed for five years.

4.4.2. Depreciation or Capital Allowances

The domestic law normally grants a tax deduction for the capital or depreciation allowances (sometimes called wear and tear allowance) over the economic life of various assets.¹⁰⁶

101 Examples: Costa Rica, Czech Republic, Egypt, Finland, South Africa, the United States.

102 According to the Dutch tax court, Hoge Raad, only the direct costs should be inventoried under sound business practice. (Peter Essers, *The Relationship between Fiscal and Commercial Accounts in the Netherlands*, p. 17).

103 *Duple Motor Bodies v Optima* (1961), 39 TC 537; 40 ATC 21 (UK).

104 Examples: Austria, Belgium, Ecuador, Germany, Honduras, Italy, Japan, Korea, Luxembourg, Netherlands, Paraguay, Slovenia, Spain, Swaziland, Taiwan, the United States, Uruguay.

105 Examples: Australia, Brazil, Canada, Cyprus, Denmark, France, Hong Kong, India, Indonesia, Ireland, Israel, Malaysia, Nigeria, Papua New Guinea, Peru, Singapore, South Africa, the United Kingdom, Yemen, Zimbabwe.

106 Richard K. Gordon, *Depreciation, Amortisation and Depletion* (Tax Law Design and Drafting, 2000) pp. 682–717.

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There are wide variations in country practices. For example:

(a) The basis for depreciation is the purchase or manufacturing cost, but the rates may be either those used in the accounts, or those determined by the tax law. As several countries impose specific rates or specify minimum or maximum depreciation rates under the tax law, these rates may differ from the rates used in the financial statements. The difference in the book and tax depreciation leads to deferred tax liability (or deferred tax asset).

(b) The allowable tax depreciation is affected by the method of calculation. There are various methods that can be used, e.g. straight line, declining or reducing balance, sum-of-years' digit method, etc. Several jurisdictions prescribe the method or methods, which must be used to compute the tax depreciation. Some countries allow one method only, others offer a limited choice, while still others permit any method. Thus, the straight-line basis is exclusively applied in many countries¹⁰⁷, while only the declining-balance method is acceptable in certain jurisdictions.¹⁰⁸ Several countries allow both the straight-line and declining-balance methods, provided they are used consistently¹⁰⁹. A few countries follow the sum-of-years' digit method (Examples: Costa Rica, Panama, Philippines, Spain).

(c) Depreciation may be computed on a per-item basis or determined in aggregate separately for each category or basket of assets. Some countries require that the fixed assets be "pooled" by categories for calculating the depreciation allowance for each basket. Any disposal proceeds are deducted from the relevant basket. The balancing charge that arises when the "pool" is depleted is added to the taxable income.¹¹⁰

(d) The depreciation practices may vary. For example, certain countries give a partial allowance in the year of acquisition (Examples: Australia, Canada, Fiji, Germany, India, Turkey, the United States), while others grant the full allowance for the year of purchase, irrespective of the period of usage or ownership (Example: the United Kingdom). Some countries grant the depreciation on a prorated monthly basis (Examples: Belgium, France, Japan, Mexico). Certain depreciation allowances may be restricted to new plant and equipment only, and granted not on ownership, but on use.¹¹¹ A few countries permit asset revaluations, but they usually disallow the tax depreciation on the excess over the original

¹⁰⁷ Examples: Austria, Brazil, Chile, China, Congo, Ecuador, Fiji, Gabon, Greece, Guatemala, Guinea, Honduras, Iceland, Italy, Lebanon, Libya, Mauritius, Mexico, Morocco, Mozambique, Namibia, Nigeria, Paraguay, Peru, Senegal, Slovenia, Tunisia, Vietnam, Yemen.

¹⁰⁸ Examples: Canada, Finland, Gibraltar, India, Norway, Pakistan, Swaziland, Trinidad. In some jurisdictions the declining-balance is applied only to plant and machinery (Examples: Gibraltar, Ireland, Malta, Uganda, the United Kingdom).

¹⁰⁹ Examples: Belgium, Colombia, Egypt, France, Germany, Indonesia, Iran, Israel, Jamaica, Japan, Korea, Luxembourg, Malaysia, Netherlands, New Zealand, Panama, Papua New Guinea, Philippines, Poland, Portugal, Spain, Sri Lanka, Sweden, Switzerland, Taiwan, Tanzania, Turkey.

¹¹⁰ Examples: Australia, Czech Republic, Denmark, Finland, Hong Kong, India, Ireland, Japan, Norway, Slovak Republic, the United Kingdom, the United States. In Finland, a taxpayer may elect to transfer the excess proceeds over written down value into a replacement reserve for offset against assets acquired in the same or subsequent two years. Any unused reserve is added back with a 20% mark-up to the taxable income of the last year in which it should have been deducted.

¹¹¹ A plant is defined as something with which the company earns its income but is not something in which it earns that income.

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acquisition cost.¹¹² In some countries, the tax rules grant the taxpayers the option to claim the tax deduction for depreciation (Examples: Canada, Italy, Portugal, the United Kingdom), others require that the minimum depreciation must be charged for tax purposes even in loss-making years (Examples: Belgium, France, Germany, India, Luxembourg, Netherlands).

(e) Many countries grant accelerated tax depreciation rates to encourage capital investment, either on all assets or on certain types of assets. Besides higher depreciation rates, incentives may also be given as additional initial or investment allowance, or even as “free depreciation”, where the taxpayer can choose the tax depreciation rate. Some countries allow an immediate tax write-off of expenditure incurred on minor capital items below a specified “capitalisation limit” (Examples: Austria, Greece, Luxembourg, the United States). Short-life assets may also be eligible for write-off either as incurred, or within a short period (Examples: Denmark, Finland, Hungary, the United Kingdom).

(f) Not all countries permit the amortisation of intangible assets. Such amortisation is specifically denied in several countries,¹¹³ while others allow straight-line deductions for tax purposes over a specified period.¹¹⁴ The term “intangible assets” usually includes goodwill, going concern value, workforce in place, business books and records, patents, copyrights, formulae, processes, designs, patterns, know-how and formats, customer-based intangibles, supplier-based intangibles, covenants not to compete, franchises, trademarks, trade names, etc.¹¹⁵

4.4.3. Lease Accounting

Leasing involves the use of an asset for a contractual period without the legal ownership. It is a contract “whereby a separation of the ownership of an asset and its usage is established for a certain period of time”.¹¹⁶ Leasing differs both from a hire purchase agreement, in which the seller retains the title until the full payment is made, and from an instalment sale where the title is transferred on the sale but is paid in instalments.

The accounting literature distinguishes between operating and financing leases. An operating lease is essentially a rental contract. The lessor takes the ownership risks and rewards. Any subsequent sale to the lessee is made at the fair market value. On the other hand, a financing lease is a technique to finance the asset through regular payments over the economic life of the asset. The lessee has the economic, if not the legal ownership, with an option to buy the asset at a nominal value at the end of the lease.¹¹⁷ In some countries, a financing lease is treated as a conditional sales contract with the potential reversion of title to the seller.

112 Examples: France, Finland, India, Ireland, Italy, Netherlands, the United Kingdom. the United States does not permit asset revaluations for financial or tax reporting. 60% of the additional depreciation on revaluation of fixed assets is allowed for tax purposes in Portugal.

113 Examples: Congo, France, Guinea, Ireland, Ivory Coast, Morocco, Papua New Guinea, Portugal, South Africa, the United Kingdom, Uruguay.

114 Examples: Belgium, Canada, China, Colombia, Denmark, Ecuador, Finland, Germany, Greece, India, Indonesia, Italy, Japan, Namibia, Netherlands, South Korea, Spain, Sweden, Taiwan, Thailand, the United States.

115 US Budget Act 1993 Sec. 197; Har Govind, *Tax Treatment of Intangible Assets* (Intertax 1995/1).

116 G. Lindcrona and S. Tolstoy, *IFA Cahiers Vol. 75A, General Report*, 1990.

117 Marcel Coenen, *Leasing – Fiscal and Commercial Profit Accounting* (IBFD Publications, 1996) pp. 57–71.

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Generally, lease transactions give the tax benefits to the lessor as the financier, and not to the lessee as the user of the property. The lessor is entitled to the depreciation and other tax allowances as the owner, who may then pass the tax advantages to the lessee in lower lease rentals.¹¹⁸ The lessee may claim the lease rental as a tax-deductible expense.

However, certain countries treat a financing lease differently from an operating lease for tax purposes. They look at the substance and not the form. A financing lease is treated as a sale by the lessor at the present value of the future lease payments due to him. The lease payments are analysed as an instalment payment towards the cost of the asset and an interest payment on the deferred sale price. The interest element in the lease payments is taxed separately, subject to withholding taxes. The lessee is considered the economic owner for tax purposes and entitled to the tax benefits, including depreciation allowances.¹¹⁹ Not all countries recognise this distinction between financing and operating leases under their domestic tax law. In several countries, the tax treatment of leases is still unclear.¹²⁰

Under sale and leaseback transactions, the lessee either owns or acquires an asset, which is sold at a fair market value to a financing company and then leased back on a periodic rental basis to cover the capital cost and interest. Although the asset legally belongs to the lessor, the economic interests and risks remain with the lessee. This form of secured financing is accepted and widely used globally to free up capital locked in assets without the loss of their use for a guaranteed period. Some tax authorities look at sale and leaseback transactions as unacceptable tax avoidance.

The tax treatment on cross-border leases usually follows the principles applicable to domestic leases. The differences in the national treatment in various countries can create tax conflicts. The tax rules may either grant the tax allowances to both the lessor and the lessee (“double dipping”) or create double taxation with no deduction for depreciation in both countries. Triple dipping is possible, if a taxpayer in a third country, other than the lessor and lessee, is treated as the beneficial owner of the leased equipment for tax purposes. These problems of double (or triple) dip or double taxation require a harmonisation of domestic tax laws. (See Chapter 5(3.5))

Juridical double taxation may also arise on the lease rentals that are taxed on a lessor in the State of source and in the State of residence. The host country may either tax the lease fees on a net basis or levy a withholding tax on the gross rentals. As the profit margins are usually small compared to the gross income, the withholding tax under the gross basis may exceed the profit margin. If a foreign tax credit is given on a net basis in the residence country, it would lead to excess tax credits for the lessor at home.

The domestic tax laws of many countries treat the lease income as business profits, and tax the lessor only if there is a permanent establishment in their country,¹²¹ or if he

118 Examples: Argentina, Brazil, France, India, Italy, Portugal, South Africa, Spain and the United Kingdom.

119 Examples: Austria, Belgium, Canada, Germany, Japan, Korea, Luxembourg, Malaysia, Mexico, Netherlands, New Zealand, Norway, the United States and Uruguay.

120 Examples: Australia, Denmark, Finland, Hong Kong, Israel, Singapore, Sweden, Switzerland.

121 Examples: Australia, Belgium, Canada, Denmark, Germany, Finland, France, Hong Kong, Israel, Italy, Japan, Korea, Luxembourg, Netherlands, Norway, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, the United Kingdom, Uruguay.

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performs certain business activities.¹²² OECD MC 1977 included leases under the royalty article, subject to tax in the State of residence only, unless it was attributable to a permanent establishment in the host State. The OECD MC has now classified equipment lease income as business profits, which are taxable on a net basis but only if a permanent establishment exists. The UN MC does not provide this safeguard against juridical double taxation on leasing income.

4.5. Tax Allowances and Disallowances

Tax is levied on the net profits, i.e. the income after the deduction of all allowable expenditure incurred in earning the income. Most tax jurisdictions allow deductions for expenditure incurred for the purposes of the trade or business. The expenditure must be incurred “solely with the object of promoting the business or its profit earning capacity”, i.e. incurred to either produce the income, or to create new business. These expenses should reflect the taxpayer’s own business perspective and not the view of the tax authorities.

The expense deduction rules vary widely. For example:

- (a) Some countries require statutory provisions that may be tax deductible. For example, under the Mexican law the employees (except directors, administrators and general managers) have a right to receive 10% of the annual profits of the company as a profit-sharing bonus. The profits are distributed to the employees pro rata to their salary and the number of days worked by them during the year. The amount is a tax-deductible expense for the company to the extent that it exceeds the non-taxable benefits given to the employees.
- (b) Many countries specify the “wholly and exclusively” rule for the deduction of corporate expenses. The disallowed expenses are added back to compute the tax liability. Besides capital expenses, they usually include personal and non-business expenses, but could also comprise legitimate business expenses, if they are deemed excessive, unjustified or unacceptable tax avoidance.¹²³
- (c) Many jurisdictions disallow, wholly or partly, benefits in kind, such as entertainment, meals’ expenses and other employee fringe benefits. Other common disallowances include business gifts and donations, and expenses relating to the private use of motor vehicles.¹²⁴
- (d) While specific services rendered by the parent company may usually be charged (with or without a profit mark-up) to foreign group entities by its parent, the tax treatment of executive and general administrative overheads often varies. Some countries provide for the distribution of such expenses within the group, while others require such expenses to be charged only to the extent of the direct benefits to the subsidiary, or subject to prescribed limits (Example: India).
- (e) Several countries disallow deductions of “self-charged” payments or transfers between the head office and its foreign branches. A company may not make a profit from itself.

¹²² Examples: Malaysia, Luxembourg, Norway, the United Kingdom, the United States, Uruguay.

¹²³ Examples: Bangladesh, Cyprus, Guernsey, India, Ireland, Israel, Jamaica, Jersey, Kenya, Lebanon, Luxembourg, Malaysia, Mauritius, Malta, Myanmar, Namibia, Nigeria, Pakistan, Panama, Singapore, Tanzania, Trinidad and Tobago, Uganda, the United Kingdom.

¹²⁴ Examples: Belgium, Canada, China, Denmark, Finland, Ireland, Italy, Japan, Jordan, Malaysia, Mozambique, Netherlands, New Zealand, Slovenia, Trinidad and Tobago, Tunisia, the United Kingdom, the United States.

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Therefore, royalties and interest payments to the head office by an overseas branch are disallowed. Similarly, head office charges may be disallowed, wholly or partly, in the branch accounts. Actual expenses incurred or paid to third parties for the branch are usually deductible.¹²⁵

(f) Generally, no deductions are allowed for the income taxes paid, interest on late tax payments and tax penalties. Bribes and secret payments are tax-deductible in certain countries.¹²⁶ Some countries (e.g. Belgium, France) allow them but impose a penalty tax on such payments when made to an undisclosed recipient. Several countries fully disallow such expenses (Examples: Brazil, India, Italy, the United Kingdom, the United States).

(g) Revenue expenses are normally tax deductible, but capital expense items are not, unless they can be amortised or depreciated. They may also be subject to separate capital gains tax rules. The distinction usually follows the general accounting principles. Capital expenses tend to be non-recurring, relatively large and incurred to produce a long-term or enduring benefit.¹²⁷ Deferred revenue expenditure and capital improvements also have an enduring value and may be deducted over a matching period of benefits or income flows.

In June 1955, the Royal Commission on the Taxation of Profits and Income in the United Kingdom mentioned in its report that UK Courts generally used certain factors (“badges of trade”) to make their decision. They included:

- Actual subject of the transaction: Dealing in commodities is more likely to be a trade than dealing in assets used for investments.
- Length of ownership: Property that is traded is normally owned for a short period, while investments are held for a longer period.
- Frequency and number of similar transactions: A person who frequently buys and sells one type of property is more likely to be trading than a person who does so only once.
- Supplementary work: If a person who sells an asset has carried out any work to increase its value, he is more likely to be trading than if he had done nothing to improve it.
- Reasons for the sale: A sale may not be trading if it can be shown to have been made to deal with an unexpected emergency or opportunity.
- Motive: In some cases, the motive of a transaction is clearly discernible, and a motive may be inferred from the other circumstances in the absence of direct evidence from the person concerned.

Other badges of trade also exist. In case of isolated transactions not forming part of a regular trade or business, it may be inferred that the transactions were in the nature of a trade if one or more of the following factors are present:

- the existence of an organisation;
- production activities;

¹²⁵ Examples: Australia, Argentina, Belgium, Brazil, Canada, Denmark, France, Germany, Greece, Indonesia, Kenya, Luxembourg, Mexico, Portugal, Spain, the United Kingdom.

¹²⁶ Examples: Australia, Belgium, France, Germany, Japan, Netherlands, Sweden, Switzerland.

¹²⁷ *Atherton v British Insulated and Helsby Cables Ltd.* (1926) 10 TC 155 191 (UK): “Any expenditure which brings into existence an asset or any advantage of enduring nature is capital expenditure”.

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- special skills or opportunities; or
 - the fact that the nature of the asset lends itself to commercial transactions.
- (h) Tax deductions for provisions vary.¹²⁸ For example:
- Some tax jurisdictions do not grant deductions for future loss or contingency provisions;¹²⁹ others grant them for specific provisions (Examples: Australia, Egypt, Fiji, India, Israel, Lebanon, Uruguay, Uzbekistan, Venezuela); still others permit deductions for general provisions (Examples: Bulgaria, Croatia, Dominican Republic, France, Gabon, Germany, Italy, Lesotho, Luxembourg, Monaco, Peru, Portugal, Spain).
 - Some countries disallow provisions for bad debts, unless the debt is written off (Examples: Australia, Brazil, Egypt, Fiji, Hungary, India, Israel, Lebanon, Uruguay, Uzbekistan, Venezuela); others allow general or specific bad debt provisions.¹³⁰
 - The provision for inventory obsolescence is denied, wholly or partly, in certain countries (Examples: Angola, Argentina, China, Ecuador, Venezuela).
 - Some countries permit, or even require, various special provisions as tax-free reserves (Examples: Bangladesh, Finland,¹³¹ France, Germany, Italy,¹³² Korea, Mozambique, Netherlands, Portugal, Slovenia, Suriname, Sweden, Taiwan, Tunisia, Turkey).
- (i) Certain expenses may be disallowed under anti-avoidance rules. For example, excessive interest cost on related party transactions may not be deductible under thin capitalisation rules. Certain costs may be reallocated under transfer pricing rules.
- (j) The expenses are usually disallowed if the related income is tax-exempt or non-taxable. Certain expenses may be deductible only when they are paid (Example: interest payments).

Excess taxation can arise in cross-border operations due to the varying rules for expense deductibility. The domestic law in the home State may follow tax rules that differ from the host State. Local tax knowledge and professional advice are generally needed to ensure that there is no tax waste on unclaimed expenses due to ignorance of foreign laws and practices.

¹²⁸In the United Kingdom, provisions are normally tax deductible if made under UK generally accepted accounting principles (GAAP).

¹²⁹Examples: Austria, Bangladesh, Canada, Colombia, Costa Rica, Djibouti, Egypt, Fiji, Indonesia, Jordan, Kenya, Kuwait, Lebanon, Mauritius, Mexico, Namibia, Poland, Puerto Rico, Qatar, Slovak Republic, Seychelles, Slovak Republic, Solomon Islands, Sri Lanka, Swaziland, Thailand, Uganda, Uruguay, Venezuela.

¹³⁰Examples: Angola, Argentina, China, Czech Republic, Dominican Republic, Ghana, Greece, Guatemala, Honduras, Ireland, Indonesia, Italy, Jamaica, Kazakhstan, Korea, Macau, Macedonia, Myanmar, Namibia, Pakistan, Panama, Peru, Portugal, Qatar, Romania, Singapore, Taiwan, Trinidad and Tobago, Tunisia, Turkey, the United Kingdom, the United States.

¹³¹Finland permits a price fluctuation reserve to be set up at the year-end if the price of inventory ordered but not received is 10% or more lower than the price agreed with the supplier.

¹³²Italy allows a tax-deductible reserve for unrealised foreign-exchange losses based on annual revaluations of foreign assets and liabilities at the average exchange rate for the last month of the financial year.

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4.6. Tax Incentives

4.6.1. General

Incentives are measures that make one investment more attractive than another alternative investment.¹³³ They are meant to provide a more favourable regime to investors. In many cases, they offset the disadvantages that investors face due to high taxes, inadequate infrastructure, bureaucratic rules and/or poor administration in the host country. They may be given to both domestic and foreign investors or restricted to either of them, i.e. ring-fenced.

Incentives are either financial (e.g. grants, subsidised facilities, low-interest loans, etc.) or fiscal in nature.¹³⁴ They promote a general or specific economic or social development objective within a particular region, industry, activity or class of persons. A common objective is to help national or regional economic development, exports, technology transfers or employment creation. Many countries also give incentives to help develop specific industries or investors, such as manufacturing, agriculture, shipping and shipbuilding, film industry, high technology and research and development centres, financial services, tourism and hotels, software exports, etc.

Tax incentives include tax holidays or exemptions, investment credits or allowances, accelerated depreciation, additional expense deductions, reductions in the corporate or withholding tax rates, tax deferral, relief for expatriate taxes, etc. Weighted deductions may be granted for research and development expenses, approved training expenses, export market expenses, job creation, etc. Some countries partly or fully tax-exempt reinvested profits (Examples: Brazil, China, Guatemala, Italy, Malaysia, Senegal, Sweden). Certain countries grant tax incentives as fixed tax credit, rather than as a deduction from profits that are taxed progressively at the marginal rate.

The incentives may also include special deductions (partial or full) or allowances for certain expenses. For example, Switzerland permits one-third of the value of inventories to be written off through under-valuation, if it is recorded in the financial books of account. Malaysia and Singapore grant double deduction for employee training, research and development and export expenses.

Many countries provide fiscal incentives to attract inbound investments. Some countries provide tax incentives to encourage outbound investments and develop foreign market opportunities (Examples: France, Germany, Japan, Spain).¹³⁵ It is true that tax is not a primary consideration in deciding to invest abroad. However, once a decision to invest abroad has been made, the investors normally look for the most cost-effective location that meets their business objectives. Several countries give tax incentives to encourage the set-up

¹³³Very few countries do not give tax and other incentives. Examples: Austria, Croatia, Czech Republic, Dominican Republic, Guernsey, Hong Kong, Macau, Malawi, Monaco, New Zealand.

¹³⁴David Holland and Richard Vann, *Income Tax Incentives for Investment* (Tax Law Design and Drafting, 2000) pp. 1008–1020; Alex Easson, *Taxation of Foreign Direct Investment*, pp. 19–24, pp. 54–65.

¹³⁵For example, French companies may create a tax-deductible reserve for five years to cover the costs of a foreign subsidiary or branch.

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of holding companies and various group service centres¹³⁶ of multinational companies in their jurisdiction.¹³⁷

A major use of incentives is to encourage export-related operations. Many countries provide special zones or Freeport facilities with concessionary or nil customs duties and taxes.¹³⁸ At least 800 such zones exist around the world in over 100 different countries. Since high taxes make countries less competitive in international markets, the export-oriented investments (both manufacturing and services) are particularly influenced by tax incentives. Much of this investment is highly mobile, cost conscious and tax sensitive. Often, the incentives affect both the decision to invest and where to invest.¹³⁹

The effectiveness of tax incentives depends on their tax impact on both the source State of the investment and the residence State of the investor. The various incentives exempt, defer or reduce the tax costs in the source State. These measures may not be fully effective for several reasons. For example:

- The investor may not have enough taxable profits to take advantage of the tax incentives. As a result, the tax benefits may be lost unless they can be carried forward or set off against other income.
- A new investment normally makes losses in the start-up period. If the tax holiday period is not long enough, there may be no taxable profits to shelter. The tax losses during the period may be lost, unless they can be carried forward beyond the holiday period. Moreover, the taxes in the post-holiday period may be increased since there are no carry-forward losses available to offset the profits. To be effective, the tax laws should specify that the holiday starts when the cumulative net taxable profits are positive. The depreciation allowances should also be deferred to the post-holiday period.
- Acceleration of deductions or deferral of income recognition could lead to timing differences that create tax losses (or reduce profits) in earlier years for offset against the profits that arise in future. Again, unless the countries provide that the tax losses (e.g. due to unused depreciation allowances) can be carried forward for a long or indefinite period, these tax benefits of timing differences may be lost.

The tax incentives given in the source State may be recaptured when the residence State grants relief under the credit method for the foreign taxes on repatriated profits or other income. Unless tax sparing is given under a tax treaty, there is simply a transfer of tax revenue from the source country to the residence country. Although this incentive is now often restricted and given only for a limited period, many developing countries insist on tax sparing in treaty negotiations.¹⁴⁰

136 Examples: operational or regional headquarters, finance centres, co-ordination centres, distribution or marketing centres, research and development centres, licensing centres, captive insurance companies, etc.

137 Examples: Australia, Belgium, Cyprus, France, Ireland, Luxembourg, Malaysia, Mauritius, Netherlands, Philippines, Singapore, Switzerland, the United Kingdom.

138 Examples: Bangladesh, Costa Rica, Croatia, Cyprus, Ecuador, Egypt, Fiji, Germany, Guatemala, India, Ireland, Israel, Kenya, Latvia, Lithuania, Malaysia, Malawi, Malta, Mauritius, Namibia, Netherlands, Netherlands Antilles, Nigeria, Panama, Peru, Philippines, Poland, Portugal, Puerto Rico, Senegal, Spain, Sri Lanka, Taiwan, Thailand, Ukraine, the United Kingdom, the United States, Uruguay, Vietnam, Zimbabwe.

139 Alex Easson, *Taxation of Foreign Direct Investment* (Kluwer Law International, 1999) p. 62–65.

140 See Chapter 4(8.4).

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In the view of some tax commentators, tax incentives have not been very effective in attracting foreign investments or technologies, and lead to various tax avoidance schemes. Moreover, they believe that if the investment were economically justified, it would have taken place in any event. Therefore, tax incentives should be targeted to specific economic or social objectives that would not have occurred without the incentive.¹⁴¹

The Ruding Report¹⁴² issued in 1992 did not favour tax incentives and recommended the use of financial incentives. Tax incentives for geographically mobile activities, such as group financial and service activities have also been attacked by the OECD as harmful tax competition.¹⁴³ These activities can be located almost anywhere provided there is a good telecommunications service. Tax factors often play a primary role in deciding the location.

Despite these comments, tax incentives are widely given by countries to foreign investors. Just as countries are free to choose the type of fiscal and social system they prefer, investors should be free to choose among such systems. All other things being equal, the use of tax incentives helps to achieve a competitive advantage in global business activities. The tax competition among nations should also lead to more efficient tax systems and lower tax costs. In developing countries, tax incentives often help to compensate for their unattractive, or not so attractive, economic or political infrastructure.¹⁴⁴

A survey of the major companies within the European Union Member States in the nineties mentioned that 75% of the companies in the study were influenced by tax incentives in their investment decisions. The most popular tax incentives were low tax rates and, to a lesser extent, high depreciation rates and tax-favoured distribution centres.¹⁴⁵

4.7. Assessment and Withholding Taxes

Income may be taxed annually on assessment, or subject to a withholding tax on the payment at the time that it is made to the taxpayer. Generally, business income is assessed on a net income basis (i.e. with expense deductions) at the end of the year while passive income is subject to withholding taxes on the gross amount (i.e. without expense deductions). Many countries apply a hybrid system combining the assessment and withholding systems for employee taxes. Tax is deducted from their salaries and paid over to the authorities every month, based on the estimated annual income. Any adjustment due to excess tax payable or refundable is made at the end of the year against their tax return.

Under the assessment basis, the taxpayer is normally required to file a tax return giving the information necessary for the tax authorities to determine the liability. This return

141 David Holland and Richard Vann, *Income Tax Incentives for Investment (Tax Law Design and Drafting, 2000)* pp. 986–1008.

142 Report of the Committee of Independent Experts on Company Taxation – Chairman, Mr. Onno Ruding (European Communities, Luxembourg, 1992)

143 Committee on Fiscal Affairs: *Harmful Tax Competition – An Emerging Global Issue* (OECD, 1998). See Chapter 2(8.1).

144 A. Easson, *Taxation of Foreign Direct Investment (Kluwer Law International, 1999)* pp. 162–165; A. Easson, *Tax Incentives for Foreign Direct Investment (IBFD Bulletin, July/August 2001)*.

145 Terry M Browne, *International Investors Miss out on Hidden EU Tax Incentives (Tax Planning International Review, 1996)*.

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includes the details of the taxable income, allowable deductions and any other tax reliefs or disallowances. The tax authorities compute the tax and make a tax demand on the taxpayer for any tax due or give a refund for the excess tax paid. Several countries have adopted a system of self-assessment. Under this procedure, the taxpayer is required to calculate the tax himself and pay the amount. The authorities only check the assessment. The taxpayer is held responsible for the correct payment of his taxes, and any underpayment is usually subject to interest and/or penalties.

Since tax assessments cannot be made until after the end of the tax year, many countries require advance payment of the tax during the year based on estimates to ensure that it is received as soon as the taxable income is earned. The estimate is based either on the tax paid in the previous year or on an amount adjusted for known changes expected in the amount payable for the year. Final adjustments are made when the tax return is filed. Under-estimates, if material, may again be subject to an additional interest payment. Under the tax law, it is the statutory duty of every taxpayer, subject to penalties, to ensure that he pays the correct amount of annual tax due on time.

Active business income (including independent personal services) is generally taxed on a net basis on assessment, while the income from passive and dependent personal services is usually subject to a flat withholding tax. The tax is withheld at a fixed rate, either as a final tax with no tax-filing requirement,¹⁴⁶ or as a provisional tax subject to a regular assessment under his tax return.¹⁴⁷ Generally, a withholding tax is imposed on interest and dividends payments to residents and non-residents. Often, these withholding requirements are extended to royalties and in some cases to rental income and management fees. The withholding method is also applied when the collection of tax is either difficult or subject to delay.

Under the withholding tax regime, the amount of tax due from the recipient as taxpayer is withheld by the payer at source and paid over to the tax authorities on his behalf. The rate may be the full rate under the domestic law or a lower treaty rate. The tax may be final or subject to adjustment against the tax payable on assessment. The creditable withholding tax ensures the payment of tax at the earliest possible moment. As countries do not normally enforce the tax laws of another jurisdiction, withholding tax is widely used for tax collection when payments are made to nonresidents.

Tax withheld from residents is usually creditable against other taxable income and any excess tax payment is refunded. For nonresidents, the payer is required by law to deduct the appropriate withholding taxes at the time of making the payment. As the person withholding the tax is responsible for collecting (and sometimes calculating) the tax, he is jointly liable for the tax due from the nonresident payee as a "representative assessee". The payer may not be allowed to claim the payment as an expense deduction for its tax purposes unless he complies with the withholding tax rules.

¹⁴⁶ Examples: Argentina, Brazil, Chile, Cyprus, Finland, Gabon, Guatemala, Guernsey, Guinea, Honduras, Indonesia, Ivory Coast, Japan, Jersey, Mozambique, Taiwan, Turkey, Venezuela.

¹⁴⁷ David W Williams, IFA Cahiers Vol. 83B, General Report, 1998.

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The withholding tax may or may not be the final tax. The final tax simplifies the collection of tax, particularly when due from nonresidents. However, if it bears little or no relationship with the tax circumstances of the taxpayer, it may be excessive or inadequate. If it is not the final tax, any excess withholding tax can be reclaimed but only on an assessment at a later date. A similar situation also arises if the tax is not withheld at the reduced treaty rate but at the full rate, subject to refund. In both cases, there is a cash-flow disadvantage with related costs as the refund procedures can be often difficult and slow. These procedures normally require the nonresident taxpayer to file a tax return for an adjustment of the tax liability.¹⁴⁸ He must, therefore, notify the tax authorities, provide them with the necessary information to compute the tax, appoint a tax agent if required, and meet other compliance requirements.¹⁴⁹

Tax on passive income is normally imposed on the gross payment. Therefore, the withholding tax rates generally tend to be lower than the tax rates applicable on active income taxed on a net basis. As long as the home tax on the gross receipt less expenses is more than the withholding tax in the host country, the total tax liability on the recipient should not exceed his home tax liability, provided a credit is given for the foreign tax.¹⁵⁰ As mentioned above, there is a cost due to the timing of the tax payments in the host and home countries. The withholding tax is paid to the source State when the income is received, whereas the tax payment in the residence State is deferred until the prescribed due date under the domestic law at home. This deferral itself represents a tax benefit due to the time value of money.

A survey by the Ruding Committee noted that many multinationals regarded withholding taxes as a major concern when making cross-border investments.¹⁵¹ International tax planners generally choose countries with nil or low withholding tax, or attempt to reduce them by using intermediary entities. A high withholding tax in the source State is considered as a deterrent to international investment and trade.

5. TREATMENT OF TAX LOSSES¹⁵²

5.1. General

Income is taxed when it is positive. While a company pays taxes when it makes profits, it is not given a tax refund when it makes losses (i.e. negative profits).¹⁵³ However, tax losses constitute deferred tax benefits. They may be carried forward (or sometimes back) and

¹⁴⁸ Examples: Australia, Austria, Finland, Germany, Hong Kong, Luxembourg, Norway, Portugal, Switzerland, the United Kingdom.

¹⁴⁹ J.S. Phillips and M.H. Collins, IFA Cahiers Vol. 70A, General Report, 1985, pp. 26–28.

¹⁵⁰ Since the withholding tax is often levied on the gross payment without any allowance for expenses incurred in the home State, the recipient may suffer from excess foreign tax credits.

¹⁵¹ Report of the Committee of Independent Experts on Company Taxation – Chairman, Onno Ruding (European Communities: Luxembourg, 1992).

¹⁵² A. Michelsen, IFA Cahiers Vol. 83A, General Report, 1998.

¹⁵³ Julian S. Alworth, *The Finance, Investment and Taxation Decisions of Multinationals* (Basil Blackwell, 1988) p. 47.

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offset against future (or sometimes past) taxable profits. Tax losses include losses from both business operations (“operating losses”) as well as timing differences (“timing difference losses”).¹⁵⁴

Tax-loss offset rules vary widely and are generally subject to restrictions. Some countries restrict the offset of tax losses against income from the same source.¹⁵⁵ Sometimes, the operating losses can be offset against other taxable profits in the same year, but loss carry-forwards can only be set off against future income from the same source or trade.¹⁵⁶ Others allow losses, including capital losses and exchange losses, as offset against future profits from all sources.¹⁵⁷ A few countries limit the offset of timing difference losses due to unused depreciation allowances to income from the same trade that generated them. The tax treatment of foreign exchange losses may or may not follow the underlying revenue or capital transactions. The losses on tax-exempt income sources are normally disallowed since the corresponding profits are not taxable.

Separate rules may apply to “ring fence” the tax loss relief by class or by type of income. In many countries, the capital and revenue losses are subject to different offset rules. Foreign-source income may also be further divided into separate categories or “baskets”.¹⁵⁸ For example, in Argentina and Venezuela the losses from foreign-sources may offset only foreign-source income. In Germany, passive losses from foreign-sources may be set off only against similar source income from the same country. Similarly, in Israel and Romania, the losses incurred in foreign activities may be deducted only against foreign revenues on a per-source basis.

Some of the questions affecting tax loss utilisation include:

- Do the tax rules differ depending on the type of losses e.g. revenue, capital, operating, etc.? Are there any limitations under the rules? Are there any anti-avoidance rules affecting tax loss utilisation?
- Are capital losses treated differently from revenue losses? Are losses quarantined or ring-fenced so that they can only be offset against future income from the same income in future? Are operating losses treated differently from losses due to timing differences? Are there special rules for start-up losses?
- Are losses deductible against current, previous or future profits? What is the maximum period for carry-back or carry-forward of losses? Can current losses be offset against other taxable income in the same year?
- How are foreign branch losses treated for tax purposes? Are there special rules that allow the current use of losses in subsidiaries? Are there any group taxation provisions (domestic or foreign)?

¹⁵⁴ Timing difference losses arise due to the treatment of income and expense in differing tax years for book and tax purposes.

¹⁵⁵ Examples: Argentina, Australia, Belgium, Brazil, Canada (capital losses), Denmark, Norway, Germany, Hong Kong, Israel, Luxembourg, Netherlands, New Zealand, South Africa, Sweden, the United Kingdom, the United States.

¹⁵⁶ Examples: Gibraltar, Hong Kong, India, Ireland, Israel, Poland, the United Kingdom.

¹⁵⁷ Examples: Malta, Poland, Singapore, and Spain.

¹⁵⁸ Examples: Argentina, Australia, Germany, the United States.

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- Are loss carry-forwards affected by a change of ownership of the enterprise? Does the tax law provide special rules for loss utilisation that affect transfer of shares or business assets, group reorganisations, etc.?

5.2. Revenue or Trading Losses

Most countries in the world allow the carry-over of losses of residents and permanent establishments of nonresidents for either an unlimited or a specified period. Few countries also provide for the carry-back of losses for offset against past taxable profits.

Some examples of carry-forward/back period for revenue losses include:

(a) Carry-forward period for trading losses:

- **Nil:** Uzbekistan
- **Up to five years:**
 - 1 year: Guatemala
 - 3 years: Albania, Angola, Congo, Costa Rica, Dominican Republic, Ethiopia, Gabon, Guinea, Honduras, Kazakhstan, Lebanon, Macau, Macedonia, Moldova, Myanmar, Nicaragua, Paraguay, Philippines, Qatar, Senegal, Tunisia, Uruguay, Venezuela
 - 4 years: Cameroon, Mauritania, Morocco, Nepal, Nicaragua, Nigeria, Peru, Yemen
 - 5 years: Argentina, Aruba, Azerbaijan, Botswana, Bulgaria, Cambodia, China, Colombia, Croatia, Czech Republic, Ecuador, Egypt, El Salvador, Georgia, Ghana, Greece, Hungary, Indonesia, Italy, Ivory Coast, Japan, Latvia, Libya, Liechtenstein, Lithuania, Monaco, Montenegro, Mozambique, Oman, Panama, Poland, Romania, Rwanda, Seychelles, South Korea, Slovak Republic, Slovenia, Solomon Islands, Sudan, Taiwan, Tanzania, Thailand, Turkey, Ukraine, Vietnam, Yugoslavia, Zambia
- **Over five years:**
 - 6 years: Bangladesh, Brunei, Jordan, Pakistan, Palestine, Portugal, Zimbabwe
 - 7 years: Papua New Guinea, Puerto Rico, Sri Lanka, Suriname, Switzerland
 - 8 years: Colombia, Fiji, India
 - 9 years: Barbados
 - 10 years: Canada, Finland, Iceland, Mexico, Netherlands Antilles, Norway, Russia, Serbia
 - 15 years: Spain
 - 20 years: Guam, the United States
- **Indefinite:** Australia, Austria, Belgium, Bolivia, Brazil, British Virgin Islands, Chile, Cyprus, Denmark, Djibouti, France, Germany, Gibraltar, Guernsey, Guyana, Hong Kong, Hungary, Iran, Ireland, Isle of Man, Israel, Jamaica, Jersey, Jordan, Kenya, Kuwait, Lesotho, Luxembourg, Malaysia, Malta, Mauritius, Namibia, Netherlands, New Zealand, Saudi Arabia, Singapore, South Africa, Swaziland, Sweden, Tanzania, Trinidad and Tobago, Uganda, Ukraine, the United Kingdom

Source: Ernst & Young – Worldwide Corporate Tax Guide

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Some countries have different loss treatment for operating losses and tax losses due to timing differences. The latter may be carried forward indefinitely. (Examples: Bangladesh, Belgium, Cameroon, Congo, India, Malta, Monaco, Morocco, Pakistan, Senegal, Sri Lanka). Most countries require that the tax losses be used as early as practicable. Few countries allow the taxpayer to defer the loss carry-forwards for use in a later tax year (Examples: Belgium, Canada).

Certain countries grant a longer or indefinite period for losses incurred during the start-up period.¹⁵⁹ For example, in Italy and Suriname the losses during the first three years of operations may be carried forward indefinitely. The losses within the first five years may be carried forward for seven years in Japan. India allows the start-up costs to be capitalised against the assets and depreciated for tax purposes. Portugal requires that the start-up costs are capitalised and written off over three years. In Norway, the shareholders may take a tax deduction over five years for the cash contributions made to a Norwegian company engaged in a new activity.

Besides the time limitation on carry-overs, other limitations may prevent the use of tax losses. For example:

- Hungary: Operating losses in the first four tax years of a company's existence may be carried forward indefinitely. Losses in subsequent years may also be carried forward indefinitely, provided 50% of the annual turnover exceeds all costs and expenditures and the company does not incur operating losses for two consecutive years. If these conditions are not satisfied, the approval to carry forward the losses has to be obtained from the tax authorities.
- United Kingdom: The United Kingdom allows trading losses to be set off against other income and chargeable gains in the current or preceding year but loss carry-forwards can only be used for an offset against future income from the same trade.
- Other examples: Ecuador limits the past loss offset to 25% of the year's profits. Brazil and Russia limit the use of losses to 30% of the net income in any year. Germany limits loss utilisation to 60% of the balance taxable income for the year. Panama limits the loss offset to 50% of the taxable profits; furthermore, the allowable losses are restricted to 20% of the loss in each year. Poland limits the loss offset to 50% of the original loss in any year within a five-year period. In Palestine, the carry-forward loss offset is limited to 50% of the current profits over six years. Austria allows 75% of the past tax losses to be offset in any year with the balance carried forward for future offset. The losses in Guyana may not reduce the taxable income in any year by more than 50% or the tax payable to less than 2% of turnover.

Tax benefits of past losses of a company are usually denied if there is a change in the economic or legal identity.¹⁶⁰ It could be the result of a change in ownership or

¹⁵⁹ Examples: Belgium, Finland, Hungary, Italy, Germany, Japan, Luxembourg, Netherlands, South Africa, Slovak Republic, Spain.

¹⁶⁰ Examples: Australia, Belgium, Brazil, Canada, Denmark, Fiji, Finland, France, Germany, Hong Kong, Hungary, India, Ireland, Israel, Italy, Kuwait, Netherlands, New Zealand, Norway, Papua New Guinea, Philippines, Portugal, Singapore, Solomon Islands, South Africa, Spain, Sri Lanka, Switzerland, the United Kingdom, the United States, Uruguay.

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control or a change in the nature or conduct of the trade due to a reorganisation, such as a merger, division or liquidation. Several jurisdictions also have special rules for the transfer of losses on mergers and acquisitions.¹⁶¹ Certain countries restrict the carry-over of losses when a company is liquidated,¹⁶² or its debt is restructured.¹⁶³ There are very few countries that do not insist on some continuity of ownership or trade (Examples: Austria, Brunei).

(b) Carry-back period for trading losses:

- One year - Germany, Guernsey, Ireland, Isle of Man, Japan, the United Kingdom
- Two years - Guam, Jersey, the United States
- Three years - Canada, France, Monaco, Netherlands
- Indefinite - Chile

Revenue losses may be carried back in certain countries and offset against past profits to claim a refund of the taxes already paid. Ireland grants an optional carry-back of trading losses for one year. Germany permits a one-year optional loss carry-back up to EUR 511,500 for corporate income tax (but not trade income tax). The United States allows corporate taxpayers to elect a loss carry-back for two years, but the loss must be carried back fully against past profits. France permits an optional carry-back for three years. The amount may be used for the payment of corporate taxes in the following five years, and the tax benefit of any remaining unused losses is refunded to the taxpayer in the sixth year. Chile grants unlimited carry-back of losses to the extent that a taxpayer has retained profits.

Some countries allow carry-back of losses when the company ceases its business activities. (Examples: two years – Norway; three years – Ireland, Sri Lanka).

5.3. Capital Losses

Capital tax losses arise on the disposal of capital assets. In countries where capital transactions are included in ordinary income, no distinction is normally made between revenue and capital losses. In other countries, the trading losses may often be set off against capital gains, but the capital losses can be relieved only against present or future capital gains.¹⁶⁴ Some countries allow the capital losses to be offset against current trading profits. In Brazil, the capital losses are offset against ordinary income in the year they arise, but any capital loss carry-forwards can only be deducted from future capital gains. There are also a few jurisdictions that do not allow any tax relief for capital losses (Examples: Czech Republic, Myanmar, Russia).

The carry-forward period for offset of capital losses against future capital gains varies. For example, Canada, Ireland and the United Kingdom allow an indefinite carry-forward of capital losses. Canada also permits carry-back for three years. France permits long-term

¹⁶¹ Examples: Belgium, Colombia, Denmark, Finland, India, Italy, Netherlands, Sweden, the United States.

¹⁶² Examples: Denmark, Germany, India, Italy, Norway, Sri Lanka, Sweden.

¹⁶³ Examples: Argentina, Brazil, Canada, Denmark, Netherlands, Norway, South Africa, Sweden.

¹⁶⁴ Examples: Australia, Brazil, Canada, Chile, Finland (non-business assets), France, Guatemala, India, Ireland, Israel, Malta, Mexico, Pakistan, Puerto Rico, Sri Lanka, the United Kingdom, the United States.

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capital losses to be carried forward for ten years for offset against future capital gains. India provides eight years. Israel provides for a sevenyear carry-forward. Pakistan grants six years. Guatemala, United States and Puerto Rico allow capital losses to be carried forward for five years. In Denmark and Finland, the capital loss on non-business assets can only be deducted from similar gains within the following three years. Russia allows deduction for capital losses on disposal of a depreciable asset over the remaining useful life of the asset.

5.4. Foreign Branch Losses

Generally, foreign branch losses cannot be relieved against the domestic profits of an enterprise, which is taxed under the territorial tax regime. In countries that tax their residents on their worldwide income, the results of the foreign branches are normally included in the combined accounts of the enterprise. The profits and losses of the enterprise are aggregated on a current basis and a tax exemption or credit is given for any foreign taxes paid on the branch income. Thus, they grant an expense deduction for the foreign branch losses, unless the foreign branch profits are tax-exempt.

The branch losses are also available for offset against the future profits of the branch itself. Therefore, these losses are tax-deducted twice, namely (i) against the taxable income at home when they arise, and then (ii) against the future profits of the branch through loss carry-forwards. The common tax concern is to neutralise this presumed “dual benefit” of the foreign branch losses.

Under the exemption method, there is usually no duplication of loss relief. In countries that follow the credit method to avoid double taxation, the foreign loss is not ultimately deducted twice. The loss abroad reduces the combined taxable profits at home in the year of loss. If the loss is carried forward in the source country and offset against its future profits, it reduces the tax credit in that year. The subsequent recapture of the loss only creates a tax deferral or a timing issue in the home State. If the branch losses cannot be carried forward, there is no tax loss relief in the host country and there is no subsequent tax recapture in the home State. Again, there is no double relief for the tax losses of the branch.¹⁶⁵

Several jurisdictions grant partial or full tax-exemption for foreign branch profits under their domestic law or treaties.¹⁶⁶ The offset of the foreign branch loss against the profits of the head office is normally disallowed since the branch income is tax-exempt. As the branch loss is not relieved, the enterprise as a legal entity during that year pays excess taxes.¹⁶⁷ Moreover, if the foreign branch fails, the losses may be disallowed forever. A few countries with exemption relief for branch profits allow the deduction for foreign branch losses against the profits of the head office with subsequent recapture provisions when the

¹⁶⁵ Gerhard Laule, IFA Cahiers Vol. 64B, General Report, 1979.

¹⁶⁶ Examples: Australia, Austria, Belgium, Denmark, France, Germany, Luxembourg, Netherlands, Spain, Switzerland.

¹⁶⁷ Similar situations also arise when a foreign branch makes a profit and is taxable while the taxpayer makes a loss at home.

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branch becomes profitable (Examples: Austria, Belgium, Denmark, France,¹⁶⁸ Germany, Netherlands, Switzerland). South Africa taxes foreign branch profits but allows the offset of foreign branch losses only against foreign profits in future years.

Foreign subsidiaries are separate legal entities. Unlike branches, the losses of foreign subsidiaries are not normally tax deductible.

In some countries, a permanent diminution in the share value of a foreign subsidiary may be written off against its book value (Examples: Austria, Germany, Italy, Switzerland). Some countries allow a deduction for capital losses (partly or fully) on the disposal of shares in foreign subsidiaries (Examples: France, Ireland, Italy, Luxembourg, Switzerland, the United Kingdom), while others disallow them (Examples: Belgium, Germany, Netherlands, Spain). Several jurisdictions disallow any capital losses resulting from excessive profit distributions through “dividend stripping” (Examples: Austria, Belgium, Germany, Italy, Luxembourg, Netherlands).

France permits a deduction for the start-up losses of foreign subsidiaries, with recapture provisions when they become profitable. In the United States, they can be deducted only as a capital loss on the sale of the shareholding or the expected liquidation of the subsidiary. In Canada, Denmark and Sweden, a write-off requires that the foreign company be actually liquidated.

