CHAPTER 8

An Introduction to Tax Treaties

8.1 INTRODUCTION

Bilateral tax treaties are an important feature of the international tax landscape that serve as a bridge between the tax systems of the contracting states. Over 3,000 bilateral income tax treaties are currently in effect, and the number is growing. Most bilateral tax treaties are based in large part on the OECD Model Treaty or the UN Model Treaty. The UN Model Treaty is substantially similar to the OECD Model Treaty, but includes some additional and different provisions that permit source countries to impose more tax than is permitted by the OECD Model Treaty. Both of these models are discussed below.

Sections 8.2 through 8.6 below provide an overview of several of the most important general aspects of tax treaties, including the legal nature of tax treaties, their relationship with domestic law, their objectives, and the interpretation of treaties. The main features of the influential OECD and UN Model Treaties are summarized in section 8.7 in order to give readers a basic understanding of the provisions a typical tax treaty. Some special topics, including treaty abuse, nondiscrimination, resolution of disputes, and administrative cooperation, are examined in section 8.8.

Although this chapter focuses exclusively on income tax treaties, several other types of treaties deal with tax issues. For example, countries that impose estate or inheritance taxes may have treaties to eliminate double taxation with respect to those taxes. In addition, as of June 30, 2015 over ninety countries had signed the Multilateral Convention on Mutual Assistance in Tax Matters, sponsored by the OECD and the Council of Europe, which entered into force in 1995 and was significantly revised in 2011. This Convention deals with tax administration issues such as exchange of information, assistance in the collection of taxes, and dispute resolution. In addition, there are many types of treaties that deal primarily with non-tax matters but also include tax provisions. These non-tax treaties include air transportation agreements

and trade and investment treaties; most of these agreements contain carve-out provisions indicating that any income tax issues will be dealt with exclusively under the income tax treaty between the countries. The General Agreement on Tariffs and Trade (GATT), as renegotiated in 1994, and the General Agreement on Trade in Services (GATS), both of which were consolidated as part of the Agreement Establishing the World Trade Organization in 1994, contain some important provisions relating to income taxation, primarily designed to prevent the use of income tax provisions as disguised trade barriers or export incentives.

An important recent development is the proliferation of Tax Information Exchange Agreements (TIEAs), typically between high-tax countries and low- or no-tax countries with which the high-tax countries would not otherwise have a comprehensive income tax treaty. In general, TIEAs require the low- or no-tax countries to exchange information on the same basis as provided in Article 26 of OECD and UN Model Treaties.

Income tax treaties are invariably bilateral, rather than multilateral. Although proposals have been made from time to time for a multilateral income tax treaty, to date multilateral agreements have been limited to administrative issues. Countries seem to prefer customized agreements with each treaty partner that take into account the cross-border trade and investment flows between them and their income tax systems. However, trade and investment treaties, such as the GATT and the GATS, are multilateral agreements, and there is no legal impediment to a multilateral income tax treaty. In fact, a multilateral agreement is a much more efficient method of revising the vast network of bilateral treaties than renegotiating each treaty. In this regard, in BEPS Action 15: *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, the OECD has recently proposed producing a multilateral treaty to implement the changes to tax treaties that were recommended as part of the BEPS project (see section 8.8.2.3 below).

8.2 LEGAL NATURE AND EFFECT OF TAX TREATIES

8.2.1 *Vienna Convention on the Law of Treaties*

All treaties, including tax treaties, are governed by the *Vienna Convention on the Law of Treaties* ("Vienna Convention"), which was concluded on May 23, 1969 and entered into force on January 27, 1980. Although the Vienna Convention has not been signed by some countries (most notably, the United States (US)), it is generally considered to be binding on all nations because its provisions are a codification of the principles of customary international law dealing with treaties. All nations are considered to be subject to the principles of customary international law.

Treaties are agreements between sovereign nations. According to Article 2 of the Vienna Convention:

> A treaty is an international agreement (in one or more instruments, whatever called) concluded between states and governed by international law.

Thus, it does not matter that some tax treaties are called "conventions" and others are called "agreements."

Tax treaties confer rights and impose obligations on the parties or signatories to the treaty, called the contracting states. In most countries, they do not confer rights on citizens or residents of the two states unless and until the provisions of the treaty have been incorporated into the domestic laws of the contracting states in some manner. The methods for incorporating treaties into domestic law vary from country to country. In most Commonwealth countries, tax treaties are usually incorporated into domestic law by means of domestic legislation. In other countries, tax treaties are self-executing; they become part of domestic law once they are concluded and ratified by the responsible government officials. In other countries, treaties are subject to a special legislative process; for example, in the US, tax treaties entered into by the executive branch (the President) must receive the advice and consent of the US Senate before they become effective.

Article 26 of the Vienna Convention contains the *pacta sunt servanda* principle, under which treaties are binding on the contracting states and must be performed by them in good faith. Such a fundamental principle is self-evident. Treaties are binding agreements between sovereign states and must be respected by them - countries are unlikely to be interested in entering into treaties with countries that do not adhere to their obligations. Unfortunately, although the *pacta sunt servanda* principle is essential for treaties to operate as intended, there have been instances where countries have not respected the provisions of their tax treaties.

Reciprocity is a fundamental underlying principle of tax treaties, although its precise meaning is unclear. The provisions of almost all bilateral tax treaties are reciprocal. For example, if the rate of tax on dividends, interest, and royalties under a treaty is limited to 10 or 15 percent, that rate invariably applies equally to payments of these amounts by residents of one contracting state to residents of the other contracting state and by residents of the other state to residents of the first state. Moreover, the reciprocal limitation of the rates of tax imposed on dividends, interest, and royalties by the contracting states applies notwithstanding that the flows of these payments between the two contracting states may be unequal. The application of the principle of reciprocity is especially difficult with respect to provisions such as exchange of information and assistance in the collection of tax. These provisions impose potentially costly obligations on states. Although the provisions apply in the same manner in both states, does the principle of reciprocity require that both states make reasonably equal use of the provisions, or is it acceptable for one state to make disproportionate or even exclusive use of the provisions?

8.2.2 The Relationship between Tax Treaties and Domestic Law

The relationship between tax treaties and domestic tax legislation is much more complex than many commentators and tax professionals realize. Many of them think that the relationship consists of nothing more than the basic principle that a treaty prevails in the event of a conflict between the provisions of domestic law and the

treaty. In fact, the relationship between tax treaties and domestic law is complex, involving the following issues:

(1) the effect of tax treaties on subnational taxes;
(2) whether tax treaties limit domestic tax, allocate taxing rights, or impose tax;
(3) the limited impact of tax treaties in that they do not displace domestic law entirely;
(4) the incorporation of meanings of terms in domestic law into tax treaties;
(5) the incorporation of tax treaty terms into domestic law; and
(6) domestic laws that override the provisions of tax treaties.

These issues are discussed briefly below.

In general, tax treaties apply to all income taxes imposed by the contracting states, including taxes imposed by provincial (state), local, and other subnational governments. In some federal states, however, the central government is prevented by the constitution or established tradition from entering into tax treaties that limit the taxing powers of their subnational governments. Accordingly, the tax treaties of some federal states, such as Canada and the US, apply only to national taxes. In such circumstances, a subnational government may impose taxes that contravene the provisions of an applicable tax treaty despite the fact that the central government could not impose similar taxes.

In general, tax treaties do not impose tax, nor do they allocate taxing rights between the contracting states – the right to tax is derived from the domestic law of a state. Tax treaties limit the taxes otherwise imposed by a state; in effect, they are primarily relieving in nature. France and several African countries that follow the French practice are notable exceptions in this regard because taxes may be imposed pursuant to treaty provisions even where they are not imposed under domestic law. In other words, these countries impose tax on amounts that a treaty allows them to tax, despite the fact that those amounts may not be taxable under their domestic law. In contrast, for most countries, if an amount is not taxable under domestic law, that is the end of the matter; it is unnecessary to refer to the treaty.

The provisions of tax treaties do not displace the provisions of domestic law entirely. For example, a person who is considered to be a resident of both Country A and Country B under their domestic laws may be deemed to be a resident of Country A pursuant to the tie-breaker rule in the treaty between Country A and Country B. Article 4(2) (Resident) of both the OECD Model and UN Model Treaties provides a series of tie-breaker rules to make a dual-resident individual a resident of only one country for purposes of the treaty. However, although the individual may be considered to be a resident of Country A for purposes of the treaty, the individual will remain a resident of Country B under its domestic law for all purposes not affected by the treaty. If, for example, the individual makes payments of dividends, interest, or royalties to nonresidents, the person may be subject to any withholding obligations imposed by Country B on such payments made by residents of Country B.

Many tax treaty provisions include explicit references to the meaning of terms under domestic law. As a result, the meanings of terms in a tax treaty are determined

by reference to the meanings of those terms under the domestic law of the contracting states. For example, under Article 6 (Income from Immovable Property) of both the OECD and UN Model Treaties, income from immovable or real property located in a country is taxable by that country. For this purpose, the term "immovable property" is defined in Article 6(2) to have the meaning that it has under the domestic law of the country in which the property is located. In addition, Article 3(2) (General Definitions), which is discussed below, provides that any undefined terms in a treaty should be given the meaning that they have under the law of the country applying the treaty. Conversely, in some countries where the domestic law uses terms that are also used in the treaty, the meaning of those terms for purposes of domestic law may be interpreted in accordance with the meaning of the terms for purposes of the treaty. In effect, in these circumstances, treaty meanings are incorporated into domestic law.

As noted above, as a general rule, the provisions of tax treaties prevail in the event of a conflict with the provisions of domestic law. In some countries, this principle is enshrined in the constitution; in other countries, it is enacted as a statutory rule; in yet other countries, treaties prevail over other laws because they are considered to be special (*lex specialis*). In the US, the basic rule for resolving conflicts between statutes and treaties is that the later-in-time prevails. Except in countries that give constitutional priority to treaties, it is possible for countries to adopt legislation that takes priority over their tax treaties. Such legislation is often referred to as a **treaty override**. For example, some countries have passed legislation to modify or overturn the interpretation of a tax treaty by its domestic courts, perhaps on the basis that the court decisions are inconsistent with the Commentary on the OECD or UN Model Treaties or the intentions of the contracting states. Such legislation, adopted in good faith, may not violate a country's obligations under its tax treaties. A country contemplating a treaty override may consult with its treaty partners in advance to demonstrate good faith and prevent misunderstandings.

Occasionally, some countries have included treaty overrides in legislation to prevent taxpayers from arguing in court that the countries' tax treaties prevent the application of the legislation. This type of treaty override is very controversial. Tax treaties are solemn obligations that should not be disregarded except in extraordinary circumstances. If a country becomes dissatisfied with the provisions of a tax treaty, the appropriate remedy is the renegotiation or termination of the treaty. At the same time, countries must have the ability to amend the provisions of their domestic tax legislation to keep it current and to clarify interpretive difficulties concerning the relationship between the treaty and domestic law.

8.3 THE OECD AND UN MODEL TAX TREATIES

There are two influential model tax treaties - the OECD *Model Tax Convention on Income and on Capital* (available at www.oecd.org) and the United Nations *Model Double Taxation Convention between Developed and Developing Countries* (available at www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf), the most recent versions of which are 2014 and 2011 respectively. Some countries have their own model

tax treaties, which are often not published but are provided to other countries for the purpose of negotiating tax treaties. The US has published its model treaty, available at www.irs.gov. The UN Model Treaty and the various country models are broadly similar to the OECD Model Treaty and can be viewed as modified versions of the OECD Model Treaty rather than as separate models.

The OECD Model Treaty has a long history, beginning with early diplomatic treaties of the nineteenth century. The limited objective of those treaties was to ensure that diplomats of one country working in another would not be discriminated against; they were extended to cover income taxation once income taxes began to be widely adopted in the early part of the twentieth century. After the First World War, the League of Nations commenced work on the development of a model treaty dealing exclusively with income tax issues. This work culminated in draft model conventions in 1943 and 1946. These conventions were not unanimously accepted, and the work of creating an acceptable model treaty was taken over by the OECD. Currently, the OECD has thirty-four members, consisting of most of the major industrialized countries. Membership in the OECD has recently been extended to Chile, Estonia, Israel, and Slovenia. It seems likely that several other countries, such as Colombia, Costa Rica, Latvia, and Lithuania will become members in the near future.