5.5. Group Taxation¹⁶⁹

Several jurisdictions provide special rules to offset the losses and profits of companies within a group. Some of these rules allow for tax-free transfer of assets within a qualifying group of companies. The gain on the transfer of capital assets is only taxed when they leave the group (Examples: France, Ireland, Netherlands, Portugal, Spain, the United Kingdom). These tax consolidation provisions avoid the need to operate as a single legal entity with divisions or branches for tax purposes. While many countries allow tax consolidation of resident companies, there are only four countries (e.g. Austria, Denmark, Italy and France) that currently offer worldwide tax consolidation.¹⁷⁰

Group taxation systems may be broadly divided into three main categories:¹⁷¹

- (i) **Fiscal Unity system:** The group is treated as a single entity for tax purposes. It pools the profits and losses of the group members and files a joint (consolidated) tax return. Generally, the losses incurred before the consolidation period by a company cannot be applied to offset joint profits within the tax group. Such losses may be carried over by

¹⁶⁸ France: The start-up losses of foreign branches during the first five years may be deducted with claw-back out of profits in the following five years; Germany: allows the offset of losses if the branch is tax exempt under a treaty. The amount is recaptured from subsequent profits in that country, unless there is loss carry-forward; Netherlands: The recapture period is limited to eight years; Switzerland: The losses are recaptured from subsequent profits within seven years.

¹⁶⁹ See Chapter 5(6).

¹⁷⁰ Bertil Wiman, *Equalising the Income Tax Burden in a Group of Companies* (Intertax, 2000) pp. 352–359; Abadan Jasmon and Junaid Shaikh, *Developments and New Ideas in the Group Relief Framework* (IBFD Asia-Pacific Tax Bulletin, October 2002) pp. 334–339; for a detailed analysis of group taxation issues, readers are advised to review the IFA Cahiers Vol. 89B on Group Taxation, 2004.

¹⁷¹ Terry M Browne, *Group Taxation in the European Union* (Tax Planning International Review, 1997).

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the company for offset against its own future profits. Usually, all group companies must be tax-resident, taxable and within the prescribed level of ownership or voting control. Examples: Austria (2005),¹⁷² Australia, Denmark, France, Germany, Iceland, Israel, Italy, Japan, Luxembourg, Mexico, the Netherlands, New Zealand, Poland, Portugal, Slovenia, Spain, Tunisia, the United States.

- (ii) **Group contribution system:** A profitable company contributes to one or more loss-making companies within the group. These contributions are tax-deductible for the paying company and taxable for the receiving company. Each company files its own tax return and pays its own taxes. Both the receiving and paying companies must be resident for tax purposes.

Examples: Finland, Norway, Sweden.

- (iii) **Group relief system:** A loss-making resident company surrenders its current losses to the profitable resident companies in the group, with or without a subvention payment.¹⁷³ Each company files its own tax return and pays its own taxes.

Examples: Austria (see above), Barbados, Cyprus, Ireland, Latvia, Malta, Mauritius, New Zealand, Singapore, Trinidad and Tobago, the United Kingdom.

6. ADVANCE TAX RULINGS

6.1. General

Many countries provide advance tax rulings (“ATR”) today. These rulings are issued either under a formal legislation by a separate body (Examples: India, Sweden) or given by the tax authorities with or without any statutory obligation. Typically, the ruling is given on application before undertaking a transaction, although some jurisdictions grant rulings on completed transactions. An OECD Report issued in 2004 defined a ruling as “any advice, information or undertaking provided by a tax authority to a specific taxpayer or a group of taxpayers concerning their tax situation and on which they are entitled to rely”.¹⁷⁴

Advance tax rulings may be public or private rulings. The tax authorities provide public rulings or opinions on general or specific tax issues. These public rulings inform the taxpayer on broadly described situations, and may not be legally binding. They deal with administrative practices and procedures and give their interpretation of the tax laws. Such rulings are usually published and can be applied by the taxpayer without making an application for a ruling. These public rulings do not deal with specific situations. On the other hand, private rulings are “a statement issued, upon request, to a (potential) taxpayer indicating the tax administration’s view of the tax treatment of a particular set of facts and circumstances contemplated, in the process of completion, or completed but not yet assessed”.¹⁷⁵

¹⁷² As from 2005, Austria provides for full fiscal unity for resident subsidiaries and group relief for foreign subsidiaries.

¹⁷³ A subvention payment is an intercompany payment specifically made for the transfer of company losses.

¹⁷⁴ Committee on Fiscal Affairs: Consolidated Application Note – Guidance in applying the 1998 Report to Preferential Tax Regimes (OECD, 2004) pp. 47–60.

¹⁷⁵ D. Sandler, *The International Guide to Advance Rulings* (IBFD Publications BV, 1997).

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Private rulings provide tax certainty to taxpayers in their tax planning. On latter transactions, they avoid additional tax costs from litigation, penalties and interest. The tax authorities also benefit through reduced compliance workload and improved tax administration. Such rulings may be binding on the tax authorities for a specific taxpayer, provided all the relevant facts are fully disclosed, and the transactions follow the ruling request. Since they are personal rulings, they may not be directly applicable to other taxpayers but may provide guidance to them in similar circumstances.

An effective private ruling system should contain several features. For example, the taxpayer should be offered an opportunity to obtain an advance ruling on the tax consequences of bona fide transactions within a reasonable time. It should be given at least in cases of general legal importance or if they are of material significance to the taxpayer. The taxpayer should be able to negotiate with the authorities and either amend the transaction or withdraw the application before a negative ruling is issued. The fiscal authorities (and the courts) should be bound by the advance ruling upon which a taxpayer has relied in good faith. Any subsequent change in the law should be applied as far as possible without retrospective effect. The advance rulings should be published to ensure the uniform application of law.

Other desirable factors require that the grant of the private tax ruling should be obligatory under the law and not left to the discretion of the tax authorities. It should be issued at no cost to all taxpayers as a legal right. Exceptional circumstances when it may be refused should be explicitly defined by statute. There should also be a right of appeal in cases of delayed or no rulings and adverse rulings, wherever this is administratively and legally practicable. Moreover, the opportunity to obtain the advance rulings should neither be limited to special problems nor to certain taxes, but be provided on all taxes and tax issues.

Thus, some questions to ask on advance tax ruling systems are:

- Is there a ruling practice? Who can apply for a ruling? What is the scope and legal basis for the rulings? What tax areas and issues or types of transactions can they cover? In what circumstances must a ruling be granted? In what circumstances can a ruling be refused or not given? Can the taxpayer appeal against a refusal to give a ruling?
- What are the procedures for requesting a ruling? Who should it be submitted to, and in what form? When should it be made (pre or post transaction)? Are there any charges levied? What is the time limit for obtaining a ruling? Can a taxpayer appeal against a delay in the grant of a ruling or a decision not to give a ruling?
- Is the ruling legally binding on the tax authorities? Is it binding on the taxpayer? To what extent, is it binding? Is there a time limit for the binding period? Are legal rulings binding on the courts?
- Can a taxpayer modify or withdraw a request for a ruling? When can a ruling be withdrawn? What is the effect of judicial decisions or changes in tax laws? Can the authorities revoke or modify a ruling previously given? Is there any protection given to the taxpayer in such cases? Can a taxpayer appeal against an adverse ruling?
- In what circumstances are rulings made public or published? Can they be relied upon by other taxpayers as tax precedents on other transactions? Can they bind similar or continuing transactions by the same taxpayer or similar transaction by other taxpayers?

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- Are advance rulings given on transfer pricing issues, e.g. advance pricing arrangements?

Private rulings may not be worthwhile in all cases. They normally require full disclosure of the proposed transaction or transactions, and could involve time-consuming preparation of the application and negotiations with the authorities. In situations involving contentious interpretations on tax legislation, the ruling may be conservatively given by the tax authorities, and without an appeal procedure. In some countries, it is possible to withdraw a ruling application, but this may not always be permitted. An adverse ruling may become binding on the taxpayer and lead to tax litigation.

An advance pricing arrangement (“APA”) is “an arrangement that determines, in advance of controlled transactions, an appropriate set of criteria for the determination of the transfer pricing for those transactions over a fixed period of time”. These arrangements are similar to mutual agreements, as defined in OECD MC Article 25. No appeal is normally allowed and they have no value of precedence. Their validity period is not fixed and usually varies from three to six years.

An APA differs from an ATR. ATR deals primarily with legal aspects of a single transaction based on the facts presented by the taxpayer, while APA requires a detailed review and verification of the factual assumptions underlying several transactions. Often, they cover several transactions, several types of transactions on a continuing basis, or all of a taxpayer’s transactions for a given time period. The APA application normally accompanies detailed documentation on the methodology, assumptions and predictions of future events on which the proposed transfer pricing is to be based.

While ATRs tend to be unilateral and do not have to involve or be communicated to the tax authorities of another country, an APA on transfer pricing issues may be unilateral, bilateral or multilateral. Wherever possible, it should be concluded on a bilateral or multilateral basis to ensure that it is binding on the other tax authorities affected by the arrangement.¹⁷⁶

6.2. Country Examples

Australia

The Taxation Ruling (Public) System gives the views of the Australian Tax Office (ATO) on various tax issues. A binding public ruling procedure was introduced in 1992 to support the self-assessment tax system. The public rulings are published. The criteria for the grant of a public ruling are as follows: (i) it should provide an interpretation, guideline, precedent, practice or procedure to be followed on decisions that affect the rights and liabilities of taxpayers; (ii) it should establish a new or revised interpretation of administration of tax laws; and (iii) it should affect all the taxpayers or a section of the taxpaying community.

Advance private rulings are also given. Like public rulings, these private rulings are legally binding on the tax authorities. They apply only to the applicant for a proposed transaction under the given facts and for specific fiscal years. The taxpayers have a right of appeal on an adverse ruling given by the Commissioner.

¹⁷⁶Maarten Ellis, IFA Cahiers Vol. 84B, General Report, 1999, pp. 48–49; See Chapter 6(6.6).

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Advance private ruling requests will only be considered if:

- (i) the relevant parties to a proposed transaction are identified by name and address;
- (ii) the transactions are seriously contemplated and not hypothetical;
- (iii) all material facts are made known;
- (iv) the specific legislative provisions are specified and the request addresses such questions, i.e. it is not used as a free tax research or advisory bureau;
- (v) all relevant documents (including drafts) are made available for examination; and
- (vi) the relevant details, in case the request is submitted to any other branch or section of the tax department for interpretation.

Tax rulings may be withdrawn, if the transaction and the year to which they relate have not begun, in the following situations: (a) the applicable laws have changed since the issue of the ruling, or (b) the interpretation has changed or been modified by relevant tribunal or court decisions, or (c) the ruling is no longer appropriate for commercial, administrative or legal reasons. Any changes in interpretation tend to be prospective.

Canada

Canada introduced its advance tax ruling system as early as 1970. There is no legal provision for the tax authorities to issue private rulings. However, the tax authorities give rulings on bona fide business transactions that are seriously contemplated. It could include questions of fact where it is possible to determine all the material facts, and where the facts can reasonably be expected to prevail. The transaction must be completed within the stipulated period, unless the tax department confirms the validity for future periods. The ruling is only binding on the authorities for the taxpayer to whom it is issued.

There is a list of circumstances when rulings may be denied. For example, if there is a material omission or misrepresentation of the facts or purpose, the rulings can be revised retrospectively. They can be revoked without notice from the date of change or a Court ruling if there is a change in the law or a differing ruling. They may be revoked prospectively only in cases when there is a change in the tax department's practice or the ruling is in error and a notice of revocation is given. There is no right of appeal, but there are procedures for reconsideration or withdrawal of rulings. The rulings are published.

India

India introduced a system of advance tax rulings in 1993 for nonresident taxpayers. It established an Authority for Advance Rulings with prescribed powers and procedures under the domestic tax law. The Authority can deal with questions of both law and fact. The tax issues could refer to any existing or proposed transaction, which does not involve (i) matters pending before a tax authority, tribunal or court, or (ii) the determination of the fair market value of property, or (iii) transactions designed prima facie for the avoidance of taxes.¹⁷⁷ The ruling must be given within six months. It is binding on both the taxpayer and the tax

¹⁷⁷NatWest Case (Advance Ruling No. P9 (1995), 220 ITR 377) (India): The Authority did not give an advance ruling since the use of intermediary entities by a UK bank in Mauritius lacked commercial substance and the transactions appeared to be undertaken prima facie to avoid tax.

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authorities, unless there is a change in the law or facts. There is no right of appeal. Moreover, the ruling does not set a precedent.

In 1999, the Indian Government extended the benefits of the advance ruling procedure to (i) state-owned companies and (ii) resident taxpayers in relation to past or proposed transactions with a nonresident taxpayer. Rulings are published.

Netherlands

The Netherlands has well-established procedures for rulings on domestic and international tax issues. Private rulings are given under an open system for non-standard tax situations. The rulings cannot extend the tax law but can confirm the tax consequences on specific transactions. Any tax officer qualified to make tax assessments can give advance rulings on domestic tax issues. However, international rulings on corporate tax issues follow a standardised format and the authority is limited to the Rotterdam Inspectorate for the entire country.

Advance Tax Rulings (ATR) may be requested for (i) the application of the participation exemption, provided none of the subsidiaries of the holding company carries on business activities in the Netherlands, (ii) international structures involving hybrid financial instruments or hybrid entities, and (iii) the determination of whether or not a foreign company has a permanent establishment in the Netherlands.

The rulings are legally binding for four to five years but longer periods may be granted in special circumstances. The rulings can be overruled if the facts change. Third parties can rely upon the rulings. No ruling is granted if there is an abuse of law, or if the grant of such a ruling would be in contravention of the good faith that (tax) treaty partners owe each other.

The Dutch ruling practice was significantly changed by several Decrees issued in March 2001. On August 10, 2004, amended versions of these Decrees, except for the Decree on hybrid loans, were issued. These new measures were primarily aimed at conduit finance structures, which had little or no substance or business risks. Under these new Decrees, an ATR will not be given for non-qualifying group service companies and for hybrid instruments or entities that are used primarily for tax avoidance purposes. Group services are defined as intercompany transactions comprising, legally or actually, directly or indirectly, largely receipt and payment of interest and royalties within the group under any name or in any form.¹⁷⁸

These new rules replace the old interest and royalty rulings. In order to prevent the abuse of the Dutch tax system there must be real substance, local management and control, and a physical presence. For example:

- The board of directors of the company must have the authority to bind it and be responsible for its actions. At least half of its managing directors should be resident in the Netherlands; moreover, the managing directors should have the professional skills required for the operation of the business.

¹⁷⁸ Hans Pijl and Wobke Hahlen, *The New Advance Pricing Agreement and Advance Tax Ruling Practice in the Netherlands* (IBFD Bulletin, December 2001) pp. 614–629.

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- Important management decisions must be taken in the Netherlands, and the company must have qualified staff at its disposal to allow the company to function.
- The main bank account must be kept in the Netherlands, and the bookkeeping must be performed in the Netherlands. The equity capital of the company must be adequate for the activities performed by the company.
- The company must have met its fiscal obligations, i.e. filing tax returns and paying tax due. It must be resident in the Netherlands and must not be dual resident for tax purposes.

A ruling may still be obtained if the taxpayer agrees to a spontaneous exchange of information with the source State of the interest and royalties. The 2004 amendment states that the ruling on conduit financing structures will only be granted in combination with an advanced pricing agreement.

The new Decrees also provide rules governing unilateral, bilateral and multilateral APAs.¹⁷⁹

New Zealand

The tax authorities issue non-binding policy statements in three forms as interpretation statements, interpretation guidelines and standard practice statements. In addition, New Zealand provides three types of advance tax rulings:

- (i) Public rulings are initiated by the tax authorities on specific issues. They apply to a particular arrangement and how the taxation laws apply to that arrangement. They can be for a set period of time or indefinitely.
- (ii) Private rulings are issued to taxpayers on a particular arrangement or transaction. They can be pre-transaction, ongoing or for a completed transaction. Private rulings are binding but not published. A cost-based fee is charged for private rulings.
- (iii) Product rulings are given to decide the application of certain tax provisions on specific taxable products that potentially involve a class or group of people. Generally, they are requested by the promoters of financial products to clarify the tax consequences.

Sweden

The Council for Advanced Rulings gives rulings at its discretion on the consequences of proposed transactions. The Council can issue rulings on both direct and indirect taxes, and relate to domestic or international tax issues. In practice, they address questions concerning legal interpretation only. A ruling is not given on matters affecting property valuation, or if the answer is either obvious or can be found in the law or the case laws.

The rulings are not binding on the taxpayer, but they are binding on the tax authorities, provided the relevant law and conditions remain unchanged. Both parties have the right of appeal. It generally takes 6 to 8 months to get a ruling. The taxpayer has no legal right to obtain a ruling, but normally receives it on material issues of tax law interpretation or judicial practice. The rulings are not published.¹⁸⁰

¹⁷⁹ See Chapter 6(6.8 – Netherlands).

¹⁸⁰ Duncan Bentley, *Advance Rulings – Lessons from the Swedish Model* (IBFD Bulletin, May 1997).

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United Kingdom

There is no statutory or published administrative procedure on tax rulings. In practice, the Inland Revenue publishes its interpretations on the application of various tax provisions, and gives informal private rulings and tax advice. A taxpayer can make an application to the Revenue.

In the late 1990s, the Inland Revenue decided against a formal system of pre-transaction rulings, since it concluded that it would require onerous disclosures by the taxpayer and would be expensive. The Inland Revenue is currently considering the issue of rulings for completed transactions under the self-assessment system. They will be binding on the Revenue, but with no right of appeal on adverse rulings.

United States

The Internal Revenue Service has established various procedural guidelines for the issue of advance rulings on federal taxes. In certain cases, a favourable ruling may be mandatory either before (e.g. change in accounting method or period) or after the transaction.

The Internal Revenue Service gives “private letter rulings” to clarify or confirm the tax consequences of particular transactions. These rulings apply to specific taxpayers. Rulings are granted on legal but not factual issues. The request can relate to any federal tax but must address the tax implications of contemplated future transactions. A taxpayer may rely on the advance ruling, but it is not binding on him. The tax authorities are obliged to publish the advance rulings in a redacted form that obscures information that could identify the requesting taxpayer. However, the published rulings cannot be taken as precedent by any other taxpayer.

The taxpayer does not have any legal rights to receive a ruling, which may be refused on many issues. The tax authorities issue periodic lists (“no rule lists”) of particular legal issues on which advance rulings may not be obtained. These situations include when:

- There is a lack of a bona fide business purpose or the prime motive is to reduce federal tax; moreover, the ruling is not granted where the issue is factual in nature.
- The issue is under a tax audit or pending litigation, or it relates to a completed transaction after the tax return has been filed for the year.
- Hypothetical situations or part of a proposed transaction, or if the matter involves alternative plans of proposed transactions.
- The taxpayer withdraws the request before the formal reply is given.
- The requests by foreign governments on the US tax effects of their laws.
- The effect of proposed legislation (whether federal, state or foreign).
- Eligibility to claim benefits under the Limitation of Benefits provision of a treaty or issues under competent authority relief.
- Certain inherently factual issues, such as whether a foreign taxpayer is doing business in the United States.

Retroactive revocation or modification by the tax authorities is permitted, but rarely made if (i) there has been no misstatement or omission of material facts; (ii) the transaction accorded with the ruling in material respects; (iii) there is no change in the applicable

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law; and (iv) the taxpayer acted in good faith in relying on the ruling and the retroactive revocation would be detrimental to him.

7. PASSIVE INCOME

7.1. Dividend Income

7.1.1. General¹⁸¹

Dividends are normally understood to refer to a profit share paid out by a company to its shareholders out of retained earnings. For tax purposes, they have a wider meaning. Broadly, a dividend is any distribution from a corporation to its owners by virtue of their ownership status.¹⁸²

Dividends refer to any economic benefit in any form provided to the shareholders. Besides profits, they include other payments to shareholders, such as the return of share capital or of capital surplus that are not made out of profits. They also include certain payments as dividend under the deeming provisions in the tax law, such as constructive dividends. Undistributed profits of controlled foreign corporations may also be treated as dividends under anti-avoidance rules. Besides cash, dividends may be paid in kind, either as shares (e.g. bonus shares) or as assets. Stapled stocks may be used to pay cross-border dividends directly from a subsidiary to parent company's shareholders without withholding tax.

The OECD MC Article 10 defines the term "dividend" to include all income from corporate rights taxable as income from shares under the domestic tax law of a country. The definition of dividend under the domestic tax laws of various countries varies widely. For example:

- United States: The tax law generally follows a substance over form principle to determine if a payment is a dividend. A dividend is any distribution of property made by a corporation to its shareholders out of its current and/or accumulated earnings and profits (IRC S.316(a)). Any excess is a return of capital limited to the capital contribution and the balance is treated as capital gains.
- United Kingdom: The term "distribution" includes, besides dividends, any distribution (whether in cash or otherwise) in respect of shares in the company unless it is a capital repayment. Tax law also lists several other payments as distributions as well as provides for exemptions.¹⁸³
- Netherlands: A dividend is any direct or indirect distribution to a shareholder. It includes any payment in excess of the capital contributed, whether made in cash or assets, or as a compensation or loan.

Thus, the meaning under the domestic tax laws of countries varies widely with the taxation needs of a country. In many cases, it also differs from the definition under the

¹⁸¹ Robert J. Patrick, IFA Cahiers Vol. 65B, General Report, 1980, pp. 22–23.

¹⁸² Marjaana Helminen, *The Dividend Concept in International Tax Law* (Kluwer Law International, 1999).

¹⁸³ The list of distributions specifically includes the issue of redeemable preference shares unless paid by new consideration, interest payments on certain securities the cost of which is borne by the company, transfers of assets or liabilities to shareholders for inadequate payment, repayment of share capital followed by bonus share issue, etc. Exemptions include repurchase of shares by a company and capital repayment on liquidations.

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company law of the country. These differences can lead to both double taxation and double non-taxation.

Not all distributions are dividends. To qualify as a dividend, there must be a special relationship between the parties and the benefit must be transferred due to this relationship. They may also be classified as interest or capital gains (or vice versa) depending on the domestic law. For example, the tax treatment of liquidation proceeds varies between dividends and capital gains. (See Chapter 5(3.4)) Hybrid instruments may also be classified differently as debt or equity in different jurisdictions. (See Chapter 8(8.2))

The taxation rules on dividends vary. Generally, countries either provide lower tax rates or exempt the dividends from qualifying direct (i.e. non-portfolio) participations or shareholdings. Tax treaties also impose a lower maximum withholding tax on such dividends (MC Article 10). The EU Parent-Subsidiary Directive provides for tax exemptions on qualifying dividend receipts and payments to encourage investment capital flows within the European Union. (See Chapter 5(5.3))

Tax systems affect the taxation of dividends. Under the classical or separate tax system, corporate profits suffer from economic double taxation. They are first taxed in the hands of the distributing company and the taxed profits are then taxed again on the shareholders when distributed. This double taxation is avoided in several countries using various forms of shareholder relief systems. They either fully or partly attribute the taxes paid by the company to the shareholders under an imputation system, or grant them partial or full tax exemption on the dividends. These shareholder relief systems include dividend exemption, half inclusion, flat rate and dual income tax system.¹⁸⁴

7.1.2. Constructive Dividends

A variety of payments by companies to shareholders or associated persons may not be expressed as dividends. They may nevertheless be deemed by the tax law as distribution of profits and treated for tax purposes as if they were dividends. These payments are sometimes referred to as “constructive dividends” or hidden profit distributions. Such distributions may be disallowed as deductions in calculating the taxable profits of the paying company and the tax authorities may recover any withholding tax, which would have been due, from the paying company. The paying company may be subject to penalties for late payment of tax or for tax evasion.

The kinds of payment that may be considered as a constructive dividend include amounts paid to an associated company in excess of an arm’s length price for goods or services, excessive payments of interest to shareholders, and loans or advances to shareholders. They may also include interest payments on loans treated by the domestic law of the paying company’s country as profit distributions under rules designed to prevent tax loss through “hidden” capitalisation. Such loans may include “convertible loans” (i.e. loans that are convertible into shares at some stage) or “participating loans” (i.e. loans with interest that

¹⁸⁴ See Chapter 5(5); Richard Vann, IFA Cahiers Vol. 88A, General Report, 2003, pp. 28–35.

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depend on the profitability of the company) or loans that exceed a certain fixed proportion (the “debt/equity ratio”) of the total capital of the company.

The deemed dividend provisions under the tax rules are applied under several anti-avoidance measures. Interest payments may be regarded as hidden profit distributions under the thin capitalisation rules, while retained profits of controlled foreign corporations may be taxed currently as deemed dividends under certain anti-deferral rules. Constructive dividends could also arise as a secondary adjustment under the transfer pricing rules.

7.1.3. Domestic Dividends

Tax treatment of dividends payments to residents varies widely. For example:

- Certain countries do not tax dividend income under their tax law.¹⁸⁵
- Many countries exempt intercompany dividends if they are paid out of taxed income.¹⁸⁶
- Withholding tax on the dividend payments may be final or creditable against the tax liability of the shareholder.¹⁸⁷
- Dividends received from qualifying shareholdings under their participation exemption or affiliation privilege rules are not taxable.¹⁸⁸
- Countries grant a dividend-received deduction at varying rates to qualifying companies.¹⁸⁹
- Resident shareholders receive an imputation credit to offset their tax liability on the dividend income.¹⁹⁰

7.1.4. Dividend Payments to Nonresidents

Dividend payments to nonresidents are usually taxable. However, their tax treatment may vary. For example:

- Dividends paid to nonresidents are subject to a dividend withholding tax that is final in many countries.¹⁹¹

185 Examples: Argentina, Brazil, Estonia, Greece, Hungary, India, Myanmar, Namibia, Nicaragua, Qatar, Saudi Arabia, Singapore, Slovak Republic, South Africa, Seychelles, Tunisia.

186 Examples: Aruba, Austria, Australia, Barbados, Bolivia, Botswana, Brunei, Canada, Colombia, Costa Rica, Croatia, Cyprus, Ecuador, Egypt, Estonia, Fiji, Germany, Greece, Guatemala, Ghana, Hungary, Iceland, Ireland, Israel, Italy, Jamaica, Japan, Latvia, Lebanon, Lesotho, Macau, Mauritius, Mexico, Morocco, Netherlands Antilles, Norway, Oman, Papua New Guinea, Philippines, Portugal, Russia, Slovenia, South Africa, Sri Lanka, Swaziland, Sweden, Trinidad and Tobago, Turkey, Zimbabwe.

187 Examples: Azerbaijan (final), Botswana, Cameroon, Cyprus, Czech Republic (final), Dominican Republic, Ethiopia, Gabon, Germany, Gibraltar, Guinea, Honduras (final), Indonesia, Italy, Ivory Coast, New Zealand, Papua New Guinea, Poland, Portugal, Russia (final), Senegal, Spain, Sri Lanka, Sweden.

188 Examples: Angola, Cameroon, Congo, Denmark, France, Finland, Gabon, Italy, Ivory Coast, Kenya, Luxembourg, Netherlands, Portugal, Senegal, Spain, Suriname, Sweden, Switzerland, Tanzania, Thailand.

189 Examples: Belgium, Iceland, Ivory Coast, Japan, Puerto Rico, Thailand, the United States.

190 Examples: Australia, Malaysia, Malta, Mexico, New Zealand, Taiwan, United Kingdom. (See Chapter 5(5.2)).

191 Examples: Austria, Barbados, Belgium, Cameroon, Canada, Czech Republic, Denmark, Dominican Republic, Finland, Guatemala, Guyana, Indonesia, Ireland, Jersey, Kenya, Lesotho, Mozambique, Namibia, Nigeria, Pakistan, Papua New Guinea, Portugal, Romania, Slovak Republic, Solomon Islands, Tanzania, Uganda, Zambia.

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- Several countries do not withhold tax under their domestic law on dividends paid to nonresidents.¹⁹²
- Few countries tax defer or exempt the dividend payment if the amount is reinvested in the country: (Examples: Colombia, Hungary)
- Qualifying dividend payments to parent companies within the European Union are not subject to withholding tax under the EU P-S Directive.¹⁹³
- Few countries have extended the withholding tax exemption on dividends under the EU P-S Directive to qualifying companies resident in non-EU treaty countries. (Examples: Denmark, Ireland, Luxembourg)

7.1.5. Dividends Received from Nonresidents

Countries with a worldwide tax system usually tax the foreign dividend income of their residents. However, several of them provide for relief of the economic double taxation on the dividend income. For example:

- Several countries have extended the exemption under their domestic participation exemption rules to qualifying foreign dividend income or granted exemption under tax treaties.¹⁹⁴
- Many countries give an indirect credit for the underlying tax paid by the distributing company, usually under tax treaties.¹⁹⁵
- Foreign dividends from Member States in the European Union are either tax-exempt or granted indirect tax credit under the EU Parent-Subsidiary Directive.¹⁹⁶
- Economic double taxation of dividends in the hands of the individual shareholder may be relieved through shareholder relief systems.¹⁹⁷

7.1.6. Dividend Source Rules

The source of the dividend is generally the country of residence of the paying company or the country where the shares are registered. The origin of the income paid as dividends by the company is usually irrelevant. However, there are a few countries (Example: Australia), which treat dividends paid out of the branch profits of a foreign company as domestic-source and apply a withholding tax. This “secondary withholding tax” is not permitted under the OECD MC Article 10(5).

192 Examples: Albania, Argentina, Aruba, Australia (franked), Brazil, British Virgin islands, Brunei, Cambodia, China, Cyprus, Ecuador, Egypt, Greece, Hong Kong, India, Jersey, Korea, Kuwait, Malaysia, Malta, Mauritius, Mexico, Monaco, Myanmar, Netherlands Antilles, Nicaragua, Peru, Qatar, Saudi Arabia, Singapore, South Africa, Tunisia, the United Kingdom, Venezuela.

193 Austria, Belgium, Cyprus, the Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Portugal, Poland, the Slovak Republic, Slovenia, Spain, Sweden and the United Kingdom.

194 Examples: Australia, Austria, Belgium, Cameroon, Canada, Congo, Denmark, Finland, France, Gabon, Germany, Hungary, Italy, Ivory Coast, Kenya, Luxembourg, Monaco, Netherlands, Norway, Portugal, South Africa, Spain, Sweden, Switzerland.

195 Examples: Australia, Austria, Canada, Denmark, Estonia, Finland, Germany, Greece, Ireland, Japan, Korea, Malta, Mauritius, Mexico, Namibia, Nigeria, Norway, Singapore, Spain, the United Kingdom, the United States.

196 See Chapter 5(5.4).

197 Examples: Finland, France, Germany, Italy, Norway. (See Chapter 5(5.2)).

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7.2. Interest Income and Expense

7.2.1. General

Unlike dividend, which is a return on equity, interest is a return on debt. Interest is paid on debt capital. Debt capital normally refers to capital raised through debt or loan instruments on fixed or floating interest payments. It also includes hybrid debt instruments such as convertible bonds, profit sharing bond, etc.

Few countries provide a statutory definition of interest. It is generally taken to refer to the return for the use of monies lent. OECD MC Article 11 includes a comprehensive definition of interest for treaty purposes. It means income from debt-claims of every kind, including bonds and debentures. Interest on participating or convertible bonds remains as interest until actually converted into shares, unless the debtor shares the business risks.

An enterprise can select either equity or debt, or generally a combination of the two, to finance his business activities. Although the financing mix is dictated by commercial considerations, debt is preferable to equity from a tax viewpoint. Normally, the interest payments are tax deductible while dividends are not. Thus, a company financed by a loan has a tax advantage over a company provided with equity capital. Moreover, the interest paid to a nonresident investor are often subject to a lower withholding tax in the source State than a dividend under a treaty. The use of loan capital rather than equity can, therefore, reduce the tax liability.

An excessive use of debt can lead to the problem of thin capitalisation. Various approaches have been adopted to deal with this problem. (See Chapter 6(5)).

7.2.2. What is Debt and Equity?

Equity capital shares in the rewards of the business but also bears the entrepreneurial risks. The company does not owe the shareholder the money and cannot repay the capital invested except on share reduction or liquidation. As a shareholder, he receives income only when the company distributes it to him. He is entitled to his share of the distributable profits as dividends without any limit, but only if the company makes a profit. He can lose his entire capital in business losses. Equity capital may also be of different classes or types, such as ordinary or preferred shares. The preference shares may or may not be redeemable. The shares may have equal or unequal rights over voting control, and/or distribution of profits, assets or liquidation proceeds.

Loan capital differs from equity capital both in legal and economic terms. The loan provider does not share the risks and rewards in the borrower's business. The capital lent is a liability of the company and is repayable with interest, no matter what profits are made. The lender can expect regular fixed repayments of interest on due dates and have the right to receive back the capital at the end of the loan period. The loan may be unsecured or secured by the assets of the company or by guarantees from the borrower or third parties. The rights of lenders take priority over those of the shareholders in respect of the interest and the repayment of their loans.

The distinction between debt and equity capital may be blurred in certain financial instruments. Loan capital can take the form of different types of debt claims with varying

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terms that depend on the interest payments, repayment periods and the financial risks involved. They may also have the characteristics of both debt and equity and may be treated as debt in one taxing jurisdiction and as equity in another, such as in hybrid or derivative financial instruments.¹⁹⁸ Profit-participating loans are sometimes, but not usually, treated as equity. Convertible loans are generally treated as loan capital until the time of conversion.

7.2.3. Taxation of Interest

Cross-border interest is affected by the tax rules in (a) the residence country of the provider of the funds (e.g. lender), and (b) the source country of the interest payment (e.g. borrower). Both countries tax the lender. The source country applies a withholding tax on the interest when paid (unless exempt) while the residence country taxes it as interest income. The double taxation is relieved under domestic law or tax treaties. In addition, the source country usually provides a deduction for the interest expense to the borrower.

(i) Tax on the Lender

Some of the tax issues affecting the foreign lender include:

(a) Many countries withhold tax at source when it is paid or credited by the borrower. This tax is usually a final tax on the interest payment in the source State for the nonresident lender. In cases where the agreed interest is paid free of taxes, the withholding tax is levied on the grossed-up amount.¹⁹⁹

There are also several countries that do not tax or impose a withholding tax on cross-border interest payments.²⁰⁰ As from 2004, there is no withholding tax on qualifying interest payments within EU Member States under the EU Interest/Royalty Directive.²⁰¹

(b) The tax treatment of interest income in the source country could be affected by factors, such as:

- the tax or legal status of the debtor or borrower;
- the terms of the loan;
- the currency of the loan
- a listing on a foreign stock exchange;
- the nature of the source of the interest;
- the approval of tax, exchange control or other authority;
- the use of the funds; etc.

These considerations may grant special tax exemptions on the interest income in the source State. For example, several countries tax-exempt the interest on government bonds and/or government-approved loans when paid to nonresidents.²⁰² There is no withholding tax on the interest paid to nonresidents on ordinary commercial loans in certain

¹⁹⁸ See Chapter 8(7).

¹⁹⁹ For a discussion on factors affecting the interest withholding tax rate under tax treaties, see UN Commentary Article 11, paras. 11–18.

²⁰⁰ Examples: Aruba, British Virgin Islands, Cyprus, Finland, Kuwait, Luxembourg, Malta, Mauritius, Monaco, Namibia, Netherlands, Netherlands Antilles, Norway, Qatar, South Africa, Sweden, Uruguay.

²⁰¹ See Chapter 2(7.3).

²⁰² Examples: Argentina, Australia, Barbados, Belgium, Brazil, Canada, China, Egypt, France, Greece, Hungary, India, Israel, Italy, Japan, Malaysia, Portugal, Spain, Turkey.

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countries.²⁰³ The interest on certain bank deposits, bonds and debentures is also tax-exempt in several countries.²⁰⁴

The United States grants an exemption from withholding tax on portfolio debt obligations and bank interest paid to nonresidents. Switzerland does not tax the interest on commercial loans, including loans from a foreign parent to the Swiss subsidiaries, but taxes bank and bond interest. No withholding tax is paid on the interest paid to nonresidents in Germany, except on certain bank loans. Spain exempts the interest on loans from European Union countries (unless listed as a tax haven), or if a public body or government is the payer or payee.

(c) The residence State grants either a credit or an exemption relief for the foreign withholding tax suffered by the lender. This relief may not eliminate the double taxation fully due to conflicting source rules, the amount of foreign taxes suffered or the limitations imposed on the tax credits and deductions.²⁰⁵ For example, several source countries apply the withholding tax on the gross interest payment. The foreign tax credit is given in the residence country usually on the net interest amount (gross interest less financing expenses). The net interest basis often results in excess foreign tax credits for the lender.²⁰⁶

Double tax relief may also be restricted under the domestic law. For example, the Netherlands grants tax credit only on interest earnings from certain developing countries, and gives an expense deduction in other cases. Belgium limits the credit for the withholding tax to 15% gross-up rate.

(d) Both the withholding tax in the borrowing State and the income recognition in the lending State may follow different timing rules. The interest income may be taxable in the year when it is received (the cash method), or when it becomes due (the payable method), or when it is accrued (the accrual method). Most countries tax the accrued interest, even when it is not due. On the other hand, many countries provide the foreign tax credit to resident lenders only when the tax is withheld and paid over by the borrower. Thus, the interest income of the lender may be taxed currently on the accrual method while the withholding taxes are creditable at a later date, when paid. The timing differences can lead to income tax liability and deductions in different tax periods.

(ii) Tax Deduction for the Borrower

(a) Some of the tax issues affecting the foreign borrower include:

The borrower is affected if the interest is not tax-deductible in calculating his taxable profits. Generally, it is deductible as a cost if it is incurred to earn taxable income. This interest expense may, however, be disallowed for several reasons, such as:

- The expense deduction is given only when the interest is paid, i.e. on a cash basis.

²⁰³ Examples: Austria, France, Germany, Ireland, Switzerland.

²⁰⁴ Examples: Belgium, France, Greece, Guernsey, Ireland, Isle of Man, Jersey, Norway, Spain, Thailand, the United Kingdom, the United States.

²⁰⁵ Ernst Hohn, IFA Cahiers Vol. 67A, General Report, 1982.

²⁰⁶ Klaus Vogel, IFA Cahiers Vol. 69A, General Report, 1984, p. 123–124.

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- The tax on the payment has not been withheld by the payer and paid over to the authorities,²⁰⁷ or it reflects a non-arm's length transaction (e.g. excessive interest rate) between related parties, or it finances personal expenditure.
 - Thin capitalisation rules restrict the deductibility of interest expense.
 - The interest expense incurred on the construction or acquisition of certain assets is capitalised and amortised over their life: Argentina, Canada, Italy, Netherlands, China, Sri Lanka, the United States.
 - The expenses relating to a loan (e.g. refinancing interest and administration costs) taken for the purchase of foreign shares may not be tax-deductible. While some countries grant the interest relief on such loans against other taxable income,²⁰⁸ others disallow the loan interest and expenses incurred to finance overseas investments.²⁰⁹
- (b) The tax deductibility of interest expense may also depend on the use of the borrowed funds. Most countries require that the interest expense be incurred for income-earning purposes. Some of them use the tracing method to link the interest expense to the income or to a particular generic or geographic source of income. Other countries apply the allocation method under either the ordering or stacking rules, or the apportionment rules. In the former case, the borrowed money is assumed to be used first for qualifying purposes (e.g. to earn income), and then for non-qualifying purposes (e.g. personal consumption). Under the apportionment method, the borrowed money is allocated between qualifying and non-qualifying uses based on the cost or asset value. Many countries use more than one method.²¹⁰

Several countries allow an interest deduction if it is a business expense. There are a few countries that allow the interest expenses as tax deductible, irrespective of the use of the borrowed funds (Examples: Netherlands, Norway, Sri Lanka, Sweden, the United Kingdom). In the United Kingdom, there is no purpose test that specifies that the interest should be incurred for a UK trade or to generate taxable profits. Non-trading interest expense is, therefore, deductible either as annual interest, wherever paid, or as interest payable to a UK bank.²¹¹

7.2.4. Interest Source Rules

There is no general rule that defines the source of interest. It depends on the domestic law. For example, the interest income could be derived for tax purposes from any of the following sources:

- where the payer or borrower is resident or has a permanent establishment (“debtor principle”): Argentina, Brazil, France, India, Mexico, Peru, Turkey.
- where the loan or borrowed funds are used (“user principle”): Argentina, Brazil, France, India, Mexico, Peru, Turkey.

207 Examples: Argentina, Australia, India, Mexico, Singapore, Sri Lanka, the United Kingdom.

208 Examples: Belgium, Canada, Denmark, France, Germany, Italy, Ireland, Japan, Luxembourg, Mexico, Norway, Spain, Sweden, Switzerland, the United Kingdom, the United States.

209 Examples: Argentina, Australia, Austria, Brazil, Colombia, Hong Kong, Korea, Netherlands, Singapore.

210 Brian J. Arnold, IFA Cahiers Vol. 79A, General Report, 1994, pp. 498–502.

211 Ian Wallschutzky and Grant Richardson, The Deductibility of Interest – An International Comparison (IBFD Asia Pacific Tax Bulletin, January 1995).

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- where the money is lent: Australia, New Zealand, South Africa.
- where the debt can be enforced: the United Kingdom.
- where the real property or assets given as security for the loan are situated: Australia, Austria, Greece, Hong Kong.
- where the loan contract is entered: Australia.
- where the source of income out of which the interest is paid is located: the United States.
- where the interest is remitted from: Morocco, Tunisia.

The most common source rules follow either the debtor or use principle.

7.3. Royalty Income and Payments

7.3.1. General

A royalty is normally a payment received for the use or the right to use any intangible right or know-how under licence.²¹²

However, the term “royalties” covers a wide range of payments under the domestic law of different jurisdictions. The term normally refers to payments for the use, or the right to use, intellectual property, know-how or copyrights. Several countries regard income from equipment leasing as royalties. The income from pre-packaged computer software is taxed by many countries as royalties from a copyright, and not a sale of a copyrighted product.²¹³ Royalties are also paid for the exploitation of natural resources connected with land, most commonly mineral resources, gravel or timber.²¹⁴

Know-how refers to trade secrets and technical information, and the experience necessary to carry on the commercial activity. It is the existing knowledge and experience of the grantor. It is “what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique”. The know-how contracts comprise the transfer of intellectual property or secret technical knowledge, which is not in the public domain. The supplier does not provide any service or assistance, and does not guarantee the results. The payments are usually determined based on a percentage of sales or profits.²¹⁵

Technical service and assistance differs from know-how.²¹⁶ Examples of technical services include payments for after-sales service, services under product warranty and opinions given by an engineer, an advocate or an accountant. The provider executes a scope of work for which he takes responsibility. Technical assistance involves a scope of services usually under the supervision and control of the customer. Both of them may include “show-how” or the process of transferring knowledge through instruction, training or supervision. Technical advice provided electronically or through “trouble-shooting”

²¹² Examples: patents, inventions, models, secret formulae, processes, designs, trademarks, service marks, trade names, brand names, franchises, licenses, commercial or industrial know-how, copyrights, cultural activities, films or television rights, literary, artistic or scientific works, computer software, exclusivity rights, etc.

²¹³ See Chapter 8(2).

²¹⁴ Lee Burns and Richard Krever, *Taxation of Income and Business Investment (Tax Law Design and Drafting, 2000)* pp. 615–617.

²¹⁵ OECD Commentary: Article 12, para. 11.

²¹⁶ Technical service fees are taxed similar to royalties in several jurisdictions. (See Chapter 8(3)).

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databases are technical services or assistance. The payments for information concerning computer programming are know-how payments when made to acquire information constituting ideas and principles on condition of confidentiality.

Tax treaties usually limit the domestic definition to payments for the use of, or the right to use, intellectual property. As the treaty definition is comprehensive, the use of definitions under domestic law may not be appropriate. The OECD Commentary mentions that income from equipment leasing should not be taxed as royalties, but as business income.²¹⁷ The sale of computer software and related services is a business income and not royalty income. The Commentary on software payments recommends:

- (i) The sale of shrink-wrapped or canned software should be treated as a sale of a copyrighted article.
- (ii) Payments for the transfer of complete ownership over the copyrights are not royalties. They are either business income or capital gains.
- (iii) Payments for purchase of partial rights in the copyright may be royalties in certain circumstances.²¹⁸

As royalty income is essentially a payment relating to the usage of an intangible asset, a capital payment for the purchase of intellectual property normally will not be a royalty. It will be taxable as a capital gain. Similarly, the income received for creating the intangible right is a business or service income. The OECD Commentary excludes technical service and assistance fees (“show-how payments”) from the royalty provision. They are treated as active business income.²¹⁹ This tax treatment under the OECD MC is not followed by many countries. (See Chapter 8(3)).

7.3.2. Royalty Payments

Royalty payments are generally a tax-deductible expense in the year in which they arise for the licensee or payee. Lump-sum royalties are usually spread over a fixed period or the period for which the lump sum is paid as an advance royalty. Lump-sum payments for know-how may not be deductible in certain countries (Examples; Australia, Canada, France, the United States), unless a period is specified. They may also be taken as a capital payment for an outright purchase of an intangible asset in certain circumstances.

Many countries levy a withholding tax on royalty payments made to nonresidents under their domestic law. Under tax treaties, it may or may not be taxable in the source State. This taxing right is denied to the source State under treaties that follow the OECD Model (Article 12) since exclusive taxing right on royalty income is given to the residence State. However, many OECD Member States and several non-members have negotiated treaties that retain the taxing right of the source State over royalty income. The UN MC permits the source taxation of royalties.²²⁰

²¹⁷ OECD Commentary: Article 7, para. 37; See Chapter 3(4-Article 12).

²¹⁸ OECD Commentary: Article 12, paras. 12–19.

²¹⁹ OECD Commentary: Article 12, para. 11; See Chapter 8(3.3).

²²⁰ For a discussion on factors affecting the royalty withholding tax rate under tax treaties, see UN Commentary Article 12, paras. 8–11.

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Several source countries do not tax royalties paid to nonresidents.²²¹ Certain countries limit the taxation to specific royalties only. For example, the United Kingdom does not levy withholding tax on film copyright royalties and equipment royalties paid to nonresidents.²²² Denmark excludes all copyright royalty payments to nonresidents from the withholding tax. The royalty income from the exploitation of artistic, musical and cultural works wholly developed and produced in Ireland is tax-exempt. China exempts the royalty payments on advanced technology, or if technology is provided on preferential terms.

As from 2004, qualifying royalty payments within the EU Member States are not subject to withholding tax under the EU Interest/Royalty Directive.²²³

7.3.3. Royalty Income

Royalties are generally taxed as income of the licensor in his residence State. Credit or exemption relief is given for any withholding tax paid in the source State. When royalties are taxable in the source State, the tax is usually collected from the licensor by a withholding tax, either on the gross payment, with no current expense deduction, or on the net payment. The latter amount may be computed with an expense deduction based on a flat rate derived from an estimated fixed percentage or on the actual expense incurred.

As foreign tax credits are usually given on a net income basis by the home State, unless the actual expenses are deductible the licensor can suffer excessive withholding tax in the host State on royalty income and end up with unusable foreign tax credits. This problem is particularly significant on deemed royalties derived from technical services and assistance, where the work is performed on relatively low profit margins compared to the withholding tax rate.

7.3.4. Royalty Source Rules

The royalty source rules vary widely. The most common rule is the residence of the payer (“pay rule”). Several countries also regard the source as the State where the intangible property is utilised (“use rule”). In a few cases, it is the residence of the inventor (Example: South Africa), or the place where it is developed (Example: Argentina). It may also be the place of the royalty agreement, or where the intangible rights are registered or transferable. The royalties for trademarks and copyrights are usually sourced in the country of registration or the residence of the payer.

Some country examples include:

- Australia: In Australia, the source generally depends on the place of the contract and the place where the property is situated. For example, royalties are sourced in Australia if they are paid for conducting a business wholly or partly in Australia.

²²¹ Examples: Aruba, Brunei, Croatia, Kuwait, Liechtenstein, Malta, Mauritius, Monaco, Mozambique, Netherlands, Netherlands Antilles, Norway, Qatar, Slovenia, Suriname, Sweden, Switzerland. Sweden does not impose a withholding tax and taxes royalties as domestic-source income.

²²² The United Kingdom does not tax royalties from intangible assets, other than patents and copyrights, unless they are annual payments. Annual payments require that there are no related expenses for set-off against the royalty income of the nonresident.

²²³ See Chapter 2(7.3).

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- Germany: Germany does not define royalties separately under its domestic law. Royalty income is classified under the existing types of income (e.g. business income, rental income, independent personal services or other income) and, therefore, may be taxed under different source rules. The income from a patent, copyright or know-how of the person, who develops or invents them, is deemed as an income from independent personal services.
- India: Royalty income is from a domestic source in India if it is payable by the Indian government (“pay rule”). For other resident or nonresident payers, it is from a domestic source if the payment for the right, property or information is for its use in a business or profession in India or for earning any income in India (“use rule”).
- Japan: Royalties are domestic income if a person, who is engaged in a business in Japan, pays them for his business use in Japan. The Japanese source rules use a mixture of the “use rule” and the “pay rule”, with the emphasis on the place of use principle.
- United States: The United States has specific source rules for royalties under its domestic law. Royalty income is domestic-source if the property is located within the United States, or if the intangible rights are used in the United States.