The OECD Model Treaty was first published, in draft form, in 1963. It was revised in 1977 and again in 1992. In 1992, the OECD decided that the Model Treaty should be ambulatory, with more frequent, periodic updates rather than complete revisions at less frequent intervals. Consequently, since 1992 the OECD Model Treaty has been revised nine times: in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010 and, most recently, 2014. The Committee on Fiscal Affairs, which consists of senior tax officials from the member countries, has responsibility for the Model Treaty as well as other aspects of international tax cooperation. The Committee on Fiscal Affairs operates through the Centre for Tax Policy and Administration, which was created in early 2001; it has a large staff that deals with various aspects of international taxation, including tax treaties, and oversees several Working Parties. The Working Parties consist of delegates from the member countries; Working Party No. 1 is responsible for the Model Treaty and examines issues related to the treaty on an ongoing basis.

The work of the United Nations on a model treaty commenced in 1968 with the establishment by the UN Economic and Social Council (ECOSOC) of the UN Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries. The Group of Experts produced a *Manual for the Negotiation of Bilateral Tax treaties between Developed and Developing Countries*, which led to the publication of the UN *Model Taxation Convention between Developed and Developing Countries* in 1980. The UN Model Treaty was revised in 2001 and again in 2011. In 2004, the Group of Experts became the Committee of Experts on International Cooperation in Tax Matters. In addition to maintaining the UN Model Treaty and its **Commentary**, the Committee has published several useful reference works dealing with international tax, including a manual on transfer pricing for developing countries and a handbook on the administration of tax treaties.

The members of the Committee are tax officials nominated by their governments and appointed by the Secretary-General of the UN. They serve for four-year terms in

their individual capacity rather than as representatives of their governments; however, the practical reality is that many members of the Committee usually adopt positions that are consistent with those of their governments. A majority of the members of the Committee are from developing countries and countries with economies in transition. The members of the Committee are tax specialists and include several treaty negotiators.

The UN Model Treaty follows the pattern set by the OECD Model Treaty, and many of its provisions are identical, or nearly identical, to those of the OECD Model Treaty. The chief difference between the two models is that the UN Model Treaty imposes fewer restrictions on the taxes that may be imposed by developing countries. For example, the UN Model Treaty does not contain specific limitations on withholding tax rates on dividends, interest, and royalties imposed by source countries; instead, the withholding rate levels are left to bilateral negotiations between the contracting states. Similarly, as discussed in section 8.7.3.2 below, the UN Model Treaty allows source countries to tax more cross-border business profits than the OECD Model by lowering the threshold for a PE.

A detailed Commentary, organized on an article-by-article basis, accompanies both the OECD and the UN Model Treaties. In particular, the OECD Commentary has become increasingly important with respect to the interpretation and application of tax treaties, including treaties between countries that are not members of the OECD. To take into account the positions of some non-member states, the OECD opened up the Commentary in 1997 for non-member countries to register their positions on the provisions of the OECD Model Treaty and its Commentary. As of 2014, thirty-three countries have done so.

In general, and in comparison to the UN Model Treaty, the OECD Model Treaty favors capital-exporting (residence) countries over capital-importing (source) countries. Often it eliminates or mitigates double taxation by requiring the source country to give up some or all of its taxing rights on certain categories of income earned by residents of the other treaty country. This aspect of the OECD Model is appropriate if the flow of trade and investment between the two countries is reasonably equal and the residence country taxes any income that the source country exempts from tax. The following example illustrates this point.

Country A and Country B are both developed countries contemplating a tax treaty. Both countries tax their residents on a worldwide basis, and both provide their residents with a foreign tax credit for withholding taxes paid with respect to foreign source income. Country A has one taxpayer, Taxpayer A, who earns royalties of 1,000 from Country B. Country B likewise has one taxpayer, Taxpayer B, who earns royalties of 1,000 from Country A. Absent a treaty, Country B would impose a 15 percent withholding tax on royalties paid to Taxpayer A, and Country A would do the same with respect to royalties paid to Taxpayer B. Country B would allow Taxpayer B to claim a foreign tax credit for the withholding taxes paid to Country A, and Country A would allow a credit for the comparable taxes paid by Taxpayer A to Country B. If the two countries agree in their tax treaty to reduce withholding at source on royalties to a rate of zero for residents of the other contracting state, each country would thereby lose

source-tax revenue of 150 (1,000 × 0.15). They would recoup the lost source-tax revenue, however, by collecting 150 in additional tax from their own residents.

Two important points may be drawn from the above example. First, a country that gives up the domestic tax that it imposes on income derived from its territory cannot expect to recoup the lost revenue from an expansion of its residence jurisdiction if it uses an exemption system to relieve international double taxation.

Second, a trade off of domestic tax based on the source of income for tax, which is based on the residence of the taxpayer, is likely to be unfavorable for a country that is a net importer of capital. Of course, investment flows between two contracting states are never as exact as in the above example; some deviations from strict reciprocity are acceptable, especially for countries with a network of tax treaties. If a group of countries enters into bilateral treaties based on the OECD Model Treaty, what is important is that the investment flows within that group be roughly in balance. In such circumstances, a country that loses revenue under some of its treaties can expect to recoup the revenue under other treaties.

Developing countries are net capital importers, and many of them use the exemption method for granting double taxation relief to their resident taxpayers. Consequently, developing countries entering into a tax treaty with a developed country would not benefit from the trade-off of taxation based on the source of income for taxation, based on the residence of taxpayers, contained in the OECD Model Treaty. As noted above, because of the shortcomings of the OECD Model Treaty, developing countries devised their own model treaty under the auspices of the UN.

The success of the OECD Model Treaty has been remarkable – virtually all existing bilateral tax treaties are based on it. As noted above, even the UN Model Treaty and US Model Treaty follow the basic pattern of the OECD Model Treaty. This wide acceptance of the OECD Model Treaty, and the resulting standardization of many international tax rules, has been an important factor in reducing international double taxation and facilitating international trade and investment.

Nevertheless, the OECD Model Treaty has several deficiencies. For example, some provisions are intentionally vague in order to disguise disagreements among OECD member countries. Also, many important aspects of international tax, such as foreign-currency gains and losses, sophisticated financial arrangements, cross-border reorganizations, and corporate integration methods, are not dealt with in the Model Treaty at all. Moreover, in some ways the OECD Model Treaty is a victim of its own success. Changing the articles of the OECD Model Treaty to correct flaws and respond to new developments is extremely difficult. One source of this difficulty is that countries can adopt revisions of the OECD Model Treaty only by renegotiating their existing treaties, which is time-consuming, especially for countries with large treaty networks.