The royalty payments may be taxed under the “pay rule” in one country, and under the “use rule” in the other country. The definition and source conflicts can lead to double (or multiple) taxation for the licensor. An example of multiple taxation is the royalty received for technical services performed at home but paid abroad for the use in a third country. Royalties may be taxable in the country where the services are performed, the country where the payer resides and the country where they are used. Such multiple taxes in the source countries may not be relieved in the country of residence under the domestic law or tax treaties.

7.4. Capital Gains

7.4.1. General

Capital gains or losses arise from the disposal of capital assets. Very few countries provide a definition of capital assets in their tax law (Examples: France, Israel, the United States). They are characterised often by the circumstances relating to the transaction. In certain countries, case law has established certain badges of trade.²²⁴

For example:

- Certain jurisdictions base the distinction on the frequency of transactions or the type or character of the property (Examples: Denmark, Israel, Sweden, Switzerland, the United States). The number of transactions involving similar activities is used to distinguish between revenue and capital assets. Infrequent transactions would suggest a capital item with an intention to invest rather than trade, particularly if the asset is held for a long period.
- The method of financing may decide the nature of the transaction. A purchase with borrowed funds may imply operating assets, while the use of own funds would suggest an investment.

²²⁴ See Chapter 4(4.5).

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- Some countries apply the intention at the time when, and the circumstances in which, the property was originally acquired (Examples: Brazil, Canada, Denmark, Israel, the United Kingdom).

Some countries only levy capital gains tax on the disposal of certain assets, e.g. real estate, ships, securities and works of art. Other assets are exempt from the capital gains tax regime, e.g. the sale of a personal residence (although capital gains tax may only be deferred in certain circumstances). If the capital gains tax is deferred until similar assets that are purchased to replace the asset are disposed of, the deferral is described as a “roll-over” relief.

Under the treaty, the OECD MC Article 13 allows the source country to tax nonresidents on the capital gains arising from immovable property located in their State and from movable property effectively connected with a permanent establishment. Except for ships or aircraft in international traffic and inland waterways transport, the taxing rights on other gains are left exclusively to the State of residence. The UN MC provides for the sharing of these rights.

7.4.2. Taxation of Capital Gains

Capital gains tax is levied only when the gain is realised on alienation (i.e. disposal) of the asset and not on accrual basis. As a rule, taxable gains are computed as the difference between the selling price and the price or value upon acquisition, plus the expenditure incurred on the asset between the time of acquisition and disposal. In some cases, the gain is computed subject to certain adjustments, such as monetary correction, index-linked adjustment, etc.

The taxation of capital gains on the disposal (sale or exchange) of capital assets varies considerably from country to country. For example:

- Several countries do not tax capital gains under the domestic law.²²⁵
- Many countries make no distinction between revenue and capital profits and tax both of them as ordinary income. The sale proceeds of a business enterprise are taxable, regardless of their nature.²²⁶
- Certain countries follow the “fruit and tree doctrine” where the ordinary income is the fruit from the tree, which is taxed as a capital asset.²²⁷
- Capital gains are normally taxed only on realisation. The gain may be computed differently from ordinary income and may be taxed at the same rate or a special (usually lower) rate.²²⁸ The tax rate may again be different for specific assets and may be applied

²²⁵ Examples: Barbados, Bolivia, Brunei, Cambodia, Costa Rica, Fiji, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jamaica, Jersey, Kenya, Macau, Malaysia, Mauritius, Namibia, New Zealand, Papua New Guinea, Seychelles, Singapore, Solomon Islands, South Africa, Swaziland, Tanzania, Zambia.

²²⁶ Examples: Albania, Angola, Aruba, Argentina, Australia, Austria, Azerbaijan, Belgium, Brazil, Cameroon, Chile, China, Colombia, Congo, Croatia, Czech Republic, Denmark, Dominican Republic, Ecuador, Egypt, Estonia, Finland, Gabon, Germany, Greece, Guinea, Honduras, Hungary, Iceland, Indonesia, Italy, Ivory Coast, Japan, Jordan, Kazakhstan, Korea, Kuwait, Latvia, Lesotho, Liechtenstein, Lithuania, Luxembourg, Macedonia, Malta, Mexico, Monaco, Morocco, Mozambique, Netherlands, Netherlands Antilles, Nicaragua, Norway, Oman, Paraguay, Peru, Poland, Portugal, Qatar, Romania, Russia, Senegal, Slovak Republic, Slovenia, Spain, Suriname, Sweden, Switzerland, Taiwan, Thailand, Tunisia, Turkey, Uganda, Ukraine, Uruguay, Uzbekistan, Venezuela, Vietnam, Yemen.

²²⁷ Examples: Australia, Canada, France, India, Israel, the United Kingdom, the United States.

²²⁸ Examples: Bangladesh, Botswana, Bulgaria, Canada, Cyprus, France, Ghana, Guatemala, Guyana, India, Indonesia, Ireland, Israel, Lebanon, Morocco, Myanmar, Nigeria, Pakistan, Panama, Philippines, Puerto Rico, Sri Lanka, the United Kingdom, the United States, Zimbabwe.

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to each gain, or to the total gains of the taxpayer. The rate may vary for individual and corporate taxpayers. There may also be special rules for the carry-over of capital losses, which may only be offset against present and future capital gains. (See Chapter 4(5.3).

(e) Long-term capital gains are generally taxed more favourably at reduced rates, while short-term gains are taxed as ordinary income.²²⁹ A long-term gain is based on the “holding period” of varying duration, depending on the asset.²³⁰ The preferential taxation often encourages tax arbitrage through the characterisation of business or personal income into capital gains. It also encourages the taxpayer to hold the asset until its disposal qualifies as a long-term gain.

For example, the United States taxes individuals on long-term gains at the lower tax rate of 20%, France taxes long-term gains of companies at the reduced rate of 15%. Italy allows the corporate taxpayers to spread the gain on assets held for at least three years over a five-year period. Canada taxes only 50% of the capital gains at ordinary tax rates. Denmark exempts the capital gains on the disposal of shares from tax if they are held for more than three years.

(f) Tax treatment also differs on gains arising from depreciating assets. Some countries treat the entire gain from such assets as ordinary business income,²³¹ while others regard only the excess over the acquisition cost as subject to capital gains tax.²³² The rest of the gain is added to ordinary income as a recapture of the depreciation allowances.²³³ Several countries that use a “pooling basis” for capital allowances just deduct the sales proceeds, including the gain, from the pool (Examples: Australia, India, Finland, Greece, the United Kingdom). The asset base is, therefore, reduced by the capital gain for depreciation purposes.

(g) The method for calculating the gain varies. For example, several jurisdictions allow the acquisition costs to be adjusted for inflation in computing the taxable gains.²³⁴ Israel and Turkey tax-exempt the gain from the inflationary component, and tax the real gain at the regular corporate rate. Mozambique allows for currency devaluation. India permits nonresidents to compute the gain or loss on shares in an Indian company in the foreign currency of purchase, instead of inflation indexation.

(h) Special rules often apply for the deferral of capital gains tax, in cases of approved reinvestment (“rollover relief”) of sales proceeds within a stipulated period.²³⁵ Other special

229 Examples: Bangladesh, Belgium, Chile, France, Greece, Guyana, India, Macedonia, Morocco, Nigeria, Pakistan, Sri Lanka, Tanzania, Zimbabwe, the United States.

230 Examples: Puerto Rico – six months; Pakistan, Trinidad – one year; France – two years; the United States: eighteen months; India (for shares, listed securities and mutual fund units) – one year, and other assets – three years; Italy – three years; Morocco grants deductions from the gain depending on holding period from 25% (four years) to 50% (eight years); Bangladesh – five years.

231 Examples: Austria, Belgium, Denmark, Finland, France, Germany, Italy, Netherlands, Spain, Sweden, Switzerland. In Denmark and Sweden, the gain from the sale of plant and equipment is taxed as ordinary income while other depreciable assets are subject to capital gains tax.

232 Examples: Canada, South Africa, the United Kingdom, the United States.

233 Examples: Canada, Denmark, France, India, Jamaica, the United States, Zambia, Zimbabwe.

234 Examples: Australia, Botswana, Colombia, Cyprus, India, Ireland, Israel, Mexico, Portugal, Spain, Turkey, the United Kingdom.

235 Examples: Argentina, Australia, Austria, Belgium, Cameroon, Congo, Egypt, Finland, Gabon, Germany, Ghana, Guinea, India, Iceland, Ireland, Ivory Coast, Japan, Luxembourg, Malta, Monaco, Morocco, Netherlands, Nigeria, Portugal, Senegal, Spain, Turkey, the United Kingdom.

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rules include an “exit tax” in certain countries on the unrealised but accrued gains on assets when an individual emigrates, based on the deemed disposition of all his movable property at its fair market value. A few of them allow the use of an uplifted base cost on assets and tax only the gain arising since the date of immigration (see Chapter 6(7.2)). Special rules also apply to the gains arising in business reorganisations, acquisitions and mergers.²³⁶ Liquidation proceeds are treated as capital gains in many jurisdictions.

(i) Certain countries exempt (or tax at reduced rates) the capital gains on the sale of specified assets held by nonresidents.²³⁷ For example, the gains on the sale of shares in qualifying shares may be exempt from tax under the participation exemption rules.²³⁸ Certain countries do not levy capital gains on assets held by nonresidents, unless attributable to the trading operations within the country (Examples: Belgium, Hungary, Finland,²³⁹ Ireland, Luxembourg, the United Kingdom).²⁴⁰ In Australia and Canada, nonresidents are taxed only on capital gains arising from certain assets connected with the country. The United States does not tax capital gains unless a nonresident is present in the country for more than six months in the year of the gain or the assets are effectively connected with a US trade or real property.²⁴¹

8. FOREIGN TAX RELIEF

8.1. General

As mentioned above, the taxes on the income derived in the source State are collected either through a withholding tax or through a tax payment under the assessment procedure. Unless the foreign income is tax-exempt, juridical double tax would arise if it were taxed again in the State of residence.

The foreign-source income of residents may be treated under the domestic law in several ways:²⁴²

- The foreign income is taxable despite the taxes paid on the same income in the source country (“double taxation”);
- The foreign income is taxable but the taxes paid in the source country are allowed as an expense deduction (“deduction method”);
- The foreign income is exempt from tax (“exemption method”);

²³⁶ Examples: Australia, Belgium, Canada, Germany, India, Norway, the United Kingdom, the United States.

²³⁷ Examples: Bangladesh, Botswana (50%), Croatia, Denmark, Ecuador, Jordan, Latvia, Macedonia, Netherlands (shares), Norway, Pakistan, Peru, Portugal, Sri Lanka, the United Kingdom, the United States, Zimbabwe.

²³⁸ Examples: Austria, Belgium, Denmark, France (partial), Germany, Ireland, Italy (partial), Luxembourg, Netherlands, Spain, Switzerland, the United Kingdom.

²³⁹ Germany exempts capital gains on sale of shares for both residents and nonresidents, unless held by a bank of financial institution or enterprise. Capital loss from exempt shares is not deductible.

²⁴⁰ In the United Kingdom, nonresidents are not taxable on gains derived from foreign-sourced assets. An asset has its source where it has its legal location or situs, e.g. shares are sourced where the share register is maintained. UK residents, who are non-domiciled, are taxed on a remittance basis. The individual must be resident or ordinarily resident both in the year when the gain arises and in the year when the proceeds are remitted.

²⁴¹ Yaakov Neeman, IFA Cahiers Vol. 61A, General Report, 1976; J. S. Phillips and M.H. Collins, IFA Cahiers Vol. 70A, General Report, 1985, pp. 48–91.

²⁴² T. Viherkentta, Tax Incentives in Developing Countries and International Taxation, pp. 37–38.

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- The foreign income is taxable but the taxes paid on the income are credited against the tax due (“foreign tax credit”);
- A credit is given for certain notional taxes that are not actually payable in the source country (“tax-sparing credit”); and
- The foreign income is taxable but at a reduced tax rate (“reduced rate method”).

The first method leads to juridical double taxation with no relief. The last method is seldom used. The other four methods provide for foreign tax relief. Most jurisdictions use a mixture of these four approaches.

Most countries provide unilateral relief measures under the domestic tax law. The treaty relief provisions normally override these measures and vary the relief available under the domestic law either from deduction to exemption or credit, or from credit to exemption. They may also retain the relief method but provide for more favourable tax treatment. Tax sparing credit may be granted under tax treaties. However, they do not provide for the expense deduction method of relief.

Countries that follow the territorial tax regime do not tax foreign-source income and, therefore, they do not normally give relief for the foreign taxes paid.

8.2. Expense Deduction

The tax treatment varies. For example:

- The domestic tax law in several countries allows a deduction for foreign tax payments as an expense, provided the foreign income is taxable at home (Examples: Antigua, Barbados, Belgium Czech Republic, Egypt, France, Gibraltar, Jamaica, Kenya, Mozambique, Netherlands, Switzerland).
- Certain countries allow the taxpayer to elect for either a tax expense deduction or tax credit (Examples: Canada, Guernsey, Germany, Japan, Jersey, Ireland, Luxembourg, Norway, Philippines, Sweden, Thailand, the United Kingdom, the United States).
- There are some countries that do not give an expense deduction for foreign taxes but provide tax credit or exemption relief under their domestic tax law. (Examples: Australia, Austria, Colombia, Denmark, Finland, Greece, Italy, New Zealand, Spain).

The expense deduction method limits the double tax relief to the foreign tax paid as multiplied by the marginal tax rate. Thus, only partial relief is given for the foreign tax and the juridical double taxation is not fully eliminated. This tax relief is less desirable than other methods, except in a tax loss situation when the excess foreign tax credit cannot be carried forward. In such cases, the deduction at least increases the loss carry-forward of the taxpayer.

8.3. Exemption Method

Foreign-source income may be exempted from tax in the residence country for several reasons. For example:

- The foreign-source income is outside its tax jurisdiction.
- The foreign-source income is not taxable under the domestic law.

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- The foreign-source income is exempt to prevent juridical double taxation.
- The foreign-source income is exempt to avoid economic double taxation.

Countries that follow the territorial tax regime exempt the foreign-source income from taxation under the domestic law. Several countries with the worldwide tax regime also exempt, either fully or partly, all or certain foreign income. The exemption may be with or without progression for rate purposes.²⁴³ Many of them require that the foreign income is “subject to tax” (or taxable at a comparable rate) in the source State. Normally, no deduction is given for the costs related to the foreign income, which is tax-exempt. If the source tax is lower than the residence tax, the tax exemption in the home State is preferable to a foreign tax credit.

The exemption method is consistent with a policy of capital import neutrality. It ensures that the taxpayer is subjected to the same overall tax rate on his income derived in the host country as applicable to a local taxpayer. Broadly, the civil law countries favour the exemption method, while the jurisdictions based on English common law prefer the credit method. Several countries (Examples: Australia, Canada, Germany) follow a partial or selective exemption system. Some countries (Examples: Japan, the United Kingdom, the United States) maintain that the partial exemption method is not justified by its benefits. They only provide the credit relief on foreign-source income.

8.4. Foreign Tax Credit

8.4.1. General

The credit method provides tax neutrality at home irrespective of whether the income is earned at home or abroad. The residence State taxes its residents on their worldwide income but provides a credit for the foreign tax payments. The foreign tax credit offsets the foreign tax actually paid against the home tax payable. If the home tax on the foreign-source income is more than the foreign tax, the taxpayer must pay the deficit as additional tax at home. However, if the foreign tax exceeds the home tax on the same income, the excess tax credit may be carried forward (or back) or forfeited.

The foreign tax credit may be either full credit or ordinary credit. The full credit leaves the taxpayer with the same post-tax income at home, irrespective of the source of the income. The taxpayer receives full credit for the foreign tax paid, and is liable to pay only the difference between the home and foreign tax due on the same income. If the foreign tax exceeds the home tax, the residence State refunds the excess tax payment. The full credit method is rarely used. Most countries using the credit method grant ordinary credit relief for foreign taxes.

Under the ordinary credit relief method, the foreign tax credit cannot exceed the domestic tax payable on the income in the country of residence. It limits the tax credit to the tax on the same income, as computed under its domestic tax law, as if it were earned at home

²⁴³ Under the exemption with progression method, the foreign income is not taxed but is taken into account to determine the tax rate on other taxable income. The difference is only relevant when the tax rate is progressive.

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in the same accounting period. Therefore, the taxpayer pays the deficit as tax if the home equivalent tax exceeds the foreign tax paid on the same income, but the excess tax is not refunded if the foreign tax exceeds the home tax. He ends up paying the higher of the source and residence taxes.

Unlike the exemption method, the credit method avoids double taxation within the worldwide tax principle. If the home tax exceeds the foreign tax paid, the difference is payable as a residual tax. Excess foreign tax credit arises if the foreign tax paid exceeds the foreign tax credit given at home. Some countries allow the excess foreign tax credit to be carried forward or back for offset. Many of them, however, do not have provisions for the carry-over of excess credits, which are then lost.

The foreign tax credit depends not only on the tax rate in the source State, but also on how the home country computes the credit limitation under its domestic law. It may be calculated for each foreign item or source or aggregated by either country, worldwide or on some other basis. In certain countries, the tax credit on specified sources of foreign income may be limited to a fixed percentage and a deduction given for any excess tax cost (Examples: Canada, Japan, Luxembourg). Several countries grant the tax credit only for foreign taxes that are similar to the taxes levied in their country (Examples: Belgium, Canada, Denmark, Finland, Italy, Netherlands, Sweden, Switzerland, the United States).

Foreign tax credits can be direct credits, indirect credits, or tax sparing credits.

8.4.2. Direct Credit

The direct credit relief is given for taxes paid by a resident taxpayer in the source country. They may be withholding taxes or the taxes paid on assessment. The taxpayer must have actually paid the tax, or have a legal obligation to pay it, either directly or through the payer.²⁴⁴

The tax treatment varies, as follows:

- A large number of countries grant direct tax credit under their domestic law.²⁴⁵
- Certain countries provide for it only under tax treaties.²⁴⁶
- Some countries give this relief unilaterally to income derived from British Commonwealth countries.²⁴⁷

8.4.3. Indirect Credit

The indirect credit relieves the economic double taxation on foreign dividend income. Besides the direct credit, an indirect credit is given for the pro rata share of the corporate tax

²⁴⁴ Klaus Vogel, IFA Cahiers Vol. 69A, General Report, 1984, pp. 107–108.

²⁴⁵ Examples: Argentina, Aruba, Australia, Austria, Azerbaijan, Bangladesh, Belgium, Brazil, Brunei, Bulgaria, Canada, Chile, China, Colombia, Croatia, Cyprus, Denmark, Estonia, Faeroes Islands, Finland, Germany, Greece, Guyana, Hungary, Iceland, India, Indonesia, Iran, Ireland, Isle of Man, Italy, Japan, Kazakhstan, Korea, Latvia, Lesotho, Lithuania, Luxembourg, Malaysia, Mauritius, Mexico, Netherlands, New Zealand, Nigeria, Norway, Pakistan, Papua New Guinea, Peru, Philippines, Portugal, Puerto Rico, Russia, Singapore, Slovak Republic, Solomon Islands, Spain, Sri Lanka, Suriname, Sweden, Taiwan, Thailand, Trinidad and Tobago, Turkey, Uganda, Ukraine, the United Kingdom, the United States, Yugoslavia, Zambia.

²⁴⁶ Examples: Czech Republic, Egypt, France, Fiji, Kenya, Mozambique, Poland, Russia, Switzerland.

²⁴⁷ Examples: Barbados, Brunei, Gibraltar, Guyana, Jamaica, Malta, Singapore.

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paid by the foreign distributing company. It is computed as a percentage of the corporate tax paid by the company that the gross dividend distribution bears to the after-tax profits. The net dividend received plus the withholding tax (if any) is taken as a percentage of the related after-tax profits of the paying company and multiplied by the corporate tax paid. The dividend is grossed up by the direct and indirect credits to compute the foreign income subject to tax in the home country. The ordinary credit limitation is applied on the grossed-up dividend.

Since the dividends may be paid out of both current and past profits, the domestic law or practice provides the “ordering” rules. These rules relate the dividends to the relevant post-tax profits out of which the distribution is made, and the creditable tax is determined by the effective tax rate imposed on those profits.²⁴⁸ The computation is also affected by the exchange rate used to translate the creditable foreign tax. It could be either the rate prevailing at the time of payment of the foreign tax (historical rate), or the rate when the dividend was distributed (current rate). The US law requires that the foreign tax be translated at the historical rate, while the United Kingdom generally applies the current rate.

Several countries give relief for the underlying tax on foreign dividends under their domestic law or tax treaties.²⁴⁹ Generally, the indirect credit is granted only for substantial participations when the shareholder holds a minimum shareholding or voting rights in the foreign company. In addition, most jurisdictions provide for a tax credit to the parent company for the foreign tax paid by the subsidiary when its undistributed income is attributed under the controlled foreign corporation rules.

Some countries allow the indirect credit computation to include taxes paid by lower-tier companies. For example, Argentina, Japan and Norway permit the indirect foreign credit up to two tiers of subsidiaries. Spain gives the indirect credit for taxes paid up to three tiers of qualifying foreign subsidiaries, while the United States now grants them up to six tiers. Australia, Ireland, Mauritius, South Africa and the United Kingdom permit the credit for taxes suffered in all lower-tier companies, provided the prescribed minimum equity or voting rights are maintained at each tier.

8.4.4. Tax Sparing Credit

The ordinary tax credit method limits the relief to the lower of the domestic tax payable and the foreign tax paid. If the actual foreign tax paid is lower than the domestic tax liability on the same income, the taxpayer must pay the difference as additional tax in the residence country. Any tax saving through special exemptions or deductions granted in the host country is, therefore, recaptured by the home country unless a matching notional credit is given to spare the tax waived. Without a tax-sparing clause in the treaty, the net

²⁴⁸In the United States, the dividends are deemed to be distributed from a pool of retained profits, and the underlying foreign tax is the average effective tax rate. Prior to 1986, the indirect credit was based on a last-in-first-out method.

²⁴⁹Examples: Argentina, Australia, Austria, Canada, Denmark, Estonia, Finland, Germany, Greece, Ireland, Japan, Korea, Malta, Mauritius, Mexico, Namibia, Nigeria, Norway, Singapore, Spain, the United Kingdom, the United States. Germany gives indirect credit for participations in active business only.

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result will be a transfer of the tax revenues between the two countries with no ultimate benefit from the incentives to the taxpayer himself.

Tax sparing or deemed credits are seldom found in domestic law. Several countries provide for tax sparing credits in their treaties.²⁵⁰ They grant a notional tax credit for the tax not paid under special incentive schemes or similar allowances in the source country. These credits are usually attached to dividends, interest and royalty payments, but may also apply to income from foreign branches. They may relate to all or only certain specified incentives, and may be for either an unlimited or a specified period. Usually, the sparing credit is given only for a limited duration. Many treaties provide that the future tax incentives of a similar nature also qualify under certain conditions.

This credit given by the residence country allows the taxpayer to retain the tax waived (i.e. spared) by the host country. It assumes that the regular tax has been paid in the source country although the tax was actually waived (i.e. not paid) for reasons of economic policy. The tax sparing credit may also be modified to give more or less tax credit than the amount actually waived. For example, the tax at a rate specified under the treaty may be deemed paid, irrespective of the actual foreign tax liability.

In some countries, this credit is given as an extended or matching credit for a higher amount than the actual tax waived. This approach grants a tax preference (i.e. incentive) even in cases where no tax incentives were provided in the source country, and may amount to a full or partial exemption. The credit may also be computed as a percentage of the tax payable in the residence country. These notional credits may or may not be subject to time limitations.²⁵¹

The tax sparing credit is not based on the actual taxes paid but the tax that has been spared. As the amount of the spared tax is effectively included in the post-tax payment derived from the source country, the taxable income is not grossed up by the “phantom” unpaid creditable tax. It is increased only by the actual foreign taxes paid, if any. This gross income is generally subject to ordinary credit limitations, and the tax credit, including the tax sparing credit, is restricted to the equivalent domestic tax on that income.

Tax sparing provisions become irrelevant when the recipient country grants a tax exemption. They cannot be applied to income, which is exempted in the residence country. Unlike the exemption method that reduces the tax base, the tax-sparing credit reduces the amount of tax payable.²⁵²

As a policy, the United States does not grant tax-sparing credits in its bilateral tax treaties. Some developed countries believe that they are an ineffective way to promote foreign

²⁵⁰ Examples: Bangladesh, Barbados, Belgium, Botswana, Brazil, China, Cyprus, Egypt, Fiji, France, Germany, Ghana, Greece, Hungary, India, Indonesia, Ireland, Israel, Italy, Jamaica, Japan, Kenya, Luxembourg, Malaysia, Malta, Mauritius, Morocco, Netherlands, Pakistan, Philippines, Poland, Portugal, Romania, Singapore, South Africa, South Korea, Spain, Sudan, Switzerland, Syria, Thailand, Trinidad and Tobago, Tunisia, the United Kingdom, Yugoslavia, Zambia. The United States does not give tax-sparing credit under its treaties.

²⁵¹ David Holland and Richard Vann, *Income Tax Incentives for Investment (Tax Law Design and Drafting, 2000)* pp. 1013–1016.

²⁵² T. Viherkentta, *Tax Incentives in Developing Countries and International Taxation (Kluwer Law International, 1991)* p.140.

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investment in developing countries and lead to double non-taxation. Moreover, by reducing the tax cost of repatriating profits to the home country, they discourage reinvestment of the profits in the host country.²⁵³ Tax sparing is still required by most developing countries to protect the benefits of tax incentives given to foreign investors and is permitted under the UN MC.²⁵⁴ The OECD Committee on Fiscal Affairs also accepts that they may be appropriate for developing countries. The Commentary Update 2000 states “tax sparing should be considered only for States whose economic level is considerably below the level in OECD Member States”.²⁵⁵

8.4.5. Limitations on Foreign Tax Credit

Under the ordinary credit rules, the total creditable foreign tax is limited to the domestic tax on the same income in the residence country. This limitation may be computed on a per-item basis that restricts the tax relief to the foreign tax paid on that item only. A slight variation includes a per-source limitation where the income from the same source in a country may be aggregated. The per-item or per-source method is found in certain countries (Examples: Bangladesh, Cyprus, Finland, Greece, Ireland, India, Malaysia, New Zealand, Mauritius, Pakistan, Singapore, the United Kingdom), or applied in specific cases by other countries.²⁵⁶

Most countries allow some level of aggregation. These aggregation methods are generally based on a per-country or worldwide limitation, or various combinations of them:

(i) Per-country limitation: This method adds up the foreign income derived in a country and the taxes paid on that income. It then applies the ordinary credit limitation on the aggregate income from that country. The foreign tax credit is restricted only if the total foreign tax paid in or allocated to a source country is higher than the tax that would be payable on that income at home. The country allocation may be based either on the country from where the income is directly derived when it is included in the taxpayer’s income, or traced under the “look-through” rules to the country where it actually arose in an economic sense. The per-country limitation method allows the averaging of the effective foreign tax rates for calculating the foreign tax credit at the country level. However, it does not allow the averaging of taxes paid in low-tax and high-tax countries (Examples: Austria, Canada, Denmark, Estonia, Finland, France, Greece, Germany, Indonesia, Italy, Luxembourg, Netherlands, New Zealand, Philippines, Poland, Portugal, Spain).

(ii) Worldwide or overall limitation: Under this method, all foreign income and taxes are aggregated, and the ordinary credit limitation is computed on a worldwide basis. This approach provides for the maximum averaging of foreign taxes. The effective home tax on the total foreign tax, irrespective of the countries involved, should not exceed the total foreign taxes paid. It is, therefore, possible to combine high and low taxed

²⁵³ Committee on Fiscal Affairs: Tax Sparing - A Reconsideration (OECD, 1998).

²⁵⁴ See Chapter 2(5.5).

²⁵⁵ OECD Commentary: Article 23, para. 78.1.

²⁵⁶ In the United States, the dividends from uncontrolled foreign companies where at least a US corporation (“10/50 companies”) holds 10% shares are treated on a per-item basis.

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foreign income to avoid any ordinary credit limitation under the per-country method (Examples: Australia, Belgium, Hungary, Japan, Korea, Luxembourg, Mauritius, Malta, Mexico, Norway, Sweden, Switzerland, Turkey, the United States).

(iii) Per-category limitation: The aggregation of the foreign income is categorised by line of business, character of income, etc. There may also be separate baskets of high-taxed and low-taxed foreign income (Examples: Australia, Israel, the United States). These methods are usually applied along with the per-country or overall limitation. For example, the United States applies the foreign tax credit limitation on both the worldwide basis, and by various “baskets” comprising certain types or sources of taxable income. Australia divides the foreign income, unless exempt, into three worldwide baskets, namely passive income, offshore banking income and other income.

Sometimes, the per-country limitation may be more advantageous than the overall limitation method.²⁵⁷ If the worldwide income is negative due to losses either at home or in one or more foreign countries, there is no tax to pay at home and, therefore, both limitation methods would reduce the foreign tax credit to nil. Moreover, if the worldwide income is positive but there are losses in one or more foreign countries, these losses would offset the taxable profits in other foreign countries. As a result, the total foreign income and the allowable foreign tax credit would be reduced (or nil) under the worldwide limitation, but not under the per-country limitation. To overcome these problems, some countries use a modified overall limitation method. For example, in Sweden the foreign tax credit limitation is based on the gross foreign-source income (not net of foreign losses) as a percentage of the total worldwide income (net of foreign losses).

The tax deductions, allowances and disallowances and the rules for computing the tax base and the tax liability in the home State affect the foreign credit limitation. The method of calculating the foreign tax credit can also make a difference. For example, the foreign credit limitation is computed at the marginal tax rate in some countries (Example: the United Kingdom), whereas many countries adopt the average rate (Examples: Finland, India, Ireland, Japan, Malaysia, the United States). The allowable foreign tax credit is calculated as a proportion of the total tax liability based on the ratio of net foreign income divided by the net worldwide income, i.e. at the average tax rate.

The allocation of related expenses to the foreign-source income also affects the amount of the net foreign income and the calculation of the allowable tax credit. In certain cases, domestic expenses may be allocated, partly or fully, to the foreign income. The larger the allocation of expenses against the foreign income, the smaller such income becomes and the proportionate amount of the total tax as foreign tax credit is reduced accordingly. The foreign tax credit calculation is also affected by the treatment of exchange gains or losses as domestic or foreign-source income or expense.²⁵⁸

²⁵⁷ According to Vogel, per-country limitation normally applies under a treaty, unless the domestic law or the treaty provides for overall limitation. The per-item or per-source is used only in exceptional cases. (Klaus Vogel, *Double Taxation Conventions*, Article 23, m.no. 167–168).

²⁵⁸ Committee on Fiscal Affairs: *Attribution of Income to Permanent Establishments* (OECD, 1994) pp. 26–28.

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8.4.6. Excess Foreign Tax Credit

Excess foreign tax credit represents the excess of foreign taxes paid for which the home State has not granted the tax credit. As most countries limit the total credit for the foreign taxes to the domestic equivalent tax liability under their own tax rules, excess foreign tax credits arise. The excess foreign tax credits may also be due to the limitation method used or tax losses. Timing differences could cause similar situations. For example, the residence State may treat the foreign tax as paid in the source State in year one, and regard the related income as taxable in year two, or vice versa. Thus, there may be foreign tax payments with no foreign tax credits or foreign tax credits without any foreign tax payments. In either case, the foreign tax credits may be deferred or lost, unless the residence State taxes the income and grants the foreign tax credit in the same year.

In some countries, the excess credits may be deducted as an expense.²⁵⁹ Most countries do not permit the taxpayer to carry forward or back any unused tax credits, and the excess credits are forfeited.²⁶⁰ There are just a few countries that allow the excess credits to be carried back and/or forward for offset for a specified period. For example:

Carry-back

- Two years: the United States²⁶¹
- Three years: Canada, Israel, the United Kingdom
- Eight years: Italy

Carry-forward

- One year: Finland
- Three years: Sweden, Japan
- Five years: Australia, France, Israel, Portugal, the United States, South Korea
- Seven years: Canada, Spain
- Eight years: Italy
- Ten years: Mexico, Norway
- Indefinite: Ireland, Netherlands, the United Kingdom

The unused foreign credits represent tax benefits, and their loss is a tax waste to be avoided through proper tax planning.

8.4.7. Comments

Some common questions affecting foreign tax credits include:

- What foreign taxes are creditable?
- How should the limitation on foreign tax credit be calculated? On a per-item basis? On a per-source basis? Per-basket? On a per-country basis? On a worldwide basis? Or, some combination of these methods?
- What rules should be adopted for determining the source of income and expense for the foreign tax credit calculations? How should the transactions in foreign currencies be translated and the exchange gains or losses treated?

²⁵⁹ Examples: Canada, Czech Republic, Japan, Luxembourg, Netherlands, Norway, Sweden, the United Kingdom.

²⁶⁰ Examples: Finland, Germany, Greece, India, Italy, New Zealand, Portugal, Singapore, Spain.

²⁶¹ As from 2007, the periods will be changed to one-year carryback and ten years carryforward of foreign tax credits.

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- Should a credit be allowed for the underlying and/or spared foreign taxes on the income out of which the dividend is paid? How should the timing of the dividend received be matched with the underlying foreign profits?
- What are the rules for the carry-forward or carry-back of excess foreign tax credits? Can they be relieved under group relief or tax consolidation?

8.5. Country Examples

Argentina

Argentina grants direct and indirect foreign tax credits on dividends. To qualify, the Argentine company must own directly 25% of the shares of the first-tier subsidiary. Credit is also given for the second tier subsidiary, if the indirect ownership is at least 15%.

Australia

Australia divides the foreign income, unless exempt, into three worldwide baskets, e.g. passive income, offshore banking income, and other income. The limitations on foreign tax credits are computed separately for each basket.²⁶² Unused foreign tax credits in each basket can be carried forward for future offset for five years. The foreign tax credit limitation is calculated using the tax base under the source country rules.

Australia grants both direct and indirect credit for the foreign taxes paid on non-portfolio dividend income. The foreign tax credits are also given for taxes paid by lower-tier subsidiaries, provided there is a direct controlling interest of at least 10% at each tier, and the Australian parent has a minimum 5% direct or indirect voting control of each subsidiary. The above provisions do not apply to qualifying dividends, which are tax-exempt under the participation exemption rules in Australia.

Canada

The foreign tax credit is given on a per-country basis²⁶³ for the foreign taxes on the net income or gains for the year, regardless of when they are paid. However, no credit may be claimed for the foreign taxes paid on income, which is exempt from Canadian income tax.

Separate rules apply for business and non-business income, as follows:

- (a) Business income tax (active income): Unilateral relief is generally given for the foreign taxes as an ordinary credit but not as an expense deduction. The unused foreign tax credits may be carried back three years and forward ten years for credit against the Canadian tax on future income from the same source. The carry-over amounts must be used in the order in which they arise.
- (b) Non-business income tax (passive income and employment income): Ordinary credit is granted for the withholding tax only. The credit is given in the year in respect of

²⁶² The excess foreign tax credits may also be offset against similar foreign income derived in the same year by another wholly owned group company.

²⁶³ The per-country limitation is calculated on the income earned in a country as the percentage of the worldwide income of the taxpayer.

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which the foreign tax is paid. In case of foreign income from property (other than real estate income), the tax credit is limited to 15% for individuals, and any excess credit may be claimed only as a deduction. There is no carry-over of the excess foreign tax credits. Non-business income excludes the income of a corporate taxpayer from shares of a foreign affiliate.

Special credit rules apply to income from foreign affiliates received by Canadian corporations. A foreign affiliate is a nonresident foreign corporation in which a Canadian taxpayer, directly or indirectly, owns at least 1% equity and together with related persons, directly or indirectly, owns at least 10% of the shares of any class. Canadian residents must include the amount of the dividend received from the foreign affiliate in taxable income. However, corporations resident in Canada may claim a deduction for all or a portion of the dividend, depending on whether it is deemed to be paid out of exempt, taxable or pre-acquisition surplus, as follows:

- Exempt surplus includes active business income from designated treaty countries.²⁶⁴ Dividends from exempt surplus are fully deductible from the income and, therefore, exempt from Canadian tax. No credit is given for the foreign taxes paid.
- Taxable surplus includes passive investment income and active income²⁶⁵ from non-treaty countries. Deductions from income relating to the underlying foreign tax as well as to any foreign withholding taxes applicable to the dividends are granted in respect of dividends from taxable surplus.
- Pre-acquisition surplus consists of all surplus other than exempt or taxable surplus. Dividends from pre-acquisition surplus are fully deductible from income when received but the amount is deducted from the cost base of the shares, resulting in a higher capital gain on their subsequent disposal becomes negative.

France

France follows a territorial tax regime for corporate tax purposes. No foreign tax credit is given on foreign branch profits (i.e. active income) since they are tax-exempt. France grants an expense deduction for the foreign taxes paid on non-exempt income under the domestic law. A direct credit is usually given under the tax treaties for the foreign withholding tax paid on passive income. The credit is given on per-country basis. The excess foreign tax credits cannot be carried forward or backward.

Germany

The domestic law provides for either ordinary tax credit on a per-country basis or expense deduction for foreign taxes, provided they are similar to German taxes. Excess

²⁶⁴ To qualify, the affiliate must be resident in a designated treaty country for purposes of the relevant treaty and under common law. Under the common law of residency, a company is resident in the country where the central management and control ("mind and management") resides. A foreign affiliate that is denied treaty benefits is not considered as resident in that country for surplus account purposes. However, the domestic law provides for certain exemption to these rules under Reg. 5907(11.2) c).

²⁶⁵ Certain businesses are specifically excluded from the list of active business. For example, an investment business does not qualify unless the foreign affiliate is a regulated financial services provider with more than five full-time employees and the transactions are conducted on an arm's length basis.

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foreign tax credits cannot be carried back or forward. The company can claim an expense deduction for excess credits. All foreign-source related expenses are allocated to the income in calculating the foreign tax credit. These expenses include related trade tax, direct and indirect funding costs and costs relating to exchange or default risks. German tax treaties usually exempt income from foreign real estate and permanent establishment.

Ireland

The foreign tax credit is usually given under tax treaties for each country on a per-source basis. In other cases, the unilateral relief is limited to an expense deduction. However, Ireland allows direct and underlying tax credit (including state and municipal taxes) unilaterally on dividend income from foreign subsidiaries provided it owns, directly or indirectly, at least 5% voting rights. This credit is also granted for lower-tier companies if they are similarly related to their immediate parent, and connected with the Irish company. A company is connected if at least 5% of its voting rights are held directly or indirectly by the ultimate Irish parent company.

As from 2001, double taxation relief is available to Irish branches of companies resident in other member states of the European Union. This tax relief was extended in 2002 to companies resident in countries with an Irish treaty within the European Economic Area.

Certain activities (e.g. computer software and services, special economic zones, etc.) are entitled to 90% unilateral foreign tax credit. Unilateral tax relief is also given for tax withheld on interest received from a non-treaty country.

As from 2004, companies can mix foreign tax credits on dividends from 5% subsidiaries under “onshore pooling” rules. Excess credits can be carried forward indefinitely for future offset.

Italy

Italy generally provides foreign tax credit under its domestic law. The ordinary credit relief is given on a per-country limitation basis for foreign taxes paid. The tax credit is limited to the equivalent Italian tax on the foreign income derived from each country, computed at the average tax rate applicable to the aggregate taxable income of the taxpayer after deduction for past losses. As from 2004, excess credits relating to foreign business income (i.e. income derived from permanent establishments or by foreign subsidiaries consolidated for Italian tax purposes) can be carried back or forward for an eight-year period. Moreover, the foreign tax on the income may be deducted from the Italian taxes even if the actual payment of the tax takes place later.

Japan

Japan grants unilateral direct credit against its national tax and prefectural and municipal inhabitant tax (but not enterprise tax). The foreign tax credit limitation is calculated on a worldwide basis. Unused foreign tax credits may be carried forward for three years.

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The taxpayer cannot elect for ordinary credit and claim an expense deduction for the excess tax credits.

Foreign tax credits are subject to several limitations. For example:

- the total foreign-source income may not exceed 90% of the worldwide income;
- two-thirds of the tax-free or exempt foreign income is deemed to be domestic-source income;
- if the effective tax rate in a particular foreign country is 50% or more, the excess is not creditable but allowed as a deduction;
- the income of foreign branches is determined according to Japanese tax law; and
- the head office expenses must be allocated to a foreign-source on a reasonable and consistent basis.

An indirect foreign tax credit is given on foreign dividends for the underlying tax paid by a first-tier foreign company, provided the Japanese parent company holds direct and indirect ownership or voting rights of at least 25% (or treaty percentage) for at least six months. Similar credit is also given for a second-tier foreign subsidiary, if 25% or more of the voting shares are held for at least six months by the first-tier foreign subsidiary, and the Japanese parent indirectly owns 25% or more of the voting shares of the second-tier foreign subsidiary. The indirect credit for each qualifying subsidiary is limited to the amount of the dividend paid minus twice the foreign withholding tax on the dividend. Several tax treaties contain tax sparing credit provisions.

Luxembourg

A unilateral direct credit is given for the taxes on foreign income that have been subject to comparable tax abroad (at least 15% rate if foreign income was taxed in Luxembourg). The tax credit is granted on a per-country basis. Any excess foreign taxes paid are deductible as expenses.

Luxembourg also allows the corporate taxpayers to elect for a worldwide foreign tax credit on dividend and interest income, provided (a) the tax credit on each foreign item of income does not exceed 25% of the income, and (b) the total tax credits do not exceed 20% of the aggregate tax liability on the same income, when computed under the domestic law. Many treaties provide for an exemption with progression on the foreign-source income or contain a tax-sparing clause.²⁶⁶

Malta

Malta provides four different methods to grant foreign tax relief on a per-source basis, as follows:

- (i) The foreign taxes may be relieved through credits under a double tax treaty.
- (ii) A Maltese company may claim double tax relief with respect to British Commonwealth income tax.

²⁶⁶ Examples: Brazil, China, Greece, Morocco, South Korea, Singapore, Spain.

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(iii) Malta grants unilateral tax relief that extends to the underlying tax paid on foreign dividend income, if the taxpayer has proof of the foreign tax suffered.

(iv) If no evidence of foreign taxes paid is available, a company may elect for a deemed flat-rate foreign tax credit (FRFTC) at 25% rate on the net foreign income and gains received. The net foreign income plus the FRFT credit, less any related expenses, is subject to full Maltese income tax with relief for the deemed credit. This tax credit is limited to 85% of the Maltese tax liability. The deemed credit applies to all foreign-source income allocated to the Foreign Income Account.

Mauritius

Mauritius grants direct credit for foreign taxes under its domestic law. Indirect credits are given on foreign dividend income for the taxes paid by foreign subsidiaries, provided at least 5% equity is held by the parent company. The tax credit is also given for the taxes paid by all lower-tier subsidiaries that satisfy the same holding requirements as the parent company in Mauritius. Resident companies can use either the per-source or the worldwide basis for calculating the foreign tax credit, but the per-country method is not allowed. Offshore companies may claim 80% credit against the Mauritius tax payable without any proof of the actual taxes paid abroad. Excess credits cannot be carried forward or back.

Mexico

Mexico grants unilateral ordinary credit under its domestic law. Direct credit is given on foreign taxed income. An indirect foreign credit is also provided on dividends received from a foreign subsidiary, which is owned at least 10% by a Mexican corporation for a minimum period of six months. It is calculated on the overseas pre-tax income as multiplied by the Mexican tax rate. The tax credits are granted under the worldwide or overall limitation. The excess foreign tax credits may be carried forward for ten years for future offset. No credit is given if the foreign tax is conditional on the grant of the credit in Mexico. The second-tier foreign tax credit, previously given, was abolished as from January 2003.

Netherlands

The domestic law only provides for an expense deduction for foreign taxes paid, unless the “Unilateral Relief Decree” applies.²⁶⁷ Under the Decree, the Netherlands grants unilateral relief to tax-exempt certain foreign-source income. They comprise the profits and losses of foreign permanent establishments or dependent agents of residents,²⁶⁸ the income from foreign immovable property and certain rights managed abroad.

267 H. Pijl, The Dutch Unilateral Decree for the Avoidance of Double Taxation (IBFD Bulletin, May 1997); a new Decree was issued in January 2001.

268 Under the Dutch tax code, the foreign branch must be subject to tax locally at an amount varying with its profits as an independent taxable entity.

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The Decree provides for a modified exemption with progression method applied, as follows:

- (i) the qualifying foreign income or loss computed under the Dutch law is included in the worldwide taxable income;
- (ii) the total Dutch tax on the worldwide income is computed; and
- (iii) the portion attributable to the foreign income reduces the Dutch tax on the worldwide income.

Under a fixed corporate tax rate, the Decree relief effectively grants a tax exemption on the qualifying income. Unused tax credits may be carried forward indefinitely.

The Unilateral Decree also provides for a foreign tax credit for the withholding tax paid on dividends, interest and royalties (including technical service fees) derived from certain developing countries.²⁶⁹ This credit is given under the worldwide limitation method. The ordinary credit is limited to the lower of (i) the actual foreign taxes paid and (ii) the pro rata share of the Dutch tax payable on the worldwide income. The maximum amount of foreign tax paid on dividends is deemed never to be higher than 25%. Any excess credits may be carried forward indefinitely for future offset.

Most treaties provide for exemption with progression relief for active income and credit relief for passive income. Relief is given on a per-country basis. Taxpayers can elect to use a worldwide limitation basis from January 1999 for qualifying dividends, interest and royalties. They may also elect for expense deduction for foreign taxes on dividend, interest and royalty income; however, part deduction and part credit is not permitted. Under the Unilateral Decree, foreign source income is only eligible for exemption if it is, in principle, subject to income tax in the source state. No relief is given if the foreign income is tax-exempt under domestic law.

Norway

Norway grants ordinary direct credit under the worldwide limitation method or an expense deduction for foreign taxes paid. Excess credits may be carried forward for ten years.

Besides direct credit, Norway also gives indirect tax credit on foreign dividends, if the Norwegian company owns at least 10% equity and voting rights of the foreign subsidiary. Similar credit is granted for taxes paid by a second-tier subsidiary if (i) both the subsidiaries are resident in the same country, and (ii) the parent company in Norway indirectly holds at least 25% equity of the second-tier subsidiary. This tax credit is given for the underlying taxes paid on the current profits and on the profits earned during the previous four years in relation to a dividend distribution. The credit may not exceed the domestic tax due on the grossed-up dividend.²⁷⁰

Singapore

Double tax relief is granted on a source-by-source basis. There are no carry-forward or carry-back provisions.

²⁶⁹ The Netherlands published a list of countries under a Decree issued in September 2002.

²⁷⁰ U. Bjelland, Norway Opens out Credit Regime (International Tax Review, July/August 1999).

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Unilateral relief is given as direct credit for taxes paid in British Commonwealth countries when there is no tax treaty, provided the other country grants reciprocal relief (“Commonwealth relief”). This relief is limited to 50% of the Singapore rate, but a 100% credit is given if the effective foreign tax rate is less than half the Singapore rate. Therefore, the tax credit is usually limited to the lower of the foreign tax paid or one-half of the Singapore tax payable before foreign tax relief.

A unilateral direct credit is given for the dividend withholding tax. In addition, indirect credit is granted on dividends paid by a 25% (or more) owned foreign subsidiary. The foreign tax credits do not extend to second-tier subsidiaries. The unilateral tax relief is also given for foreign taxes paid on income derived from professional, consultancy and other services rendered in an overseas territory, income remitted from certain countries, on the foreign employment income of Singapore citizens, and on remittances of royalties (effective from assessment year 2004) and branch profits.

Singapore tax treaties normally provide for ordinary credit for direct and underlying taxes, and often contain tax-sparing provisions.

South Africa

South Africa grants ordinary tax credit for foreign taxes paid by residents under the worldwide or overall basis.²⁷¹ Direct ordinary credit is normally given for the foreign withholding tax. Where the holding in the equity share capital exceeds 25% the dividend is exempt and no credit is given for the foreign tax on that dividend. If the holding is between 10% and 25%, the shareholder can elect to claim indirect tax credit on the dividend income. This tax credit is also given for lower tier subsidiaries, provided at least 50% equity ownership exists at each tier.

Switzerland

Switzerland grants foreign tax credits only under tax treaties under a lump sum tax credit system but foreign tax payments may be claimed as an expense deduction under unilateral relief. Swiss treaties provide relief through exemption with progression, except for foreign-source dividend, interest and royalty income where the ordinary credit method is used on the gross treaty-favoured income less related costs and expenses. The lump sum credit is calculated on a worldwide limitation basis. Tax sparing credits are given on certain treaties with developing countries. No credit is given if the taxable income is offset by loss carry-forwards. Foreign tax credits may not be carried forward.

Switzerland levies separate taxes at federal, cantonal and communal levels. Generally, federal tax represents around one-third of the cantonal and communal tax liability. The tax credit is allocated to each level and granted if tax is payable at that level for the non-recoverable foreign tax at source.

²⁷¹ Foreign tax credits are converted into domestic currency at the average exchange rate for the assessment year.

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To qualify for lump sum tax credit, the foreign-source income must be fully taxable in Switzerland and declared in the Swiss tax return. If the income is tax-exempt in Switzerland, the tax credit is denied. No tax credit is given if there is treaty abuse under the 1962 Abuse Decree, as modified.²⁷²

United Kingdom

Unilateral relief is given as ordinary tax credit for foreign taxes paid on a per-source basis. A UK company may elect to claim a foreign tax credit as an expense. However, it cannot elect to take part as a credit, and part as an expense. The tax credit is computed under the UK tax principles.

The United Kingdom grants an indirect tax credit on dividend income for the taxes paid by a foreign company and any lower-tier subsidiary companies. To qualify, the UK corporate shareholder must hold at least 10% voting control at each level. The individuals and companies with less than 10% participation are only entitled to a direct credit for the withholding tax.

In 2001, the United Kingdom abolished the use of an offshore “mixer” holding company to average foreign taxes paid by lower-tier subsidiaries abroad. It adopted a restricted form of onshore pooling of dividend income to relieve foreign taxes paid. The underlying tax on any foreign dividend in the pool is limited to the UK corporate rate (currently 30%). Excess foreign tax credits may be carried back for three years and forward indefinitely for offset against the UK tax on income from the same source. Dividends paid by controlled foreign companies are excluded from the pool.²⁷³

United States

The United States allows foreign tax credit for foreign income taxes paid or deemed paid. A taxpayer can choose to claim an expense deduction for foreign taxes paid instead of a tax credit, if he wishes. To qualify for tax credit, the income must be foreign-source income and the tax must be an income tax. Direct credit is permitted on all foreign-source income. Indirect credit is available for the underlying tax of subsidiaries of corporations (not individuals), provided the ownership interest comprises 10% or more of the voting stock of the first-tier foreign subsidiary. The second through sixth tiers are similarly treated if the immediate parent owns at least 10% voting stock and a minimum 5% of its equity is held directly or indirectly by the US parent.²⁷⁴ No indirect credit is given to individual and less than 10% corporate shareholders.

The ordinary tax credit is limited to the US tax on the foreign-source income, as determined under the US tax principles. Besides the ordinary credit limitation on worldwide

²⁷² Howard R Hull, *The Foreign Tax Credit in Switzerland* (IBFD Bulletin, March 2002) pp. 124–129; Stephan Baumann, *What the Swiss Lump-sum Tax Credit System Offers* (International Tax Review, December/January 2004) pp.19–21.

²⁷³ A. Shilling and N. Coles, *UK Opts for Onshore Pooling* (International Tax Review, November 2000).

²⁷⁴ In addition, subsidiaries at levels from fourth to sixth must be classified as a controlled foreign corporation of the US parent company in order to generate qualifying indirect foreign tax credits.

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foreign income, the tax credits are subject to further limitations, based on separate limitations or “baskets”, as follows:

- Passive income, e.g. foreign personal holding company and passive foreign investment income.
- Sale of non-income producing property.
- Dividend income from each foreign corporation with participation over 10% but not over 50% of voting power or stock value.
- Interest income subject to foreign withholding tax of at least 5%.
- Income from banking, financial business and certain insurance companies.
- Shipping income.

Note: As from 2007, there will only be two baskets: a passive income basket and a “general limitation income” basket.

Foreign tax credits and net operating losses may only reduce the tax liability up to 90% of the alternative minimum tax. Any unused tax credits may be carried back for two years (2007-one year) and forward for five years (2007-ten years).

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APPENDIX

GLOSSARY OF INTERNATIONAL TAX TERMS

Note: This glossary provides brief definitions of selected terms commonly used in international taxation. It is not meant to be comprehensive.

ABUSE OF LAW DOCTRINE (Chapter 6(2.2))

It is a civil law concept similar to the substance over form doctrine found in the common law systems. The abuse of law doctrine permits the tax authorities to disregard a transaction in the form used by the taxpayer and recharacterise it with the “normal” transaction.

ACCELERATED DEPRECIATION (Chapter 4(4.4))

Tax relief, which allows taxpayers to claim a higher depreciation deduction in the first year or earlier years of the useful life of business assets.

ACCRUAL BASIS (Chapter 4(4.3))

An accounting method under which income and expenses are recognised when they are earned or spent and not when they are received or paid.

ACTIVE AND PASSIVE INCOME (Chapter 4(4.1))

These terms are used to differentiate between income derived from a trade, profession, employment, etc. (active income) and income derived from investments, dividends, interest, royalties, rents, pensions, etc. (passive income). A distinction is usually made between passive and active income to justify taxing passive income at lower rates or limiting the deductions granted to passive income.

ADMINISTRATIVE OFFICE (Chapter 7(5.5))

An administrative office may be used to co-ordinate international or regional activities, to provide certain services (e.g. management or financial services) or to perform a given function (e.g. marketing) for companies within an multinational group. It is often located in a country other than that of the headquarters office, the parent company or a country of operation.

Several jurisdictions provide special tax concessions for group administrative offices. Examples: Australia, Belgium, Cyprus, Denmark, France, Hong Kong, Ireland, Mauritius, Netherlands, Singapore, Switzerland, the United Kingdom.

Appendix

ADVANCE PRICING AGREEMENT (Chapter 4(6.1))

An agreement between a multinational enterprise and the tax authorities approving the transfer pricing method for use by the enterprise in future. The APAs may be unilateral or bilateral, i.e. involving two tax authorities.

ADVANCE RULING (Chapter 4(6.1))

Taxpayers planning certain transactions may obtain a tax ruling on a present or future transaction from the tax authorities, provided all the relevant facts are given to them. In some countries, an advance ruling binds the tax authorities if the taxpayer uses the ruling.

AFFILIATED PRIVILEGE (Chapter 5(5.3))

The tax relief or exemption given on dividend distributions made by a subsidiary to its parent company provided it meets certain ownership requirements. In some countries, capital gains on the sale of the participation are also exempt from tax. The term is also widely known as “participation exemption”.

AGENT (Chapter 5(2.3))

Agent is a person who acts on behalf of a principal. Under common law, an agent always acts on behalf of the principal and legally binds him. Under civil law, the law of representation applies. A person binds the principal if he acts in his name (“direct representation”) but not when he intends to bind himself to the third party (“indirect representation”). A civil law commissionaire or commission agent normally concludes contracts in his own name on behalf of the principal and does not bind him.

ALLOCATION OR ATTRIBUTION OF PROFITS (Chapter 8(4))

In the case of companies with branches, it may be necessary to attribute or allocate the company’s worldwide profits to compute the taxable business profits of the branch. The profits may be allocated by either the direct method or the indirect method. Under the direct method, the profits are attributed as if it was a separate, unrelated and distinct enterprise engaged in the same or similar activities under the same or similar circumstances. Under the indirect method, the income of the permanent establishment is based on an allocation of the total income derived by the enterprise using acceptable factors. An OECD Working Party is currently investigating the use of transfer pricing guidelines for attribution of profits.

ALLOWANCES (Chapter 4(4.5))

Allowances are deductions from taxable income depending on personal tax status. They do not require specific expenditure. Common allowances include amounts for marital status, children and provision for disability or support of dependents. Allowances may either be fixed amounts or vary with certain personal or business expenses. Some countries use the terms “relief” or “exemption” for allowances.

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AMALGAMATION (Chapter 5(3.2))

The term “amalgamation” is used when a company merges with another company, or both merge to form a third company, to form a merged or amalgamated company. Tax rules generally provide for tax exemption on transactions arising from business amalgamation or merger. For example, transfers of assets between amalgamating companies may be made at their written-down tax values, together with capital gains tax deferral, and the tax losses may be carried forward. Company amalgamation may involve the exchange of shares on a “paper for paper” basis; such transactions usually result in capital gains tax rollover relief.

AMBULATORY INTERPRETATION (Chapter 2(3.5))

When interpreting tax treaties, a country may apply its domestic law meaning unless the context requires otherwise. The question arises as to whether the applicable law is the law at the time the treaty was concluded, or the law in effect at the time the treaty is applied. The ambulatory interpretation requires that the domestic law should be the law in effect at the time the treaty is applied.

The term is also used for the use of the latest Commentary issued by the OECD when interpreting a tax treaty.

AMORTISATION (Chapter 4(4.4))

Amortisation is a term used to refer to depreciation of an intangible asset over its useful life. Certain intangible assets, i.e. those with an indefinite life (goodwill) may or may not be amortisable. Intangibles such as patents and copyrights, however, are generally amortisable. The term is also used for periodic repayment of debt.

ANSTALT (Chapter 7(6.1-xii))

Although the term “Anstalt”, as used in some German-speaking countries, means “establishment”, it is a generally used to refer to a special entity with limited liability in Liechtenstein. One or more persons, either natural or juridical, can establish it. The legal entity has some features of a trust with corporate personality. Its capital may or may not be divided into shares. The Anstalt can carry on normal business activities and is subject to corporate income tax and net worth tax. If its activities are comparable to a holding or domiciliary company, it receives similar favourable tax treatment.

ARM'S LENGTH PRINCIPLE (Chapter 6(6.3))

An arm's length price is the price that independent parties would agree to pay in a transaction under the same or similar circumstances. Where business is transacted between two persons, one of whom controls the other, or both of whom are controlled by a third person, the prices and terms of the transactions may differ from the prices and terms on transactions between unrelated parties (e.g. inflated or deflated buying or selling prices, excessive or inadequate royalties, interest-free loans, etc.). Often several methods are used to arrive at the arm's length price to provide a range of values.

Appendix

ARTISTE COMPANY (Chapter 3(4-Article 17))

A tax avoidance device (also known as a rent-a-star company) under which an entertainer or sportsman enters into a contract with another person, typically a company, which grants the right to provide the entertainer's services. If the company does not have a permanent establishment in the country where the services are performed, the profits are tax-free. The OECD MC contains a provision to counter such practices under Article 17. The income derived by an entertainer, which accrues to the artiste company, may be taxed in the country where the activities are exercised.

ASSOCIATED ENTERPRISE (Chapter 3(4-Article 9))

Two related enterprises are associated if they are directly or indirectly or under a third enterprise connected through management, control or capital.

BACK-TO-BACK LOAN (Chapter 6(5.3))

Back-to-Back loans may be used to solve a financing or exchange control problem. They involve the use of an intermediary entity. The lender makes a loan to an intermediary who in turn lends the money to the borrower. Where A and C are related companies and B is an independent entity (e.g. a bank), the structure may enable A to effectively pay interest to C without either party being affected by thin capitalisation rules, i.e. rules that treat the interest paid to shareholders or to related parties as dividends for tax purposes. Back-to-back loans are also used for treaty shopping to lower withholding tax rates on interest under tax treaties.

BADGES OF TRADE (See Chapter 4(4.5))

In many jurisdictions, particularly common law jurisdictions, it is important whether the transactions conducted by a person amount to a trading operation for tax purposes. The profit from a trade is income, whereas the profit from transactions not amounting to trade is generally capital gain. Whether or not a trade exists is a question of fact and is decided on a case-by-case basis. Certain criteria or badges of trade have been developed through past legal decisions.

BALANCING ALLOWANCES AND CHARGES (Chapter 4(4.4))

Balancing allowances and charges refer to tax adjustments on the sale of depreciated assets. When the assets are sold, destroyed or scrapped, the sum received from the sale, insurance policy or scrap proceeds is compared to the depreciated or written-down value and any deficit is allowed as a deduction to the taxpayer, while any excess is subject to tax. If a depreciable asset is sold or otherwise disposed of for more than the "written down value", the tax rules may "recapture" this excess depreciation by a balancing charge. If the sale proceeds are less than the written-down value, the difference is tax deductible as a balancing allowance.

BANK SECRECY (Chapter 7(7.3))

In most countries the relationship between a banker and his customer requires that the banker keeps the customer's affairs secret. Staff members are normally required to sign a

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declaration of secrecy as regards the business of the clients. Where numbered accounts are used, they limit the number of persons who know the identity of the client. Generally, this duty of bank secrecy does not apply where fraud, money laundering or drugs are involved. The updated exchange of information clause contained in the OECD MC allows the tax authorities to obtain tax-related information from banks in the other country under a treaty, in certain circumstances (See Article 26 – 2005 Update).

BASE EROSION (Chapter 3(4-Article 22(US))

A term used for erosion or reduction in the taxable income i.e. the tax base.

BASIC RELIEF (Chapter 4(4.5))

Any tax relief available to all taxpayers regardless of their personal circumstances.

BEARER SHARE or BOND (Chapter 7(3.2))

Shares or bonds issued without the name of the holder and transferable by delivery of the certificate. They differ from registered shares or bonds where the name of the holder is specified and transfer requires a transfer instrument.

A coupon is the detachable part of a bearer share or bond. The coupon gives its holder the right to the interest payments that are due on the bond. The owner normally claims dividends and interest on bearer securities by clipping a coupon from the sheet of coupons issued with the security upon purchase. Since the tax authorities may not know the owner of a bearer security, some tax systems provide for tax (i.e. coupon tax) to be deducted at source from all coupon payments.

BENEFICIAL OWNER (Chapter 6(3.5))

The concept of beneficial ownership looks behind the owner of the legal owner to find its “true owner”. In countries that follow the common law, the term “beneficial owner” refers to the person who ultimately enjoys the benefit of an asset, as opposed to the legal owner who may be only a nominee. Different persons or the same person may hold the beneficial and legal ownership of an asset.

BENEFIT IN KIND (Chapter 4(4.5))

The benefit provided to employees other than in cash or money for their services. The value is taxable but in some countries the tax is payable by the employer.

BILATERAL TAX TREATIES (Chapter 3(5.2))

Treaties for the avoidance of double taxation with respect to taxes on income and capital, which are concluded between two treaty partners (also called Contracting States).

BIT TAX (Chapter 8(1.4))

A form of consumption tax or tariff levied on the transmission of digital information.

Appendix

BOARD OF DIRECTORS (Chapter 4(2.3))

The company's top body that takes decisions on policy issues which are beyond the day-to-day responsibility of the company management. They owe the shareholders a duty of ordinary care, good faith and loyalty to the company. The directors appoint the executive team or officers of the company. They are responsible as an oversight body with fiduciary responsibilities towards the shareholders, who elect them. The company's bylaws (e.g. Articles of association) specify their responsibilities and operating procedures governing them. They may be held liable for negligence if they fail to perform their duties. Many European countries have a supervisory board comprising top management and a management board responsible for the day-to-day running of the company.

BRACKETS (Chapter 4(4.2))

Under a progressive tax system, the tax rate varies on different levels or slabs of income. These levels or slabs are called brackets.

BRANCH TAX (Chapter 6(7.4))

In many countries, the profits of branches of foreign companies are taxed under a "branch tax". The branch tax resembles the tax on dividends which would be due if the branch had been a subsidiary of the foreign company and distributed its profits as dividends.

"BUSINESS PURPOSE" TEST (Chapter 6(2.1))

A test used in certain countries against tax avoidance schemes. Tax planning schemes may be disregarded if they do not serve a "business purpose".

CAPITAL EXPORT NEUTRALITY or CEN (Chapter 2(1.7))

Under capital neutrality, investors in the capital exporting country bear the same overall tax liability regardless of whether the income is derived from investments at home or abroad.

CAPITAL GAINS TAX (Chapter 4(7.4))

A tax imposed on the profits realised from the disposal of capital assets or investments by a taxpayer. There is considerable variation in the tax treatment of capital gains. Usually common law countries impose a separate tax on capital gains under a schedular tax system. Civil law countries normally tax capital gains on a global basis as part of ordinary income. Some countries tax such gains as ordinary income but compute them differently.

CAPITAL IMPORT NEUTRALITY or CIN (Chapter 2(1.7))

Capital import neutrality refers to a situation where domestic and foreign suppliers of capital earn the same after-tax rate of return on similar investments.

CAPITAL INCOME (Chapter 4(4.3))

Income from capital includes income from passive investments such as rentals from immovable property, dividends from shares in a company, interest from loans and bonds, rental payments from leasing of property, capital gains, etc. It differs from active income,

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such as business income (manufacture, trading, provision of services, etc.), employment income (i.e. from labour) or income from independent personal services. Generally, capital income is subject to lower flat tax rates levied on unearned income while earned income from business or employment income is taxed at higher progressive tax rates.

CAPTIVE BANK (Chapter 7(5.7))

The term “captive bank” refers to a banking subsidiary, which operates principally for the benefit of the companies within a multinational group and their customers and suppliers.

CAPTIVE INSURANCE COMPANY (Chapter 7(5.8))

A wholly owned subsidiary of a multinational group of companies, which exclusively insures or reinsures the risks of companies that belong to the group.

CENTRAL MANAGEMENT AND CONTROL (Chapter 4(2.3))

The location of central management and control is a test for establishing the place of residence of a company in several countries. It usually refers to the highest level of control of the business of a company. The place where this control is exercised may differ from the place where day-to-day administration is conducted. Central management and control is similar but not the same as the place of effective management criterion used in the tiebreaker rule in the OECD Model treaty.

CHECK THE BOX RULES (Chapter 9-United States)

Under the US tax rules, certain organisations are automatically taxable as corporations, while others can make an election for tax purposes. In the latter case, the classification follows the default rules unless an election is made. The election is normally irrevocable for five years. An entity with only one equity holder is a “disregarded entity” and treated as a branch of the owner.

The tax laws provide the “check the box” rules for the taxpayer to select the classification of an entity for tax purposes either as a company or as a pass-through or flow-through entity. It is then treated as a partnership if there is more than one owner or a disregarded entity if there is one owner. These recognition rules apply to both US and foreign entities. Therefore, it is possible to form hybrid entities, which are taxed as a company abroad but treated as a fiscally transparent entity in the United States, or vice versa (e.g. reverse hybrid).

CHERRY PICKING (Chapter 3(4-Article 1(US))

The practice of targeting (and obtaining) the best from a list of alternatives.

CIVIL LAW (Chapter 2(4.1))

The term “civil law” is given to a legal system determined largely by statutes or enacted legislation and not by past decisions of the Courts. Many civil law countries in Europe and Latin America derive their legal system from the 1804 Napoleonic Code.

Appendix

CLASSICAL SYSTEM OF TAXATION (Chapter 5(5.1))

The classical system treats the company as a distinct and separate entity from the shareholders. The shareholders are liable for tax on dividends paid out of income already taxed on the company. Unless the shareholder is entitled to a credit for the tax paid on the corporate income, there is double taxation of profits when distributed. This double taxation is avoided under the imputation system and other shareholder relief systems.

COMMENTARIES (Chapter 3(1.2))

The Commentaries to the OECD or UN Model Convention (MC) explain the provisions of the Model Treaty. The OECD MC also provides the Reservations and Observations of the OECD Member States and the Positions of several non-OECD countries on the Articles in its Model treaty. The Commentaries are widely used for the interpretation and application of tax treaties but are not binding except possibly on the tax authorities.

COMMON LAW (Chapter 2(4.1))

The term “common law” is given to a legal system that accepts the uncodified law based on past Court cases on similar legal issues. It is the law made by judges as opposed to the enacted or statutory law. Most common law jurisdictions are found in countries influenced by English law, such as the British Commonwealth and the United States.

COMPARABLE PROFIT (Chapter 6(6.4))

A method for determining transfer prices in transactions between related parties based on the profits earned by unrelated parties engaged in similar activities.

COMPENSATING ADJUSTMENT (Chapter 6(6.7))

A transfer pricing adjustment to compensate or correct the actual price charged on the transaction between associated enterprises.

COMPETENT AUTHORITY (Chapter 3(4-Article 25))

A person officially appointed under a tax treaty (Article 25) to resolve disputes arising from the application and/or interpretation of a double tax treaty. Both Contracting States appoint a representative (usually from the Ministry of Finance) as the competent authority to assist taxpayers by acting as the official liaison with the foreign competent authority.

CONDUIT COMPANY (Chapter 7(3.3))

A conduit company receives income in an intermediary jurisdiction for onward distribution to nonresidents. It is normally based in a country with a preferential tax regime and a wide tax treaty network. A conduit company may use a direct conduit or a stepping stone conduit method. The direct conduit method makes use of an exemption from tax in the intermediary country while the stepping stone method reduces a tax liability in that country by a counterbalancing expense.

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CONSTRUCTIVE DIVIDEND (Chapter 6(5.3))

Constructive dividends are non-dividend payments made by companies to shareholders or associated persons that are treated for tax purposes as if they were dividends. As hidden profit distributions, such payments may be disallowed as deductible expenses for tax purposes. The tax authorities may also claim any withholding tax, which would have been due, from the paying company, on dividends. The paying company may be subject to penalties for late payment of tax or for tax evasion. Examples of constructive dividend include amounts paid to an associated company in excess of an arm's length price for goods or services, excessive payments of interest to shareholders, and loans or advances to shareholders.

CONTRACTING STATES (Chapter 1(2))

The countries that are parties to a contract under a tax treaty. The treaty may be between two parties (bilateral) or with more than two parties (multilateral).

CONTROLLED FOREIGN COMPANY or CORPORATION (Chapter 6(4))

Under the tax rules, a shareholder cannot be taxed on his underlying share of the corporate profits of a company until it is distributed as dividends to him. A controlled foreign corporation or company (CFC) is a foreign company over which its shareholders have sufficient influence to determine when to pay the dividends. The CFC rules counter the deferral of taxation in such companies. Under its rules, the income earned by a CFC is attributed on a current basis to the shareholders on a pro rata basis even when not distributed to them. Generally, CFC rules apply only to certain types of income, e.g. passive income and profits from certain related party sales or services. This income is sometimes referred to as tainted income. Credit is usually given for tax paid on attributed income against the liability arising when the profits are distributed. Most CFC systems provide numerous exemptions.

COORDINATION CENTRE (Chapter 7(5.5))

An enterprise whose only purpose is either to coordinate the activities of affiliated or group companies, or to conduct research or to perform support activities for their benefit.

CORRELATIVE OR CORRESPONDING ADJUSTMENT (Chapter 6(6.7))

A term used for the "corresponding adjustment" under the OECD MC (Article 9). When the tax authorities in one State make a primary transfer pricing adjustment, the tax authorities of the other State may make a corresponding or correlative adjustment, consistent with the primary adjustment. The purpose of such an adjustment is to prevent the economic double taxation due to the transfer pricing adjustment.

COST CONTRIBUTION (Chapter 6(6.4))

The parent company may require its group companies to share the costs incurred by either itself or another group company for in-house services, research and development, etc. These cost contributions may be allocated on sales or some other acceptable basis (cost funding). Alternatively, they may be determined on a detailed analysis of specific benefits provided to each group Member (cost sharing).

Appendix

COST-PLUS METHOD (Chapter 6(6.4))

A transfer pricing method that uses the profit mark-up of a supplier in an unrelated transaction to determine the transfer price for a related-party transaction. An appropriate gross margin (“cost-plus mark-up”) is added to the cost, to make an appropriate profit for similar functions performed under similar market conditions. The method may be particularly appropriate if, for example, the transaction concerns the sale of semi-finished products between related enterprises, or if one affiliate is a subcontractor for the other affiliate company.

CREDIT METHOD (Chapter 2(5.3))

Foreign taxes paid by a resident of a country are credited against residence country tax on the foreign income.

CURRENCY SWAP (Chapter 8(8.3))

A transaction involving the exchange of cash flows from interest and principal in one currency for those in another with an agreement to reverse the currency swap at a future date.

CYBERSPACE (Chapter 8(1.1))

The virtual environment created by computer networks in which text, audio and video electronic signals travel.

DATABASE (Chapter 8(1.5))

A term used for a store of computer data.

DATA MINING (Chapter 8(1.5))

The use of sophisticated computer programs to search systematically through a large database.

DATA WAREHOUSING (Chapter 8(1.5))

The process of organizing the storage of large quantities of electronic data in such a way that it meets the needs of the organisation.

DEBENTURES (Chapter 4(7.2))

Debenture is a term given to interest-bearing loan instruments, usually unsecured, issued by a company or government.

DEBT CAPITAL (Chapter 4(7.2))

Debt capital normally refers to capital raised through debt or loan instruments on fixed or floating interest payments. Hybrid debt instruments include convertible bonds, profit sharing bond, etc. Often their tax treatment varies depending on whether they are treated as debt or equity capital.

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DEBT/EQUITY RATIO (Chapter 6(5.3))

Relationship of total debt of a company to its ordinary share capital (sometimes referred to as gearing). If a corporate debt is disproportionately high in comparison with its equity, the debt may be recharacterised as equity, resulting in a disallowance of the interest deduction and taxation as dividends.

DECLARATION OF TRUST (Chapter 8(9.1))

A trust may be created in certain jurisdictions through a document of declaration made by a trustee or a trust company. The settlor does not have to be identified or be a signatory to the declaration.

DECLINING-BALANCE DEPRECIATION METHOD (Chapter 4(4.4))

A method for computing annual depreciation deductions based on a fixed depreciation rate applied to the declining or written-down value of the asset at each year-end. It differs from the commonly used straight-line depreciation method, under which a depreciation amount is spread equally over the economic life of the asset. This method is also called the “reducing-balance method”.

DEEP DISCOUNT BOND (Chapter 4(7.2))

A deep discount bond is issued at an amount below par, and the full nominal value is paid to the owner upon maturity. The difference represents the cumulative interest payment on maturity. The deep discount bonds may be treated for tax purposes in a manner similar to a zero coupon bond.

DEFERRED COMPENSATION (Chapter 5(4.3))

Deferred compensation refers to remuneration for a period of tax residence that is paid later, when the individual is not resident. Many countries levy a tax on all payments for services rendered in that country, regardless of when or where it is paid.

DEFERRED TAX (Chapter 4(4.3))

Tax deductions can be absolute or due to timing differences. Timing differences result from deductions given for tax purposes but not allowable as deductions in the accounts in a particular year. They defer tax payments. The deferred tax liabilities reverse themselves in later years when the deduction may be claimed for book purposes but not for tax purposes.

DEPRECIATION (Chapter 4(4.4))

For tax purposes, depreciation is the decline in the value of fixed assets resulting from their use, exhaustion, wear and tear and obsolescence. The loss in value is deductible in computing the taxable income. For accounting purposes, depreciation is seen as a method of spreading the cost of a fixed asset over its economic life. Depreciation deductions are given for decline in the value of the asset over its useful life. These deductions spread the cost of the asset over the period of its use. In the case of exceptional use of plant and machinery, tax depreciation is sometimes granted at an accelerated rate.

Appendix

DERIVATIVE FINANCIAL INSTRUMENT (Chapter 8(8.3))

Financial contracts whose values are based on, or derived from, the price of an underlying financial asset or price. It is linked to or depends on the value of a primary (underlying) instrument, e.g. debt assets, liabilities and equity investments. Derivative financial instruments usually involve futures, options and swaps. Derivative agreements may be entered into on currencies, commodities, interest rates, etc., or a combination thereof.

DEROGATION (Chapter 2(7.1))

In the European Union, a Member State may be authorised by the European Council of Ministers to apply a special measure that derogates (i.e. deviates) from the provisions of a Directive generally for a limited period of time.

DIGITISATION (Chapter 8(1.2))

The conversion of an analog or continuous signal of zeros and ones, i.e. into a digital format. Software applications, written text, photographs and audio and video signals are, or can be, digitised and transmitted over computer networks.

DIRECTIVE (Chapter 2(7.1))

A legislative instrument in the European Union, which is binding on the Member States. It requires them to pass domestic legislation to achieve the objective of the Directive. Directives differ from Regulations that have immediate effect throughout the European Union.

DIRECT INVESTMENT COMPANY (Chapter 7(5.1))

A direct investment company refers to a company holding substantial interest in either the capital or voting rights of another company. It differs from a portfolio investment company.

DIVIDENDS (Chapter 4(7.1))

Dividends may be defined broadly to include any corporate distribution providing an economic benefit to the shareholders. They may be paid out of current or retained earnings, capital or capital surplus. There are different types of dividends. Although dividends are usually paid in cash, they may also be issued as a stock dividend or in the form of assets of the company. Typically, they will include bonus issues, repayments of share capital made in certain circumstances, advances to shareholders, interest received on debentures issued in lieu of shares, etc. Some countries do not allow payment of dividends except out of profits; otherwise, it is a return of capital or capital surplus. Dividends are usually taxed as income, often subject to a withholding tax that may or may not be creditable. Liquidation proceeds may be treated as dividends or as capital gains. Dividends do not actually have to be paid. They may be deemed to be paid in certain cases. (*See Constructive Dividends*)

DIVIDEND STRIPPING (Chapter 5(5.4))

A tax avoidance device whereby a company that has reserves of taxed profits is purchased and the profits are distributed as dividends for which tax relief is available. The company is then resold at a loss, which is tax-deductible.

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DOMICILE (Chapter 4(2.5))

In civil law countries domicile means a permanent home under the tax residence rules. The meaning in common law countries differs. It is the place where the person believes he always intends to return as his ultimate home, or where he wishes to die or be cremated, or where he has his cultural and social roots. It is the most long-lasting form of attachment between the individual and the State. Every person must have a domicile, but only one domicile. Under the tax law, certain countries do not tax non-domiciled persons on their worldwide income except on remittance basis, e.g. the United Kingdom.

DOMICILIARY COMPANY (Chapter 9-Switzerland)

Switzerland offers tax relief to “domiciliary companies”, i.e. companies that do not engage in trade or business within the country. Relief is generally granted by way of an exemption from cantonal (but not Swiss federal) corporate income tax.

DOUBLE DIP LEASING (Chapter 4(4.4))

A leasing arrangement under which the lessor and the lessee are both able to claim the tax benefits of ownership of the leased property in their country of residence. For example, a double dip arises if the lessor resides in a country that regards the lessor as the owner of the leased asset, and the lessee resides in a country that regards the lessee as owner. In such circumstances, it may be possible for both the lessor and the lessee to claim depreciation deductions. A triple dip may arise if a taxpayer in a third country is interposed between the lessor and the lessee and that taxpayer is regarded as the owner of the leased asset.

DOUBLE TAXATION (Chapter 2(1.2))

Double taxation occurs when the same taxable item is taxed more than once. It may be economic or juridical double taxation.

DOWNSTREAM LOAN (Chapter 5(3.3))

This term is used for a loan given by a parent company to its subsidiary company.

DUAL EMPLOYMENT CONTRACT (Chapter 5(4.4))

An expatriate assigned for duties in more than one country may have separate contracts for services in the host country, and services outside the host country.

DUAL RESIDENCE (Chapter 3(4-Article 4))

A person or company may be resident in two or more countries under the law of those countries, because the two countries adopt different definitions of residence. For example, the same company may be resident in one country because that is where it is incorporated, and in another country, because that is where the effective or central management is conducted.

Appendix

EARNINGS STRIPPING (Chapter 6(5.6-United States))

The practice of reducing the taxable income of a corporation by paying excessive amounts of interest to related third parties. Such third parties may be tax exempt with respect to the interest or subject to a lower rate of tax.

E-BUSINESS (Chapter 8(1.1))

E-Business is an umbrella term that refers to any type of business transaction on the Internet. Some writers, however, use the term in a more restricted context such as a business-to-business (B2B) transaction as opposed to a business-to-consumer (B2C) transaction. E-Commerce refers more to the B2C context where a firm sells goods on the internet and makes collections via some payment scheme such as online credit card transactions.

ECONOMIC DOUBLE TAXATION (Chapter 2(1.2))

Double taxation is “economic” if more than one person is taxed on the same item due to some economic connection. For example, where one country, for tax purposes, makes a downward adjustment to transfer prices paid by a subsidiary company in its transactions with a nonresident parent company, and the country of residence of the parent does not make a corresponding adjustment for tax purposes to the receipts of that company. Another form of economic double taxation arises where a company pays tax on its profits, and its shareholders are taxed separately on the dividends paid out of taxed profits. Economic double taxation may be avoided or mitigated by giving relief to the company when it distributes its profits or by giving relief to the shareholders by means of an imputation tax credit or a credit for underlying taxes already paid by the company.

EFFECTIVE RATE OF TAX (Chapter 4(4.1))

The effective tax rate is defined as the taxpayer’s actual tax payable as a percentage of a pre-tax income and not as a percentage of taxable income, i.e. book profits as adjusted for tax purposes.

ELECTRONIC COMMERCE (Chapter 8(1.1))

Broadly, the delivery of information, products and services by telephone, computer or other automated media. More narrowly, it refers to business-to-consumer (B2C) and business-to-business (B2B) transactions conducted over computer networks.

EQUALISATION TAX (Chapter 5(5.2))

The additional tax payable to ensure that the company pays dividends out of profits taxed at the full corporate rate. Equalisation taxes prevent the shareholders from receiving an imputation credit for tax that has not been paid by the company.

EQUITY CAPITAL (Chapter 4(7.2))

Capital derived from money received through the issue of shares from shareholders or owners of a business. They are entitled to a share of profits in the form of dividends and a proportionate share of the proceeds upon liquidation.

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EUROPEAN ECONOMIC AREA (Chapter 2(7.5))

The European Economic Area was established in January 1994 between the Member States of the European Union and European Free Trade Association (excluding Switzerland). There are only three EFTA countries now left in the EEA. They are Iceland, Liechtenstein and Norway.

EUROPEAN ECONOMIC INTEREST GROUPING or "EEIG" (Chapter 2(7.3))

EEIG is a special structure under the EU Regulations to facilitate cross-border activities within the European Union. It can operate under its own name with legal rights and obligations. There must be members from at least two EU countries. Member States may decide whether EEIG registered in their countries has legal personality. The profits and losses of an EEIG are taxable only in the hands of its Members as a fiscally transparent entity. An EEIG is normally a taxable person for VAT purposes.

EUROPEAN UNION (Chapter 2(7.1))

The present members of the European Union are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. In May 2004, ten new members joined the Union. They were Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, the Slovak Republic and Slovenia. Bulgaria, Romania and Turkey have applied to join the Union.

EXCHANGE CONTROLS (Chapter 6(7.3))

Controls over foreign currency transactions and transfers imposed by a government of a country.

EXCHANGE OF INFORMATION (Chapter 6(7.1))

Tax laws frequently contain provisions prohibiting the tax authorities from disclosing information about the affairs of taxpayers to third parties except in restricted circumstances, as provided under the law. In the absence of special rules, it could prevent the tax authorities of a country from giving tax information to the tax authorities of another country. If the two countries have concluded a tax treaty, the tax authorities of one country may need information about a taxpayer in the other country to apply correctly the treaty, to ensure collection of taxes under the treaty or to prevent fraud or tax evasion. Consequently, most tax treaties contain a provision under which the tax authorities of one country can request the tax authorities of the other country to supply information on a taxpayer, subject to certain conditions.

EXEMPTION METHOD (Chapter 2(5.3))

Exemption method provides for relief of double taxation by the residence State either under its domestic law or more often under tax treaties. Under this method, the residence State tax exempts the income where the taxing rights are granted under the treaty to the source State.

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This method differs from the credit method where the residence State taxes the income but gives credit for the taxes levied in the source State.

EXEMPTION WITH PROGRESSION (Chapter 3(4-Article 23A))

Some countries, which relieve juridical double taxation through the exemption method, consider the foreign income for setting the tax rate to apply to the taxable income. The income is included in the tax base of the taxpayer to determine the overall tax rate and the amount of tax. The taxpayer is then allowed a pro rata tax deduction for the exempt income. The relief is defined as exemption with progression. Since corporate tax is commonly levied at a fixed rate, the exemption from progression usually effects the taxation of individuals.

EXIT TAX (Chapter 6(7.2))

Expatriation rules may subject a taxpayer to tax when he gives up his residence or his citizenship to prevent tax avoidance due to emigration.

FISCAL NEUTRALITY (Chapter 2(1.7))

Under the fiscal neutrality principle, economic decisions are not affected by tax considerations. There should be no tax advantage in choosing a particular form of investment or business entity since the income will be subject to the same amount of tax.

FISCAL TRANSPARENCY (Chapter 8(7.1))

Fiscal transparency means “looking through” an entity and attributing the profits and losses to the entity’s members. The profits of certain forms of enterprise (e.g. partnerships) are taxed in the hands of the members (on a pro rata basis), rather than at the level of the enterprise.

FISCAL UNITY (Chapter 4(5.5))

Term used to describe the tax treatment where the profits and losses of group companies may be aggregated for tax purposes. The definition of what constitutes a group for tax purposes varies considerably from country to country. Generally, only resident companies can be part of the group and the parent company must hold a certain minimum percentage of the share capital of the subsidiary. Only one corporate income tax return is filed by the parent company under a tax consolidation.

FIXED BASE (Chapter 3(4-Article 14))

The term “fixed base” is now used in the UN (and US) MC only under independent personal services (Article 14). It refers to a fixed or permanent place from which such activities are conducted. Examples include a physician’s consulting room or the office of an architect or a lawyer. The treaty grants the right to tax the income from independent personal services to the source State if the taxpayer has a fixed base available to him in that country and income is attributable to that fixed base.

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FLAG OF CONVENIENCE (Chapter 7(5.9))

The flag of another country, which is chosen for ship registration to take advantage of the tax benefits and other non-tax advantages such as lower labour costs, manning scale and other requirements relating to officers and crew and trade union practices. The term is used when the flag of a country differs from the State where the company owning the ship is incorporated.

FORCE OF ATTRACTION (Chapter 3(4-Article 7))

Under this principle, a permanent establishment or branch is taxed on not only its own income but also certain other income derived by its foreign head office from sources in that country. The OECD Model treaty does not allow the use of this taxing principle. The UN Model provides for limited force of attraction.

FORCED HEIRSHIP (Chapter 8(9.5))

The rights, which a person has to the estate or part of an estate of a deceased person under the law of the domicile of the person or where the property is situated. In some jurisdictions, these rules are mandatory, and known as forced heirship rules. A part of the estate is awarded to one or more of the deceased's heirs under the law.

FOREIGN-SOURCE INCOME (Chapter 4(3.3))

Generally, this refers to income derived from countries outside the country of residence of the taxpayer. In many countries income of a resident taxpayer arising in another country is taxed subject to special reliefs or exemptions under domestic law or under a tax treaty with the other country. Such relief usually takes the form of a tax credit, tax exemption or tax reduction.

FOREIGN TAX CREDIT (Chapter 4(8.4))

International double taxation is avoided usually either by exemption or credit method. Under the credit method, if income is received from abroad, any foreign tax on that income may be deducted from the domestic tax payable on that income. It is common for countries granting a credit for foreign taxes to limit the credit to the amount of domestic tax that would be imposed on that foreign-source income if no credit for foreign tax were given.

FORMULARY APPORTIONMENT (Chapter 6(6.4))

A method for allocating the profits or losses of a multinational enterprise among its component parts under a formula based on factors such as sales, assets and payroll.

FORWARD RATE (Chapter 8(8.3))

Forward rate arrangements allow a currency to be sold at an agreed price for delivery at a future date for a fee. Many countries do not allow deductions for exchange rate losses. In such cases, a forward rate contract provides a hedge for a tax-deductible fee.

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FOUNDATION (Chapter 8(9.5))

Few civil law jurisdictions (Examples: Austria, Liechtenstein, Netherlands Antilles, Panama) provide a special regime for set up of foundations. Foundations serve a similar purpose as common law trusts in many respects. They may be public or private foundations. Public foundations are normally allowed for non-business activities with its income tax exempt and the donations received tax-deductible. Private foundations are permitted to conduct business operations. The foundations are governed by the rules and procedures under its bylaws.

FRANKED INCOME (Chapter 4(7.1))

Income received from another company out of profits that have already borne corporate tax. To prevent double taxation, such income is exempt from tax in the hands of the recipient.

FRAUS LEGIS DOCTRINE (Chapter 6(2.2))

Under the Dutch law, the tax authorities have authority to disregard a transaction primarily intended to avoid tax and to substitute it with a transaction that allows tax to be imposed.

FREE TRADE ZONES (Chapter 4(4.6))

Free trade zones are designated areas which are exempt from normal customs duties.

FRINGE BENEFITS (Chapter 4(4.5))

The term “fringe benefits” is used for benefits given to employees either as cash allowance or in non-cash form. The fringe benefits are normally taxed as part of the remuneration in most countries. Few countries (e.g. Australia, India, New Zealand) have a separate fringe benefits tax.

FUNCTIONAL ANALYSIS (Chapter 6(6.5))

An analysis of functions performed (after considering the assets used and risks assumed) by associated enterprises in controlled transactions or by independent enterprises in comparable uncontrolled transactions for transfer pricing adjustments.

FUTURES CONTRACT (Chapter 8(8.3))

The buyer and a seller agree to exchange securities or commodities for a specified price at a future date under a standardised contract on an organised futures exchange.

FUTURE RATE AGREEMENT (Chapter 8(8.3))

A type of interest forward contract, whereby a forward interest rate is agreed and the interest differential between the agreed rate and the actual rate on a specific future date is paid or received by the parties.

GEARING (Chapter 6(5.3))

Term broadly used to indicate a company’s debt/equity ratio. A company is highly geared if the ratio of debt to equity is high. It is also sometimes referred to as capital gearing or leveraging.

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GLOBAL FORMULARY METHOD (Chapter 6(6.4))

A method to allocate the global consolidated profits of a multinational group among the associated enterprises in different countries based on a predetermined formula.

GLOBAL TAX SYSTEM (Chapter 4(4.1))

A tax system with a single and comprehensive definition of income and a single rate structure for all taxpayers.

GLOBAL TRADING (Chapter 8(8.4))

Global trading is defined as the capacity of financial institutions to execute customers' orders, to operate as a market maker and to manage their positions in financial products in markets around the world and around the clock.

GOODWILL (Chapter 4(4.4))

Goodwill is a term used to determine the earning capacity of an entity due to intangible factors such as location, marketing organisation, reputation, clientele, etc. of a trade of business. It represents a value in excess of the tangible assets of the organisation.

GRANDFATHER CLAUSE (Chapter 7(6.2-Netherlands Antilles))

A clause that allows the parties to continue to apply the provisions in existence prior to the change in the agreement.

GROSSING UP (Chapter 4(8.4))

The foreign income, which is received net of taxes, is grossed up by adding the amount of foreign tax paid. Credit relief for the tax deducted abroad is usually given by taxing the foreign income on the gross amount and charging domestic tax less a credit for the foreign tax. In the case of a dividend, where relief is given for underlying tax, this may require two stages as follows: (i) calculate the gross dividend i.e. the dividend before deduction of withholding tax (direct credit) and (ii) calculate the profit before payment of company profits tax (indirect or underlying credit).

HEAD OFFICE EXPENSES (Chapter 3(4-Article 7))

Where an enterprise with its head office in one country operates through a branch or permanent establishment in another country, the expenses incurred by the head office may be deducted in computing the taxable profits of the permanent establishment. Such expenses would normally be deductible to the extent they have been incurred for the purposes of the business of the permanent establishment, e.g. general management and administrative expenses, the cost of specific services provided to the permanent establishment and interest on capital or royalties in respect of patents, etc. used in the business of the permanent establishment.

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HEDGING TRANSACTION (Chapter 8.3)

In a hedging transaction, a person protects himself against future price or currency fluctuations by buying or selling commodities or currencies forward.

HIDDEN RESERVES (Chapter 6(5.3))

Reserves, which are not disclosed on the balance sheet of an enterprise, by either overvaluing debts or undervaluing assets. Hidden reserves are usually subject to income tax upon merger (unless specifically exempt) or liquidation of an enterprise or the transfer of its seat or place of management abroad.

HISTORIC COST ACCOUNTS (Chapter 4(4.3))

The accounts prepared using the amount spent in obtaining an asset at the time of acquisition, i.e. the purchase price and associated costs, or if the taxpayer constructs the asset himself, the cost of construction and installation, as well as cost of materials, labour, etc. These accounts differ from inflation-adjusted accounts.

HOLDING COMPANY (Chapter 7(5.1))

A company whose main purpose is to hold shares of other companies. There is a difference between direct holding companies, which hold substantial shares of a limited group of companies for management and control, and portfolio holding companies used to hold shares as investors. Special tax rules often apply to grant tax exemptions on dividends and capital gains of direct holding companies.

HYBRID COMPANY (Chapter 7(5.12))

A company limited by guarantee but with share capital. The shareholders manage the company but they do not share in its profits. The beneficiaries, who are called guarantee members, do not own the shares. Their liability is limited to a fixed guaranteed sum as their contribution in case of liquidation. Although its traditional use is for charitable organisations and professional and trade associations, they can be structured to function as a quasi-trust or foundation in corporate form in certain jurisdictions. They may be suitable for use in civil law as a company since many of them do not recognise common law trusts.

HYBRID ENTITY (Chapter 8(7.4))

An entity that is characterised differently in two or more jurisdictions. For example, an entity is taxed as a partnership in one jurisdiction and as a corporation in another. An entity treated as a flow-through in its home jurisdiction but considered a corporation by the second jurisdiction is a reverse hybrid. (See “*Check the Box Rules*”)

HYBRID INSTRUMENT (Chapter 8(8.2))

Financial instrument that has the characteristic of more than one type of instrument. For example, it may be a debt in one jurisdiction and equity in another, or vice versa.

IMPUTATION SYSTEM (Chapter 5(5.2))

A system under which at least part of the tax paid by a company on its profits is credited against the tax liability of shareholders on dividends paid out of those profits. Imputation reduces or eliminates the double taxation of distributed profits that arises under the classical system of taxation. Many countries have adopted an imputation system in one form or another.

INITIAL ALLOWANCE (Chapter 4(4.4))

Deduction for depreciation given in the first year for which a tax deduction is due in respect of a qualifying asset. It is usually granted in addition to the ordinary annual deduction or allowance. While the latter is generally calculated with some regard to the actual wear and tear of an asset by reference to its estimated useful life, an initial allowance is usually intended as an incentive to encourage investment in new plant and machinery, etc.

INDIRECT CREDIT (Chapter 4(8.4))

Tax credit given to a shareholder on dividends received from a foreign company for the underlying corporate tax paid on the income out of which the dividend was paid.

INTANGIBLE ASSET (Chapter 6(6.5))

A business asset, which does not exist physically (i.e. not tangible) but has a value for the owner. They may be trade or manufacturing intangibles (e.g. patents, trademarks, in-house know-how, etc.) or marketing intangibles (e.g. trade names, distribution networks, mailing or customer lists, etc.). Other intangibles include goodwill (either purchased or acquired) and various forms of intellectual property, such as copyrights, designs, etc. There are usually special tax rules governing transfer or write-off of intangibles. Generally, purchased goodwill may be amortised or written off over a period. Other intangibles are usually transferred under a licence agreement for payment of a royalty. Intangibles are usually of high value and subject to special transfer pricing rules.

INTELLECTUAL PROPERTY (Chapter 4(7.3))

An intangible asset derived from the right to possess, use or dispose a creation of human intellect. It includes property such as copyright, patent, trademarks, know-how, design, etc. Intellectual property can be licensed for exploitation under royalty payments or the rights can be bought or sold to a third party as an asset.

INTER-NATION EQUITY (Chapter 2(1.7))

A concept requiring a fair sharing among nations of the tax revenue derived from taxation.

INTERNATIONAL BUSINESS COMPANY (Chapter 7(3.2))

Several countries allow incorporation of international business companies (IBC) under a special law which restricts them to non-domestic business activities and ownership by nonresidents only. An IBC usually provides for maximum privacy and tax-free status. It pays a low annual government fee each year for its registration.

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INTERNATIONAL TAX PLANNING (Chapter 5(1.1))

The object of international tax planning is to determine, from the tax point of view, whether or not, to embark on a project. If it has been embarked upon or already commenced, then to lawfully minimise or defer the imposition of the tax burden falling on taxable persons and events, in the attainment of the desired business and other objectives. The planning should take into consideration all relevant tax factors that could lead to double taxation and examine the advantages that may be derived from the inter-relationship of two or more tax systems and any material non-tax factors.

INTERNET (Chapter 8(1.1))

Internet (or “interconnected networks”) is a global, public network of computers over which digital data can be received or sent. Any person using a computer through telecommunications equipment (e.g. a modem and a telephone line) and appropriate computer software can access it.

A term “Intranet” is used for a computer network that is internal to an organisation. Only users within the organisation have access to the Intranet. Typically, they also have access to the Internet, but outside access to the Intranet is prevented by a firewall.

INTERNET SERVICE PROVIDER (Chapter 8(1.2))

An organisation that provides individuals and businesses with access to the Internet. Internet service providers (ISP) may be wholesalers or retailers, or both. Wholesalers usually resell bandwidth (e.g. carrying capacity of a network) and other services to smaller ISPs who act as retailers. The amount of bandwidth purchased is the most significant component of the sale price.