Another source of difficulty is the OECD tradition of amending the Model Treaty only with the unanimous consent of all OECD members. The practical significance of the unanimity rule is diminished because member countries that disagree with any aspect of the Model Treaty can register a reservation to the particular provision of the Model Treaty. These reservations are found in the Commentary on the Model Treaty. A reservation indicates that the country does not intend to adopt the particular

provision of the OECD Model Treaty in its tax treaties. Most countries have entered reservations on some aspects of the Model Treaty. For example, fourteen member countries have entered reservations on Article 12 dealing with royalties by asserting their intention to levy withholding taxes on royalties.

The Commentary also contains observations by particular countries on specific aspects of the Commentary. Observations are usually used to indicate that a particular country's interpretation of a provision of the Model Treaty or a part of the Commentary differs from the interpretation of the majority of the member countries. A country making an observation does not reject the particular article of the Model Treaty. The purpose of the observation is to indicate that the country will include the provision in its treaties, but will interpret and apply the provision in a manner different from the view expressed in the Commentary. A country is not expected to enter an observation if the Commentary sets out alternative positions and the country adopts one of those positions.

The Commentary on the OECD Model Treaty is much easier to change than the articles of the Model Treaty itself. According to the Commentary, the views expressed in the Commentary, subject to any reservations or observations, should be taken into account in interpreting and applying all treaties between Member States, even those treaties entered into before the revisions of the Commentary. This practice of applying revisions of the Commentary to previously existing tax treaties raises some interesting questions of interpretation that are dealt with in section 8.6 below.

8.4 THE PROCESS OF NEGOTIATING AND REVISING TAX TREATIES

The negotiation of a tax treaty typically begins with initial contacts between the countries. Usually, a country will consider many factors, including the level of trade and investment with another country, in deciding whether to enter into negotiations for a tax treaty with that country. Once the countries have decided to negotiate, they exchange their model treaties (or their most recent tax treaties, if they do not have a model treaty) and schedule face-to-face negotiations.

Traditionally, treaties are negotiated in two rounds, one in each country. During the first round of negotiations, the negotiating teams agree on a particular text – usually the OECD Model or UN Model Treaty – to use as the basis for the negotiations. After presentations by both sides about their domestic tax systems, the negotiations proceed on an article-by-article basis. Aspects of the text that cannot be agreed on are usually placed in square brackets, to be dealt with later. Once the wording of an article is agreed on, the parties initial it. Once all the articles have been agreed on by the treaty negotiators, arrangements are made for the treaty to be signed by an authorized official (often an ambassador or government official). After signature, each state must ratify the treaty in accordance with its own ratification procedures. The treaty is concluded when the countries exchange instruments of ratification. The treaty enters into force in accordance with the specific rules in the treaty (Article 30 (Entry into Force) of the OECD Model Treaty and Article 29 (Entry into Force) of the UN Model Treaty).

Thus, the process for the adoption of a tax treaty involves several separate steps or stages: signature, ratification, conclusion, and entry into force. Each of these steps has a special meaning and particular consequences.

Once a treaty has been adopted, it may be modified in minor or major ways by the mutual consent of the contracting states. It is common for a tax treaty to be amended by the parties entering into a Protocol to the treaty. Under the provisions of the Vienna Convention as discussed in section 8.2.1 above, an agreement designated as a Protocol is simply a treaty under a different name. Thus, as described above, it must be ratified under the rules applicable to treaties before it becomes effective.

Tax treaties require updating just like domestic tax laws. In practice, the amendment process is often exceedingly slow and difficult – it is not uncommon for a Protocol to take as long to negotiate as a treaty. Often, once one aspect of a treaty is opened up for renegotiation, other aspects of the treaty become negotiable. Consequently, if a country has a broad network of tax treaties – some have tax treaties with over 100 countries – the renegotiation of the entire network could take decades.

To a limited degree, tax treaties may be updated without a formal amendment procedure through the interpretive process. For example, as discussed in section 8.3 above, the OECD Commentary is frequently updated to clarify the meaning of the articles of the treaty, and the OECD takes the position that the revisions to the Commentary should be applied to tax treaties that were entered into before those revisions were made (see paragraphs 33-36 of the Introduction to the OECD Model Treaty). In addition, Article 25 (Mutual Agreement Procedure) of both the OECD and UN Model Treaties authorizes the competent authorities of the two states to resolve issues of interpretation. The general rules for interpreting treaties are discussed below in section 8.6.

8.5 OBJECTIVES OF TAX TREATIES

The fundamental objective of tax treaties, broadly stated, is to facilitate cross-border trade and investment by eliminating the tax impediments to these cross-border flows. This broad objective is supplemented by several more specific operational objectives.

From the perspective of taxpayers, the most important operational objective of bilateral tax treaties is the elimination of double taxation. Several provisions of the typical bilateral tax treaty are directed at the achievement of this goal. For example, tax treaties contain tie-breaker rules (Article 4(2) and (3) of the OECD and UN Model Treaties) to deem a taxpayer who is otherwise resident in both countries to be a resident of only one of the countries. They also limit or eliminate the source country tax on certain types of income (Articles 10, 11 and 12 of the OECD and UN Model Treaties) and require residence countries to provide relief for source country taxes, either by way of a foreign tax credit or an exemption for the foreign source income (Article 23 of the OECD and UN Model Treaties). The mechanisms for granting relief from double taxation are discussed in Chapter 4, section 4.3.

In the mid- twentieth century, the focus of tax treaties was almost exclusively on solving the problem of double taxation. This focus was reflected in the title of the 1963

and 1977 OECD Model Treaties: "Convention between (State A) and (State B) for the avoidance of double taxation with respect to taxes on income and on capital." At that time, multinational enterprises were facing risks of substantial double taxation, few countries provided unilateral relief for double taxation, and widespread treaty networks were just starting to develop. Treaty solutions to most of the major double-tax problems were worked out in the 1950s and early 1960s, however, and they are now routinely accepted by states when they enter into tax treaties.