INVENTORY VALUATION METHODS (Chapter 4(4.4))

There are several inventory valuation methods. The most common inventory valuation methods for tax purposes are the cost or market value and the cost or net realisable value, whichever is lower. In some countries, the lower of cost, market value or replacement cost is applied. Several methods also exist to relate the cost of the goods sold to their purchase costs. They include last-in, first-out (LIFO), first-in, first-out (FIFO), average cost, base stock method and replacement values. Generally, FIFO is permitted for tax purposes.

INVESTMENT ALLOWANCE (Chapter 4(4.4))

The term refers to an allowance given on a qualifying investment in a depreciable asset as a further tax deduction. It is usually given in the year of acquisition. As a result, the investment allowance and the depreciation deductions together exceed the acquisition cost of the asset. These allowances are granted to eligible taxpayers as an incentive for capital investment.

INVESTMENT INCENTIVE (Chapter 4(4.6))

Investment incentives are granted to encourage local or foreign investment in certain activities (e.g. exports, technological transfers, research and development, etc.) or particular

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areas (e.g. backward regions or designated areas as part of a decentralisation policy). These incentives may be of various types, such as grants, interest-free loans, factory sites, exemption from exchange restrictions. They are often given as a package together with tax incentives e.g. tax holidays, accelerated depreciation, etc.

INVESTMENT PROTECTION AGREEMENT (Chapter 5(3.6))

A government-to-government agreement between two countries to protect investors from country risks relating to exchange controls and expropriation of property without compensation.

JOINT VENTURE (Chapter 5(2.3))

A type of business partnership involving joint management and the sharing of risks and profits between two or more enterprises usually under a contractual arrangement. A joint venture can be a company with shareholders or like a partnership. It may be for a single venture or a long-term relationship.

JOUISSANCE SHARE (Chapter 3(4-Article 10))

Jouissance share gives the shareholders a right to the capital surplus (if any) upon liquidation of a company and entitle them to a share of the annual profits. The shares represent compensation for the loss suffered by the shareholders when a company is reorganised and the rights of the current shareholders are reduced.

JURIDICAL DOUBLE TAXATION (Chapter 2(1.2))

Juridical double taxation arises where there is an imposition of comparable taxes by two (or more) tax jurisdictions (i.e. international) on the same taxpayer in respect of the same taxable income or capital. Double taxation can arise in a domestic or in an international context. Domestic double taxation arises when comparable taxes are imposed within a federal country by its political subdivision or local authorities as well as the State. International double taxation arises when comparable taxes are imposed in two or more States on the same taxpayer in respect of the same taxable income or capital, e.g. where income is taxable both in the source country and in the country of residence of the recipient of such income.

KNOW-HOW (Chapter 8(3.1))

Know-how refers to all undivulged technical information, whether or not capable of being patented, necessary for the industrial reproduction of a product or process, i.e. knowing how a product is made or how a particular process works. As far as it is derived from experience, the know-how represents what a manufacturer cannot know from the mere examination of the product or the mere knowledge of a process or technique. Know-how is a form of intellectual property that has value and may be transferred or sold. The payments for know-how are usually taxed as royalties or capital gains.

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LEASE (Chapter 4(4.4))

A lease is a contract in respect of fixed or movable property, under which the owner grants to another the right to possess, use and enjoy the property for a specified period in exchange for periodic rental payments. Most leases are either finance leases or operating leases. In a finance lease, the economic ownership is effectively transferred to the lessee and the leasing company acts as a lending institution. It retains the legal ownership of the leased assets and has recourse to these assets if the lessee fails to pay the rent. In an operating lease, the leasing company purchases the equipment and leases it to the lessee on rent, while retaining the economic ownership. Tax depreciation deductions may be given to either the lessor or lessee depending on the domestic tax law.

LETTER-BOX COMPANY (Chapter 7(3.2))

A paper company, shell company or money-box company, i.e. a company that exists only on paper. It has no location, assets or employees in the country of organisation, but it has an address of a person (often a bank or attorney) to whom letters can be addressed. The actual commercial activities are conducted in another country.

LETTER OF WISHES (Chapter 8(9.1))

A letter provided by the settlor of a trust to the trustee giving his suggestions as to how he wishes the trust to be managed and/or the funds should be distributed to the beneficiaries. Although the letter is not binding on the trustee in law, he normally follows the instructions.

LIMITED LIABILITY COMPANY (Chapter 9-United States)

A Limited Liability Company (LLC) is a company that has the legal status as a company with limited liability and tax status as a transparent entity. The number of shareholders is often limited and shares cannot be freely transferred. An LLC may be taxed either as a partnership or as a corporation depending on how it is organised. In the United States, an LLC may elect to be taxed either as a separate or fiscally transparent entity in certain circumstances under the "Check the Box Rules".

LIMITATION ON BENEFITS (Chapter 3(4-US MC Article 22))

Tax treaty provision designed to restrict treaty benefits to persons who meet one or several tests. These tests may require minimum levels of local ownership or business activities in the country where residence is claimed for tax purposes. The person claiming the treaty benefits may also have to meet certain criteria to ensure that a treaty resident is not being used as a conduit company by third-country residents.

LIMITED PARTNERSHIP (Chapter 8(7.1))

Limited partnership comprises a partnership with partners whose liability is limited to their investment. Normally, the entity must have at least one general partner with unlimited liability. The general partner is involved in the management and day-to-day operation of the partnership. A limited partner only makes a capital contribution to the partnership and shares

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in the profits. Limited partners generally cannot take an active part in the management of the business of the partnership or allow their name to be used for its business.

LOAN BONUS SCHEME (Chapter 5(4.4))

Loan-bonus scheme comprises of a loan provided by the employer to pay some or all the tax liability of an expatriate during his overseas assignment. The loan is repaid through a bonus, which is granted after the individual completes the assignment and is nonresident in that country. It is given in consideration to help the employee resettle on his return back to his home country. A similar scheme involves a bonus-loan when a bonus is paid in advance of the assignment. In both cases, the scheme may not be tax effective if the expense is borne by the host country employer or entity.

MARGINAL RATE OF TAX (Chapter 4(4.2))

Marginal tax rate applies in case of progressive taxation. It is the rate applicable to the top slice or bracket of a taxpayer's income or taxable item. The term may also be used to describe the additional income tax payable when income rises, divided by the increase in income.

MARK TO MARKET (Chapter 8(8.3))

The adjustment of the book value of assets to the fair market value at a specific date. It is normally required in some countries to value certain types of futures contracts, foreign currency contracts and options at year-end.

MIXER COMPANY (Chapter 7(5.1))

A term used for an intermediate holding company where income from various foreign sources is mixed to maximise the benefit of foreign tax credits on that income. It is commonly used when a country gives relief for foreign taxes paid on a source-by-source basis only. The mixer company in an intermediary country receives income both from countries with a higher tax rate than that of the destination country and from countries with a lower tax rate, which it then pays out as a single dividend at the average tax rate.

MONEY LAUNDERING (Chapter 7(7.2))

A process to legitimise illegal funds by introducing them into the international financial system so that they can be used for legal activities. Anti-money laundering measures are mostly based on reporting requirements for deposits and on the principle of "know your customer" (KYC) rules.

MULTINATIONAL ENTERPRISE or MNE (Chapter 6(6.1))

A multinational enterprise (MNE) is a company or a group of companies with business establishments in two or more countries.

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MULTILATERAL TAX TREATIES (Chapter 2(6.1))

Treaties for the avoidance of double taxation with respect to taxes on income and capital, which are concluded between more than two treaty partners.

MUTUAL FUND (or UNIT TRUST) (Chapter 7(5.10))

The term refers to a portfolio of securities held by an investment company on behalf of investors. A mutual fund may be an open-ended fund or a close-ended fund. A regulated investment company (RIC) is a mutual fund, formed under the US law. It makes diversified investments with funds provided by investors, who receive dividends and capital gains realised by the company. It is generally treated as a fiscally transparent entity. A RIC is broadly similar to a unit trust when “open-ended”, but may also be “close-ended”. In the latter case, the shares issued to the public are fixed in number and are traded on the stock exchange.

MUTUAL LEGAL ASSISTANCE TREATY or MLAT (Chapter 7(7.2))

MLAT is a treaty that provides for mutual legal assistance in cases where criminal offences have been committed. The United States has been particularly active in this area, especially in relation to drug trafficking and suspected money laundering.

NET INCOME (Chapter 4(4.1))

Net income is gross income less deductible income-related expenses. Taxable income is normally computed from the net income after adjustments for tax allowances and disallowances.

NON-DISCRIMINATION (Chapter 3(4-Article 24))

A principle that a country should tax nonresidents, foreigners and foreign-owned domestic corporations in the same or similar way as residents, citizens or domestically-owned corporations in similar circumstances.

NOTHINGS (Chapter 8(5.1))

A term used to refer to intangible assets of a capital nature such as goodwill, incorporation expenses, rights, franchises and other intangible assets of indefinite life. It is also used to describe expenditure, which is genuinely incurred but which is not eligible for tax relief.

OECD (Chapter 2(5.1))

The OECD (Organisation for Economic Co-operation and Development) was founded in 1961 to co-ordinate economic and social policies of its Member States. Its Committee on Fiscal Affairs is responsible for the maintenance and update of its Model Treaty and Commentary.

The following countries were Members of the OECD in 2004: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand,

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Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, the United Kingdom and the United States.

OFFSHORE (Chapter 7(1))

A broad definition includes any country, other than one's own, where one has nonresident status. The term is normally used for operations outside the country where it is incorporated or organised.

OFFSHORE BANKING UNIT or OBU (Chapter 7(5.7))

A bank in an offshore financial centre, not allowed to conduct business in the domestic market.

OFFSHORE FUND (Chapter 7(5.10))

A mutual fund offering its shares to persons who are resident outside the country in which it is incorporated.

OFFSHORE GROUP OF BANKING SUPERVISORS (OGBS)

OGBS was set up in October 1980 on the advice of the Basle Committee on Banking Supervision. Its main purpose is to improve the supervision of banks and encourage cooperation between the Basle Committee and the banking supervisors in Member countries. Current OGBS Members are Aruba, Bahamas, Bahrain, Barbados, Bermuda, Cayman Islands, Cyprus, Gibraltar, Guernsey, Hong Kong, Isle of Man, Jersey, Lebanon, Malta, Mauritius, Netherlands Antilles, Panama, Singapore and Vanuatu.

OFFSHORE TRADING COMPANY (Chapter 7(5.4))

A company organised in a foreign country to buy goods from an exporter in one or more foreign countries and to sell them to importers in other foreign countries. The offshore trading company processes the documents and handles all managerial, administrative and day-to-day financial transactions. The goods are shipped from the seller in one country to the buyer in the other country directly, without being shipped or landed in the country where the offshore trading company is located.

OPTION (Chapter 8(8.3))

Derivative financial instrument consisting of a firm agreement granting one party the right, but not the obligation, to buy or sell quoted commodities or securities at a specified future date at a specified price. Option may be traded over the counter or in the form of an exchange-traded contract. Gains on put contract are subject to capital gains tax in some countries.

PARENT COMPANY OR CORPORATION (Chapter 5(2.3))

A company or corporation that controls another company or corporation (referred to as a subsidiary).

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PARENT-SUBSIDIARY DIRECTIVE (Chapter 5(5.4))

A Directive issued by the European Commission in 1990 to provide for payment of dividends within the EU Member States free of withholding tax in the paying State and receiving the dividends effectively tax-free in the receiving State.

PARTICIPATION EXEMPTION (Chapter 5(5.3))

Under participation exemption, dividend income from substantial participation (i.e. shareholding) is exempt from corporate tax since they have already been taxed in the hands of the paying company. In some countries, capital gains on the sale of the participation are also exempt from tax. The participation exemption is also known as “affiliation privilege” or “substantial holding privilege”.

PARTNERSHIP (Chapter 8(7.1))

A partnership is an association of two or more persons (individuals or companies) formed for making a profit. Such an association may be based on an oral or written agreement. A partnership can be a general partnership or a limited partnership depending on the extent of each party’s liability. A general partnership is characterised by the unlimited liability of the general partners for partnership debts. A limited partnership is comprised of at least one general partner who has unlimited liability for partnership debts and one or more limited partners who are only liable to the extent of their capital contribution. Limited partners, however, may not participate in the management of the business.

PASS-THROUGH ENTITY (Chapter 8(7.1))

Pass-through or flow-through entity refers to an entity, which is fiscally transparent. An example is a partnership which is not itself taxable and the tax is payable by the partners.

PATENTS (Chapter 4(7.3))

Most countries provide for patent laws under which an inventor can register his invention. The registration protects his right and entitles him to exclusive exploitation of his invention for a limited period. The inventor may, however, sell or license the use of his patent while retaining the ownership rights in return for royalty payments during the period.

PERMANENT ESTABLISHMENT (Chapter 3(4-Article 5))

Permanent establishment (PE) is used in double tax agreements (although it may also be used in national tax legislation) to determine when a non-resident enterprise is taxable in the source State. An enterprise in one country is not liable to the income tax of the other country, unless it has a “permanent establishment” through which it conducts business in that other country either directly or through a dependent agent. The expression is used in double taxation agreements and is defined in the Model treaties.

PLACE OF CENTRAL MANAGEMENT (Chapter 4(2.3))

A rule under which a corporation is considered to be a tax resident of the country in which it is controlled or managed (usually where the Board of Directors meets and exercises control over the affairs of the corporation).

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PLACE OF EFFECTIVE MANAGEMENT (Chapter 3(4-Article 4))

Place of effective management is the test used as the tiebreaker rule in the OECD MC to determine the residence of a company where it is tax resident in both Contracting States. The effective management may differ from the place of central management.

PLANT AND MACHINERY (Chapter 4(4.4))

The definition of plant and machinery for depreciation allowance varies. Plant and machinery employed in a business usually qualify for depreciation deductions at a rate higher than deductions on buildings or other assets. In addition, depending on the use and purpose, they may qualify for accelerated depreciation or specific investment incentives.

POOL BASIS (Chapter 4(4.4))

Under this principle, all similar assets are effectively treated as a single asset for depreciation purposes. The deduction for depreciation is calculated based on the aggregate book value of all assets in the category at the beginning of the taxable year, plus the cost of assets acquired during the taxable year, less the proceeds derived from the sale of assets during the taxable year.

PORTFOLIO INVESTMENT COMPANY (Chapter 5(2.3))

A company holding equity or debt investments that do not provide the company as an investor with substantial influence in the management of the investee companies. An equity ownership interest of less than 10 percent of the outstanding shares of a company is usually treated as a portfolio investment.

PREFERENCE INCOME (Chapter 5(5.2))

Preference income is defined as income that is not taxed at the full rate (also called “headline rate”). It comprises income excluded from tax, or taxed at lower rates due to rate reductions or tax credits. They may be temporary preferences and grant a deferral of tax due to timing differences. Permanent preferences permanently reduce the tax burden for which they are granted when compared with income subject to full taxation.

PREFERENCE SHARES (Chapter 5(2.3))

Shares that carry a right to a prior and usually fixed dividend, ahead of dividends paid to ordinary shareholders. They often carry a prior claim to repayment of capital upon liquidation.

PREFERENTIAL TAX REGIME (Chapter 2(8.2))

A term used by the Organisation for Economic Co-operation and Development for tax haven practices of its Member States. Some commentators also call them non-traditional tax havens.

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PRESUMPTIVE TAX (Chapter 4(4.2))

Tax levied on an estimated taxable base. The taxpayer is subject to tax on a presumptive income or presumed turnover, which is computed, based on gross receipts, expenses incurred, assets owned, outward signs of lifestyle, etc.

PRIMARY ADJUSTMENT (Chapter 6(6.7))

An adjustment that a tax administration makes to a company's taxable profits because of the arm's length principle to transactions involving an associated enterprise.

PRIVATE RULING (Chapter 4(6.1))

Private ruling refers to an advance tax ruling given to a single taxpayer, usually with respect to a single transaction or series of transactions, in the United States. Normally the ruling can be relied upon only by the taxpayer, to whom it is issued, but not by other taxpayers, and is binding upon the tax authority provided all the relevant facts have been disclosed.

PRIVILEGED TAX REGIME (Chapter 6(4.2))

It is a term used for a tax regime, which is more tax beneficial.

PROFIT-SPLIT METHOD (Chapter 6(6.4))

A method for the allocation of the worldwide profits of a multinational enterprise among its corporate Members in proportion to their contributions to the earning of the profits.

PROTECTOR (Chapter 8(9.1))

An individual appointed by the settlor of a trust to ensure that the trustee(s) administers and manages the trust assets in accordance with the trust deed. He is often vested with the power to appoint and remove trustees.

PROTOCOL (Chapter 2(1.4))

For tax purposes, a protocol is an agreement reached by the parties to a tax treaty, which is signed and ratified by them, in addition to an existing tax treaty. It is a self-standing treaty that amends or is subsidiary to an existing treaty. The Protocol may be signed simultaneously with the tax treaty or subsequently to clarify, modify or action the provisions in the agreement.

REAL TIME (Chapter 8(1.3))

A term used generally used with computer systems that take little or no time to perform their functions, i.e. they carry out instructions almost instantaneously.

REALISATION OF ASSETS (Chapter 4(7.4))

The sale or other disposal of assets for consideration or deemed consideration. The tax consequences of realisation usually depend on the national tax laws and the type of asset involved. Realisation may thus give rise to taxable or tax-free capital gains (or capital losses) or ordinary income (or deductible loss). Relief may be available by applying special low rates of tax or by rollover relief.

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REGISTERED COMPANY (Chapter 5(2.3))

A company registered with the authorities of the country in which it is established or incorporated. However, a company may not always be registered in its country of incorporation. In most countries, it is illegal to operate as a company without being registered.

REGISTERED OFFICE (Chapter 5(2.3))

The registered office is the place where the registered agent can be found. It may be the corporate office, or it may be the office of the corporation's attorney.

REMITTANCE BASIS (Chapter 4(1.4))

Under the remittance basis of taxation, foreign-source income is taxed only when it is actually remitted to a country. Remittance is usually given an extended definition to include constructive remittance, for instance, when an amount is credited to a taxpayer's account or used to offset a domestic liability. Where foreign-source income is remitted, the tax liability normally takes account of the foreign tax paid thereon. In some countries, the remittance basis applies to persons, who are resident but either not domiciled, or not ordinarily resident. (Example: United Kingdom)

REPATRIATION (Chapter 5(3.3))

Individuals and legal entities, who invest their capital in a foreign country to derive income from such capital, generally expect to transfer this capital or resulting income back to their home country. Repatriation restrictions could arise due to foreign exchange control regulations. To avoid such problems and generally to stimulate investment by nonresidents, countries often allow free repatriation of capital and any income derived from such capital, either under their law or under an investment protection agreement.

REPO (Chapter 8(8.3))

Repo is an agreement to sell securities with a future repurchase by the seller at a higher price. It may be treated either as a secured loan with the differential price as the interest payment or as capital gains on a buy-sell transaction for tax purposes.

RESIDENCE (Chapter 4(1.3))

Residence is one basis for imposing tax (the other is source). Usually a resident taxpayer is taxed on his worldwide while nonresidents only pay tax on income derived from the country. Some countries do not define resident in their tax legislation, leaving it to be defined or clarified by practice or Court rulings. Other countries lay down rules defining when a person is to be treated as a resident or nonresident.

RING FENCE OR QUARANTINE (Chapter 4(5.1))

A method used to protect or restrict the tax legislation only to certain transactions or groups of transactions.

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ROLLOVER RELIEF (Chapter 4(7.4))

Rollover relief is given by many countries to defer the capital gains tax when the proceeds from an asset disposal are reinvested in new assets. There is usually a requirement that the transferor acquires another asset with the disposal proceeds, usually of the same kind as the asset disposed of, within a certain period after the disposal. The base cost of the new asset is reduced by reference to the amount of the gain rolled over, so that on a subsequent disposal of the new asset a larger gain will give rise that includes the gain deferred on the earlier disposal. Rollover relief may also be given on asset transfers between connected parties (for example, from spouse to spouse, between companies in a group or from an incorporated taxpayer to a company in return for shares).

ROYALTIES (Chapter 4(7.3))

Royalties comprise mainly periodic payment based on output or sales but lump-sum consideration also falls within the definition. The OECD Model treaty includes payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematographic films, any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience. The tax laws and tax treaties of many countries contain a similar (although sometimes less extensive) definition of royalties.

SAFE HARBOUR (Chapter 6(6.6))

Where tax authorities give general guidelines on the interpretation of tax laws, they may mention that the tax authorities will accept transactions falling within a certain range without further questions. For instance, a ruling may be issued that interest on loans between related persons would be accepted if the interest rate falls within certain parameters. Such limits are referred to as safe harbour or safe haven rules.

SAVINGS DIRECTIVE (Chapter 2(7.3))

A Directive issued by the European Commission in 2003 to ensure that savings income of individuals is effectively taxed when paid within the European Union. The EU Directive also applies to associated and certain dependent territories of EU Member States. The Directive requires Member States to permit automatic exchange of information for monitoring the tax collection on cross-border interest payments to European Union residents without requiring reciprocity. As a transitional measure, three States (namely, Austria, Belgium and Luxembourg) are permitted to apply a withholding tax on interest payments until 2010.

SCHEDULAR TAX SYSTEM (Chapter 4(4.1))

Under the schedular system, the income from different sources is taxed separately under different schedules at the same or different tax rate. A schedular tax system may be imposed on both individuals and corporations and on other legal entities, and it may be imposed at a progressive or a flat rate. Often losses are ring-fenced i.e. they can be only offset against profits under the same schedule.

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SERVER (Chapter 8(1.1))

A computer that acts as a host (i.e. serves) for data accessible to the users of a network on the Internet. Servers are managed by organisations called Internet Service Providers (ISP), which provide individuals and businesses with access to the Internet.

SECONDARY ADJUSTMENT (Chapter 6(6.7))

The secondary adjustment refers to the deemed secondary transaction because of the primary adjustment under the arm's length principle. It is a constructive payment under the laws of some countries to make the profit allocation consistent with the primary adjustment. Secondary transactions may take the form of constructive dividends, constructive equity contributions or constructive loans.

SETTLOR or GRANTOR (Chapter 8(9.1))

The person who creates a trust. In the United States, the term used is Grantor.

SHADOW DIRECTOR (Chapter 4(2.3))

A shadow director is not actually a director but a person whose instructions or advice is followed by others.

SHAM TRANSACTION (Chapter 6(2.1))

A sham is a pretence or something that is simulated. A sham transaction is intended to create the appearance that one transaction took place, whereas in fact another transaction or no transaction took place. A sham transaction is entered into for tax avoidance or tax evasion purposes, and may be disregarded by the tax authorities.

SHELF COMPANY (Chapter 7(3.2))

An inactive or dormant company available for use with annual registration, capital and stamp duty fees currently paid. The directors and officers are replaced when the company is taken off the shelf and becomes active.

SILENT PARTNERSHIP (Chapter 8(7.1))

Silent partnership arrangement is similar to a limited partnership, i.e. the silent partner contributes capital and is entitled to a specific share of the partnership profits and losses. However, the identity of a silent partner may not be made public. The degree of liability of a silent partner may be set as a fixed percentage of total partnership liabilities or may be restricted to the amount of his contribution.

SMURFING (Chapter 7(7.2))

Breaking large sums of money into small deposits through anonymous bank accounts and offshore "shell" companies to avoid reporting these transactions.

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SOURCE OF INCOME (Chapter 4(3.1))

The place (or country) where a particular item of income is deemed to originate or is generated. The rules that determine the source of income are usually included in the domestic tax law or legal decisions. Tax treaties provide source rules that are agreed by the Contracting States.

SPLIT PAYROLL (Chapter 5(4.4))

Split payroll involves payment of part of the employment income of an expatriate outside the host country of assignment. Depending on circumstances, it may be non-taxable in certain countries under dual employment contracts, and/or avoid exchange control restrictions on repatriation.

STAPLED STOCK (Chapter 4(7.1))

The shares of two (or more) separate corporate entities based in different jurisdictions are referred to as stapled stock if they are linked together in such a way as to form, in effect, one unit for commercial purposes. The linkage ensures that the stapled shares are traded together, and the mechanism for linking the shares depends on the laws of the jurisdictions involved. Stapled stock arrangements are used to enable dividend payments to be made directly from a subsidiary to the parent company's shareholders either to avoid a tax charge at intermediate levels or to entitle them to tax credits under the imputation system through dividend access schemes.

STATIC INTERPRETATION (Chapter 2(3.5))

Where reference is made to domestic law in a tax treaty, the question arises as to whether the applicable law is the law in effect at the time the treaty is entered, or the law in effect at the time the treaty is applied. The static interpretation dictates that the domestic law be the law in effect at the time the treaty is entered into force.

STATUTE OF ELIZABETH (Chapter 8(9.3))

The Statute under English common law governing fraudulent conveyances to avoid creditors. The Statute was incorporated into the English Law of Property Act 1925 and has been replaced by the Insolvency Act 1986 in the United Kingdom. Under the Statute, the creditors can void a transfer of property to a trust due to the subjective intent of the settlor. The Statute has been replaced by specific legislation with more objective criteria in several countries. Originally, the penalty for a violation under the Statute of Elizabeth was the forfeiture of one-half of the property or assets to the State and one-half to the injured creditor, along with six months' imprisonment.

STATUTES (Chapter 2(1.1))

Statutes are laws passed by the legislative bodies in a country. They often authorise an administrative agency to issue regulations to supplement the statute. In the event of a conflict, statutes overrule regulations.

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STEPPING-STONE COMPANY (Chapter 7(3.3))

The term used to describe companies set up to enable the benefits of a tax treaty between two countries to be enjoyed by residents of a third country. Inbound income is offset by a slightly lower outbound payment and corporate tax is levied on the difference or “turn” at regular tax rates in the intermediary jurisdiction.

SUBPART F INCOME (Chapter 6(4.3-United States))

A term which refers to those sections of the US tax code which provide for the taxation of US shareholders of controlled foreign corporations (CFC) in order to prevent the tax-free accumulation of earnings outside the United States.

SUBSIDIARY (Chapter 7(5.1))

A corporation that is directly controlled by another corporation. A foreign subsidiary of a corporation is a corporation resident outside the country of residence of the contracting corporation.

SUBSTANCE OVER FORM DOCTRINE (Chapter 6(2.1))

Doctrine that allows the tax authorities to ignore the legal form of an arrangement and to look at its substance to prevent artificial structures from being used for tax avoidance purposes.

SUPER ROYALTY (Chapter 6(6.8-United States))

The US Income Tax Reform Act of 1986 provides that royalties for the transfer (by sale, licence or otherwise) of intangible property to related foreign companies, which have been determined at the time of the transfer on an arm’s length basis, may be adjusted in future years by the IRS if they are not commensurate with the income attributable to that intangible. This is called the super royalty provision.

SURCHARGE or SURTAX (Chapter 4(4.2))

Additional tax, which is calculated on and added to the normal charge or levy. The base on which a surcharge or surtax is assessed is the normal or basic amount due.

SWAP (Chapter 8(8.3))

Swap is a derivative financial instrument. Under a swap, two parties agree to exchange payments calculated by reference to a notional principal amount. It is a single, purely reciprocal contract between two or more parties, each leading to the exchange of sums of money or to setting off price or exchange differences and amounting in the economic sense to a mutual exchange of debts with the same life, but with different interest conditions and/or currencies.

In a currency swap, the parties contract to exchange cash flows (or equal value) of specific assets or liabilities which are expressed in different currencies. In an interest rate swap, they contract to exchange interest payments based on the same amount of indebtedness of the same maturity and with the same payment dates. Basis swaps (floating rate swaps based

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on different indices, e.g. prime against LIBOR and combined interest rate and currency swaps) are also common. There are numerous variations resulting in highly complex swap transactions involving many counter parties.

TAINTED INCOME Chapter 6(4.2)

Income of a controlled foreign corporation that is taxed to the resident shareholders of the corporation when earned by the foreign corporation rather than when distributed. Generally, tainted income consists of passive investment income and certain related company income.

TAX ASSESSMENT (Chapter 4(4.7))

A formal agreement between a taxpayer and a government as to how much tax is due from the taxpayer for a particular period.

TAX AVOIDANCE (Chapter 6(1.1))

Tax avoidance implies that a taxpayer has arranged his affairs in such a way that his tax burden is less than it would otherwise have been, or that no tax is payable because of such arrangement. It refers to the reduction of tax liability by legal means. It may be acceptable or unacceptable. Often the term is understood in the latter sense when the tax planning is achieved through dubious means, such as tax loopholes, anomalies or other deficiencies in the tax law. In contrast with avoidance, tax evasion is the reduction of tax by illegal means.

TAX BASIS (Chapter 5(3.2))

Term used in the United States to refer to an amount that represents the taxpayer's investment in an asset. It is generally used as a reference for calculating tax depreciation, amortisation, or gain or loss on an asset for tax purposes. Tax basis can be computed by reference to the initial cost of an asset, or by its substituted carry-over or inherited tax basis.

TAX CLEARANCE CERTIFICATE (Chapter 6(7.2))

A certificate issued by the tax authorities confirming that an individual leaving the country has fulfilled all his income tax obligations and has no tax arrears. The certificate must be shown to customs and emigration authorities on departure.

TAX CONSOLIDATION (Chapter 5(6.1))

Rules that permit related corporations within a group to aggregate their income and losses, thereby allowing the losses of one affiliated corporation to offset the profits of another corporation.

TAX DEDUCTIBLE (Chapter 4(4.5))

Any expense, which can be paid for out of untaxed income as an allowance without creating a tax liability for the recipient.

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TAX-EXEMPT COMPANY (Chapter 7(3.2))

Tax-exempt company can be set up by nonresidents as an offshore entity in certain tax jurisdictions. Tax-exempt companies only pay a fixed fee each year and no tax on their income.

TAX EVASION (Chapter 6(1.1))

This term refers to illegal activities to evade taxes. Tax evasion includes sham transactions, filing of false tax returns and keeping fictitious books of account. It differs from tax avoidance, which is legal but may or may not be acceptable to the authorities.

TAX EXILE (Chapter 5(1.4))

Generally speaking, a natural or legal person who severs all ties which make him fiscally resident in a particular country and moves to another jurisdiction for tax reasons.

TAX HAVEN or PARADIS FISCAL (Chapter 2(8.2))

Tax haven in the literal sense refers to a country, which is used to avoid tax that would be payable otherwise in another country. Besides the traditional “low or nil tax” jurisdictions, a high-tax country may be characterised as a tax haven if it offers certain exemptions, incentives, investment opportunities or other preferential treatment. They are often termed as non-traditional tax havens or preferential tax regimes. In contrast to a traditional tax haven, these countries generally have an extensive treaty network, which can be used to avoid taxation.

TAX HOLIDAY (Chapter 4(4.6))

A tax holiday refers to a period of exemption from income tax, usually for new industries, in order to develop or diversify domestic industries. The exemption is given for a term of years to “pioneer” or “infant” industries.

TAX INCENTIVE (Chapter 4(4.6))

The term “tax incentive” is normally used when tax benefit is part of an economic development programme. Most tax incentive measures fall into one or more of the following categories, namely (i) tax exemption (tax holiday); (ii) deduction from the taxable base; (iii) reduction in the rate of tax; and (iv) tax deferment.

TAX LOOPHOLE (Chapter 5(1.6))

Opportunities available in the tax law to minimise taxes that are not intended by the legislature.

TAX LOSS (Chapter 4(5.1))

Tax loss differs from book loss. While book loss is the figure based on financial accounts, tax loss is the loss figure arrived at after making various tax adjustments to the book loss. An accounting or book profit may also become a tax loss due to various deductions and incentives.

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TAX RETURN ((Chapter 4(4.7))

The form on which the details of a taxpayer's income, expenditure and capital gains are sent to the tax authorities.

TAX SHELTER (Chapter 6(1.1))

Term may be used with at least two different implications. One is the lawful use of a tax relief or exemption or deferral. "Tax shelter" is also the term given to a scheme to avoid or reduce a liability to taxation through dubious means. In domestic tax law, the term applies to methods used to create artificial losses, i.e. losses that are not true losses but are available as deductions under the tax laws. These artificial losses may be offset not only against income from the investment out of which they arise, but also against the taxpayer's other income, usually from his regular business or professional activity.

TAX SPARING (Chapter 4(8.4))

Tax sparing refers to a special form of double taxation relief in tax treaties with developing countries. Where a country grants tax incentives to encourage foreign investment (e.g. a tax holiday in respect of the profits of a company carrying on a pioneer industry) and that company is a resident of another country with which a tax treaty has been concluded with credit relief, the other country may give the company "tax sparing" relief. This is achieved by the other country giving a credit against its own tax for the tax that the company would have paid if the tax had not been "spared" (i.e. given up). The purpose of tax sparing relief is to preserve the incentive offered by the developing country.

TAX TREATIES (Chapter 1(3))

Tax treaties are agreements concluded under public international law to eliminate double tax between Contracting States. They may be multilateral involving more than two countries or more often bilateral between two jurisdictions or Contracting States.

TECHNICAL SERVICES (Chapter 8(3.1))

Technical service contracts involve the use of customary skills to execute a scope of work for the other party where the provider takes full responsibility for the pre-agreed results. Technical assistance contracts entail a scope of services, usually under the supervision and control of the customer, where the provider takes no responsibility for the commercial results. Both of them may include show-how. Show-how is defined as the process of transferring knowledge through instruction, training, supervision and other technical assistance. The payments are normally based on the value of the services or assistance provided to the customer.

TERRITORIALITY PRINCIPLE or REGIME (Chapter 4(1.4))

Under the territorial principle or regime, tax is levied only within the territorial jurisdiction of a sovereign tax authority or country. Residents are not taxed on any foreign-source income.

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THIN CAPITALISATION (Chapter 6(5.1))

Thin capitalisation rules limit the deduction of interest expense when companies are highly geared or leveraged. A company may be financed in two ways: by equity capital or by debt capital. Generally, it will be financed by a combination of debt and equity. A company is said to be “thinly capitalised” when its equity capital is small in comparison to its debt capital.

TIE-BREAKER RULE (Chapter 3(4-Article 4))

Tax treaty provision designed to prevent an individual from being deemed resident in both treaty countries for purposes of the treaty.

TOTALISATION AGREEMENT (Chapter 5(4.6))

In the absence of international social security agreements, an individual might contribute to social security systems in different countries, and yet not meet the initial residence or coverage requirements for access to benefits. Social security agreements guard against this possibility by providing that the periods of social security coverage in one signatory country will count as qualifying periods of coverage in the other country, i.e. the periods in the first country are “totalised” with periods in the second. Social security agreements are thus called “totalisation agreements”. Under these agreements, some countries have either waived their right to tax in certain circumstances, or granted total or partial credit for the pension contributions paid at home by the nationals of the other State.

TRADE INTANGIBLE (Chapter 6(6.2))

Intangible asset developed from non-marketing activities, such as manufacturing, research and development, purchasing, etc. Examples include patents, trade secrets, know-how, etc.

TRANSFER PRICING (Chapter 6(6.1))

A transfer price is the price charged by a company for goods, services or intangible property to a subsidiary or other related company. Since these prices are not negotiated in a free, open market they may deviate from prices agreed upon by non-related trading partners in comparable transactions under the same circumstances. Some examples of transactions where transfer pricing issues generally arise include sharing of costs for research and development (R&D) of technology or know-how (i.e. a cost-sharing agreement); pricing of products manufactured by one entity in the group of companies for distribution by another entity in the group; and establishing the rate of royalties for access to intangible property. If the goods, services or intangibles are overpriced in a transaction between related parties, the seller’s profitability is increased and the buyer’s decreased. Conversely, if the goods, services or intangibles are underpriced the buyer’s profitability is increased and the seller’s decreased.

TRANSPARENT OR CONDUIT ENTITY (Chapter 5(1.4))

A form of business organisation in which the members or partners are subject to individual tax and/or legal liability for the obligations of the organisation. A fiscally transparent

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entity is known as a conduit. Transparent entities include S corporations (US), partnerships, trusts, and limited liability companies taxable as a partnership. The advantage of a fiscally transparent entity forming a transparent or conduit entity is the pass-through (also called flow-through) of the profit and loss and related tax liability directly to the investors or shareholders.

TRAVAUX PREPARATOIRES (Chapter 2(3.2))

Article 32 of the Vienna Convention on the Law of Treaties permits the use of preparatory materials or “*travaux préparatoires*”, either to confirm the meaning of the text or to determine the meaning of the text where the application of the principal rule leads to an ambiguous or absurd result. Such materials refer to documents considered by the contracting parties during their negotiations.

TREATY OVERRIDE (Chapter 2(2.4))

Treaty override is a term used when a subsequent law or action conflicts with prior treaty obligations. As a rule, the provisions of a tax treaty prevail over domestic legislation even if the provisions conflict. In some countries the relationship between treaties and domestic law is governed by the “last in time” rule, i.e. if there is a conflict between a treaty and domestic legislation, the last in time prevails. In recent years, certain countries have enacted legislation designed to specifically override treaty provisions. Because treaty overrides potentially undermine existing treaty obligations, they have been the subject of intense criticism.

TREATY SHOPPING (Chapter 6(3.1))

The use of a tax treaty by a person who is not resident in either of the treaty countries, usually using a conduit entity resident in one of the countries.

TRUST (Chapter 8(9.1))

A trust is an arrangement allowed in most “common law” jurisdictions for the holding of property by a person (trustee) transferred from a person (settlor) for the benefit of other persons (beneficiaries). A trust must have a settlor (also called a grantor) or a person who establishes the trust to take over the ownership of assets. The trustee is an individual or corporation to which legal ownership of the assets is transferred. He must supervise, manage, invest and distribute the assets in accordance with the trust deed. The trust deed mentions the terms and conditions under which the trustee operates. A beneficiary is the intended owner of the assets placed in the trust. The protector is a guardian who ensures that trustees carry out the wishes of the settlor. A beneficiary can sue the trustees if the conditions of the trust are not followed or the trust assets are not held safely.

UN MODEL TREATY (Chapter 3(2.1))

A Model income tax treaty sponsored by the United Nations with a wider objective to promote social and economic development and inflows of foreign investment. Unlike the OECD Model, it recognises the different treaty policies of developed and developing

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countries It also provides for more taxing rights for the source State compared to the residence State under the treaty.

UNCONTROLLED TRANSACTION (Chapter 6(6.4))

Transactions between enterprises that are independent enterprises (i.e. unrelated) to one another.

UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES or “UCITS” (Chapter 7(5.10))

Investment funds approved within a Member State of the European Union under legislation that complies with the relevant EU Directive and, therefore, may be marketed throughout the European Union.

UNDERLYING TAX (Chapter 4(8.4))

Tax charged on corporate income out of which dividends are paid, but which does not appear as a direct deduction or withholding from the dividend itself.

UNILATERAL RELIEF (Chapter 4(8.1))

Double tax relief given under the domestic law.

UNITARY APPROACH (Chapter 6(6.4))

A system of global formulary apportionment under which the worldwide profits and losses of a multinational enterprise are allocated among its component parts in accordance with a formula based on factors such as sales, assets and payroll. It does not follow the arm's length principle. Under this system the entire group is treated as a single unit, and a profit split method is used on the combined income of the entire corporate group (domestic and foreign), after eliminating intra-group transactions.

UNIT TRUST (Chapter 7(5.10))

A unit trust or mutual fund (known in the European Union as an Undertaking for Collective Investment in Transferable Securities or “UCITS”) is a collective investment scheme where small investors, known as unit-holders, pool their capital, thus enabling risks to be spread over a range of investments (and/or jurisdictions). A unit trust may be a closed or open-ended fund. The open-ended fund allows the capital in the form of units to increase or decrease as units are issued or redeemed by the trust manager. Closed-ended funds are for a limited duration and at its end of the period the fund assets are liquidated and distributed to the unit holders. A number of countries have introduced special regimes to deal with the taxation of unit trusts.

UPSTREAM LOAN (Chapter 5(3.3))

The term refers to a loan given by a subsidiary company to a parent company.

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USUFRUCT (Chapter 3(4-Article 6))

Usufruct is the right for a person to use certain property and the income derived from it even when the property is owned by another person. However, the person only has the right of use of the property and its income; he cannot change, damage or sell the property.

VALUE ADDED TAX or VAT (Chapter 2(7.1))

An indirect tax charged on the value added at each stage in the production and distribution process on supplies of goods and services. Although it is levied on the person, who consumes the goods or services, the liability is on the supplier of goods or services. VAT is recovered as a percentage on the price charged by the seller of the goods or services.

VIENNA CONVENTIONS (Chapter 2(1.1))

The Vienna Conventions codify existing rules of international law rather than create new provisions. There are four multilateral “Vienna Conventions” that are relevant for tax purposes, namely:

- the Convention of 18 April 1961 on Diplomatic Relations;
- the Convention of 24 April 1963 on Consular Relations;
- the Convention of 23 May 1969 on the Law of Treaties;
- the Convention of 21 March 1986 on the Law of Treaties between States and International Organisations or between International Organisations.

WATER’S EDGE LEGISLATION (Chapter 6(6.8-United States))

A law in several states in the United States to limit the taxing authority over multinational companies under the unitary method of taxation. The water’s edge legislation limits (or provides an election to limit) the application of the unitary method only to income from business activities within the geographical boundaries of the United States.

WEBSITE (Chapter 8(1.1))

A document, “page”, or collection of documents, stored on a server, that is accessible to the users of the World Wide Web. The web site of an individual, business, government or organisation is usually accessed first through the home page, which typically provides an overview of the contents of the web site. Commercial web sites often include software applications that allow consumers to order and pay for products advertised on the site.

WITHHOLDING TAX (Chapter 4(4.7))

A tax levied by the source State generally at a flat rate on the payments made to nonresidents. The tax is collected and paid to the host government by the resident payer. Various kinds of passive income (such as dividends, interest, royalties) are taxed at source by requiring the payer to withhold the tax due and account for it to the tax authorities. This withholding tax may or may not be final or creditable on the recipient for residents. For nonresident taxpayers, the withholding tax is often the final tax liability in the source State.

Glossary of International Tax Terms

WORLD WIDE WEB or WWW (Chapter 8(1.1))

The graphical, hypertext portion of the Internet. It blends text, images, video and audio instead of displaying simple text. Web documents are hypertext documents, which can contain links to other documents that can be accessed by “clicking” on these links. Accessing the WWW requires a browser program. Hypertext contains embedded links to other documents or information.

WRITTEN DOWN VALUE (Chapter 4(4.4))

The asset value less accumulated depreciation permitted under tax rules.

EXHIBITS – MODEL TREATIES

1. OECD MODEL TAX CONVENTION ON INCOME AND ON CAPITAL¹ (updated as of January 28, 2003, and including the changes proposed in the 2005 Update on Articles 19 and 26)

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Title of the Convention

Convention between (State A) and (State B) with respect to taxes on income and on capital.

Preamble to the Convention²

Chapter I Scope of the Convention

Article 1: Persons Covered

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

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 sub-divisions 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.

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

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

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Chapter II Definitions

Article 3: General Definitions

1. For the purposes of this Convention, unless the context otherwise requires:
 - (a) the term “person” includes an individual, a company and any other body of persons;
 - (b) the term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;
 - (c) the term “enterprise” applies to the carrying on of any business;
 - (d) the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
 - (e) the term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
 - (f) the term “competent authority” means:
 - (i) (in State A):
 - (ii) (in State B):
 - (g) the term “national”, 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.
2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the 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 sub-division or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
 - (a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);

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- (b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
- (c) if he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
- (d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

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

Article 5: Permanent Establishment

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

2. The term “permanent establishment” includes especially:

- (a) a place of management;
- (b) a branch;
- (c) an office;
- (d) a factory;
- (e) a workshop, and
- (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

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

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- (a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
- (b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- (c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- (f) the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 6 applies – is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent

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establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

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

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

Chapter III Taxation of Income

Article 6: Income from Immovable Property

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

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

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

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

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.

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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.

Article 8: Shipping, Inland Waterways Transport and Air Transport

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

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

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

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

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

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

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

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

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

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

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

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

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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, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term "interest" as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.
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

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

4. Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50% of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed 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.

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

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

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

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: Artists and Sportsmen

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

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

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

(Note: The changes proposed in the 2005 Update are shown in italics.)

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.

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2. (a) *Notwithstanding the provisions of paragraph 1, a pension or 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 pension *or 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 represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

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

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Chapter V Methods for Elimination of Double Taxation

Article 23 A: Exemption Method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.
3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.
4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

Article 23 B: Credit Method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
 - (a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
 - (b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

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

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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 the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement

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with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities 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.

Article 26: Exchange of Information

(Note: The changes proposed in the 2005 Update are shown in italics.)

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. 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, or 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.

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.*

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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 Taxes³

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.

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.

³ 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.

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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: Territorial Extension

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.
2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 30 shall also terminate, in the manner provided for in that

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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.

Chapter VII Final Provisions

Article 30: 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 31: 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 CLAUSE⁴

⁴ The terminal clause concerning the signing shall be drafted in accordance with the constitutional procedure of both Contracting States.

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2. UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES OF JANUARY 11, 2001

Title of the Convention

Convention between (State A) and (State B) with respect to Taxes on Income and on Capital.

Preamble of the Convention

[The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of both Contracting States.]

Chapter I Scope of the Convention

Article 1: Persons Covered

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

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 sub-divisions 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 which 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 significant changes made to their tax law.

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 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;

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- (d) The term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
 - (e) The term “competent authority” means:
 - (i) (in State A):
 - (ii) (in State B):
 - (f) The term “national” means:
 - (i) Any individual possessing the nationality of a Contracting State.
 - (ii) Any legal persons, partnership or association deriving its status from the laws in force in a Contracting State.
2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the 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 any 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 incorporation, place of management or any other criterion of a similar nature, and also includes that State and any subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
- (a) he shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
 - (b) if the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has a habitual abode;
 - (c) if he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
 - (d) if he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1, a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

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Article 5: Permanent Establishment

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

2. The term “permanent establishment” includes especially:

- (a) a place of management;
- (b) a branch;
- (c) an office;
- (d) a factory;
- (e) a workshop;
- (f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term “permanent establishment” also encompasses:

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

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
- (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

The maintenance of a fixed place of a 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 the combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person – other than an agent of an independent status to whom paragraph 7 applies – is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

- (a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned

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in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will be considered an agent of an independent status within the meaning of this paragraph.

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

Chapter III Taxation of Income

Article 6: Income from Immovable Property

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

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

3. The provisions of paragraph 1 shall also 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 and to income from immovable property used for the performance of independent personal services.

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Article 7: Business Profits

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

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

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

4. 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. 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.

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

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

Article 8: Shipping, Inland Waterways Transport and Air Transport

Article 8 (Alternative A)

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 (Alternative B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by... per cent. (The percentage is to be established through bilateral negotiations.)
3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

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Article 9: Associated Enterprises

1. Where:

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

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

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

Article 10: Dividends

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

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

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

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

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

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

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

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

Article 11: Interest

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

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ... per cent (the percentage is to be established through bilateral negotiations) 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, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities

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referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, 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 or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

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 paid to a resident of the other Contracting State may be taxed in that other State.

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

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

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and

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such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base 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 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 or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

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

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

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

(2) For the purposes of this paragraph “principally” in relations to ownership of immovable property means the value of such immovable property exceeding fifty percent of the aggregate value of all assets owned by the company, partnership, trust or estate.

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

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

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Article 14: Independent Personal Services

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:
 - (a) if he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or
 - (b) if his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State; or
2. The term "professional services" includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15: Dependent Personal Services

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 or a fixed base which the employer has in the other State.
3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16: Directors' Fees and Remuneration of Top-Level Managerial Officials

1. 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.
2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

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Article 17: Artistes and Sportspersons

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

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

Article 18: Pensions and Social Security Payments

Article 18 (Alternative A)

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 shall be taxable only in that State.

2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political sub-division or a local authority thereof shall be taxable only in that State.

Article 18 (Alternative B)

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 other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.

3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political sub-division or a local authority thereof shall be taxable only in that State.

Article 19: Government Service

1. (a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division 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 other 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.

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2. (a) Any pension paid by, or out of funds created by, a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority shall be taxable only in that State.
- (b) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.
3. The provisions of Articles 15, 16, 17 and 18 shall apply to salaries, wages and other similar remuneration and to pensions, in respect of services rendered in connection with a business carried on by a Contracting State or a political sub-division or a local authority thereof.

Article 20: Students

Payments which a student or business trainee or 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, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.
3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

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 or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.

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

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

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

Chapter V: Method for the Elimination of Double Taxation

Article 23 A: Exemption Method

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

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where in accordance with any provision of this 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.

Article 23 B: Credit Method

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State; and 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 this 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 either 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 6 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 the Contracting State of which he is

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a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this 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. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

Article 26: Exchange of Information

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by Article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.

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

- (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- (b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- (c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Article 27: Members of Diplomatic Missions and Consular Posts

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

Chapter VII Final Provisions

Article 28: 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 29: 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

Note: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

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**3. UNITED STATES MODEL INCOME TAX CONVENTION
OF SEPTEMBER 20, 1996**

Convention between the United States of America and for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income.

The United States of America and..., desiring to conclude a Convention for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income, have agreed as follows:

Article 1: General Scope

1. This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.

2. The Convention shall not restrict in any manner any benefit now or hereafter accorded:

- (a) by the laws of either Contracting State; or
- (b) by any other agreement between the Contracting States.

3. Notwithstanding the provisions of subparagraph 2(b):

(a) the provisions of Article 26 (Mutual Agreement Procedure) of this Convention exclusively shall apply to any dispute concerning whether a measure is within the scope of this Convention, and the procedures under this Convention exclusively shall apply to that dispute; and

(b) unless the competent authorities determine that a taxation measure is not within the scope of this Convention, the non-discrimination obligations of this Convention exclusively shall apply with respect to that measure, except for such national treatment or most-favoured-nation obligations as may apply to trade in goods under the General Agreement on Tariffs and Trade. No national treatment or most-favoured-nation obligation under any other agreement shall apply with respect to that measure.

For the purpose of this paragraph, a "measure" is a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

4. Notwithstanding any provision of the Convention except paragraph 5 of this Article, a Contracting State may tax its residents (as determined under Article 4 (Residence)), and by reason of citizenship may tax its citizens, as if the Convention had not come into effect. For this purpose, the term "citizen" shall include a former citizen or long-term resident whose loss of such status had as one of its principal purposes the avoidance of tax (as defined under the laws of the Contracting State of which the person was a citizen or long-term resident), but only for a period of 10 years following such loss.

5. The provisions of paragraph 4 shall not affect:

(a) the benefits conferred by a Contracting State under paragraph 2 of Article 9 (Associated Enterprises), paragraphs 2 and 5 of Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support), and Articles 23 (Relief From Double Taxation), 24 (Non-Discrimination), and 25 (Mutual Agreement Procedure); and

(b) the benefits conferred by a Contracting State under paragraph 6 of Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support), Articles 19 (Government Service), 20 (Students and Trainees), and 27 (Diplomatic Agents and Consular

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Officers), upon individuals who are neither citizens of nor have been admitted for permanent residence in that State.

Article 2: Taxes Covered

1. The existing taxes to which this Convention shall apply are:
 - (a) in the United States: the Federal income taxes imposed by the Internal Revenue Code (but excluding social security taxes), and the Federal excise taxes imposed with respect to private foundations.
 - (b) in :
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 existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their respective taxation laws or other laws affecting their obligations under the Convention, and of any official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions.

Article 3: General Definitions

1. For the purposes of this Convention, unless the context otherwise requires:
 - (a) the term “person” includes an individual, an estate, a trust, a partnership, 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 according to the laws of the State in which it is organized;
 - (c) the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State, and an enterprise carried on by a resident of the other Contracting State; the terms also include an enterprise carried on by a resident of a Contracting State through an entity that is treated as fiscally transparent in that Contracting State;
 - (d) the term “international traffic” means any transport by a ship or aircraft, except when such transport is solely between places in a Contracting State;
 - (e) the term “competent authority” means:
 - (i) in the United States: the Secretary of the Treasury or his delegate; and
 - (ii) in :
 - (f) the term “United States” means the United States of America, and includes the States thereof and the District of Columbia; such term also includes the territorial sea thereof and the sea bed and subsoil of the submarine areas adjacent to that territorial sea over which the United States exercises sovereign rights in accordance with international law; the term, however, does not include Puerto Rico, the Virgin Islands, Guam or any other United States possession or territory;
 - (g) the term means
 - (h) the term “national” of a Contracting State, means:
 - (i) any individual possessing the nationality or citizenship of that State; and

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- (ii) any legal person, partnership or association deriving its status as such from the laws in force in that State;
 - (i) the term “qualified governmental entity” means:
 - (i) any person or body of persons that constitutes a governing body of a Contracting State, or of a political sub-division or local authority of a Contracting State;
 - (ii) a person that is wholly owned, directly or indirectly, by a Contracting State or a political sub-division or local authority of a Contracting State, provided (A) it is organized under the laws of the Contracting State, (B) its earnings are credited to its own account with no portion of its income inuring to the benefit of any private person, and (C) its assets vest in the Contracting State, political sub-division or local authority upon dissolution; and
 - (iii) a pension trust or fund of a person described in subparagraph (i) or (ii) that is constituted and operated exclusively to administer or provide pensions benefits described in Article 19; provided that an entity described in subparagraph (ii) or (iii) does not carry on commercial activities.
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 common meaning pursuant to the provisions of Article 25 (Mutual Agreement Procedure), have the meaning which 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: Residence

1. Except as provided in this paragraph, 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, citizenship, place of management, place of incorporation, or any other criterion of a similar nature.
- (a) The term “resident of a Contracting State” does not include any person who is liable to tax in that State in respect only of income from sources in that State or of profits attributable to a permanent establishment in that State.
 - (b) A legal person organized under the laws of a Contracting State and that is generally exempt from tax in that State and is established and maintained in that State either:
 - (i) exclusively for a religious, charitable, educational, scientific, or other similar purpose; or
 - (ii) to provide pensions or other similar benefits to employees pursuant to a plan is to be treated for purposes of this paragraph as a resident of that Contracting State.
 - (c) A qualified governmental entity is to be treated as a resident of the Contracting State where it is established.
 - (d) An item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State shall be considered to be derived by a resident of a State to the extent that the item is treated for purposes of the taxation law of such Contracting State as the income, profit or gain of a resident.

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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 of the State in which he has a permanent home available to him; if he has a permanent home available to him in either States, he shall be deemed to be a resident 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 does not have a permanent home available to him in either State, he shall be deemed to be a resident 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 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 endeavour to settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a company is a resident of both Contracting States, then if it is created under the laws of one of the Contracting States or a political sub-division thereof, it shall be deemed to be a resident of that State.

4. Where by reason of the provisions of paragraph 1, a person other than an individual or a company is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to settle the question by mutual agreement and determine the mode of application of the Convention to such person.

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, or an installation or drilling rig or ship used for the exploration of natural resources, constitutes a permanent establishment only if it lasts or the activity continues for 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;

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- (d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information, for the enterprise;
- (e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- (f) the maintenance of a fixed place of business solely for any combination of the activities mentioned in subparagraphs (a) through (e).

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

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

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

Article 6: Income from Real Property (Immovable Property)

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

2. The term "real property (immovable property)" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated.

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

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

5. A resident of a Contracting State who is liable to tax in the other Contracting State on income from real property situated in the other Contracting State may elect for any taxable year to compute the tax on such income on a net basis as if such income were business profits attributable to a permanent establishment in such other State. Any such election shall be binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the Contracting State in which the property is situated agrees to terminate the election.

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Article 7: Business Profits

1. The business 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 business profits of the enterprise may be taxed in the other State but only so much of them as are 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 business profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. For this purpose, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment.

3. In determining the business profits of a permanent establishment, there shall be allowed as deductions expenses that are incurred for the purposes of the permanent establishment, including a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses incurred for the purposes of the enterprise as a whole (or the part thereof which includes the permanent establishment), whether incurred in the State in which the permanent establishment is situated or elsewhere.

4. No business 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.

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

6. Where business profits include items of income that are dealt with separately in other Articles of the Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

7. For the purposes of the Convention, the term “business profits” means income from any trade or business, including income derived by an enterprise from the performance of personal services, and from the rental of tangible personal property.

8. In applying paragraphs 1 and 2 of Article 7 (Business Profits), paragraph 6 of Article 10 (Dividends), paragraph 3 of Article 11 (Interest), paragraph 3 of Article 12 (Royalties), paragraph 3 of Article 13 (Gains), Article 14 (Independent Personal Services) and paragraph 2 of Article 21 (Other Income), any income or gain attributable to a permanent establishment or fixed base during its existence is taxable in the Contracting State where such permanent establishment or fixed base is situated even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.

Article 8: 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. For the purposes of this Article, profits from the operation of ships or aircraft include profits derived from the rental of ships or aircraft on a full (time or voyage) basis. They

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also include profits from the rental of ships or aircraft on a bareboat basis if such 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. Profits derived by an enterprise from the inland transport of property or passengers within either Contracting State, shall be treated as profits from the operation of ships or aircraft in international traffic if such transport is undertaken as part of international traffic.

3. Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers (including trailers, barges, and related equipment for the transport of containers) used in international traffic shall be taxable only in that State.

4. The provisions of paragraphs 1 and 3 shall also apply to profits from 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 that differ from those that would be made between independent enterprises, then, any profits that, but for those conditions, would 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 other Contracting State agrees that the profits so included are profits that would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those that 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 paid 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 resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the payer is a resident and according to the laws of that State, but if the dividends are beneficially owned by a resident of the other Contracting State, except as otherwise provided, the tax so charged shall not exceed:

- (a) 5 percent of the gross amount of the dividends if the beneficial owner is a company that owns directly at least 10 percent of the voting stock of the company paying the dividends;

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(b) 15 percent of the gross amount of the dividends in all other cases.

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

3. Subparagraph (a) of paragraph 2 shall not apply in the case of dividends paid by a United States person that is a Regulated Investment Company or a Real Estate Investment Trust (REIT). In the case of a United States person that is a REIT, subparagraph (b) of paragraph 2 also shall not apply, unless the dividend is beneficially owned by an individual holding a less than 10 percent interest in the REIT.

4. Notwithstanding paragraph 2, dividends may not be taxed in the Contracting State of which the payer is a resident if the beneficial owner of the dividends is a resident of the other Contracting State that is a qualified governmental entity that does not control the payer of the dividend.

5. For purposes of the Convention, the term “dividends” means income from shares or other rights, not being debt-claims, participating in profits, as well as income that is subjected to the same taxation treatment as income from shares under the laws of the State of which the payer is a resident.

6. 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 payer is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the dividends are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

7. A Contracting State may not impose any tax on dividends paid by a resident of the other State, except insofar as the dividends are paid to a resident of the first-mentioned State or the dividends are attributable to a permanent establishment or a fixed base situated in that State, nor may it impose tax on a corporation’s undistributed profits, except as provided in paragraph 8, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in that State.

8. A corporation that is a resident of one of the States and that has a permanent establishment in the other State or that is subject to tax in the other State on a net basis on its income that may be taxed in the other State under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains) may be subject in that other State to a tax in addition to the tax allowable under the other provisions of this Convention. Such tax, however, may be imposed on only the portion of the business profits of the corporation attributable to the permanent establishment and the portion of the income referred to in the preceding sentence that is subject to tax under Article 6 (Income from Real Property (Immovable Property)) or under paragraph 1 of Article 13 (Gains) that, in the case of the United States, represents the dividend equivalent amount of such profits or income and, in the case of, is an amount that is analogous to the dividend equivalent amount.

9. The tax referred to in paragraph 8 may not be imposed at a rate in excess of the rate specified in paragraph 2 (a).

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Article 11: Interest

1. Interest arising in a Contracting State and beneficially owned by a resident of the other Contracting State may be taxed only in that other State.
2. The term “interest” as used in this Convention 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 or prizes attaching to such securities, bonds or debentures, and all other income that is subjected to the same taxation treatment as income from money lent by the taxation law of the Contracting State in which the income arises. Income dealt with in Article 10 (Dividends) and penalty charges for late payment shall not be regarded as interest for the purposes of this Convention.
3. The provisions of paragraph 1 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State, in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the interest is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, 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 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 State, due regard being had to the other provisions of this Convention.
5. Notwithstanding the provisions of paragraph 1:
 - (a) interest paid by a resident of a Contracting State and that is determined with reference to receipts, sales, income, profits or other cash flow of the debtor or a related person, to any change in the value of any property of the debtor or a related person or to any dividend, partnership distribution or similar payment made by the debtor to a related person, and paid to a resident of the other State also may be taxed in the Contracting State in which it arises, and according to the laws of that State, but if the beneficial owner is a resident of the other Contracting State, the gross amount of the interest may be taxed at a rate not exceeding the rate prescribed in subparagraph (b) of paragraph 2 of Article 10 (Dividends); and
 - (b) Interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit may be taxed by each State in accordance with its domestic law.

Article 12: Royalties

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

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2. The term “royalties” as used in this Convention means:

- (a) any consideration for the use of, or the right to use, any copyright of literary, artistic, scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like right or property, or for information concerning industrial, commercial, or scientific experience; and
- (b) gain derived from the alienation of any property described in subparagraph (a), provided that such gain is contingent on the productivity, use, or disposition of the property.

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 through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the royalties are attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, 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 the Convention.

Article 13: Gains

1. Gains derived by a resident of a Contracting State that are attributable to the alienation of real property situated in the other Contracting State may be taxed in that other State.

2. For the purposes of this Convention the term “real property situated in the other Contracting State” shall include:

- (a) real property referred to in Article 6 (Income from Real Property (Immovable Property));
- (b) a United States real property interest; and
- (c) an equivalent interest in real property situated in

3. Gains from the alienation of personal property that are attributable to a permanent establishment that an enterprise of a Contracting State has in the other Contracting State, or that are attributable to a fixed base that is available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, and gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such a fixed base, may be taxed in that other State.

4. Gains derived by an enterprise of a Contracting State from the alienation of ships, aircraft, or containers operated or used in international traffic or personal property pertaining to the operation or use of such ships, aircraft, or containers shall be taxable only in that State.

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

Article 14: Independent Personal Shelves

1. Income derived by an individual who is a resident of a Contracting State in respect of the performance of personal services of an independent character shall be taxable only in that State, unless the individual has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities. If he has such a fixed base, the income attributable to the fixed base that is derived in respect of services performed in that other State also may be taxed by that other State.

2. For purposes of paragraph 1, the income that is taxable in the other Contracting State shall be determined under the principles of paragraph 3 of Article 7.

Article 15: Dependent Personal Services

1. Subject to the provisions of Articles 16 (Directors' Fees), 18 (Pensions, Social Security, Annuities, Alimony, and Child Support) and 19 (Government Service), salaries, wages, and other 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 taxable year concerned;
- (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 or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration described in paragraph 1 that is 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 operated in international traffic shall be taxable only in that State.

Article 16: Directors' Fees

Directors' fees and other compensation derived by a resident of a Contracting State for services rendered in the other Contracting State in his capacity as a member of the board of directors of a company that is a resident of the other Contracting State may be taxed in that other Contracting State.

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Article 17: Artistes and Sportsmen

1. Income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio, or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, which income would be exempt from tax in that other Contracting State under the provisions of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services) may be taxed in that other State, except where the amount of the gross receipts derived by such entertainer or sportsman, including expenses reimbursed to him or borne on his behalf, from such activities does not exceed twenty thousand United States dollars (\$20,000) or its equivalent in for the taxable year concerned.

2. Where income in respect of activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income, notwithstanding the provisions of Articles 7 (Business Profits) and 14 (Independent Personal Services), may be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised, unless it is established that neither the entertainer or sportsman nor persons related thereto participate directly or indirectly in the profits of that other person in any manner, including the receipt of deferred remuneration, bonuses, fees, dividends, partnership distributions, or other distributions.

Article 18: Pensions, Social Security, Annuities, Alimony, and Child Support

1. Subject to the provisions of Article 19 (Government Service), pension distributions and other similar remuneration beneficially owned by a resident of a Contracting State, whether paid periodically or as a single sum, shall be taxable only in that State, but only to the extent not included in taxable income in the other Contracting State prior to the distribution.

2. Notwithstanding the provisions of paragraph 1, payments made by a Contracting State under provisions of the social security or similar legislation of that State to a resident of the other Contracting State or to a citizen of the United States shall be taxable only in the first-mentioned State.

3. Annuities derived and beneficially owned by an individual resident of a Contracting State shall be taxable only in that State. The term "annuities" as used in this paragraph means a stated sum paid periodically at stated times during a specified number of years, under an obligation to make the payments in return for adequate and full consideration (other than services rendered).

4. Alimony paid by a resident of a Contracting State, and deductible therein, to a resident of the other Contracting State shall be taxable only in that other State. The term "alimony" as used in this paragraph means periodic payments made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, which payments are taxable to the recipient under the laws of the State of which he is a resident.

5. Periodic payments, not dealt with in paragraph 4, for the support of a child made pursuant to a written separation agreement or a decree of divorce, separate maintenance, or compulsory support, paid by a resident of a Contracting State to a resident of the other Contracting State, shall be exempt from tax in both Contracting States.

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6. For purposes of this Convention, where an individual who is a participant in a pension plan that is established and recognized under the legislation of one of the Contracting States performs personal services in the other Contracting State:

- (a) Contributions paid by or on behalf of the individual to the plan during the period that he performs such services in the other State shall be deductible (or excludible) in computing his taxable income in that State. Any benefits accrued under the plan or payments made to the plan by or on behalf of his employer during that period shall not be treated as part of the employee's taxable income and shall be allowed as a deduction in computing the profits of his employer in that other State.
- (b) Income earned but not distributed by the plan shall not be taxable in the other State until such time and to the extent that a distribution is made from the plan.
- (c) Distributions from the plan to the individual shall not be subject to taxation in the other Contracting State if the individual contributes such amounts to a similar plan established in the other State within a time period and in accordance with any other requirements imposed under the laws of the other State.
- (d) The provisions of this paragraph shall not apply unless:
 - (i) contributions by or on behalf of the individual to the plan (or to another similar plan for which this plan was substituted) were made before he arrived in the other State; and
 - (ii) the competent authority of the other State has agreed that the pension plan generally corresponds to a pension plan recognized for tax purposes by that State.

The benefits granted under this paragraph shall not exceed the benefits that would be allowed by the other State to its residents for contributions to, or benefits otherwise accrued under a pension plan recognized for tax purposes by that State.

Article 19: Government Service

1. Notwithstanding the provisions of Articles 14 (Independent Personal Services), 15 (Dependent Personal Services), 16 (Directors' Fees) and 17 (Artistes and Sportsmen):

(a) Salaries, wages and other remuneration, other than a pension, paid from the public funds of a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State or sub-division or authority in the discharge of functions of a governmental nature shall, subject to the provisions of subparagraph (b), be taxable only in that State;

(b) such remuneration, however, 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. Notwithstanding the provisions of paragraph 1 of Article 18 (Pensions, Social Security, Annuities, Alimony, and Child Support):

(a) any pension paid from the public funds of a Contracting State or a political sub-division or a local authority thereof to an individual in respect of services rendered to that State

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- or sub-division or authority in the discharge of functions of a governmental nature shall, subject to the provisions of subparagraph (b), be taxable only in that State;
- (b) such pension, however, shall be taxable only in the other Contracting State if the individual is a resident of, and a national of that State.

Article 20: Students and Trainees

Payments received by a student, apprentice, or business trainee 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 for the purpose of his full-time education at an accredited educational institution, or for his full-time training, shall not be taxed in that State, provided that such payments arise outside that State, and are for the purpose of his maintenance, education or training. The exemption from tax provided by this Article shall apply to an apprentice or business trainee only for a period of time not exceeding one year from the date he first arrives in the first-mentioned Contracting State for the purpose of his training.

Article 21: Other income

1. Items of income beneficially owned by 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 real property as defined in paragraph 2 of Article 6 (Income from Real Property (Immovable Property)), if the beneficial owner of the income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the income is attributable to such permanent establishment or fixed base. In such case the provisions of Article 7 (Business Profits) or Article 14 (Independent Personal Services), as the case may be, shall apply.

Article 22: Limitation of Benefits

1. A resident of a Contracting State shall be entitled to benefits otherwise accorded to residents of a Contracting State by this Convention only to the extent provided in this Article.
2. A resident of a Contracting State shall be entitled to all the benefits of this Convention if the resident is:
 - (a) an individual;
 - (b) a qualified governmental entity;
 - (c) a company, if
 - (i) all the shares in the class or classes of shares representing more than 50 percent of the voting power and value of the company are regularly traded on a recognized stock exchange, or
 - (ii) at least 50 percent of each class of shares in the company is owned directly or indirectly by companies entitled to benefits under clause (i), provided that in the case of indirect ownership, each intermediate owner is a person entitled to benefits of the Convention under this paragraph;

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- (d) described in subparagraph 1 (c) (i) of Article 4 (Residence);
 - (e) described in subparagraph 1 (c) (ii) of Article 4 (Residence), provided that more than 50 percent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or
 - (f) a person other than an individual, if:
 - (i) On at least half the days of the taxable year persons described in subparagraphs (a), (b), (c), (d) or (e) own, directly or indirectly (through a chain of ownership in which each person is entitled to benefits of the Convention under this paragraph), at least 50 percent of each class of shares or other beneficial interests in the person, and
 - (ii) less than 50 percent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State (unless the payment is attributable to a permanent establishment situated in either State), in the form of payments that are deductible for income tax purposes in the person's State of residence.
3. (a) A resident of a Contracting State not otherwise entitled to benefits shall be entitled to the benefits of this Convention with respect to an item of income derived from the other State, if:
- (i) the resident is engaged in the active conduct of a trade or business in the first-mentioned State,
 - (ii) the income is connected with or incidental to the trade or business, and
 - (iii) the trade or business is substantial in relation to the activity in the other State generating the income.
- (b) For purposes of this paragraph, the business of making or managing investments will not be considered an active trade or business unless the activity is banking, insurance or securities activity conducted by a bank, insurance company or registered securities dealer.
- (c) Whether a trade or business is substantial for purposes of this paragraph will be determined based on all the facts and circumstances. In any case, however, a trade or business will be deemed substantial if, for the preceding taxable year, or for the average of the three preceding taxable years, the asset value, the gross income, and the payroll expense that are related to the trade or business in the first-mentioned State equal at least 7.5 percent of the resident's (and any related parties') proportionate share of the asset value, gross income and payroll expense, respectively, that are related to the activity that generated the income in the other State, and the average of the three ratios exceeds 10 percent.
- (d) Income is derived in connection with a trade or business if the activity in the other State generating the income is a line of business that forms a part of or is complementary to the trade or business. Income is incidental to a trade or business if it facilitates the conduct of the trade or business in the other State.
4. A resident of a Contracting State not otherwise entitled to benefits may be granted benefits of the Convention if the competent authority of the State from which benefits are claimed so determines.
5. For purposes of this Article the term "recognized stock exchange" means:
- (a) the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and exchange Commission

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as a national securities exchange under the U.S. Securities Exchange Act of 1934; and
(b) [stock exchanges of the other Contracting State].

Article 23: Relief from Double Taxation

1. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income

(a) the income tax paid or accrued to by or on behalf of such citizen or resident; and

(b) in the case of a United States company owning at least 10 percent of the voting stock of a company that is a resident of and from which the United States company receives dividends, the income tax paid or accrued to by or on behalf of the payer with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in paragraphs 1 (b) and 2 of Article 2 (Taxes Covered) shall be considered income taxes.

2. In accordance with the provisions and subject to the limitations of the law of (as it may be amended from time to time without changing the general principle hereof), shall allow to a resident or citizen of as a credit against the tax on income

(a) the income tax paid or accrued to the United States by or on behalf of such resident of citizen; and

(b) in the case of a company owning at least 10 percent of the voting stock of a company that is a resident of the United States and from which the company receives dividends, the income tax paid or accrued to the United States by or on behalf of the payer with respect to the profits out of which the dividends are paid.

For the purposes of this paragraph, the taxes referred to in paragraphs 1 (a) and 2 of Article 2 (Taxes Covered) shall be considered income taxes.

3. Where a United States citizen is a resident of:

(a) with respect to items of income that under the provisions of this Convention are exempt from United States tax or that are subject to a reduced rate of United States tax when derived by a resident of who is not a United States citizen, shall allow as a credit against tax, only the tax paid, if any, that the United States may impose under the provisions of this Convention, other than taxes that may be imposed solely by reason of citizenship under the saving clause of paragraph 4 of Article 1 (General Scope);

(b) for purposes of computing United States tax on those items of income referred to in subparagraph (a), the United States shall allow as a credit against United States tax the income tax paid to after the credit referred to in subparagraph (a); the credit so allowed shall not reduce the portion of the United States tax that is creditable against the tax in accordance with subparagraph (a); and

(c) for the exclusive purpose of relieving double taxation in the United States under subparagraph (b), items of income referred to in subparagraph (a) shall be deemed to arise in to the extent necessary to avoid double taxation of such income under subparagraph (b).

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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 that is more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, particularly with respect to taxation on worldwide income, are or may be subjected. This provision shall also apply to persons who are not residents of one or both of the Contracting States.

2. The taxation on a permanent establishment or fixed base that a resident or 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 or residents of that other State carrying on the same activities. The provisions of this paragraph 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 that it grants to its own residents.

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

4. 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 that is more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

5. Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in paragraph 8 of Article 10 (Dividends).

6. The provisions of this Article shall, notwithstanding the provisions of Article 2 (Taxes Covered), apply to taxes of every kind and description imposed by a Contracting State or a political sub-division or local authority thereof.

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, and the time limits prescribed in such laws for presenting claims for refund, present his case to the competent authority of either Contracting State.

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

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taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits or other procedural limitations in the domestic law of the Contracting States. Assessment and collection procedures shall be suspended during the pendency of any mutual agreement proceeding.

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. In particular the competent authorities of the Contracting States may agree:

- (a) to the same attribution of income, deductions, credits, or allowances of an enterprise of a Contracting State to its permanent establishment situated in the other Contracting State;
- (b) to the same allocation of income, deductions, credits, or allowances between persons;
- (c) to the same characterization of particular items of income, including the same characterization of income that is assimilated to income from shares by the taxation law of one of the Contracting States and that is treated as a different class of income in the other State;
- (d) to the same characterization of persons;
- (e) to the same application of source rules with respect to particular items of income;
- (f) to a common meaning of a term;
- (f) to advance pricing arrangements; and
- (g) to the application of the provisions of domestic law regarding penalties, fines, and interest in a manner consistent with the purposes 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 also may agree to increases in any specific dollar amounts referred to in the Convention to reflect economic or monetary developments.

5. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs.

Article 26: Exchange of Information and Administrative Assistance

1. The competent authorities of the Contracting States shall exchange such information as is relevant for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention insofar as the taxation thereunder is not contrary to the Convention, including information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. The exchange of information is not restricted by Article 1 (General Scope). Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention 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.

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

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

(b) to supply information that 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 that 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).

3. Notwithstanding paragraph 2, the competent authority of the requested State shall have the authority to obtain and provide information held by financial institutions, nominees or persons acting in an agency or fiduciary capacity, or respecting interests in a person, including bearer shares, regardless of any laws or practices of the requested State that might otherwise preclude the obtaining of such information. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall obtain that information in the same manner and to the same extent as if the tax of the first-mentioned State were the tax of that other State and were being imposed by that other State, notwithstanding that the other State may not, at that time, need such information for purposes of its own tax. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State shall provide information under this Article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of that other State with respect to its own taxes.

4. Each of the Contracting States shall endeavour to collect on behalf of the other Contracting State such amounts as may be necessary to ensure that relief granted by the Convention from taxation imposed by that other State does not inure to the benefit of persons not entitled thereto. This paragraph shall not impose upon either of the Contracting States the obligation to carry out administrative measures that would be contrary to its sovereignty, security, or public policy.

5. For the purposes of this Article, the Convention shall apply, notwithstanding the provisions of Article 2 (Taxes Covered), to taxes of every kind imposed by a Contracting State.

6. The competent authority of the requested State shall allow representatives of the applicant State to enter the requested State to interview individuals and examine books and records with the consent of the persons subject to examination.

Article 27: Diplomatic Agents and Consular Officers

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

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Article 28: Entry into Force

1. This Convention shall be subject to ratification in accordance with the applicable procedures of each Contracting State. Each Contracting State shall notify the other as soon as its procedures have been complied with.

2. The Convention shall enter into force on the date of the receipt of the later of such notifications, and its provisions shall have effect:

(a) in respect of taxes withheld at source, for amounts paid or credited on or after the first day of the second month next following the date on which the Convention enters into force;

(b) in respect of other taxes, for taxable periods beginning on or after the first day of January next following the date on which the Convention enters into force.

Article 29: Termination

1. This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention by giving notice of termination to the other Contracting State through diplomatic channels. In such event, the Convention shall cease to have effect:

(a) in respect of taxes withheld at source, for amounts paid or credited after the expiration of the 6 month period beginning on the date on which notice of termination was given; and

(b) in respect of other taxes, for taxable periods beginning on or after the expiration of the 6 month period beginning on the date on which notice of termination was given.

IN WITNESS WHEREOF, the undersigned, being duly authorized thereto by their respective Governments, have signed this Convention.

DONE at in duplicate, in the English and languages, both texts being equally authentic, this day of (month), 19 ...,

FOR THE GOVERNMENT OF THE UNITED STATES OF AMERICA:

FOR THE GOVERNMENT OF :

Exhibits

**4. LEAGUE OF NATIONS MODEL BILATERAL CONVENTION
(WITH COMMENTARIES) FOR THE PREVENTION OF
DOUBLE TAXATION IN THE SPECIAL MATTER OF
DIRECT TAXES PRESENTED IN GENEVA,
OCTOBER 1928 (1928 DRAFT)**

General Considerations

In their report, the technical experts had stated that their draft bilateral Convention for the Prevention of Double Taxation applied more particularly to countries which levy impersonal taxes and also a personal general tax; but that the model text they proposed could also be made to serve in the event of the simultaneous existence of a general tax in the country of domicile, and schedular taxes in the country of origin. They added that the text of the Convention could be abridged whenever two Contracting States possessed sufficiently similar fiscal systems.

From the very outset it became clear to the General Meeting of Government Experts that it would be highly desirable to draw up, in addition to the first text, such simplified texts. The Meeting therefore added to the draft Convention for the Prevention of Double Taxation prepared by the technical experts two new texts of model bilateral Conventions which draw no distinction between impersonal and personal taxes, the first applying particularly to relations between countries in which taxation by reference to domicile predominates, and the second to relations between countries possessing different fiscal systems.

It should be mentioned that, in drawing up the Articles of these drafts, it was endeavoured to make the texts as similar as possible, in order to reduce to a minimum differences of interpretation.

(i) Text of Draft Convention No. Ia

Article 1

The present Convention is designed to prevent double taxation in the sphere of direct impersonal or personal taxes, in the case of the taxpayers of the Contracting Parties, whether nationals or otherwise.

For the purposes of this Convention the following shall be regarded as impersonal taxes:

- (a)
- (b)
- (c)

For the purposes of this Convention, the following shall be regarded as personal taxes

- (a)
- (b)
- (c)

Exhibits

I. Impersonal Taxes

Article 2

The income from immovable property, i.e., that which corresponds to the actual or presumed rental value of such property, as well as any other income from such property which is not covered by Article 5, shall be taxable in the State in which the property in question is situated.

This rule shall apply to income from mortgages or other similar obligations.

Article 3

Income from public funds, bonds, including mortgage bonds, loans and deposits or current accounts, shall be taxable in the State in which the debtors of such income are at the time resident.

Article 4

Income from shares or similar interests shall be taxable in the State in which the real centre of management of the undertaking is situated.

Article 5

Income, not referred to in Article 7, from any industrial, commercial or agricultural undertaking and from any other trades or professions shall be taxable in the State in which the permanent establishments are situated.

The real centres of management, branches, mining and oilfields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country.

Should the undertaking possess permanent establishments in both Contracting States, each of the two States shall tax the portion of the income produced in its territory. The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment.

Nevertheless, income from maritime shipping and air navigation concerns shall be taxable only in the State in which the real centre of management is situated.

Article 6

The fees of managers and directors of joint-stock companies shall be taxable in accordance with the rule laid down in Article 4.

Article 7

Salaries, wages or other remuneration of any kind shall be taxable in the State in which the recipients carry on their employment.

Salaries of officials and public employees who are serving abroad shall, however, be taxable in the State which pays these salaries.

Exhibits

Article 8

Public or private pensions shall be taxable in the State of the debtor of such income.

Article 9

Annuities or income from other sources not referred to in the previous paragraphs shall be taxable in the State of fiscal domicile of the creditor of such income.

II. Personal Taxes

Article 10

The personal tax on the total income shall be levied by the State in which the taxpayer has his fiscal domicile, i.e., his normal residence, the term "residence" being understood to a permanent home.

The State of domicile shall deduct from its personal tax the lesser of the two following amounts:

- (a) Either the amount of the tax actually paid in the other Contracting State on income from immovable property (Article 2) and on income from industrial, commercial or agricultural undertaking (Article 5); or
- (b) The amount of the tax relating to the income referred to in paragraph (a) at the rates in force in the State of domicile.

This deduction shall not in total exceed x per cent of the total personal tax leviable in the State of domicile.

When the State of domicile imposes impersonal taxes, the deduction provided for above shall not include impersonal taxes which correspond or relate to income taxed in the other Contracting State.

Article 11

In the case of taxpayers who possess a fiscal domicile in both Contracting States, the personal tax shall be imposed in each of these States in proportion to the period of stay during the fiscal year, or according to a division to be determined by agreement between the competent administrations.

III. Miscellaneous Provisions

Article 12

The principles laid down in the preceding articles shall be applicable, *mutatis mutandis*, to the recurrent taxes on total wealth, capital, or increments of total wealth, according as these taxes are impersonal or personal.

Article 13

As regards any special provisions which may be necessary to enable the present Convention to be applied, more particularly in cases not expressly provided for, the financial administrations of the two Contracting States shall confer together and take the measures required in accordance with the spirit of this Convention.

Exhibits

Article 14

Should a dispute arise between the Contracting States as to the interpretation or application of the provisions of the present Convention, and should such dispute not be settled either directly between the States or by the employment of any other means of reaching agreement, the dispute may be submitted, with a view to an amicable settlement, to such technical body as the Council of the League of Nations may appoint for this purpose. This body will give an advisory opinion after hearing the parties and arranging a meeting between them if necessary.

The Contracting States may agree, prior to the opening of such procedure, to regard the advisory opinion given by the said body as final. In the absence of such an agreement, the opinion shall not be binding upon the Contracting States unless it is accepted by both, and they shall be free, after resort to such procedure or in lieu thereof, to have recourse to any arbitral or judicial procedure which they may select, including reference to the Permanent Court of International Justice as regards any matters which are within the competence of that Court under its Statute.

Neither the opening of the procedure before the body referred to above nor the opinion which it delivers shall in any case involve the suspension of the measures complained of; the same rule shall apply in the event of proceedings being taken before the Permanent Court of International Justice, unless the Court decides otherwise under Article 41 of its Statute.

COMMENTARY

Article 1

This article defines the purpose of the present Convention; it is designed to prevent double taxation in the sphere of direct taxes in the case of the taxpayers of the Contracting Parties.

The tendency of modern fiscal law is to consider that all persons domiciled in a State should be liable to the same taxation therein whatever their nationality may be. This is why Article 1 of the draft speaks of all taxpayers, whether nationals or otherwise. Supposing, for instance, that two States A and B have concluded a convention on these lines, the nationals of a third State C which had not concluded a similar agreement will nevertheless be entitled to the benefits of the treaty, if they are taxpayers of States A and B, either because they have their fiscal domicile in these States or derive income from them.

If, for economic reasons, or with a view to inducing certain States to conclude similar conventions, the Contracting Parties deem it preferable provisionally to limit the scope of the Convention to their own nationals, they need only delete in the text of Article 1 the words "whether nationals or otherwise". They may, on the other hand, extend its application to the nationals of States with which they have concluded such conventions.

After stating the general purpose of the Convention, Article 1 defines its scope: it governs direct impersonal or personal taxes.

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Desirous of avoiding any controversy on matters of doctrine, the experts have not defined the two great categories of direct taxes. They merely note, by way of indication, that impersonal taxes are in most cases levied on all kinds of income at the source, irrespective of the personal circumstances of the taxpayer (nationality, domicile, civil status, family responsibilities, etc.) thus differing from personal taxes which rather concern individuals and their aggregate income.

The Contracting States will themselves decide which of their direct taxes they regard, for the purposes of the Convention, as being impersonal or personal taxes.

Similar forms of taxation levied on behalf of subordinate public bodies (provinces, cantons or departments, municipalities, etc.) may be included in the list, if circumstances justify such a measure, as well as the tax on business turnover in so far as this is in the nature of direct taxation.

The assignment of individual taxes to the two categories of direct taxes mentioned above is particularly important, as the draft lays down different provisions as regards each of these categories.

If necessary, the rules governing impersonal taxes might be made to apply to all special forms of income tax imposed by the State of origin and limited to income derived from sources situated in that State.

I. Impersonal Taxes

Article 2

Article 2 embodies a generally accepted principle: that income from immovable property, i.e., the income which corresponds to the actual or presumed rental value, as well as every other form of income from immovable property not covered by Article 5, shall be taxable in the State in which the property in question is situated.

The above principle applies, irrespective of the nature of the right or fact (property, usufruct possession, lease in perpetuity, etc.), from which the taxable income is derived.

The term "other income from such property" is only intended to cover income which is not derived from industrial, commercial or agricultural undertakings, mentioned in Article 5 of the draft.

The second paragraph of Article 2 lays down that the rule set forth in the first paragraph shall apply to income from mortgages and other similar obligations.

This provision is intended to apply to income from mortgages or other similar obligations whether it is deducted from the income derived from the immovable property or not. If the deduction referred to is not made, special measures will have to be taken in order to prevent the State of domicile from having to grant excessive relief.

Article 3

This clause deals with income derived from investments in transferable securities other than shares. It lays down that income from public funds, bonds, including mortgage-bonds, loans, and deposits or current accounts shall be taxable in the State in which the debtors of such income are at the time resident.

Exhibits

By “public funds” is meant the securities issued by the State or by other public bodies (provinces or departments, cantons, municipalities, other public establishments, etc.)

The bonds considered are those of non-commercial (*sociétés civiles*) or commercial companies, even if secured by mortgages.

As regards loans, deposits, or current accounts, these terms are here used with their legal or customary meaning; as a rule, this clause will only be applied to income from non-commercial loans, deposits or current accounts. Interest on professional accounts opened for business purposes by traders or persons engaged in industry is, in fact, included under profits of business undertakings, which are covered by Article 5.

As regards interest on deposits or current accounts, the debtor is the establishment or branch which pays this interest.

The Contracting States shall decide whether a second paragraph should be added to Article 3 providing for an exception to the rule laid down in the first paragraph. This exception might be worded as follows:

“If this income is paid in one of the Contracting States to persons domiciled in the other Contracting State, the tax applicable thereto shall be refunded upon production of proper evidence. In such case, the said income may be taxed in the State of domicile of the creditor”.

This would be a special clause to be discussed between the Contracting States. The refunding of the tax by the State of the debtor will generally depend upon economic or budgetary conditions; the levying of the tax by the State of the creditor will in some cases, however, be justified by reasons of equity, but will not be compulsory. Such refund may be limited to certain forms of income and made contingent upon the application of the deduction provided for under Article 10.

Where necessary, measures will have to be taken to prevent fraud by means of affidavits or other documents signed by or on behalf of the persons entitled to the income. In this connection, reference should be made to the draft Convention on Administrative Assistance.

A request was put forward that the tax on income from bonds might, if necessary, be shared according to the rules laid down in Article 5.

This view was not generally accepted, but it was thought that the procedure suggested might be adopted by countries where special circumstances existed. The same observation applies to income from shares and to managers’ fees referred to in Articles 4 and 6 below.

Article 4

Income from shares or similar interests is the subject of Article 4 of the draft; under the provisions of this article, it is taxable in the State in which the real centre of management of the undertaking, that is to say the management and control of the business, is situated, so that the case of a purely nominal centre of management is excluded.

This clause will have to be supplemented if it is agreed that the system of refunds contemplated in the commentary on Article 3 shall apply also dividends. Here, again, the determining factors will be economic or budgetary considerations, or even political circumstances.

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It must also be noted that draft Convention No. I b contemplates this more extended system of relief.

Article 5

This clause has reference to income from any industrial, commercial or agricultural undertakings, and from any other trades or professions, not referred to in Article 7; it is to be taxable in the countries in which the persons controlling the undertakings or engaged in the trade or profession, possess permanent establishments.

The word “undertakings” must be understood in its widest sense, without making any distinction between natural and legal persons.

The second paragraph gives a list of the establishments which are considered as permanent; they are: real centres of management, branches, mine and oilfields factories, workshops, agencies warehouses, offices and depots, no matter whether such establishments are used by the traders themselves, by their partners, attorneys, or their other permanent representatives.

Nevertheless, the fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country.

The words “bona-fide agent of independent status” are intended to imply absolute independence, both from the legal and economic points of view. The agent’s remuneration must not be below what would be regarded as a normal remuneration. The Committee has not expressed an opinion on the point whether purchasing offices or sales offices and plants are to be considered as places of business, this being a question of fact.

Paragraphs 2 and 3 of this clause govern the case in which the undertaking possesses permanent establishments in both Contracting States; in that event, “each of the two States shall tax the portion of the income produced in its territory”. This is an application of the so-called system of apportioning the income according to its source.

“The competent administrations of the two Contracting States shall come to an arrangement as to the bases for apportionment”.

These bases will vary essentially according to the undertakings concerned; in certain States account is taken, according to the nature of the undertakings, of the amount of capital involved, of the number of workers, the wages paid, receipts, etc. Similarly, in cases where the products of factories are sold abroad, a distinction is often made between “manufacturing” and “merchanting” profits, the latter being the difference between the price in the home market and the sale price abroad, less cost of transport. These criteria are, of course, merely given as indications.

The last paragraph of Article 5 contains an express exception to the principle laid down in the first paragraph: it provides that income from maritime shipping or air-navigation concerns shall be taxable only in the State in which the real centre of management is situated.

“If maritime shipping or air-navigation concerns carry on other activities independent of shipping (for example, the business of sale of goods, banking or of a warehouse-keeper),

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such activities will respectively be dealt with in accordance with the other provisions of this Convention”.

Furthermore, the scope of the last paragraph of Article 5 may be extended so as to apply also to river and lake shipping.

Article 6

This article provides that the fees of managers and directors of joint-stock companies shall be taxable in accordance with the rule laid down in Article 4, that is, in the State in which the real centre of management of the undertaking is situated.

This provision is designed to cover the special tax on variable fees, which are deducted from profits and hence constitute a part of the latter. Fixed salaries, on the contrary, come within the category of general expenditure and are governed by the following article.

Article 7

Salaries, wages and other remuneration of any kind (with the exception of the fees mentioned in Article 6) shall be taxable in the State in which the recipients carry on their employment.

The income is actually produced in that State and the tax can easily be levied at the source.

Nevertheless, special clauses may be inserted to meet the case of persons working in the vicinity of the frontier or engaged in any itinerant occupation, employment or trade.

The second paragraph of Article 7 lays down that salaries of officials and public employees who are serving abroad shall be taxable in the State which pays these salaries.

The fiscal regime for diplomatic or consular agents is, however, at present the object of special studies which are being carried on in conjunction with the Committee of Jurists for the Progressive Codification of International Law.

Article 8

This article provides that public or private pensions shall be taxable in the State of the debtor of such income.

It appeared both right and practical that all pensions should be made subject to the same rules.

In the special case of private pensions, however, the country of the debtor may be taken to be that in which the activity was carried on within the meaning of Article 7, or that in which the parties concerned subsequently established their domicile.

Article 9

Contrary to the above-mentioned provisions, annuities or income from other claims not referred to in the previous paragraphs shall be taxable in the State of fiscal domicile of the creditor of such income.

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The exception which is thus made for annuities is justified by the special nature of this form of income, since the recipient is free to select the country which is to be liable for the payment.

II. Personal Taxes

Article 10

Under the terms of this article, the personal tax on total income is to be levied by the State in which the taxpayer has his fiscal domicile, i.e., his normal residence, the term "residence" being understood to mean a permanent home.

This provision is of double import: it specifies the place at which the personal or general tax shall be levied and, further gives a definition of fiscal domicile in terms which were discussed at great length and are those accepted by the majority of the existing codes of law.

The words "permanent home" convey the idea of an establishment intended to last for some time. Even a person who stays at an hotel for several months may be considered as normally residing there. Moreover, a State is always free to tax any of its own nationals who would not be taxed because they are continually moving about.

Article 10 provides for a modification of the rule which it lays down.

In order to avoid double taxation, the State of domicile will make a deduction from its personal tax with regard to the income taxed in the country of origin. But what should be the amount of such deduction? It is to be limited to the lesser of the two following amounts, i.e.:

- (a) Either the amount of the tax actually paid in the other Contracting State on income from immovable property (Article 2) and from industrial, commercial or agricultural undertakings (Article 5); or
- (b) The amount of the tax on the income referred to in paragraph (a) at the rates in force in the State of domicile.

This deduction may not exceed x per cent of the total amount of the personal tax levied in the country of domicile.

This restriction is designed to prevent a taxpayer whose whole income is derived from abroad from escaping all taxation in his country of domicile.

The following example will explain the application of the system of deductions advocated by the experts: A taxpayer domiciled in State A draws a total income of 100,000 francs, 20,000 of which are derived from an industrial or commercial undertaking situated in State B, which, under this head, levies an impersonal tax of 4,000 francs.

The tax in State A will be calculated on the total of the income (for instance, at the rate of 20 per cent), i.e., $100,000 \times 20/100 = 20,000$ francs, but the fiscal authorities will deduct therefrom the sum of 4,000 francs mentioned above, so that the tax will be reduced to $20,000 - 4,000 = 16,000$ francs.

If, however, in the State of domicile the tax only amounts to 3,000 francs on an income of 20,000 francs, 3,000 francs will be deducted and the tax will then be reduced to $20,000 - 3,000 = 17,000$ francs. A State will thus not suffer loss owing to the fact that its nationals engage in business in other States.

Exhibits

The relief provided for above will be granted in particular in cases in which the State of domicile only levies a general income tax. If this general tax is of a purely complementary nature, and is additional to impersonal taxes, there will be no need for relief, or at any rate such relief will have to be limited. For this reason, the last paragraph of Article 10 lays down that, if the State of domicile levies impersonal taxes, the deductions provided for under (a) or (b) in Article 10 shall not include the impersonal taxes corresponding or relating to the income taxed in the State of origin.

The experts have further contemplated another method of avoiding double taxation. The tax in the State of domicile of the taxpayer would be calculated at the rate applicable to the whole of his income, but it would only be levied on that part of his income which is taxable in that country, that is to say, exclusive of the income taxed in the country of its origin. Thus a taxpayer domiciled in State A drawing a total income of 100,000 francs, 20,000 of which is derived from immovable property situated in State B, would only be taxed in State A on 80,000 francs, but at the rate applicable to 100,000 francs.

Article 11

This article is designed to cover a special case, namely, that of taxpayers with a fiscal domicile in both Contracting States. In this case, the tax will be imposed in each of these States in proportion to the period of stay during the fiscal year, or according to a division to be determined by agreement between the competent administrations, for instance, in proportion to the amount of income produced in each country. This clause might, if necessary, be applied to taxpayers who change their domicile during the fiscal year.

III. Miscellaneous Provisions

Article 12

Article 12 provides that the principles laid down in the preceding articles shall be applicable, *mutatis mutandis*, to the recurrent taxes on total wealth, capital or increments of total wealth, according as these taxes are impersonal or personal.

Succession duties form the subject of a separate Convention.

As regards taxes of an exceptional nature, special agreements may have to be concluded, having due regard to the nature of these taxes.

The provision of Article 12 is, moreover, not compulsory, inasmuch as countries which conclude a convention will have the option of omitting this article.

Article 13

Any special provisions which may be necessary to enable the Convention to be applied more particularly to cases not expressly provided for shall be settled by agreement between the financial administrations of the Contracting States in accordance with the spirit of the Convention. Article 13 is designed to give effect to this principle.

Exhibits

Article 14

There still remained to determine the procedure which should be followed in the event of a dispute as to the interpretation or application of the Convention; this procedure is laid down in Article 14, which is based upon the text inserted in other international conventions, in particular the Convention for the Simplification of Customs Formalities signed at Geneva on November 3rd, 1923. It seemed advisable, however, to state that the Contracting States will have the option of accepting the opinion of the advisory body in advance.

(ii) Text of Draft Convention No. 1b

The present Convention is designed to prevent double taxation as regards the following specified taxes, in the case of the taxpayers of the Contracting States, whether nationals or otherwise.

- (a)
- (b)
- (c)

Article 1

Taxes at the fiscal domicile

A. In principle, income shall be taxable by the State in which the taxpayer has his fiscal domicile, *i.e.*, his normal residence, the term “residence” being understood to mean a permanent home.

B. In the case of taxpayers who possess a fiscal domicile in both Contracting States, the tax imposed in each of these States in proportion to the period of stay during the fiscal year, or according to a division to be determined by agreement between the competent administrations.