The historical emphasis on the elimination of double taxation should not obscure the fact that most tax treaties have another equally important operational objective – the prevention of tax evasion and avoidance. This objective is the converse of the elimination of double taxation. Tax treaties are intended to eliminate double taxation of cross-border income, but are not intended to facilitate double non-taxation. The underlying assumption of tax treaties is that cross-border income should be taxed, but should be taxed only once.

Originally, the OECD and UN Model Treaties included a preamble stating that the treaty was intended to eliminate double taxation and prevent fiscal evasion. The meaning of the term "fiscal evasion" was unclear; some countries interpreted it broadly to include tax avoidance while others, such as Switzerland, restricted the term to criminal tax evasion. The references in the preamble to the avoidance of double taxation and prevention of fiscal evasion were eliminated from the OECD and UN Model Treaties and moved to a footnote in 1992 and 2001 respectively. However, in 2003 the Commentary on the OECD Model Treaty was revised to include an explicit statement that "[I]t is also a purpose of tax conventions to prevent tax avoidance and evasion" (paragraph 7 of the Commentary on Article 1). Although the Commentary on the UN Model Treaty does not reproduce this sentence from the OECD Commentary, it is reasonably clear from the UN Commentary on Article 1 that one of the important purposes of the treaty is to prevent tax avoidance and the improper use of the treaty.

The increasing focus on the use of tax treaties to facilitate tax avoidance led the OECD, as part of the BEPS project, to recommend changes to the title and preamble of the OECD Model Treaty to refer explicitly to the prevention of tax avoidance (see BEPS Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, available at www.oecd.org and discussed in section 8.8.2.3). The proposed title of the OECD Model Treaty will be "Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and on capital and the prevention of tax evasion and avoidance." The proposed preamble will also include explicit references to double non-taxation and treaty shopping:

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

Although the elimination of tax avoidance and evasion is an explicit objective of most tax treaties, few provisions in those treaties are designed to achieve that objective. Both the OECD and UN Model Treaties contain provisions for the exchange of

information (Article 25) and assistance in the collection of taxes (Article 27). These provisions give the contracting states two important tools to prevent tax avoidance and evasion; however, neither Model Treaty currently contains any general anti-avoidance rule, and both Model Treaties contain few specific anti-avoidance rules. The OECD BEPS Action 6 proposes to add a detailed anti-treaty shopping rule similar to the limitation-on-benefits provision included in US tax treaties; it also proposes to add a general anti-abuse provision to the OECD Model, under which treaty benefits would be denied if one of the principal purposes of a transaction or arrangement was to avoid tax, unless the treaty benefits are in accordance with the object and purpose of the treaty. See sections 8.8.2.1 and 8.8.2.2 for a discussion of treaty abuse and treaty shopping respectively.

In addition to the two principal operational objectives of tax treaties, there are several other ancillary objectives. One ancillary objective, which is discussed in section 8.8.1, below, is the elimination of discrimination against foreign nationals and non-residents. Most countries entering into tax treaties want to ensure that their residents are treated the same as residents of the other contracting state, and certainly no worse than residents of any third state. Other ancillary objectives, discussed in section 8.8.4 below, are the exchange of information between the contracting states and assistance in the collection of taxes. As noted above, allowing countries to obtain information about the income-earning activities of taxpayers is an important tool in combating tax avoidance and, more generally, in ensuring that the provisions of the treaty are applied properly. Similarly, requiring countries to provide assistance in collecting the taxes imposed by their treaty partners can prevent taxpayers from avoiding and evading tax by moving to another country or hiding assets or funds in another country. Finally, most contracting states provide a mechanism in their treaties for resolving disputes with respect to the application of the treaty and, in particular, transfer pricing disputes. Dispute-resolution mechanisms are discussed in section 8.8.3, below.

An important effect of tax treaties – and an implicit purpose – is to provide certainty for taxpayers with respect to the tax consequences of cross-border investment. Investors like certainty. Tax treaties have an average life of approximately fifteen years. As a result, nonresident investors know that, despite changes that will inevitably be made to the tax laws of the source country, the basic limitations in the treaty on the source country's right to tax will prevent future changes from affecting those limitations. For example, if Company A, a resident of Country A, makes an investment in the shares of Company B, a resident Country B, Company A knows that the limit provided in the treaty between Country A and Country B on the rate of withholding tax imposed by Country B on dividends will continue to apply even if Country B increases the rate of withholding tax on dividends under its domestic law.

Another important effect, and an implicit objective, of a tax treaty is the allocation of tax revenues from cross-border activity between the two contracting states. The provisions of tax treaties determine how much tax revenue from the cross-border activity between the two states will be subject to tax by each of those states. For example, if Country A agrees to include in its treaty with Country B a provision similar

to Article 12 of the OECD Model Treaty dealing with royalties, any royalties paid by residents of Country A to residents of Country B will be taxable exclusively by Country B, and vice versa. If royalty flows between Country A and Country B are relatively equal, the allocation of the tax revenues from those flows will also be relatively equal. However, if the flows are disproportionately from residents of Country A to Country B (as would usually be the case if Country A is a developing country and Country B is a developed country), the tax revenues would be allocated disproportionately to Country B. Country A might attempt to avoid this result by insisting that Article 12 of the treaty allow the source country to tax royalties paid by its residents to residents of the other country at a limited rate of, say 15 percent. In this case, Country A would derive tax revenues equal to 15 percent of any royalties paid by its residents to residents of Country B, and Country B would derive tax revenues equal to its tax rate on royalties derived by its residents from residents of Country A, less 15 percent of those royalties.

8.6 INTERPRETATION OF TAX TREATIES

8.6.1 Introduction

In certain respects, the interpretation of tax treaties is similar to the interpretation of domestic tax legislation. The meaning of the words of the treaty, the context in which they are used, and the purpose of the treaty are generally important factors in interpreting both treaties and domestic tax legislation. As a result, it seems likely that a country's tax authorities and its courts would interpret tax treaties in the same manner as domestic tax legislation. There are, however, several important differences between tax treaties and domestic tax legislation:

(1) Because tax treaties are bilateral, questions of interpretation should be resolved by reference to the intentions of both states.
(2) Tax treaties are addressed to both the governments and the taxpayers of both countries, whereas domestic tax legislation has a narrower scope.
(3) Tax treaties are often drafted using different terms from those used in domestic legislation. For example, the OECD and UN Model Treaties use the term "enterprise," which is not used in the domestic legislation of many countries.
(4) Unlike domestic tax legislation, tax treaties do not generally impose tax; they limit the taxes imposed by the contracting states.
(5) The influential OECD Model Treaty and Commentary and the UN Model Treaty and Commentary have no counterparts in the context of domestic tax legislation.