Article 2

Taxes at Source

The following classes of incomes shall be taxable by priority at their respective sources as described below:

A. Income from Immovable Property

The income from immovable property, *i.e.*, that which corresponds to the actual or presumed rental value of such property, as well as any other income from such property which is not covered by paragraph B below shall be taxable in the State in which the property in question is situated. This rule shall apply to income from mortgages or other similar claims.

B. Industrial, Commercial or Agricultural Income

Income from any industrial, commercial or agricultural undertaking, and from any other trades or professions not referred to in paragraph D, shall be taxable in the State in which a permanent establishment is situated.

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The real centres of management, branches, mining and oil-fields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a *bona-fide* agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country.

Should the undertaking possess permanent establishments in both Contracting States, each State shall impose the tax applicable to that part of the income produced on its territory. The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment.

Nevertheless, income from maritime shipping and air navigation shall be taxable only in the State in which the real centre of management is situated.

C. Fees of Managers and Directors

The fees of managers and directors of joint-stock companies shall be taxable in the State where the real centre of management of the undertaking is situated.

D. Salaries and Wages

Salaries, wages or other remuneration of any kind shall be taxable in the State in which the recipients carry on their employment.

Salaries of officials and public employees who are serving abroad shall, however, be taxable in the State which pays these salaries.

E. Public Pensions

Public pensions shall be taxable in the State of the debtor of such income.

Article 3

Relief through Deductions and Refunds

A. Deductions

On reporting his or its total income from all sources, any person or company domiciled in the territory of one of the Contracting States shall be granted relief in respect of taxes payable in the other Contracting State on income taxable under Article 2 by priority in such other Contracting State.

For this purpose the State of domicile shall deduct from its tax on the total income the lesser of the two following amounts:

(a) The tax imposed by the other Contracting State on income taxable by priority therein;
or

(b) An amount which represents the same proportion of the tax payable on the total income as the income taxable by priority bears to the total income.

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B. Refunds

The State which has collected an origin tax on revenues not enumerated under Article 2 shall refund the amount on production of proper evidence.

Article 4

As regards any special provisions which may be necessary to enable the present Convention to be applied, more particularly in cases not expressly provided for, the financial administrations of the two Contracting States shall confer together and take the measures required in accordance with the spirit of this Convention.

Article 5

Should a dispute arise between the Contracting States as to the interpretation or application of the provisions of the present Convention, and should such dispute not be settled either directly between the States or by the employment of any other means of reaching agreement, the dispute may be submitted, with a view to an amicable settlement, to such technical body as the Council of the League of Nations may appoint for this purpose.

This body will give an advisory opinion after hearing the Parties and arranging a meeting between them if necessary.

The Contracting States may agree, prior to the opening of such procedure, to regard the advisory opinion given by the said body as final. In the absence of such an agreement, the opinion shall not be binding upon the Contracting States unless it is accepted by both, and they shall be free, after resort to such procedure or in lieu thereof, to have recourse to any arbitral or judicial procedure which they may select, including reference to the Permanent Court of International Justice as regards any matters which are within the competence of that Court under its Statute.

Neither the opening of the procedure before the body referred to above nor the opinion which it delivers shall in any case involve the suspension of the measures complained of; the same rule shall apply in the event of proceedings being taken before the Permanent Court of International Justice, unless the Court decides otherwise under Article 41 of its Statute.

COMMENTARY

Draft bilateral Convention No. 1b for the Prevention of Double Taxation differs essentially from the previous one in that it assigns income from transferable securities by priority to the State of domicile and does not maintain the distinction previously adopted between impersonal and personal taxes or between schedular and general taxes.

Article 1 provides that, in principle, the State of domicile shall levy its tax on all kinds of income. Article 2 contains a list of the forms of income taxed by priority at their source.

Double taxation is prevented by a system of abatements and refunds which is provided for in Article 3. The abatements will be allowed by the State of domicile in respect of taxes paid in virtue of the right of priority in the State of origin. The abatement allowed will either be equal to the amount of the taxes levied in the State of origin or will be based on a

Exhibits

percentage of the tax at domicile, depending on the ratio between the income derived from the country of origin and the total income. Further, refunds will be allowed by the State of origin where it collects tax on income over which it has no right of priority, for example, in the case of income from transferable securities.

Inasmuch as the language of Convention Ia has been employed to a large extent in Convention Ib, the Commentary applicable to Convention Ia applies, *mutatis mutandis*, to Convention Ib.

(iii) Text of Draft Convention No. Ic

Article 1

The present Convention is designed to prevent double taxation as regards the following specified taxes in the case of the taxpayers, whether nationals or otherwise, of the Contracting States:

- (a)
- (b)
- (c)

Article 2

The income from immovable property, i.e., that which corresponds to the actual or presumed rental value of such property, as well as any other income from such property which is not covered by Article 3, shall be taxable in the State in which the property in question is situated.

This rule shall apply to income from mortgages or other similar obligations.

Article 3

Income derived from any industrial, commercial or agricultural undertaking and from any other trades or professions, and not referred to in Article 7, shall be taxable in the State in which the permanent establishments are situated.

The real centres of management, branches, mining and oil fields, factories, workshops, agencies, warehouses, offices, depots, shall be regarded as permanent establishments. The fact that an undertaking has business dealings with a foreign country through a bona-fide agent of independent status (broker, commission agent, etc.) shall not be held to mean that the undertaking in question has a permanent establishment in that country.

Should the undertaking possess permanent establishments in both Contracting States each of the two States shall tax the portion of the income produced in its territory. The competent administrations of the two Contracting States shall come to an arrangement as to the basis for apportionment.

Nevertheless, income from maritime shipping and air navigation shall be taxable only in the State in which the real centre of management is situated.

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Article 4

The fees of managers and directors of joint-stock companies shall be taxable in the State where the real centre of management of the undertaking is situated.

Article 5

Salaries, wages or other remuneration of any kind shall be taxable in the State in which the recipients carry on their employment.

Salaries of officials and public employees who are serving abroad shall, however, be taxable in the State which pays these salaries.

Article 6

Public or private pensions shall be taxable in the State of the debtor of such income.

Article 7

The income from movable assets shall be taxable in the State in whose territory the creditor has his fiscal domicile, i.e., his normal residence, the term "residence" being understood to mean a permanent home.

When the other Contracting State levies a tax, by means of deductions at the source, on income from capital originating in the territory of that State, the right to this taxation shall not be affected by the rule in sub-paragraph I. In this case the State of domicile which in addition to its ordinary direct tax, levies a special tax on income originating in the other State, shall refrain from levying that tax or shall deduct therefrom the tax paid in the other State.

In order to avoid or to mitigate the effects of such double taxation as is not, under the various fiscal systems, prevented by the provision of the previous sub-paragraph, the Contracting States shall come to an agreement, if necessary, to allow either the remission, in respect of the tax levied by the State of domicile, of the whole or part of the tax deducted by the State of origin, or a refund, upon production of proper evidence by the State of origin, of the whole or part of the tax collected by it by means of deductions.

Article 8

Annuities or income from other claims not referred to in the previous paragraphs shall be taxable in the State of fiscal domicile of the creditor of such income.

Article 9

In the case of taxpayers who possess a fiscal domicile in both Contracting States, a tax collection of which under this Convention depends on domicile shall be imposed in each of the Contracting States in proportion to the period of stay during the fiscal year or according to a division to be determined by agreement between the competent administrations.

Article 10

The principles laid down in the preceding articles shall be applicable, mutatis mutandis, to the recurrent taxes on total wealth, capital or increments of total wealth.

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Article 11

If, under the provisions of this Convention, either of the Contracting States has surrendered any taxable element of income or wealth, it shall retain the right to apply to the entire taxable property not exempted the rate of its general tax on income or total wealth corresponding to the whole of the income or total wealth of the taxpayer:

Article 12

As regards any special provisions which may be necessary to enable the present Convention to be applied, more particularly in cases not expressly provided for, the financial administrations of the two Contracting States shall confer together and take the measures required in accordance with the spirit of this Convention.

Article 13

Should a dispute arise between the Contracting States as to the interpretation or application of the provisions of the present Convention, and should such dispute not be settled either directly between the States or by the employment of any other means of reaching agreement, the dispute may be submitted, with a view to an amicable settlement, to such technical body as the Council of the League of Nations may appoint for this purpose. This body will give an advisory opinion after hearing the parties and arranging a meeting between them if necessary.

The Contracting States may agree, prior to the opening of such procedure, to regard the advisory opinion given by the said body as final. In the absence of such an agreement, the opinion shall not be binding upon the Contracting States unless it is accepted by both, and they shall be free, after resort to such procedure or in lieu thereof, to have recourse to any arbitral or judicial procedure which they may select, including reference to the Permanent Court of International Justice as regards any matters which are within the competence of that Court under its Statute.

Neither the opening of the procedure before the body referred to above nor the opinion which it delivers in any case involves the suspension of the measures complained of; the same rule shall apply in the event of proceedings being taken before the Permanent Court of International Justice, unless the Court decides otherwise under Article 41 of its Statute.

COMMENTARY

Draft Bilateral Convention No. Ic, like the immediately previous one, does not distinguish between impersonal and personal or between schedular and general taxes. It retains, as regards, taxation at the source, the main provisions of Draft No. Ia, and does not differ essentially from it except as regards the taxation of income from movable capital. As regards the latter, it provides that the tax shall in principle be levied by the State of domicile. If the State of origin also levies a tax by deduction at the source, the State of domicile is under obligation either not to levy a special tax upon the same income or to deduct from such tax the amount paid in the other State. Further, it is agreed that, if part of the income is still subject to double taxation, the Contracting States may, where circumstances require, take

Exhibits

special steps either to deduct from the tax levied by the State of domicile the whole or part of the tax deducted by the State of origin or to grant a refund by the State of origin of the whole or part of the tax levied by deduction at the source.

As the language of Convention Ia has been employed to a large extent in Convention Ic, the Commentary applicable to Convention Ia applies, *mutatis mutandis*, to Convention Ic.

Exhibits

**5. LEAGUE OF NATIONS REVISED TEXT OF THE CONVENTION FOR
THE ALLOCATION OF BUSINESS INCOME BETWEEN STATES
FOR THE PURPOSES OF TAXATION, GENEVA,
JUNE 1935 (1935 DRAFT)**

Being desirous to prevent the double taxation of the income of business enterprises, which results from conflicting principles and methods of allocating taxable income, the High Contracting Parties have agreed to the following provisions:

Article I

1. An enterprise having its fiscal domicile in one of the Contracting States shall not be taxable in another Contracting State except in respect of income directly derived from sources within its territory and, as such, allocable, in accordance with the articles of this Convention, to a permanent establishment situate in such State.
2. If a permanent establishment of an enterprise in one State extends its activities into a second State in which the enterprise has no permanent establishment, the income derived from such activities shall be allocated to the permanent establishment in the first State.

Article II

1. For the purposes of this Convention, the term "business income" shall not include the following:
 - (a) Income from immovable property;
 - (b) Income from mortgages, from public funds, bonds (including mortgage bonds), loans, deposits and current accounts;
 - (c) Dividends and other income from shares in a corporation;
 - (d) Rentals or royalties arising from leasing personal property or from (Unclear:)an in such property, including rentals or royalties for the use of, or for the (Unclear:)privilege patents, copyrights, secret processes and (Unclear:)formulae, goodwill, trade marks, franchises and other like property, provided the enterprise is not engaged in such property;
 - (e) Profit or loss from the casual purchase and sale of immovable or movable property.
2. Notwithstanding the provisions of paragraph 1 above, the term "business income" shall include, in so far as banking and financial enterprises are concerned, all items which, in conformity with the laws in force governing national enterprises, enter into the computation of profit and loss; it shall not, however, include the following:
 - (a) Income from immovable property;
 - (b) Income from mortgages.
3. There shall be excluded with the above-mentioned items of income the related expenses (including general overhead) and charges.
4. Such items of income shall be taxed separately or together with business income, in accordance with the law and the international agreements of the States concerned.

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Article III

1. If an enterprise with its fiscal domicile in one Contracting State has permanent establishments in other Contracting States, there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. Subject to the provisions of this Convention, such income shall be taxed in accordance with the legislation and international agreements of the State in which such establishment is situated.

2. The fiscal authorities of the Contracting States shall, when necessary, in execution of the preceding paragraph, rectify the accounts produced, notably to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length.

3. If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding paragraph cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine empirically the business income by applying a percentage to the turnover of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country.

4. If the methods of determination described in the preceding paragraphs are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors be so selected as to ensure results approaching as closely as possible to those which would be reflected by a separate accounting.

Article IV

1. The net income of banking and financial enterprises shall be determined in conformity with the principles laid down in Article III.

2. Where one permanent establishment of the enterprise is in the position of a creditor or debtor in relation to another permanent establishment of the enterprise, the following provisions shall apply:

- (a) If a permanent establishment in one State (creditor establishment) supplies funds, whether in the form of an advance, loan, overdraft, deposit, or otherwise, to a permanent establishment in a second State (debtor establishment), for tax purposes interest shall be deemed to accrue as income to the creditor establishment and as a deduction from gross income to the debtor establishment, and such interest shall be computed at the inter-bank rate for similar transactions in the currency used.

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- (b) Contrary to the provisions of the preceding paragraph, from the interest accruing as income to the creditor establishment and deductible from gross income by the debtor establishment there shall be excluded the interest corresponding to the permanent capital allotted to the debtor establishment whether in the form of advances, loans, overdrafts, deposits, or otherwise.

Article V

Income from maritime shipping and air navigation enterprises shall be taxable only in the State in which the real centre of management is situate.

Article VI

When an enterprise of one Contracting State has a dominant participation in the management or capital of an enterprise of another Contracting State, or when both enterprises are owned or controlled by the same interests, and as the result of such situation there exists, in their commercial or financial relations, conditions different from those which would have been made between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the law of the State of such enterprise.

Article VII

The provisions of the present Convention shall not apply to mortgage banks or to companies the object of which is to hold real property.

Article VIII

1. Should a dispute arise between the Contracting States as to the interpretation or application of the provisions of the present Convention, and should such dispute not be settled either directly between the States or by the employment of any other means of reaching agreement, the dispute may be submitted, with a view to an amicable settlement, to such technical body as the Council of the League of Nations may appoint for this purpose. This body will give an advisory opinion after hearing the parties and arranging a meeting between them if necessary.
2. The Contracting States may agree, prior to the opening of such procedure, to regard the advisory opinion given by the said body as final. In the absence of such an agreement, the opinion shall not be binding upon the Contracting States unless it is accepted by both, and they shall be free, after resort to such procedure or in hen thereof, to have recourse to any arbitral or judicial procedure which they may select, including reference to the Permanent Court of International Justice as regards any matters which are within the competence of that Court under its Statute.
3. Neither the opening of the procedure before the body referred to above nor the opinion which it delivers in any case involves the suspension of the measures complained of; the same rule shall apply in the event of proceedings being taken before the Permanent Court of International Justice, unless the Court decides otherwise under Article 41 of its Statute.

Exhibits

PROTOCOL

At the moment of signing the present Convention, concluded on this day's date between, the undersigned plenipotentiaries have made the following declarations, which shall form an integral part of the said Convention

1. The taxes referred to in this Convention are:

- (a) For
- (b) For
- (c) For

2. (a) As used in this Convention, the term "enterprise" includes every form of undertaking, whether carried on by an individual, partnership, corporation or any other entity.

(b) The term "fiscal domicile" for the purposes of this Convention means the place where an enterprise, as defined under (a) above, has its real centre of management.

(c) The term "permanent establishment" includes the real centre of management, branches, mines and oil-wells, plantations, factories, workshops, warehouses, offices, agencies, installations, and other fixed places of business of an enterprise, but does not include a subsidiary company.

When the term "permanent establishment" is used with reference to a particular State, it includes all the permanent establishments, whatever their form, which are situate within such State.

The fact that an enterprise with its fiscal domicile in one of the Contracting States has business dealings in another Contracting State through an agent of genuinely independent status (broker, commission agent, etc.) shall not be held to mean that it has a permanent establishment in the latter State. When a foreign enterprise regularly has business relations in a State through an agent established there who is authorised to act on its behalf, it shall be deemed to have a permanent establishment in that State. A permanent establishment shall for instance, be deemed to exist when the agent established in the State;

- (1) Is a duly accredited agent (*fondé de pouvoir*) who habitually enters into contracts for the enterprise for which he works; or
- (2) Is bound by an employment contract and habitually transacts commercial business on behalf of the enterprise in return for remuneration from the enterprise; or
- (3) Is habitually in possession, for the purpose of sale, of a depot or stock of goods belonging to the enterprise.

As evidence of an employment contract under the terms of (2) above may be taken, moreover, the fact that the administrative expenses of the agent, in particular the rent of premises, are paid by the enterprise.

A broker who places his services at the disposal of an enterprise in order to bring it into touch with customers does not in his own person constitute a permanent establishment of the enterprise, even if his work for the enterprise is to a certain extent continuous or is carried on at regular periods. Similarly, a commission agent (commissionaire), who acts in his own name for one or more enterprises and receives a normal rate of commission, does not constitute a permanent establishment of any such enterprise.

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A permanent establishment shall not be deemed to exist in the case of commercial travellers not coming under any of the preceding categories.

**ALLOCATION OF THE INCOME OF INSURANCE ENTERPRISES
SPECIAL ARTICLE CONSIDERED IN FIRST READING
BY THE FISCAL COMMITTEE**

Notwithstanding Articles II and III above, the following provision shall apply as regards the allocation of the income of insurance enterprises:

When an insurance enterprise the fiscal domicile of which is situate in one of the Contracting States possesses a permanent establishment in another Contracting State, the latter State shall tax the permanent establishment situated on its territory on the basis of the same proportion of the total net income of the enterprise as the premiums paid to such establishment bear to the total premiums paid to the enterprise.

Exhibits

**6. LEAGUE OF NATIONS MODEL BILATERAL CONVENTION FOR
THE PREVENTION OF THE DOUBLE TAXATION OF
INCOME PRESENTED IN MEXICO CITY,
JULY 1943 (MEXICO DRAFT)**

Article I

1. The present Convention is designed to prevent double taxation in the case of the taxpayers of the Contracting States, whether nationals or not, as regards the following taxes:

(a) With reference to State A:

1. . . .
2. . . .
3. . . .

(b) With reference to State B:

1. . . .
2. . . .
3. . . .

2. It is mutually agreed that the present Convention shall apply also to any other tax, or increase of tax, imposed by either Contracting State subsequent to the date of signature of this Convention upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.

Article II

Income from real property shall be taxable only in the State in which the property is situated.

Article III

1. Income from mortgages on real property shall be taxable only in the State where the property is situated.

2. Income from mortgages on sea and/or air vessels shall be taxable only in the State where such vessels are registered.

Article IV

1. Income from any industrial, commercial or agricultural business and from any other gainful activity shall be taxable only in the State where the business or activity is carried out.

2. If an enterprise or an individual in one of the Contracting States extends its or his activities to the other State, through isolated or occasional transactions, without possessing in that State a permanent establishment, the income derived from such activities shall be taxable only in the first State.

3. If an enterprise has a permanent establishment in each of the Contracting States, each State shall tax that part of the income which is produced in its territory.

4. As regards agricultural and mining raw materials and other natural materials and products, the income which results from prices prevailing between independent persons or conforming to world market quotations shall be regarded as realised in the State in which such materials or products have been produced.

Exhibits

Article V

Income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in such State is taxable only in that State.

Article VI

1. Directors' percentages, attendance fees and other special remuneration paid to directors, managers and auditors of companies are taxable only in the State where the fiscal domicile of the enterprise is situated.
2. If, however, such remuneration is paid for services rendered in a permanent establishment situated in the other Contracting State, it shall be taxable only in that State.

Article VII

1. Compensation for labour or personal services shall be taxable only in the Contracting State in which such services are rendered.
2. A person having his fiscal domicile in one Contracting State shall, however, be exempt from taxation in the other Contracting State in respect of such compensation if he is temporarily present within the latter State for a period or periods not exceeding a total of one hundred and eighty-three days during the calendar year, and shall remain taxable in the first State.
3. If the person remains in the second State more than one hundred and eighty-three days, he shall be taxable therein in respect of compensation he earned during his stay there, but shall not be taxable in respect of such compensation in the first State.
4. Income derived by an accountant, an architect, a doctor, an engineer, a lawyer or other person engaged in the practice of a liberal profession shall be taxable only in the Contracting State in which the person has a permanent establishment at, or from, which he renders services.
5. If any such person has a permanent establishment in both Contracting States, he shall be taxable in each State only on the income received for services rendered therein.

Article VIII

1. Salaries, wages and other remuneration paid by one of the Contracting States, or by public bodies, institutions or services depending on it, to its nationals carrying out public functions in the other State shall be taxable only in the first State, provided that these functions are included within the normal field of activity of the State, as this field is defined by international usage.
2. Public pensions shall be taxable only in the State of the debtor entity.

Article IX

Income from movable capital shall be taxable only in the Contracting State where such capital is invested.

Exhibits

Article X

1. Royalties from immovable property or in respect of the operation of a mine, a quarry, or other natural resource shall be taxable only in the Contracting State in which such property, mine, quarry, or other natural resource is situated.
2. Royalties and amounts received as a consideration for the right to use a patent, a secret process or formula, a trademark or other analogous right shall be taxable only in the State where such right is exploited.
3. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use a musical, artistic, literary, scientific or other cultural work or publication shall not be taxable in the former State.

Article XI

Private pensions and life annuities shall be taxable only in the State where the debtor has his fiscal domicile.

Article XII

Gains derived from the sale or exchange of real property shall be taxable only in the State in which the property is situated.

Article XIII

The State where the taxpayer has his fiscal domicile shall retain the right to tax the entire income of the taxpayer whether derived from its territory or from that of the other Contracting State, but shall deduct from its tax on such entire income the lesser of the two following amounts:

- (a) The tax collected by the latter Contracting State on the income which is taxable in its territory according to the preceding Articles;
- (b) The amount which represents the same proportion in comparison with the total tax on the income that is taxable in both States as the income taxable in the other State in comparison with the total income.

Article XIV

In the case of a taxpayer with a fiscal domicile in both Contracting States, the tax, the collection of which under this Convention depends on fiscal domicile, shall be imposed in each of the Contracting States in proportion to the period of stay during the preceding year or according to a proportion to be agreed by the competent administrations.

Article XV

A taxpayer having his fiscal domicile in one of the Contracting States shall not be subject in the other Contracting State, in respect of income he derives from that State, to higher or other taxes than the taxes applicable in respect of the same income to a taxpayer having his fiscal domicile in the latter State, or having the nationality of that State.

Exhibits

Article XVI

1. When a taxpayer shows proof that the action of the tax administration of one of the Contracting States has resulted in double taxation, he shall be entitled to lodge a claim with the tax administration of the State in which he has his fiscal domicile or of which he is a national.
2. Should the claim be admitted, the competent tax administration of that State shall consult directly with the competent authority of the other State, with a view to reaching an agreement for an equitable avoidance of double taxation.

Article XVII

As regards any special provisions which may be necessary for the application of the present Convention, more particularly in cases not expressly provided for, the competent authorities of the two Contracting States may confer together and take the measures required in accordance with the spirit of this Convention.

Article XVIII

1. This Convention and the accompanying Protocol, which shall be considered to be an integral part of the Convention, shall be ratified and the instruments of ratification shall be exchanged at as soon as possible.
2. This Convention and Protocol shall become effective on the first day of January 19. . . . They shall continue effective for a period of three years from that date and indefinitely after that period. They may, however, be terminated by either of the Contracting States at the end of the three-year period or at any time thereafter, provided that at least six months prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.
Done in duplicate, at ____ this ____ day of ____, 19 ____.

PROTOCOL

On proceeding to sign the Convention for the Prevention of Double Taxation of Income concluded this day between . . . and . . . the undersigned Plenipotentiaries have agreed the following provisions, which shall form an integral part of the said Convention.

Article I

The terms “taxpayer of a Contracting State” and “enterprise of a Contracting State” mean a taxpayer or an enterprise whose fiscal domicile is in the said State.

Article II

1. For the purpose of the foregoing Convention, the term “fiscal domicile” means, in the case of an individual or of an enterprise belonging to an individual, the place where the individual has his normal residence, the term “residence” being understood to mean permanent home.
2. Should a taxpayer possess a residence in both the Contracting States, the competent administration shall determine, by common agreement, the place of his main residence,

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which shall be considered as his fiscal domicile. In order to determine, as between several residences, the main residence, the competent administration will take into account elements such as the duration, regularity, frequency of stays, the place where the family of the taxpayer is usually present, the proximity to the place where the party concerned carries out his occupation.

3. In the case of a taxpayer having a residence in both of the Contracting States of which either can be considered as his main residence, Article XVII of the Convention shall apply.

4. The fiscal domicile of partnerships, companies and other legal entities or *de facto* bodies shall be the State under the laws of which they were constituted.

Article III

Differences which arise concerning the nature of real property shall be settled in accordance with the legislation of the territory where the property is situated.

Article IV

The term “enterprise” includes any kind of enterprise whether it belongs to an individual, a partnership, a company or any other legal entity or *de facto* body.

Article V

1. The term “permanent establishment” includes head offices, branches, mines and oil-wells, plantations, factories, workshops, warehouses, offices, agencies, installations, professional premises and other fixed places of business having a productive character.

2. A building site (*chantier de construction*) constitutes a “permanent establishment” when it is destined to be used for a year at least or has been in existence for a year.

3. The fact that an enterprise established in one of the Contracting States has business dealings in another Contracting State through an agent of genuinely independent status (broker, commission agent, etc.) shall not be held to mean that the enterprise has a permanent establishment in the latter State.

4. When an enterprise of one of the Contracting States regularly has business relations in the other State through an agent established there who is authorised to act on its behalf, it shall be deemed to have a permanent establishment in that State. A permanent establishment shall, for instance, be deemed to exist when the agent:

- (a) Is a duly accredited agent (*fonde de pouvoir*) and habitually enters into contracts for the enterprise for which he works; or
- (b) Is bound by an employment contract and habitually transacts business on behalf of the enterprise in return for remuneration from the enterprise; or
- (c) Is habitually in possession, for the purpose of sale, of a depot or stock of goods belonging to the enterprise.

5. As evidence of an employment contract under the terms of B above may be taken, moreover, the fact that the administrative expenses of the agent, in particular the rent of premises, are paid by the enterprise.

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6. The fact that a broker places his services at the disposal of an enterprise in order to bring it into touch with customers does not in itself imply the existence of a permanent establishment for the enterprise, even if his work for the enterprise is, to a certain extent, continuous or is carried on at regular periods, and even if the goods sold have been temporarily placed in a warehouse. Similarly, the fact that a commission agent (*Commissionaire*) acts in his own name for one or more enterprises and receives a normal rate of commission does not constitute a permanent establishment for any such enterprise, even if the goods sold have been temporarily placed in a warehouse.

7. A permanent establishment shall not be deemed to exist in the case of commercial travellers not coming under any of the preceding categories.

8. The fact that a parent company, the fiscal domicile of which is one of the Contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State, regardless of the fiscal obligations of the subsidiary toward the State in which it is situated.

Article VI

The allocation of the income of the enterprises mentioned in Article IV of the Convention shall be effected in the following manner:

1. In respect of industrial, commercial and agricultural enterprises in general and for other independent activities:

(a) If an enterprise with its fiscal domicile in one Contracting State has a permanent establishment in the other Contracting State, there shall be attributed to each permanent establishment the net business income which it might be expected to derive, if it were an independent enterprise engaged in the same or similar activities, under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. According to the provisions of the Convention, such income shall be taxed in accordance with the legislation and agreements of the State in which such establishment is situated.

(b) The fiscal authorities of the Contracting States shall, when necessary, in execution of the preceding section, rectify the accounts produced, especially to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length. If the accounts of the permanent establishment in one Contracting State are rectified as a result of such verification, a corresponding rectification shall be made in the accounts of the establishment in the other Contracting State with which the dealings in question have been effected.

(c) If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding section cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine, in a presumptive manner, the business income by applying a percentage to the gross receipts of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country. Where the activities of the permanent establishment are

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in the nature of those of a genuinely independent commission agent or broker, the income may be determined on the basis of the customary commission received for such services.

(d) If the methods of determination described in the preceding sections are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors are so selected as to ensure results approaching as closely as possible those which would be reflected by a separate accounting.

2. In determining the net income on the basis of the separate accounting of a permanent establishment, a properly apportioned part of the general expenses of the head office of the enterprise may be deducted.

3. In respect of banking and financial enterprises, the allocation of the income shall be effected in conformity with the principles laid down in paragraph 1 of the present Article, provided that, when a permanent establishment of the enterprise is in the position of a creditor or debtor in relation to another permanent establishment of the enterprise, the following provisions shall apply:

(a) If a permanent establishment in one State (creditor establishment) supplies funds, whether in the form of an advance, loan, overdraft, deposit, or otherwise, to a permanent establishment in the second State (debtor establishment), interest shall be deemed to accrue as income to the creditor establishment and as a deduction from gross income to the debtor establishment for tax purposes, and it shall be computed at the inter-bank rate for similar transactions in the currency used;

(b) The interest corresponding to the permanent capital allotted to the debtor establishment, whether in the form of an advance, loan, overdraft, deposit or otherwise, shall be, however, excluded from the interest accruing as income to the creditor establishment and deductible from gross income by the debtor establishment.

4. The net income of insurance enterprises shall be determined in conformity with the principles laid down in paragraph 1 of the present Article. If, however, these principles are not applicable in a given case, the net taxable income of a permanent establishment belonging to an insurance enterprise may be assessed, either by applying, to the gross premiums received as a result of the activity of the permanent establishment, coefficients computed on the basis of the total income of a representative national enterprise of the particular category of insurance concerned, or by apportioning the income according to the ratio existing between the gross premiums relating to the permanent establishment and the total gross premiums received by the enterprise.

5. In cases where the foregoing rules do not result in a fair allocation of income, the competent authorities may consult to agree upon a method that will prevent double taxation.

Article VII

When an enterprise of one Contracting State has a dominant participation in the management or capital of an enterprise of another Contracting State, or when both enterprises are owned

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or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise, subject to the rights of appeal allowed under the laws of the State of such enterprise.

Article VIII

The provisions of Article IV of the Convention shall not apply to pedlars, inland shipping, touring shows and other similar occupations, which shall be taxable in accordance with the legislation of the country where these occupations are carried on and concerning which the competent administrations may, if necessary, agree special provisions.

Article IX

For the purposes of Article IX of the Convention, the term “income from movable capital” includes income from public funds, obligations, loans, deposits, whether fixed or on current account, income from shares and similar participations in companies, as well as income from sleeping partner shares or shares of partners having no powers of management or personal liability in partnerships.

Article X

Students and apprentices from one Contracting State residing in the other Contracting State exclusively for the purpose of study or for acquiring business experience shall not be taxable by the latter State in respect of remittances received by them from within the former State for the purpose of their maintenance or studies.

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**7. LEAGUE OF NATIONS MODEL BILATERAL CONVENTION FOR
THE PREVENTION OF THE DOUBLE TAXATION OF INCOME
AND PROPERTY PRESENTED IN LONDON,
MARCH 1946 (LONDON DRAFT)**

Article I

1. The present Convention is designed to prevent double taxation in the case of the taxpayers of the Contracting States, whether nationals or not, as regards the following taxes:

(a) With reference to State A:

1.;
2.;
3.

(b) With reference to State B:

1. ;
2. ;
3.

2. It is mutually agreed that the present Convention shall apply also to any other tax, or increase of tax, imposed by either Contracting State subsequent to the date of signature of this Convention upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.

Article II

Income from real property shall be taxable in the State in which the property is situated.

Article III

1. Income from mortgages on real property shall be taxable in the State where the property is situated.

2. Income from mortgages on sea and/or air vessels shall be taxable in the State where such vessels are registered.

Article IV

1. Income derived from any industrial, commercial or agricultural enterprise and from any other gainful occupation shall be taxable in the State where the taxpayer has a permanent establishment.

2. If an enterprise in one State extends its activities to the other State without possessing a permanent establishment therein, the income derived from such activities shall be taxable only in the first State.

3. If an enterprise has a permanent establishment in each of the Contracting States, each State shall tax only that part of the income which is produced in its territory.

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Article V

Income which an enterprise in one of the Contracting States derives from the operation of skips or aircraft engaged in international transport is taxable only in the State in which the enterprise has its fiscal domicile.

Article VI

1. Remuneration for labour or personal services shall be taxable in the Contracting State in which such services are rendered.

2. A person having his fiscal domicile in one Contracting State shall, however, be exempt from taxation in the other Contracting State in respect of such remuneration if he is temporarily present within the latter State for a period or periods not exceeding a total of one hundred and eighty-three days during the taxable year, and shall remain taxable in the first State.

3. If a person remains in the second State more than one hundred and eighty-three days, he shall be taxable therein in respect of the remuneration he earned during his stay there, but shall not be taxable in respect of such remuneration in the first State.

4. Income derived by an accountant, an architect, an engineer, a lawyer, a physician or other person engaged on his own account in the practice of a profession shall be taxable in the Contracting State in which the person has a permanent establishment at, or from, which he renders services.

5. If any person described in the preceding paragraph has a permanent establishment in both Contracting States, he shall be taxable in each State only on the income for services rendered therein.

Article VII

Salaries, wages, pensions and other remuneration paid by the Government, political subdivisions and governmental agencies of one of the Contracting States to nationals of such State in respect of the performance of diplomatic, consular or other governmental functions in the other State, shall be taxable only in the first State, provided that these functions are included within the normal field of governmental functions and are not connected with the carrying on of a trade or business on behalf of the State, its subdivisions and its agencies.

Article VIII

1. Dividends and other income from shares in a company and shares of profits accruing to limited liability partners in a limited liability partnership shall be taxable only in the Contracting State where the company or limited liability partnership has its fiscal domicile.

2. Notwithstanding the provisions of paragraph 1, dividends paid by a company which has its fiscal domicile in one Contracting State to a company which has its fiscal domicile in the other Contracting State and has a dominant participation in the management or capital of the company paying the dividends shall be exempt from tax in the former State.

3. Dividends paid by, or undistributed profits of, a company which has its fiscal domicile in one Contracting State shall not be subjected to any tax by the other Contracting State by

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reason of the fact that the dividends or undistributed profits represent, in whole or in part, income derived from the territory of that other State.

Article IX

1. Interest on bonds, securities, notes, debentures or on any other form of indebtedness shall be taxable only in the State where the creditor has his fiscal domicile.
2. The State of the debtor is, however, entitled to tax such interest by means of deduction or withholding at source.
3. The tax withheld at source under paragraph 2 of this Article shall in no case exceed . . . % of the taxed interest.

Article X

1. Royalties from immovable property or in respect of the operation of a mine, a quarry or other natural resource shall be taxable only in the Contracting State in which such property, mine, quarry or other natural resource is situated.
2. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State in consideration for the right to use a patent, a secret process or formula, a trade-mark or other analogous right, shall not be taxable in the former State.
3. If, however, royalties are paid by an enterprise of one Contracting State to another enterprise of the other Contracting State which has a dominant participation in its management or capital, or *vice versa*, or when both enterprises are owned or controlled by the same interests, the royalties shall be subject to taxation in the State where the right in consideration of which they are paid is exploited, subject to deduction from the gross amount of such royalties of all expenses and charges, including depreciation, relative to such rights and royalties.
4. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use an artistic, scientific or other cultural work or publication shall not be taxable in the former State.

Article XI

Private pensions and life annuities shall be taxable only in the State where the recipient has his fiscal domicile.

Article XII

1. Gains derived from the sale or exchange of real property shall be taxable only in the country in which the property is situated.
2. Gains derived from the sale or exchange of assets other than real property, appertaining to an industrial, commercial or agricultural enterprise or to any other independent occupation, shall be taxable according to the provisions of Articles IV and V.
3. Gains derived from the sale or exchange of any capital assets other than those mentioned in the preceding paragraphs of the present Article shall be taxable only in the State where the recipient has his fiscal domicile.

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Article XIII

The State where the taxpayer has his fiscal domicile shall retain the right to tax the entire income of the taxpayer whether derived from its territory or from that of the other Contracting State, but shall deduct from its tax on such entire income the lesser of the following amounts:

- (a) The tax collected by the other Contracting State on the income which is taxable in its territory according to the preceding Articles;
- (b) The amount which represents the same proportion of the tax of the State of fiscal domicile on the entire net income of the taxpayer as the net income taxable in the other State bears to the entire net income.

Article XIV

The provisions of the preceding Articles shall be applicable, *mutatis mutandis*, to taxes on property, capital or increment of wealth whether such taxes are permanent or are levied once only.

Article XV

In the case of a taxpayer with a fiscal domicile in both Contracting States, the tax, the collection of which under this Convention depends on fiscal domicile, shall be imposed in each of the Contracting States in proportion to the period of stay during the taxable year or according to a proportion to be agreed by the competent administrations.

Article XVI

A taxpayer having his fiscal domicile in one of the Contracting States shall not be subject in the other Contracting State, in respect of income he derives from that State, to higher or other taxes than the taxes applicable in respect of the same income to a taxpayer having his fiscal domicile in the latter State, or having the nationality of that State.

Article XVII

1. When a taxpayer shows proof that the action of the tax administration of one of the Contracting States has resulted in double taxation, he shall be entitled to lodge a claim with the tax administration of the State in which he has his fiscal domicile or of which he is a national.
2. Should the claim be admitted, the competent tax administration of that State shall consult directly with the competent authority of the other State, with a view to reaching an agreement for an equitable avoidance of double taxation.

Article XVIII

The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit, allowance, advantage and right of administrative or judicial appeal accorded to a taxpayer by the laws of either of the Contracting States.

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Article XIX

As regards any special provisions which may be necessary for the application of the present Convention, more particularly in cases not expressly provided for, and in the event of substantial changes in the tax laws of either of the Contracting States, the competent authorities of the two Contracting States shall confer together and take the measures required in accordance with the spirit of the present Convention.

Article XX

1. This Convention and the accompanying Protocol, which shall be considered to be an integral part of the Convention, shall be ratified and the instruments of ratification shall be exchanged at . . . as soon as possible.

2. This Convention and Protocol shall become effective on the first day of January 19 They shall continue effective for a period of three years from that date and indefinitely after that period. They may, however, be terminated by either of the Contracting States at the end of the three-year period or at any time thereafter, provided that at least six months prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

Done in duplicate, at ____ this ____ day of ____, 19 ____.

PROTOCOL

On proceeding to sign the Convention for the Prevention of Double Taxation of Income concluded this day between . . . and . . . the undersigned Plenipotentiaries have agreed the following provisions, which shall form an integral part of the said Convention.

Article I

The terms “taxpayer of a Contracting State” and “enterprise of a Contracting State” mean a taxpayer or an enterprise whose fiscal domicile is in the said State.

Article II

1. For the purpose of the foregoing Convention, the term “fiscal domicile” means, in the case of an individual or of an enterprise belonging to an individual, the place where the individual has his normal residence, the term “residence” being understood to mean permanent home.

2. Should a taxpayer possess a residence in both the Contracting States, the competent administration shall determine, by common agreement, the place of his main residence, which shall be considered as his fiscal domicile. In order to determine, as between several residences, the main residence, the competent administration will take into account elements such as the duration, regularity, frequency of stays, the place where the family of the taxpayer is usually present, the proximity to the place where the party concerned carries out his occupation.

3. In the case of a taxpayer having a residence in both of the Contracting States of which either can be considered as his main residence, Article XIX of the Convention shall apply.

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4. The fiscal domicile of a partnership, company and any other legal entity or *de facto* body shall be the State in which its real centre of management is situated.

Article III

Differences which arise concerning the nature of real property shall be settled in accordance with the legislation of the territory where the property is situated.

Article IV

The term “enterprise” includes any kind of enterprise whether it belongs to an individual, a partnership, a company or any other legal entity or *de facto* body.

Article V

1. The term “permanent establishment” includes head offices, branches, mines and oil-wells, plantations, factories, workshops, warehouses, offices, agencies, installations, professional premises and other fixed places of business having a productive character.

2. A building site (*chantier de construction*) constitutes a “permanent establishment” when it is destined to be used for a year at least or has been in existence for a year.

3. The fact that an enterprise established in one of the Contracting States has business dealings in another Contracting State through an agent of genuinely independent status (broker, commission agent, etc.) shall not be held to mean that the enterprise has a permanent establishment in the latter State.

4. When an enterprise of one of the Contracting States regularly has business relations in the other State through an agent established there who is authorised to act on its behalf, it shall be deemed to have a permanent establishment in that State.

A permanent establishment shall, for instance, be deemed to exist when the agent:

(a) Is a duly accredited agent (*fonde de pouvoir*) and habitually enters into contracts for the enterprise for which he works; or

(b) Is bound by an employment contract and habitually transacts business on behalf of the enterprise in return for remuneration from the enterprise; or

(c) Is habitually in possession, for the purpose of sale, of a depot or stock of goods belonging to the enterprise.

5. As evidence of an employment contract under the terms of B above may be taken, moreover, the fact that the administrative expenses of the agent, in particular the rent of premises, are paid by the enterprise.

6. The fact that a broker places his services at the disposal of an enterprise in order to bring it into touch with customers does not in itself imply the existence of a permanent establishment for the enterprise, even if his work for the enterprise is, to a certain extent, continuous or is carried on at regular periods, and even if the goods sold have been temporarily placed in a warehouse. Similarly, the fact that a commission agent (*commissionaire*) acts in his own name for one or more enterprises and receives a normal rate of commission does not constitute a permanent establishment for any such enterprise, even if the goods sold have been temporarily placed in a warehouse.

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7. A permanent establishment shall not be deemed to exist in the case of commercial travellers not coming under any of the preceding categories.

8. The fact that a parent company, the fiscal domicile of which is one of the Contracting States, has a subsidiary in the other State does not mean that the parent company has a permanent establishment in that State, regardless of the fiscal obligations of the subsidiary toward the State in which it is situated.

Article VI

The allocation of the income of the enterprises mentioned in Article IV of the Convention shall be effected in the following manner:

1. In respect of industrial, commercial and agricultural enterprises in general and for other independent activities:

(a) If an enterprise with its fiscal domicile in one Contracting State has a permanent establishment in the other Contracting State, there shall be attributed to each permanent establishment the net business income which it might be expected to derive, if it were an independent enterprise engaged in the same or similar activities, under the same or similar conditions. Such net income will, in principle, be determined on the basis of the separate accounts pertaining to such establishment. According to the provisions of the Convention, such income shall be taxed in accordance with the legislation and agreements of the State in which such establishment is situated.

(b) The fiscal authorities of the Contracting States shall, when necessary, in execution of the preceding section, rectify the accounts produced, especially to correct errors or omissions, or to re-establish the prices or remunerations entered in the books at the value which would prevail between independent persons dealing at arm's length. If the accounts of the permanent establishment in one Contracting State are rectified as a result of such verification, a corresponding rectification shall be made in the accounts of the establishment in the other Contracting State with which the dealings in question have been effected.

(c) If an establishment does not produce an accounting showing its own operations, or if the accounting produced does not correspond to the normal usages of the trade in the country where the establishment is situated, or if the rectifications provided for in the preceding section cannot be effected, or if the taxpayer agrees, the fiscal authorities may determine, in a presumptive manner, the business income by applying a percentage to the gross receipts of that establishment. This percentage is fixed in accordance with the nature of the transactions in which the establishment is engaged and by comparison with the results obtained by similar enterprises operating in the country. Where the activities of the permanent establishment are in the nature of those of a genuinely independent commission agent or broker, the income may be determined on the basis of the customary commission received for such services.

(d) If the methods of determination described in the preceding sections are found to be inapplicable, the net business income of the permanent establishment may be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment has participated. This determination is made by applying to the

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total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors are so selected as to ensure results approaching as closely as possible those which would be reflected by a separate accounting.

2. In determining the net income on the basis of the separate accounting of a permanent establishment, a properly apportioned part of the general expenses of the head office of the enterprise may be deducted.

3. In respect of banking and financial enterprises, the allocation of the income shall be effected in conformity with the principles laid down in paragraph 1 of the present Article, provided that, when a permanent establishment of the enterprise is in the position of a creditor or debtor in relation to another permanent establishment of the enterprise, the following provisions shall apply:

(a) If a permanent establishment in one State (creditor establishment) supplies funds, whether in the form of an advance, loan, overdraft, deposit, or otherwise, to a permanent establishment in the second State (debtor establishment), interest shall be deemed to accrue as income to the creditor establishment and as a deduction from gross income to the debtor establishment for tax purposes, and it shall be computed at the inter-bank rate for similar transactions in the currency used;

(b) The interest corresponding to the permanent capital allotted to the debtor establishment, whether in the form of an advance, loan, overdraft, deposit or otherwise, shall be, however, excluded from the interest accruing as income to the creditor establishment and deductible from gross income by the debtor establishment.

4. The net income of insurance enterprises shall be determined in conformity with the principles laid down in paragraph 1 of the present Article. If, however, these principles are not applicable in a given case, the net taxable income of a permanent establishment belonging to an insurance enterprise may be assessed, either by applying, to the gross premiums received as a result of the activity of the permanent establishment, coefficients computed on the basis of the total income of a representative national enterprise of the particular category of insurance concerned, or by apportioning the income according to the ratio existing between the gross premiums relating to the permanent establishment and the total gross premiums received by the enterprise.

5. In cases where the foregoing rules do not result in a fair allocation of income, the competent authorities may consult to agree upon a method that will prevent double taxation.

Article VII

When an enterprise of one Contracting State has a dominant participation in the management or capital of an enterprise of another Contracting State, or when both enterprises are owned or controlled by the same interests, and, as the result of such situation, there exist in their commercial or financial relations conditions different from those which would have existed between independent enterprises, any item of profit or loss which should normally have appeared in the accounts of one enterprise, but which has been, in this manner, diverted to the other enterprise, shall be entered in the accounts of such former enterprise.

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Article VIII

The provisions of Article IV of the Convention shall not apply to pedlars, inland shipping, touring shows and other similar occupations, which shall be taxable in accordance with the legislation of the country where these occupations are carried on and concerning which the competent administrations may, if necessary, agree special provisions.

Article IX

Students and apprentices from one Contracting State residing in the other Contracting State exclusively for the purpose of study or for acquiring business experience shall not be taxable by the latter State in respect of remittances received by them from within the former State for the purpose of their maintenance or studies.

**8. COMMENTARIES ON MEXICO DRAFT (EXHIBIT 6)
AND LONDON DRAFT (EXHIBIT 7) OF
THE LEAGUE OF NATIONS**

Foreword

In the report on the work of its tenth session held in London in March 1946, the Fiscal Committee of the League of Nations expressed itself as follows:

“During the last session which the Committee held before the war, in June 1939, it was suggested that a revision should be undertaken of the model bilateral conventions on tax matters which had been prepared in 1928 by the General Meeting of Government Experts on Double Taxation and Fiscal Evasion.

“These models had proved of the greatest value in facilitating the negotiation of tax treaties, and the Committee stated in 1935 that:

“The existence of model draft treaties of this kind has proved of real use in such circumstances in helping to solve many of the technical difficulties which arise in such negotiations. This procedure has the dual merit that, on the one hand, in so far as the model constitutes the basis of bilateral agreements, it creates automatically a uniformity of practice and legislation, while, on the other hand, inasmuch as it may be modified in any bilateral agreement reached, it is sufficiently elastic to be adapted to the different conditions obtaining in different countries or pairs of countries.

“The numerous tax treaties which were concluded during the decade which preceded the war contained, however, various improvements on the 1928 Model Conventions. The Fiscal Committee, for its part, had been able to carry further the work initiated by the General Meeting of Government Experts. Moreover, new trends and new problems had appeared in the fields of international trade and investment. Consequently, it seemed desirable to prepare new model conventions that would reflect the technical progress achieved since 1928 and codify the views and recommendations that had been expressed by the Fiscal Committee in the course of its various sessions.

“This work of revision and codification was undertaken by a Sub-Committee which met at The Hague in April 1940, and was continued by two Regional Tax Conferences which were held under the auspices of the Fiscal Committee, in Mexico City in June 1940 and July 1943.

“The Committee has now studied the result of this work. It wishes to express its agreement with most of the conclusions which were reached by the experts who met in Mexico City in 1943 and is of the opinion that the Model Conventions prepared by those experts represent a definite improvement on the 1928 Model Conventions. Nevertheless, since the membership of the Mexico City and London meetings differed considerably, it is natural that the participants in the London meeting held, on various points, different views from those which inspired the Model Conventions prepared in Mexico. The general structure of the Model Conventions drafted at the present session is similar to that of the Mexico models. A certain number of changes have been made in the wording, and some articles have been suppressed because they contained provisions already implied in other clauses. On other points, new articles have been inserted to make use of certain innovations contained in conventions,

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such as those between the United Kingdom and the United States, concluded since the 1943 meeting. Virtually, the only clauses where there is an effective divergence between the views of the 1943 Mexico meeting and those of the 1946 London meeting are those relating to the taxation of interest, dividends, royalties, annuities and pensions. The Committee is aware of the fact that the provisions contained in the 1943 Model Conventions may appear more attractive to some States – in Latin America for instance – than those which it has agreed during its present session. The Model Conventions, as they now stand, can afford guidance to negotiators of tax treaties. The Committee thinks that the work done both in Mexico and in London could be usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital-exporting countries and from economically-advanced and less-advanced countries, when the League work on international tax problems is taken over by the United Nations. A commentary on the new Model Conventions will be published separately in the near future, in accordance with the procedure followed in connection with the 1943 Mexico Model Conventions”.