These differences may suggest that tax treaties should be interpreted differently from domestic tax legislation. However, the interpretation of any language, including the provisions of tax treaties and domestic tax rules, is a matter of judgment that cannot be reduced to mechanical rules.

8.6.2 The Interpretive Provisions of the *Vienna Convention on the Law of Treaties*

The interpretation of tax treaties is governed by customary international law, as embodied in the *Vienna Convention on the Law of Treaties*. The interpretive rules of the Vienna Convention apply to all treaties, not just tax treaties. As discussed in section 8.2.1 above, the provisions of the Vienna Convention are binding on all nations because they represent a codification of customary international law.

Article 31(1) of the Vienna Convention provides a basic rule for the interpretation of treaties:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.

Under Article 31(2), the context of a treaty includes the text of the treaty, any agreements between the parties made in connection with the conclusion of the treaty, and any instrument made by one party and accepted by the other party. For example, the US produces a technical explanation for each of its tax treaties, and Canada publicly announced its acceptance of the US technical explanation of the US-Canada treaty. Under Article 31(3), subsequent agreements between the parties to the treaty and their subsequent practice with respect to the interpretation of the treaty, and any applicable rules of international law, must also be taken into account, together with the context. Article 31(4) provides that a treaty term may have a special meaning rather than its ordinary meaning if it is established that the parties so intend. The Commentary on the OECD or UN Model Treaty may provide evidence that a term is intended to have a special meaning.

The basic interpretive rule in Article 31(1) of the Vienna Convention makes intuitive sense. Obviously, the first step in any interpretive exercise must be to carefully consider the ordinary meaning of the words of the treaty. And those words must be read in their context - the particular provision in which the words are used and the treaty as a whole - because the meaning of words is always dependent on the context in which they are used. It also makes sense to interpret the terms of a treaty in light of the purpose of the provision and the treaty as a whole because, obviously, the contracting states are trying to accomplish something by entering into the treaty and agreeing on its terms.

Although Article 31(1) of the Vienna Convention makes sense, it must also be acknowledged that it is vague and does not provide any clear, meaningful guidance for taxpayers, tax authorities, or courts about how to interpret treaties. Most importantly, it does not indicate how much weight to give to the ordinary meaning of the words, the context, and the purpose of the relevant provisions of the treaty in any particular case. For example, if there is a conflict between the ordinary meaning of the words and the purpose of the relevant provision, Article 31(1) does not indicate how the conflict should be resolved. Although most courts and commentators would take the position that words with a relatively clear meaning should not be disregarded in order to carry

out an unexpressed, uncertain purpose, it is difficult to write an interpretive rule as to how all the relevant factors should be weighed in any particular case.

Under Article 32 of the Vienna Convention, other material, referred to as supplementary means of interpretation, which includes the *travaux préparatoires* (preparatory work) of the treaty, should be considered only to confirm the meaning established pursuant to Article 31, or to establish the meaning if applying Article 31 produces an ambiguous, obscure, absurd, or unreasonable result.

Although the Commentaries on the OECD and UN Model Treaties are very important for the interpretation of tax treaties, their legal status under the provisions of the Vienna Convention is unclear. At first glance, they appear to be supplementary means of interpretation under Article 32. If so, they are relevant only to confirm the meaning otherwise established by the application of the basic interpretive rule in Article 31, or to establish the meaning if the meaning under Article 31 is ambiguous, obscure, absurd, or unreasonable. The OECD does not intend for the Commentary to have such a limited role. In the Introduction to the Commentary, it is stated that the Commentary "can be ... of great assistance in the application and interpretation of the conventions and, in particular, in the settlement of any disputes" (paragraph 29). It is difficult, however, to justify including the Commentary as part of the context of a treaty under Article 31 of the Vienna Convention, especially if the treaty being interpreted was entered into before the Commentary was revised, or if one of the contracting states is not a member of the OECD and therefore had no part in the preparation of the Commentary.

Although the status of the OECD Model Treaty and Commentary under the Vienna Convention is a controversial topic among international tax scholars, the issue appears to be of little practical significance. In treaty cases from virtually all countries, the courts invariably give the OECD Model Treaty and Commentary substantial weight.

The provisions of tax treaties should be interpreted in the same way in both countries (the principle of common interpretation) because otherwise income may be taxed twice, or not at all. Assume, for example, that Company A, a resident of Country A, performs services in Country B for the benefit of Company B, a resident of Country B. The services result in the creation of some work product used by Company B. Company A receives a payment from Company B that is characterized under the laws of Country B as compensation for services performed in Country B. In contrast, Country A characterizes the payment as a royalty for allowing Company B to use Company A's work product. Under the tax treaty between the two countries, fees for personal services are taxable in the source state, but royalties are taxable exclusively by the residence state. Under these circumstances, Company A will be subject to double taxation unless the competent authorities of the two countries can resolve the matter. Country B will impose tax on Company A's income in accordance with Article 7 of the treaty (assuming that Company A has a PE in Country B); in contrast, Country A will impose tax on the payments received by Company A as royalties under Article 12 of the treaty. Country A may not provide any relief for the tax imposed by Country B because Country B's tax is not imposed on the royalties.

Several countries have multiple official languages. When these countries enter into tax treaties, there may be multiple official versions of the treaty in different

languages. Article 33 of the Vienna Convention provides that all versions of tax treaties concluded in multiple languages are considered to be equally authentic unless the provisions of the treaty specify that one version is to govern in the event of a conflict. Some countries that conclude their tax treaties in multiple languages, such as China, provide that the English-language version of the treaty will prevail where the versions conflict.

8.6.3 The Interpretation of Undefined Terms in Accordance with Domestic Law – Article 3(2)

In addition to the provisions of the Vienna Convention, tax treaties based on the OECD and UN Model Treaties contain an internal rule of interpretation. Article 3(2) of the OECD and UN Model Treaties provides as follows:

> As regards the application of the Convention at any time by a contracting state, any term not defined therein shall, unless the context requires otherwise, 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.