The present document is intended to furnish the commentary thus requested by the Fiscal Committee. It has been prepared by the Secretariat and should not be taken as a statement in all its parts of the views of the Committee. It is merely intended to provide a working instrument in the study of the texts prepared by the Committee. The Model Conventions which are going to be considered and are reproduced refer respectively to the following subject-matters:

- (a) Prevention of the double taxation of income and property;
- (b) Prevention of the double taxation of estates and successions;
- (c) Reciprocal administrative assistance for the assessment and collection of taxes on income, property, estates and successions.

The Model Conventions on the Prevention of Double Taxation are also intended to avoid extra-territorial and discriminatory taxation of foreigners.

International double or multiple taxation arises when the taxes of two or more countries overlap in such a manner that persons liable to tax in more than one country bear a higher tax burden than if they were subject to one tax jurisdiction only. The additional burden so incurred must, of course, be due not merely to differences in tax rates for the countries concerned, but to the fact that two or more jurisdictions concurrently impose taxes having the same bases and incidence without regard to the claims of the other tax jurisdictions.

Commentary on the Model Bilateral Convention on the Prevention of the Double Taxation of Income and Property

Introduction

The cases of international double taxation that may arise in connection with taxes on income and property fall into three classes. The first and most important category includes the cases due to the co-existence of personal and impersonal tax liability. Tax liability is said to be personal when it is based on the personal status of the taxpayer himself – *e.g.*, his nationality, domicile, residence. Impersonal tax liability exists when a country taxes income earned or

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received within its territory regardless of the personal status of the recipient. Any person who is taxable in one country on account of his personal status and who receives income from another country or holds property therein is exposed to such double taxation. This result can be avoided only if one or both of the jurisdictions concerned limit their fiscal claims or allow a credit against their tax on account of the foreign tax.

Under a second category come the cases of double taxation due to the fact that countries apply different criteria as regards personal tax liability, or define differently the bases of such liability. Taxpayers whose personal allegiance is divided between two or more countries or is doubtful may be subject to double taxation of this kind, as, for instance; nationals of one country having their domicile or residence in another, persons with a domicile or residence in two different countries, persons simultaneously regarded by two tax jurisdictions as domiciled or resident in their respective territories.

A third kind of international double taxation of income and property includes the cases where two or more countries regard a given kind of income or property as taxable in their respective territories because they apply different tests of impersonal tax liability. Double taxation of this kind may occur, for instance, when the assets or activities that produce a given income are located or carried out in more than one country, or when the income is collected elsewhere than in the country where it is earned or from which it is due.

According to the proposals embodied in the Mexico and London Model Conventions, double taxation of income and property is prevented by two sets of clauses which are mutually complementary. In the first place, a definition is given of the conditions under which each kind of income as characterised by the type of property or activity from which it is derived may be taxed in a country according to the criterion of impersonal tax liability. In the second place, it is provided that taxes so paid are to be deducted from, or credited against, the tax due by the taxpayer in the country where he has his residence or "fiscal domicile".

Both in the Mexico and London drafts, Article I of the Model Convention on income and property taxes defines the general object and scope of the instruments. Articles II to XII indicate the conditions under which the various kinds of income, as defined by their economic source, may be taxed in a country when the beneficiary has his residence or "fiscal domicile" in the other country. In the Mexico draft, these articles follow the principle that income may be taxed in a country when it has its source therein: *i.e.*, when it results from property or activities located in that country. This principle is also admitted in the London draft, but it is modified as regards interest, dividends, royalties, annuities and private pensions.

In both drafts, Articles XIII and XIV refer to taxation in the country of permanent residence or fiscal domicile. In the London draft, a new Article XV has been inserted to cover taxes on property, capital and wealth. Discriminatory taxation is dealt with in Article XV of the Mexico draft and Article XVI of the London draft, which have the same wording. Protection of taxpayers' rights is the special subject of Article XVI of the Mexico draft and Articles XVII and XVIII of the London draft. Finally, the last two articles of both drafts refer to the implementation and duration of the convention.

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In both drafts, the Model Convention is followed by a Protocol containing definitions of such phrases as “fiscal domicile”, “permanent establishment” and rules of procedure on such matters as the allocation of business profits. The articles of the Protocol will be considered in the commentary which follows together with the articles of the Model Convention to which they respectively refer. Henceforth, separate reference to the Mexico or London drafts will be made only when they differ. Moreover, when an article is referred to, it should be taken as an article of the Model Convention and when reference is made to an article of the Protocol, it will be explicitly stated.

Article I: Object and Scope of the Model Convention

According to Article I, the Convention is to apply to all natural and juridical persons who have their “fiscal domicile” in one of the Contracting States and, at the same time, derive income which is taxable in the territory of the other State. Further, Article XV of the London draft extends the application of the Convention to “taxes on property, capital or increment of wealth”.

The question of defining and determining “fiscal domicile” is dealt with in Article II of the Protocol. This seemed desirable because national tax laws and practices differ in those respects.

According to Article II of the Protocol, the phrase “fiscal domicile” signifies, in the case of individuals, the place where a person has his normal residence or permanent home. This definition is that used in the earlier model conventions drafted by the Fiscal Committee. It is, however, added that, in case the taxpayer has several residences, his Fiscal domicile will be his main residence, which will be determined in the light of the duration, regularity, frequency of his stays, the place where the family of the taxpayer is usually present, the proximity to the place where the party concerned carries on his occupation. Accordingly, in determining the “Fiscal domicile” of an individual, reference would have to be made not only to the mere possession or availability of a dwelling but also the family, social and economic connections binding a person to a given place.

The wording of paragraph 4 of Article II of the Protocol differs in the Mexico and London drafts. According to the Mexico formula, the Fiscal domicile of a partnership, company or other similar entity would be situated in the country under the laws of which it was organised. According to the London formula, the Fiscal domicile of such entities would be the country in which their real centre of management is situated. In favour of the Mexico definition, it was stated that it agreed better with American legal systems. For its part, the London definition is that contained in the earlier work of the Fiscal Committee and it appears in most tax treaties concluded between European countries.

The Convention is intended to apply to all taxpayers in the Contracting States, whether nationals or foreigners, provided they have their “Fiscal domicile” in one of the two Contracting States. Indeed, since foreigners with their Fiscal domicile in a country are generally subject therein to a general tax liability on their total income from domestic and foreign sources, it is legitimate that they should enjoy the double-taxation relief provided by the Convention.

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Nationals of the Contracting States who have their “Fiscal domicile” in a third State do not come under the provisions of the Convention, since most countries do not tax their nationals having their Fiscal domicile abroad, except, of course, on the income they derive from their country. The status of such persons would have to be considered by tax treaty negotiators when one or both of the States concerned bases personal liability to income tax on nationality as well as on “Fiscal domicile”.

The Convention is intended to apply to all ordinary and special taxes on individual and corporate income, whatever may be their denomination and method of assessment. In the London draft, its provisions extend also to taxes on property, capital and wealth to which a reference is made in Article XV of that draft. The structure of Article I is such as to enable tax negotiators to indicate, through an enumeration, the taxes to which the Convention should apply. Such an enumeration might include, in addition to national taxes levied by the central or federal Government, taxes levied by political subdivisions and local authorities such as the States of a federation, provinces and municipalities.

Paragraph 2 of Article I of the Convention contains a provision which is intended to assure the automatic adaptation of the Convention to changes in the taxes of the Contracting States. It does so by providing for the extension of the provisions of the Convention to taxes or increases of taxes introduced after the signature of the instrument, provided such new levies rest upon substantially the same bases as the taxes enumerated in the convention. It is moreover specified in Article XIX of the London draft that “. . . in the event of substantial changes of tax laws of either of the Contracting States, the competent authorities of the two Contracting States shall confer together and take the measures required in accordance with the spirit of the Convention”.

Article II: Income from Real Property

In both the Mexico and London versions, the Model Convention follows the generally accepted principle that income from real property is taxable in the country where the real property is situated. In this context, income from real property means the income that results directly from the ownership or possession of real property, as such income and property are defined in the country where the latter is situated, according to Article III of the Protocol. The income in question is mainly represented by the rent received from a tenant and also the rental value of the property when it is occupied by the owner or possessor personally, in case this rental value is subject to income tax or to a substitute form of taxation under the laws of the country concerned.

It may be noted that “royalties from immovable property or in respect of the operation of a mine, a quarry or other natural resource” are mentioned separately in Article X. That article, however, follows the same principle as is contained in Article II, and states that such royalties are taxable in the country where the property in respect of which they are due is situated.

Profits resulting from the sale and exchange of real property are governed by Article XII, but this article applies the same principle as in Article II and provides for the taxation of such profits in the country where the property concerned is situated.

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Income derived from the exploitation of lands, buildings, and sub-soil as a part of a business, including mining, forestry and agriculture, does not come within the purview of Article II, but of Article IV, concerning business income.

Article III: Income from Mortgages

The effect of Article III, paragraph 1, is to make the rule governing the income from real property apply also to taxation of income from mortgages on such property. This rule would, however, not apply to those so-called mortgage bonds which are not guaranteed by any specific real property and which are issued by credit institutions in order to finance the loans they grant on mortgages drawn up in their names. Such bonds would come rather under the provisions of Article IX, which applies to income from movable capital in general, in the Mexico draft, and to interest on debts in the London draft.

By analogy with the above-mentioned rule on income from mortgages on real property, the second paragraph of Article III provides that income from mortgages on sea and air vessels is taxable in the country of registry, since such vessels are generally regarded as being legally situated in that country.

Article IV: Income from Business

Both in the London and Mexico drafts, "income from any industrial, commercial or agricultural enterprise and from any other gainful occupation" is governed by Article IV of the Model Convention and Articles IV to VIII of the Protocol. Such income is mainly represented by business profits and this phrase shall be used for brevity's sake.

The first question which arises in international tax practice concerning business profits is the following: What are the facts which render an enterprise liable to taxation on its profits in a foreign country? This question is dealt with in paragraphs 1 and 2 of Article IV in both drafts. According to the Mexico version, an enterprise will be liable to tax on its profits in a foreign country if it has carried out its business or activities in that country provided such activities did not merely take the form of isolated or occasional transactions. On the other hand, the London draft requires that an enterprise should have a "permanent establishment" in a country to become subject to the income-tax laws of that country.

It was argued in favour of the criterion contained in the Mexico draft that, if an enterprise were to be taxable on its profits in a foreign country only if it had a permanent establishment in that country, some countries would lose revenue. Moreover, certain forms of Fiscal evasion might be encouraged. Indeed, some enterprises might seek to avoid taxation in a country by carrying out their business in that country without maintaining a permanent establishment therein or by concealing the existence of such an establishment.

However, when the Fiscal Committee considered in London the Mexico draft, it referred to the fact that the criterion of the "permanent establishment" more or less as defined by the Committee in its earlier work¹, was contained in nearly all double-taxation treaties relating to business income. On that occasion, it was stated that the use of this criterion was not in itself apt to facilitate Fiscal evasion since, in virtue of Article XIII of the Model Tax Convention, the total tax liability of an enterprise remains, as a rule, the same, no matter in what proportion its income is divided between its own country and the foreign

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country where it may do business. Further, it was recalled that the detection of enterprises concealing their business from the tax authorities was essentially a matter for internal tax administration. Finally, past experience was said to show that it is extremely difficult to tax foreign enterprises efficiently and equitably when they do not possess a permanent establishment in a country.

The phrase “permanent establishment” is defined in Article V, paragraph 1, of the Protocol. Two conditions are required in order for an enterprise to be considered as possessing a “permanent establishment” in a country: it must have some “fixed place” of business in the country; and that place of business must have a productive character – *i.e.*, contribute to business earnings.

There are establishments which fulfil only the first condition. These should therefore not give rise to income-tax liability in the country where they are situated. This class includes establishments which do not directly contribute to business earnings, such as research laboratories, experimental plants, information bureaux, storehouses, purchasing offices, advertising displays and showrooms where no goods are sold. To apply income tax on an assumed profit in the case of such establishments would easily lead to arbitrary or extra-territorial taxation.

The case of purchasing offices deserves special mention and various tax treaties contain specific provisions in their connection. From a general point of view, it is sometimes argued that, when goods are bought in a country, the profits should be divided between the two functions of purchase and sale just as they are divided between manufacture and sale. It is added that to exempt purchasing establishments of foreign enterprises would constitute a discrimination against domestic exporters. On the other hand, it has been pointed out that the act of purchasing in itself yields no profits. Indeed, unlike producing, converting, processing, manufacturing, sorting, preserving, assembling, packing and transporting, a purchase adds no value to the thing bought. Consequently, it seems that the taxation of a so-called purchasing profit by the country where the purchasing establishment is situated, except perhaps when income is attributed to a purchasing establishment on a commission basis – *i.e.*, as if that establishment were an independent agent working for a foreign firm – would give an extra-territorial scope to its income tax.

Though the Mexico and London drafts do not contain any explicit rule about the income-tax treatment of such establishments, it may be mentioned that an earlier unpublished draft stipulated that the “mere purchase of goods by an establishment in one country for the supply of selling or processing establishments in the other country” could not be regarded as a basis for income-tax liability in the country where the purchase was made. It seemed understood that this rule would apply only if the purchasing establishment which the enterprise concerned maintained in that country confined its activities to purchasing only, and rendered no other services such as sorting, grading, or packing goods to the enterprise to which it belonged.

The Mexico and London Model Conventions have taken over from the earlier work of the Fiscal Committee the provisions which allow a distinction to be made between dealings through an autonomous agent and dealings through a permanent establishment or branch.

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According to Article V, paragraph 3, of the Protocol, a foreign enterprise is not, in principle, liable to income tax in a country if its operations in that country are exclusively carried out through a broker, commission agent, or other agent of a genuinely independent status in that country. An agent, however, will not be considered as independent, according to Article V, paragraph 4, of the Protocol, and the enterprise for which he acts will be liable to income tax in the country where he is established in cases such as the following: the agent habitually acts in the name of the enterprise concerned as a duly accredited agent and enters into contracts on its behalf; the agent is a salaried employee of the enterprise and habitually transacts business on its account; the agent habitually holds, for the purpose of sale, a stock of goods that belong to the enterprise.

Article V, paragraph 5, of the Protocol adds that, when the office and business expenses of the agent – in particular, the rent of the premises used by him when working for the enterprise concerned – are paid by that enterprise, this fact will be regarded as proof of a contract of employment, indicating that the enterprise possesses an establishment in the country.

According to the above-mentioned provisions, there seem to be consequently four distinct criteria according to which a foreign enterprise may be deemed to have an establishment in the country where it deals through an agent:

- (a) Power of the local agent to bind the enterprise;
- (b) Existence of a contract of employment with a local agent;
- (c) Maintenance in the country of a stock of goods under the control of an agent for sales in that country;
- (d) Payment of the rent of the premises used by the agent and of his office expenses.

Any of these four conditions is sufficient to render an enterprise liable to income tax in its own name in the country where an agent operates, provided that the condition which is fulfilled corresponds to a permanent state of things or an habitual practice.

On the other hand, paragraphs 6 and 7 of Article V of the Protocol stipulate that foreign enterprises doing business in a country through brokers and commissioned agents of a genuinely independent status, or through commercial travellers visiting customers or suppliers in a country, should not be liable to income tax in that country.

Paragraph 8 of Article V of the Protocol refers to subsidiary companies. It states that a subsidiary cannot be regarded as a permanent establishment of the parent enterprise. This provision has two main effects. In the first place, the country where the subsidiary is situated is not entitled to tax the parent company except, of course, on the dividends which the parent company may receive from its subsidiary, in accordance with the provisions of Article IX of the Mexico draft and Article VIII, paragraph 2, of the London Model Convention, to which reference is made on page 25. Secondly, in taxing the parent company, the authorities of the country in which such company is situated may not take into account the actual profits made by the subsidiary company in the other country, but only the dividends and other income paid by the subsidiary to the parent company. These rules follow the principle that a subsidiary constitutes a distinct legal entity and should therefore be taxed separately. At the same time, Article VII of the Protocol indicates the criteria according to which the correctness of the mutual relations between parent and subsidiary companies can be checked so as to avoid abuses resulting in the diversion of profits or losses from one company to the other.

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While paragraphs 1 and 2 of Article IV of the Model Convention and the complementary provisions in Article V of the Protocol, which have been considered above, define the conditions under which an enterprise may be subject to income tax in a foreign country, paragraphs 3 and 4 of Article IV of the Model Convention and Article VI of the Protocol refer to the method of determining the share of its total profits on which an enterprise may be taxed in a foreign country when it possesses an establishment in that country.

The main principle regarding allocation of profits is that the profits on which a branch or permanent establishment of a foreign enterprise may be taxed in the country where such establishment is situated cannot exceed the earnings that are the direct result of the activities of the establishment concerned or the yield of the assets pertaining to it. Concerning the method of application of this principle, section (a) of paragraph 1 of Article VI of the Protocol states that “there shall be attributed to each permanent establishment the net business income which it might be expected to derive if it were an independent enterprise engaged in the same or similar activities, under the same or similar conditions”. This method of determining or allocating the profits attributable to a permanent establishment is known as the method of separate accounting. Its intended result is that each establishment or branch is taxed as if it constituted a distinct independent enterprise and the profits of the establishment are assessed independently of the results of the business done elsewhere by the enterprise to which it belongs. This method implies as a rule that records and accounts are kept for each establishment on the same basis as in the case of an independent enterprise engaged under similar conditions in the same line of business. The purpose of these accounts is to express dealings made with other establishments of the enterprise as if those dealings were with other firms unconnected with the establishment and were conducted in accordance with the market conditions relevant to such dealings.

The use of the method of separate accounting as the fundamental procedure for the determination of the profits attributable to each country in which an enterprise has an establishment is intended to serve four purposes: first, by treating a branch establishment not as part of an enterprise but as a self-contained unit and thus generally avoiding reference to results or data outside the country concerned, it gives the taxation of branch establishments a strictly territorial scope not extending beyond the boundaries of the countries concerned; secondly, the method helps to enforce the principle of equality of treatment of foreigners by placing, in principle, branches of foreign enterprises on the same footing as similar establishments of domestic enterprises as regards the computation of receipts and expenses, which, once they have been allocated or apportioned by separate accounting, are to be treated in accordance with the tax laws of the country to which they have been attributed; thirdly, the use of separate accounting as a basis for the assessment of income tax conforms to the usual practice among concerns engaged in international business of keeping separate accounts for each of their establishments; Finally, separate accounting serves the revenue interests of the country concerned, since, when it is properly applied and supervised, it prevents the concealment of profits or their diversion from one country to another. In this connection, Article VI, paragraph 1, section (b), of the Protocol specifically foresees the possibility of a rectification by the Fiscal authorities concerned of the “accounts produced, especially in order to correct errors or omissions, or to re-establish the prices or remunerations entered in

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the books at the value which would prevail between independent persons dealing at arm's length". A rectification made in the accounts of an establishment situated in one country should not, however, result in double taxation of the enterprise concerned. A rectification made in one country may therefore call for a corresponding adjustment in the accounts of the establishment in the other country with which the dealings to which the rectification referred have been effected. This matter is dealt with in the second sentence of the above-mentioned section B of paragraph 1 of Article VI of the Protocol.

The assessment of the profits of a permanent establishment according to the method of separate accounting implies that, when required, the necessary data are made available by the enterprise concerned to the tax authorities, and that the records of the establishment conform to certain standards of completeness and accuracy. When such conditions are not fulfilled, the assessment must be made on a presumptive basis. It is to this question that Article VI, paragraph 1, section (c), of the Protocol refers. There it is provided that, if the establishment does not produce an accounting, or the accounting produced is deficient and the deficiencies cannot be remedied, or if the tax authorities and the taxpayer agree, the profits of the establishment involved may be determined by applying a certain percentage to its gross receipts. The object of the procedure remains, however, to treat the establishment of the foreign enterprise according to the same standards as a similar domestic concern engaged in the same line of business. It is therefore suggested that the percentage should be fixed by comparison with the conditions and the results of similar enterprises operating in the country. Moreover, it is specified that, when the activities of a permanent establishment resemble those of a commission agent or broker, the income may be determined on the basis of the customary commission received for such services. It may be noted that this "commission basis" may, when appropriate, be used by establishments keeping regular accounts and entitled to be assessed according to the method of separate accounting.

Section (d) of paragraph 1 of Article VI of the Protocol deals with the cases where neither the method of separate accounting nor the method of a percentage of gross receipts is applicable. Such a situation arises when a comparison between the nature of the activities and the conditions of operation of the establishment of the foreign enterprise cannot be made with those of full-fledged domestic enterprises. It is provided that, in this case, the method of fractional apportionment may be applied. Under this method, the earnings of each establishment are computed as a proportion of the entire profits of the enterprise to which the establishment belongs, on the basis of the general balance-sheet and profit-and-loss account of the enterprise. Such fractional apportionment may be unlimited or limited. In the first case, it takes as its starting-point the total income derived by the enterprise as a whole from all sources. In the second case, reference is made only to that part of the total profits of the enterprise which is derived from transactions in which a part has been taken by the establishment whose share in the total profits is to be determined. It is to this second form of fractional apportionment that recourse may be had according to the Protocol. The share of the total profits from joint transactions that is attributable to the establishment concerned is to be determined by dividing these profits according to the ratio that exists between certain factors pertaining to the establishment concerned and the total of the same factors for the entire enterprise. Examples of the factors that may enter into

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the apportionment formulae are plant and equipment, circulating capital, payrolls, cost of operation, physical output, turnover. It is understood that the selection and the weighting of the different factors that it may appear appropriate to use will differ according to the type of enterprise. It is, however, provided that the formulae of apportionment should be “so selected as to ensure results approaching, as closely as possible, those which would be reflected by a separate accounting”.

Though the method of fractional apportionment is mentioned by the Model Convention only in the third place, after the methods of separate accounting and percentage of turnover, this does not mean that the partial use of fractional apportionment is excluded when, as is generally desirable, branch establishments are taxed according to the method of separate accounting. There are, indeed, in most enterprises with two or more establishments certain items of expenses that must necessarily be apportioned in order to achieve the object of separate accounting, which is to place branches of foreign enterprises on the same footing as domestic concerns. An application of this idea is found in paragraph 2 of Article VI of the Protocol, which provides that, in the determination of the net income of a permanent establishment according to separate accounting, a share of the general expenses of the head office of the enterprise may be charged to the establishment.

The object of paragraph 3 of Article VI of the Protocol is to state explicitly certain corollaries of the method of separate accounting as applied to banking and financial enterprises. Thus it says that the interest on the permanent capital allotted to a branch cannot be deducted from the income of that branch in the country where it is situated even if the capital takes the form of an advance, loan, overdraft or deposit. On the other hand, when such items do not represent the permanent capital of the establishment concerned, the corresponding interest may be deducted from the gross income of the debtor establishment and treated as a receipt of the creditor establishment.

In view of their special conditions of operation, insurance companies represent one of the forms of enterprise which call for particular rules in the allocation of their profits between their various establishments. It has seemed desirable, therefore, to specify in Article VI, paragraph 4, of the Protocol that, where required, the taxable income of the branch of an insurance company may be determined either by the method of percentage on gross receipts or by fractional apportionment. In the first case, coefficients established by reference to corresponding national enterprises in the country concerned would be applied to the gross premiums resulting from the activity of the branch concerned. In the second case, the income of the branch in question would be determined by applying, either to the total net income of the concern as a whole, or merely to that part of the total operating and investment income of the enterprise as a whole which corresponds to the kind of activities in which the branch in question is engaged, the ratio existing between the gross premiums received by the establishment and the total gross premiums received by the enterprise in connection with the same kind of business.

Article V: Income from International Navigation

The effect of Article V is to make income from international maritime and air transport taxable only in the country where the vessel is registered provided the owner or operator

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has his Fiscal domicile in that country. The difference in wording of that article in the Mexico and London drafts is due to the fact that an attempt has been made to state this rule more precisely in the latter draft. The rule in question is contained in numerous special and general tax treaties. It is intended to facilitate the operation of international transport enterprises. It also avoids the numerous difficulties which experience has shown to be involved in the taxation of profits from international navigation outside the home-country of the operating enterprise.

For its part, inland water transport is not affected by Article V and remains, like rail and road transport, subject to the provisions of Article IV, which applies to business income in general. The provisions of that article remain applicable also to the income that a maritime or air transport enterprise might derive from services other than actual maritime or air transport – *e.g.*, warehousing charges, insurance commissions and travel agency fees.

Article VI: Remuneration from Personal Services and Private Employment

Article VI of the London draft reproduces Article VII of the Mexico draft¹ and it is intended to cover the earnings from all private employments and professions. It does not apply, however, to private pensions, which are dealt with separately in Article XI, or to other forms of earned income which are mentioned in other articles such as Articles IV, V, VI and VIII.

The first paragraph of Article VI lays down the general principle that remuneration for labour and personal services, as understood in this context, is taxable only in the country where the services are rendered. According to paragraphs 2 and 3 of that article, however, a person having his Fiscal domicile in one of the Contracting States will be considered as having rendered services in the other Contracting State only if the period or periods during which he has stayed in the other country exceed 183 days. This modification of the rule of taxing the remuneration for personal services in the country where the corresponding services are rendered is intended to facilitate the operations of enterprises engaged in international trade and the movement of workers across national borders.

Paragraphs 4 and 5 deal specifically with independent professions and embody rules similar to those of paragraphs 2 and 3 of Article IV relating to the taxation of business income according to the criterion of permanent establishment. According to paragraph 4, the country where the earnings from professional services are to be taxed is determined not by the actual place where the services are rendered but by the place where the taxpayer concerned has a permanent establishment in which or from which he renders his services. Paragraph 5 relates to the person who has offices in both Contracting States. In this case, the taxpayer will be taxable in each State only to the extent that the income he receives results from services rendered in or from the office situated in that State.

Article VII: Civil Service Salaries and Pensions

(a) The paying authority must be the Government, a political subdivision or a governmental agency of one of the Contracting States;

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- (b) The payee must be a national of the above-mentioned State;
- (c) The payment must be in respect of the performance of diplomatic, consular or other governmental functions;
- (d) Such functions must fall within the normal field of governmental duties and must not be connected with the carrying-on of a trade or a business on behalf of the paying authority.

Contracting States may find it convenient to specify the officials or functions that are to be covered by this rule, which is not intended to restrict any tax immunity or privilege granted to diplomatic or consular agents under international usage or treaties.

Article VIII: Dividends

In the Mexico draft, dividends and interest were covered together under the phrase “income from movable capital” in Article IX of the Convention, which was completed by a definition in Article IX of the Protocol.

In the London draft, Articles VIII and IX, which deal separately with dividends and interest, have taken the place of Article IX of the Mexico draft. According to this article, dividends were to be taxed in the country where the capital from which they were derived was invested – *i.e.*, put into productive use. The result was that in most cases dividends would have been taxable in the same country as the business profits from which they were paid out.

According to Article VIII, paragraph 1, of the London draft, dividends are taxable in the country where the distributing entity has its Fiscal domicile or, according to the provisions of Article II, paragraph 4, of the Protocol, its “real centre of management”. Therefore, in the case of a company having a branch establishment in a foreign country, the profits earned by the company will be taxable, in whole or in part, in that country according to the provisions of Article IV, which applies to business profits as such. But the dividends, or the profits the company itself distributes, will be taxable exclusively in the country of its Fiscal domicile, subject, of course, to the provisions of Article XIII which apply to the taxation of the income as a whole of the person receiving the dividends.

The principle laid down in paragraph 1 of the present article is reasserted in paragraph 3 of that article, which refers also to “undistributed profits”. This reference is justified by the fact that, when distribution of dividends falls below a certain limit, the legislation of certain countries provides for a special tax on “undistributed profits”. It remains permissible, however, for countries which tax the earnings made by companies and similar entities through profits or corporation taxes, to apply such taxes under the rules of Articles IV and XIII.

Paragraph 2 of the present article is intended to avoid the special cases of double or multiple taxation which may occur when the income distributed by a company is derived from dividends received from subsidiaries or related companies, etc. It was thought that an equitable and convenient manner of avoiding such double taxation was to exempt inter-company dividend distributions when the recipient company had a dominant participation in the management or capital of the paying company, so that the dividends tax is collected once only on the final distribution of dividends.

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Article IX: Interest on Debts

According to the provisions of the London draft, interest on all kinds of indebtedness is to be taxed, in principle, exclusively in the State where the creditor has his Fiscal domicile. This is the opposite of the rule contained in Article IX of the Mexico draft. Indeed, it was considered that, especially as regards interest, the country from which capital originated had a prior right to tax such interest wherever the capital was invested. Nevertheless, it was conceded that the State of the debtor could tax such interest in the same way as if it were paid to nationals or residents by means of deduction or withholding at source. At the same time, it was thought that this withholding tax should not exceed a certain percentage to be fixed by agreement.

Both as regards dividends and interest, it should be noted that the treatment of income from movable capital is one of the most complex questions that arise in connection with the prevention of international double taxation. In this matter, there is an opposition of interests between capital-exporting countries and capital-importing countries. The revenue interests of the former are best served by taxation of income from capital at the home of the creditor or beneficiary; those of the latter countries by taxation at the home of the debtor or, rather, the place where the investment is used.

The practical solution of the problem depends, in most cases, on the extent to which each of the Contracting States is willing to limit its right of taxation in order to facilitate international investment. In this connection, it is advisable that regard should be had not only to the incidence of a tax on the income from imported capital, and the immediate effects of such measures on public revenue, but also to the consequences, economic and Fiscal, entailed by the economic development, trade and increase of income which in both countries may follow the capital movements in question.

Article X: Royalties from Real Estate, Patents and Copyrights

In the same way as other income from real property, which is governed by Article II of the Model Convention, royalties received by a person, as owner or possessor of real property in consideration of the right to use or exploit natural deposits and resources situated on the surface or in the subsoil of his property, such as mines, quarries, wells, springs, waterfalls, forests, are taxable in the country where the property is situated. In so far as a distinction between income governed by Article II and Article X respectively is required, for instance, in connection with computation of taxable income or application of tax rates, reference should be made to the provisions of Article III of the Protocol.

The second paragraph of Article X refers to royalties from scientific, industrial and commercial property, such as patents, secret processes and formulae, trade-marks and trade-names. The Mexico Convention, applying the principle of immediate economic origin, placed them under a single rule according to which the royalties are taxable in the country where the patent or other similar right to which they correspond is exploited. As a result, the returns of patents and similar rights always remained taxable in the country where the rights were used, whether the proprietor exploited them himself or through a lessee.

Following a similar line of reasoning to that which inspired the new wording of Articles VIII and IX of the London draft, royalties from patents and similar rights are made taxable in

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the new version of paragraph 2 of the article under consideration exclusively in the country to which the grantor belongs. A restriction to that principle is, however, made by the new paragraph 3 in case the concession has taken place between inter-related enterprises. In that case, the royalties become taxable in the country where the rights are exploited subject to deduction of “all expenses and charges including depreciation relative to such rights”.

The fourth paragraph of Article X in the London draft is identical with the third paragraph of the Mexico version. Copyright royalties from artistic and scientific productions, wherever earned, remain exclusively taxable in the country where the recipient has his Fiscal domicile or permanent establishment. The specific purpose of this rule is to facilitate cultural exchanges.

Article XI: Private Pensions and Life Annuities

The Mexico draft made private pensions and life annuities taxable according to the principle of taxation by origin in the country where the debtor has his Fiscal domicile. This was in line with the rule adopted in Article IX of that draft as regards income from movable capital. In the London draft, private pensions and life annuities are made taxable in the country of Fiscal domicile of the creditor, as in the case of interest from debts. In both drafts, Article X of the Protocol contains a special provision relating to the taxation of allowances of students and apprentices from one country who are staying in the other for their studies or training. These remittances are made exempt from taxation in the country where the beneficiaries are studying.

Article XII: Capital Gains

The first paragraph of Article XII in the London draft reproduces the provisions already contained in the Mexico draft. It stipulates that gains derived from the sale or exchange of real property are taxable only in the State in which the property is situated. As in the case of taxation of income from real property covered by Article II of the Model Convention, the clauses of Articles II and III of the Protocol would apply as regards matters of definition.

The second paragraph of Article XII in its London wording extends the provisions of Articles IV and V as regards the taxation of the gains derived from the sale or exchange of assets other than real property appertaining to a business enterprise. In other words, such gains would be taxable in the country where the income of the property which has been disposed of would itself be taxable.

The third paragraph states that gains derived from any other capital assets not covered in the preceding paragraphs should be taxed in the country of the Fiscal domicile of the recipient. It is, of course, understood that the clauses referred to above apply only to the extent that the internal tax legislation of a country provides for the taxation of such capital gains.

Article XIII: Taxation Rights of the Country of “Fiscal Domicile”

Except for a slight change in wording which affects only the last section of the English text, the provisions of Article XIII are the same in the London and Mexico drafts. This article reserves to the country where the taxpayer has his Fiscal domicile the right to tax the

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taxpayer's entire income even when it is taxable, in part or as a whole, in the other country. From the tax due in the country of "Fiscal domicile" a deduction has to be made, however, on account of the taxes paid in the other country in accordance with the preceding articles of the Model Convention. The simplest manner of determining this deduction would be to take the actual amount of tax paid in the other country. Regard is to be had, however, not only to the interests of the taxpayer but also to those of the State in which he has his Fiscal domicile. Article XIII admits, therefore, that, from the tax due in the country of "Fiscal domicile", the taxes due in the other country should be deducted only to the extent that they do not exceed that proportion of the tax effectively due in the country of domicile which corresponds to the proportion of the income taxable in the other country in relation to the entire income of the taxpayer.

It may be noted that the above-mentioned limit of deduction will operate in the country of "Fiscal domicile" only when the tax schedule in the other country is so high that the effective percentage of tax in respect of the part of income taxable in its territory exceeds the tax percentage which in the country of "Fiscal domicile" corresponds to the total income of the taxpayer.

In bilateral treaties, it may be found advantageous to combine with the clauses of Article XIII provisions fixing or limiting the rate of tax applicable to the income derived from a country by a taxpayer having his "Fiscal domicile" in the other country. Such fixed or ceiling tax rates might, in particular, be contemplated in connection with income from capital and this is provided for in paragraph 3 of Article IX of the London draft.

A special question arises in connection with dividends paid to a person by a company in the country other than that in which he has his "Fiscal domicile". Depending on the system followed by that country in respect of the taxation of corporate income, the tax borne by such dividends may take different forms *e.g.*, the form of a tax paid by the distributing company in its own name or that of a tax on corporate earnings. Therefore, to enable the taxpayer in receipt of dividends so taxed in the country of their origin to obtain, in connection with such dividends, the deduction provided by Article XIII, it may be desirable to stipulate that taxes which a company is required to withhold from dividends it distributes or to pay on such dividends shall be considered as having been paid by the shareholder for the purpose of this article.

Taxable years and tax collection dates differ from country to country. This should be considered when determining, in tax treaties, the taxes which may be deducted or offset against one another according to Article XIII.

Article XIV: Fiscal Domicile in Two Countries

Article XIV relates to the case of taxpayers who, as the result of the construction given to the articles of the Convention by the national tax administration or of the internal legislation of the Contracting parties, might be regarded as having a "Fiscal domicile" in each of the two countries concerned. It also applies to taxpayers who move from one country to another in the course of a taxable year.

In its present wording, the article implies that income tax is collected in the year following that in which the income was earned. It provides that the tax pertaining to the country

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of “Fiscal domicile” under Article XIII shall be divided between the Contracting States in proportion to the period of stay during the taxable year, or according to some other proportion to be agreed upon by the competent authorities. In connection with this article, there arises the same question as was mentioned in the final paragraph of the commentary to Article XIII concerning differences in taxable years.

Article XV: Taxes on Property and Wealth

This article, which was not included in the Mexico version, was drafted at the London meeting in order to take care of the cases of double taxation which may arise in connection with the taxes on property, capital and increment of wealth which a number of European countries apply as a complement to income taxes or have introduced as special war or post-war measures. The principle laid down in this article is that property, capital and increment of wealth may be taxed in a country only if that country would have the right to tax, according to the preceding provisions of the Model Convention, the income originating from the assets in question.

Article XVI: Equality of Treatment

The purpose of Article XVI is to prevent discriminatory treatment in one country of taxpayers having their “Fiscal domicile” in the other country whether or not they are nationals of that country. It specifically debars either of the Contracting States from subjecting taxpayers having their Fiscal domicile in the other State to higher or other taxes than those applicable in respect of the same income to taxpayers who have their Fiscal domicile in the former State or are nationals of that State. There is no doubt that these provisions are also intended to apply, *mutatis mutandis*, to the taxes on property, capital or increment of wealth mentioned in Article XV, though this is not specifically stated in the Model Convention.

Article XVII: Taxpayers’ Rights of Appeal

The special procedures of appeal provided for in Article XVII are intended not to replace but to supplement the procedures of tax appeal established by the tax legislation of the Contracting States. The taxpayer who, in spite of the provisions of the Convention, has suffered double taxation has the option of filing his appeal with the tax authorities of the country of which he is a national or of the country where he has his Fiscal domicile; for it seems legitimate that he should be able to obtain the protection in tax matters of one or the other State according to the circumstances. It should, moreover, be noted that the procedure contemplated is not a judicial procedure, but a direct consultation between the tax administrations involved.

Article XVIII: General Preservation of Taxpayers’ Rights

It may happen that the internal legislation of a country party to a double-taxation treaty grants certain benefits to taxpayers in the form of exemptions, deductions, credits, allowances, rights of appeal, etc., which are more advantageous or more convenient to the parties concerned than the provisions of the Model Convention. It is the object of the new Article XVIII of the London draft to specify that such benefits are not impaired by the provisions of the Convention.

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Article XIX: Relations between Tax Administrations

The object of Article XIX of the London draft, which, except for an additional clause, follows the wording of Article XVII of the Mexico draft, is to entitle the tax administrations of the Contracting States to correspond directly with one another and to co-operate in the application of the Convention, without necessarily having to resort to diplomatic channels. It also enables them to agree on administrative provisions which, while not expressly provided for in the Convention, are in accordance with its spirit and may be required to give it full effect.

The addition to which reference has just been made is intended to permit tax administrations to adapt the provisions of the Convention in the event of “substantial changes in the tax laws” without having resort to the formal conclusion of a new convention.

Article XX: Ratification and Duration of the Convention

The final article of the Convention deals with the procedure of ratification. It refers also to the entry into force of the Convention and to its duration. In this connection, an initial period of three years is suggested, as such a period seems to be generally desirable in order to give sufficient trial to the system of preventing double taxation which is embodied in the Model Convention. A question which tax negotiators may have to consider in fixing the dates of entry into force of the Convention is that of the possible differences in Fiscal years. In many conventions that have been concluded in the past, their date of entry into force has been fixed independently of the actual date of ratification. Quite a few of them have been made retroactively applicable to tax claims relative to previous tax years that are outstanding at the time of the signature of the convention and which would not have arisen if the facts motivating such claims had taken place after the entry into force of the convention.

**9. MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE
TAXATION BETWEEN MEMBER COUNTRIES AND
OTHER COUNTRIES OUTSIDE THE ANDEAN
SUBREGION (ANDEAN MODEL)**

CHAPTER I SCOPE OF THE CONVENTION AND GENERAL DEFINITIONS

Article 1: Scope of the Convention

The taxes subject to this Convention are:

In the case of (State A):

In the case of (State B):

This Convention shall also apply to any future amendments of the above-mentioned taxes, and to any taxes established by each Contracting State after the signing of this Convention, which, by virtue of its tax base or its taxable matter, are substantially and economically similar to any of the above-cited taxes.

Article 2: General Definitions

For the purposes of this Convention, and unless otherwise defined:

(a) The terms “one of the Contracting States” and “the other Contracting State” mean (State A) or (State B), as the context requires.

(b) The expressions “territory of one of the Contracting States” and “territory of the other Contracting State” mean the territory of (State A) or the territory of (State B), as the context requires.

(c) The word “person” means:

(i) An individual

(ii) A juridical person.

(d) An individual shall be deemed to be a resident of the Contracting State in which said individual has his or her habitual abode. A business enterprise shall be deemed to be a resident of the State specified in its articles of constitution. In the absence of articles of constitution, or if no State of residence is specified therein, the business enterprise shall be deemed to be a resident of the State wherein its actual managerial control is established. Where the determination of the State of residence under these rules is not possible, the competent authorities of the Contracting States shall decide the issue by mutual agreement.

(e) The word “source” means the activity, right or property that generates, or may generate, the income.

(f) The term “business activities” means activities undertaken by business enterprises.

(g) The word “enterprise” means an organization constituted by one or more persons that undertakes a profit-making activity.

(h) The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean an enterprise that is a resident of one of the Contracting States.

(i) The word “royalty” means any benefit, thing of value or sum of money paid for the use, or for the privilege of using, copyrights, patents, industrial drawings or models, exclusive processes or formulas, trade marks or other intangible property of a similar nature.

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(j) The term “capital gains” means the profit obtained by a person in the alienation of property not habitually acquired, produced or transferred in his ordinary line of business activity.

(k) The word “pension” means a periodic payment made in consideration of services rendered or injuries sustained; and the word “annuity” means a certain sum of money payable periodically during the life of the beneficiary, or during a certain period of time, gratuitously or in consideration of payments made in money.

(l) The term “competent authority” means, in the case of (State A), the and in the case of (State B), the

Article 3: Meaning of Undefined Terms

Any word or term not defined in this Convention shall have the meaning assigned thereto by the legislation in force of each Contracting State.

Chapter II Tax on Income

Article 4: Tax Jurisdiction

Irrespective of the nationality or State of residence of a person, income of whatever nature received by such person shall be taxable only by the Contracting State wherein the source of such income is situated, except for the cases specified in this Convention.

Article 5: Income from Real Property

Income of whatever kind from real property shall be taxable only by the Contracting State wherein such real property is situated.

Article 6: Income from Rights to Exploit Natural Resources

Any benefit received from leasing or subleasing, or from transferring or granting, any right to exploit or use in any manner whatsoever the natural resources of one of the Contracting States, shall be taxable only by such Contracting State.

Article 7: Business Profits

Profits resulting from business activities shall be taxable only by the Contracting State wherein such business activities have been undertaken.

It is understood that a business enterprise carries out activities in the territory of a Contracting State when it has in such Contracting State any of, but not limited to, the following:

- (a) An office or place of business management;
- (b) A factory, plant, industrial workshop or assembly shop;
- (c) A construction project in progress;
- (d) A place or facility wherein natural resources are extracted or exploited, such as a mine, well, quarry, plantation or fishing boat;
- (e) An agency or premises for the sale of goods;
- (f) An agency or premises for the purchase of goods;

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- (g) A depository, storage facility, warehouse or any similar establishment used for receiving, storing or delivering goods;
- (h) Any other premises, office or facilities, the purpose of which is preparatory or auxiliary to the business activities of the enterprise;
- (i) An agent or representative.

Where a business enterprise undertakes activities in both Contracting States, each one of them may tax income from sources within its territory. If the activities are undertaken through representatives, or through the use of facilities, such as the ones indicated in the preceding paragraph, the profits earned shall be attributed to such persons or facilities, provided that said persons or facilities are totally independent from the business enterprise.

Article 8: Profits of Transportation Enterprises

The profits earned by a transportation enterprise from its air, land, sea, lake or river operations, shall be liable to taxation only by the Contracting State of which such enterprise is a resident.

Alternative

The profits earned by a transportation enterprise from its air, land, sea, lake or river operations in any of the Contracting States shall be taxable only by such Contracting State.

Article 9: Royalties from the Use of Patents, Trade Marks and Technology

Royalties derived from the use of patents, trade marks, non-patented technical knowledge or other similar intangible property within the territory of one of the Contracting States shall be taxable only by such Contracting State.

Article 10: Interest

Interest derived from loans shall be taxable only by the Contracting State in the territory of which the loan has been used. Subject to rebuttal, it is presumed that the loan has been used in the Contracting State from which the interest payment has been made.

Article 11: Dividends and Shares of Profit

Dividends and shares of profit shall be taxable only by the Contracting State of which the business enterprise paying them is a resident.

Article 12: Capital Gains

Capital gains shall be taxable only by the Contracting State wherein the property is situated at the time of the sale, except for capital gains derived from the alienation of:

- (a) Ships, aircraft, buses and other transportation vehicles, which shall be taxable only by the Contracting State wherein such vehicles are registered at the time of the alienation thereof, and
- (b) Negotiable instruments, shares of stock and other securities, which shall be taxable only by the Contracting State in which territory they have been issued.

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Article 13: Income from the Rendering of Personal Services

Remunerations, fees, wages, salaries, benefits and similar compensation received as payments for services rendered by employees, professionals or technicians, or for personal services in general, shall be taxable only in the territory wherein such services have been rendered, except for wages, salaries, remunerations and similar compensation, received by:

(a) Persons rendering services to a Contracting State in the discharge of official duties duly accredited, which shall be taxable only by such Contracting State, even if the services have been rendered within the territory of the other Contracting State.

(b) The crews of ships, aircraft, buses and other transportation vehicles engaged in international traffic, which shall be taxable only by the Contracting State of which the employer is a resident.

Article 14: Professional Service and Technical Assistance Business Enterprises

Income received by business enterprises engaged in rendering professional services or technical assistance, shall be taxable only by the Contracting State wherein such services or assistance are rendered.

Article 15: Pensions and Annuities

Pensions, annuities and other periodic income of a similar character shall be taxable only by the Contracting State wherein the source of such income is situated. The source is considered to be situated in the territory of the State where the contract providing for such periodic income is executed and, if there is no contract, in the State from which the payment of such income is made.

Article 16: Public Entertainment Activities

Income derived from artistic or public entertainment activities shall be taxable only by the Contracting State wherein such activities have been carried out, without regard to the time that the persons performing said activities stay in the territory of such Contracting State.

Chapter III Taxes on Net Wealth

Article 17: Taxes on Net Wealth

Net wealth situated within the territory of one of the Contracting States shall be taxable only by such Contracting State.

Article 18: Status of Transportation Vehicles, Loans and Securities

For the purposes of the preceding Article, it is understood that:

(a) Aircraft, ships, buses and other transportation vehicles, as well as the personal property used in the operation thereof, are situated in the Contracting State wherein their respective ownership is registered.

(b) Loans, shares of stock and other securities are situated in the Contracting State of which the debtor, or the issuing enterprise, is a resident.

Chapter IV General Provisions

Article 19: Consultations and Information

The competent authorities of the Contracting States shall hold consultations between themselves and exchange the information necessary for deciding by mutual agreement any difficulty or doubt which may arise out of the application of this Convention, and for establishing the administrative controls required for the avoidance of fraud and tax evasion.

The information exchanged pursuant to the provisions of the preceding paragraph shall be considered as confidential, and shall not be transmitted to any person other than the authorities responsible for the administration of the taxes which are subject to this Convention.

For the purposes of this Article, the competent authorities of the Contracting States may communicate directly between themselves.

Article 20: Ratification

This Convention shall be ratified by the governments of the Contracting States in accordance with their respective constitutional and legal requirements.

The instruments of ratification shall be exchanged at..... as soon as possible. Upon the exchange of the instruments of ratification, this Convention shall have effect and apply:

- (a) With respect to income of individuals, to income received on and after the first day of January of the calendar year following the year of the ratification.
- (b) With respect to business profits, to profits received during the first Fiscal year starting after the ratification of this Convention.
- (c) With respect to other taxes, to those in which the assessment thereof corresponds to the calendar year following the year of the ratification.

Article 21: Effectiveness and Termination

This Convention shall remain in force and effect indefinitely, but either of the Contracting States, from the first day of January to the 30th day of June of any calendar year, may denounce the Convention by giving notice thereof in writing to the other Contracting States and, in such event, the Convention shall cease to have effect:

- (a) With respect to income of individuals, as of the first day of January of the calendar year immediately following the year in which such notice is given.
- (b) With respect to income of juridical persons after the closing of the Fiscal year, the beginning of which would have occurred during the calendar year in which notice of termination of this Convention is given.
- (c) With respect to the other taxes, as of the first day of January of the calendar year following the year in which such notice is given.

IN TESTIMONY WHEREOF, the respective plenipotentiaries have hereunto set their hands and seals.

MADE at... on the... day of... in... copies in the... language, and... copies in the... language, with the... copies being equally valid and authentic.

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