In effect, Article 3(2) provides that undefined terms used in the treaty have the meaning that they have under the domestic law of the country applying the treaty unless the context requires otherwise. For this purpose, a country applies a treaty when it takes any relevant action with respect to the treaty, such as issuing a ruling or an assessment of tax.

The application of Article 3(2) involves a three-stage process:

(1) Does the treaty provide a definition of the term?
(2) If the treaty does not provide a definition of the term, what is its domestic meaning?
(3) Does the context of the treaty require a meaning different from the domestic meaning?

The first step is not as simple as it appears, in part because some definitions in tax treaties are inclusive, while others are exclusive. For example, Article 3(1)(a) defines a "person" to include an individual, a company, and any other body of persons. In contrast, the definition of "company" in Article 3(1)(b) is exclusive ("company means ..."). Generally, an inclusive definition means that the term has its ordinary meaning plus the items that are specifically mentioned. Does Article 3(2) apply to determine the ordinary meaning under domestic law of terms that are defined inclusively, such as "person"? In my view, Article 3(2) should apply in these circumstances so that the term "person" would include any legal entity that is considered to be a person under the domestic law of the state applying the treaty. A further difficulty is that definitions in a treaty often contain terms that are undefined; for example, the terms "individual" and

"body of persons" in Article 3(1)(a) are not defined. Again, in my view, these terms should take their meaning from domestic law by virtue of Article 3(2).

The determination of the meaning of a term under domestic law may also be difficult. Article 3(2) provides that the meaning of an undefined term under a country's tax law prevails over the meaning under other domestic laws. An undefined term, however, may have more than one meaning for purposes of a country's tax law. In this situation, the domestic meaning that is most appropriate should be used for purposes of the treaty. Also, Article 3(2) refers to the "meaning" of an undefined term, not to its definition, under domestic law. A term may not be defined for purposes of a country's tax law, but it should have an ordinary meaning.

The final step in the application of Article 3(2) is to consider whether the context of the treaty requires a term to be given a different meaning from its meaning under domestic law. For this purpose, it is necessary to consider alternative meanings for the term for purposes of the treaty and whether one of these meanings is more appropriate in the context of the treaty than the domestic law meaning. Matters that should be considered in this analysis include:

- the ordinary meaning of the term as compared to the meaning under the domestic tax law;
- the meaning of the term under the other country's tax law;
- the purpose of the relevant provision of the treaty; and
- extrinsic material such as the Commentary on the OECD or UN Model Treaty.

Some international tax scholars argue that in applying Article 3(2), if at all possible, undefined terms should be given a meaning that is independent of domestic law and that a domestic law meaning should be used only as a last resort. Other scholars argue that Article 3(2) contains a preference for domestic law meanings because those meanings are displaced by treaty meanings only if "the context requires otherwise." The use of the word "requires," they argue, places a substantial onus on those seeking to justify a treaty meaning.

In my view, Article 3(2) does not establish any clear preference for domestic law meanings or treaty meanings for undefined terms. Furthermore, there are no strong arguments for establishing any residual presumption in favor of either a domestic or treaty meaning of an undefined term. As noted above, the meaning of undefined terms in a tax treaty should be determined by reference to all the relevant information.

Another important and controversial issue of interpretation in connection with Article 3(2) of the OECD and UN Model Treaties is whether a term has its meaning under domestic law at the time that the treaty was entered into (the static approach) or its meaning under domestic law as amended from time to time (the ambulatory approach). Article 3(2) of the OECD Model Treaty was amended in 1995 to clarify that Article 3(2) should be applied in accordance with the ambulatory approach. A similar conforming amendment was made to the UN Model Treaty in 2001. The ambulatory approach allows treaties to accommodate necessary changes to domestic law without the need to renegotiate the treaty. As a result, the ambulatory approach effectively permits a country to unilaterally amend its tax treaty with another country by changing

its domestic law. However, an amendment to domestic law that significantly alters the bargain between the two countries, and was not contemplated by both countries when the treaty was negotiated, is equivalent to a treaty override.

8.7 SUMMARY OF THE PROVISIONS OF THE OECD AND UN MODEL TREATIES

8.7.1 Introduction

This section describes the major provisions of the OECD and UN Model Treaties. Section 8.7.2 describes the provisions that identify the parties to a treaty and the persons whose tax obligations are affected by it, that establish the scope of the treaty, and that govern its ratification, termination, and amendment. Section 8.7.3 describes the treatment of various categories of income under a typical tax treaty; these provisions are known as the distributive rules of a treaty. Section 8.7.4 describes the rules dealing with administrative matters and cooperation between the treaty partners.

Every tax treaty includes some provision for relieving or mitigating double taxation. In the OECD and UN Model Treaties, relief from double taxation is provided either by Article 23A (Exemption Method) or Article 23B (Credit Method). Methods of providing relief from double taxation are discussed in Chapter 4.

To prevent tax avoidance through transfer pricing, the domestic tax laws of most countries give the tax authorities the power to adjust prices in transactions between related persons to reflect the prices that would have prevailed if the transaction had taken place at arm's length with an unrelated person. Article 9 (Associated Enterprises) of the OECD and UN Model Treaties provides that the contracting states are permitted (indeed, expected) to adjust prices and recompute profits from related-party transactions in accordance with this so-called arm's-length standard. Transfer pricing and the arm's-length standard are discussed in Chapter 6.

8.7.2 Coverage, Scope, and Legal Effect

The two countries that enter into a bilateral income tax treaty are called the "contracting states." Under Article 1 (Personal Scope) of the OECD and UN Model Treaties, the provisions of the treaty apply to persons who are "residents of one or both of the contracting states." Article 4 (Resident) defines a "resident" of a contracting state for purposes of the treaty as a person who is liable to tax under the domestic laws of that contracting state on the basis of certain connecting factors, such as residence, domicile, place of management, or other similar criterion. As discussed in Chapter 2, section 2.2.3, Article 4 also includes tie-breaker rules that prevent a person from being a resident of both contracting states for purposes of the treaty. A "person" is defined in Article 3 (General Definitions) to include "an individual, a company and any other body of persons." The OECD Commentary indicates that a charitable foundation is a "person" within the meaning of Article 3 - indeed, any legal entity that is recognized

under the laws of a contracting state is likely to be treated as a "person" for tax treaty purposes. Although a partnership is probably a body of persons and therefore a person for purposes of the OECD and UN Model Treaties, it may not be a resident of a contracting state if the partners rather than the partnership are liable to tax in that state.

Article 2 (Taxes Covered) of the OECD and UN Model Treaties specifies that the treaty applies "to taxes on income and on capital imposed on behalf of a contracting state or of its political subdivisions or local authorities." Some treaties do not extend coverage to subnational income taxes. Despite any limitations in Article 2, Articles 24, 26 and 27 of the OECD and UN Model Treaties dealing with nondiscrimination, exchange of information, and assistance in the collection of taxes apply to all taxes imposed by the contracting states and not just those taxes described in Article 2.

The typical tax treaty expressly lists the national taxes (and sometimes the subnational taxes) of the contracting states to which the treaty applies. Each country's personal income tax and corporate income tax are invariably listed. Most treaties also provide that the treaty applies to amendments of the listed taxes and to subsequently imposed taxes that are identical or substantially similar to the listed taxes. Some treaties also list certain income and capital taxes that are not to be covered by the treaty; for example, many tax treaties exclude from their scope payroll and social security taxes earmarked for government pensions.

According to Article 30 (Entry into Force) of the OECD Model Treaty and Article 29 (Entry into Force) of the UN Model Treaties, tax treaties become effective on ratification and the states should agree to exchange instruments of ratification as soon as possible. Each contracting state has its own internal procedures for ratifying treaties that must be satisfied. For example, many countries provide that a treaty negotiated by the government must receive legislative approval to be effective. Once these internal procedures have been satisfied, the contracting states will exchange instruments of ratification. Generally, tax treaties become effective on the first day of the calendar year following the exchange of the instruments of ratification with respect to provisions of the treaty that apply on the basis of taxation years, such as Article 7 (Business Profits). Other provisions of the treaty, such as the provisions dealing with withholding rates in the source country, may take effect earlier or later than the rest of the treaty. In addition, certain provisions of the OECD and UN Model Treaties may apply retrospectively. For example, a request for information or for assistance in the collection of taxes may relate to a year before the treaty entered into force. Such a request is valid as long as it is made after the treaty becomes effective.

Although tax treaty partners contemplate that their relationship will last indefinitely, their treaties provide for the termination of the treaty at the request of either party. Under Article 31 (Termination) of the OECD Model Treaty and Article 30 (Termination) of the UN Model Treaty, a contracting state may unilaterally terminate a treaty as of the beginning of the next calendar year by giving notice of termination to its treaty partner at least six months before the end of the current year. The contracting states may terminate a treaty at any time by mutual consent, although some treaties provide that a new treaty must remain in effect for a minimum period after it enters into force.

8.7.3 The Distributive Rules: Articles 6 through 21

8.7.3.1 Introduction

Articles 6 through 21 of the OECD and UN Model Treaties deal with the treatment of various types of income, from broad categories such as business profits to quite narrow categories such as directors' fees and pensions. This approach inevitably means that conflicts arise as to how amounts should be categorized for purposes of the treaty. These conflicts are sometimes resolved by definitions in the relevant articles. For example, Article 10(3) defines dividends as income from shares or other rights "not being debt-claims" and Article 11(3) defines interest as "income from debt-claims of every kind." Consequently, Articles 10 and 11 cannot both apply to the same amount – if an amount is income from a debt-claim, it is interest and cannot be a dividend. Sometimes the conflicts are resolved pursuant to specific provisions in the treaty. For example, where Article 7 and another article both apply, Article 7(4) of the OECD Model (Article 7(6) of the UN Model) gives priority to the other article. Some conflicts are not resolved by specific rules. Where an item of income is not covered by any of the specific articles (Articles 6-20), it is dealt with in Article 21 (Other Income).

The wording of the distributive rules of the OECD and UN Model Treaties is remarkably consistent. Where an article uses the words "shall be taxable only" in one of the contracting states, it means that the other state is precluded from taxing the relevant income. For example, under Article 8(1), profits from the operation of ships or aircraft in international traffic "shall be taxable only" in the country in which the enterprise has its place of effective management. In contrast, where the words "may be taxed" in a contracting state are used, it means that the relevant amount may be taxed by that country; however, it does not mean that the amount is not taxable by the other contracting state. In other words, the words "may be taxed" mean that the contracting states are both entitled to tax the relevant amount under the treaty. In these circumstances, the source country's tax takes priority and Article 23 requires the residence country to provide relief from double taxation by exempting the income from residence country tax or granting a credit for the source country tax against the residence country tax.

8.7.3.2 Business Income

The OECD and UN Model Treaties distinguish between several types of business income. For example, profits from immovable property, profits from international shipping and air transportation, and profits from entertainment and athletic activities are dealt with under Articles 6, 8, and 17 respectively. Article 7 of the OECD and UN Model Treaties applies to business profits that are not covered by a more specific article. Article 7 (Business Profits) provides that "an enterprise of a contracting state" is exempt from tax on its profits derived from business carried on in the other contracting state unless the business is carried on through a permanent establishment (PE) located in that other contracting state and the profits are attributable to the PE.

This limitation on a country's source jurisdiction is discussed in Chapter 2. The definition of a PE is provided in Article 5 (Permanent Establishment) and is discussed below. Article 3 (General Definitions) defines "an enterprise of a contracting state" as an enterprise carried on by a resident of a contracting state.

If an enterprise of a contracting state has a PE in the other contracting state, it is taxable by the other state only on the profits attributable to the PE. Article 7(2) of the OECD and UN Model Treaties provides that the profits of a PE should be determined on the assumption that the PE is a separate and distinct entity dealing independently with the other parts of the enterprise of which the PE is a part. The effect of these assumptions in Article 7(2) is that the transfer pricing rules applicable to associated enterprises under Article 9 also apply, by analogy, for the purpose of determining the profits attributable to a PE. The difficulties that arise in applying the arm's-length principle to determine the profits attributable to a PE are addressed in section 8.8.5 below.

Article 7 of the OECD Model Treaty does not use a so-called force-of-attraction approach, under which all of a taxpayer's income derived from a country is subject to tax by that country if it has a PE in that country. Under Article 7, if a taxpayer has a PE in a country, only the taxpayer's profits from the business that are attributable to the PE are subject to tax by that country. Other income may be taxable under other articles of the treaty, but not under Article 7.

Article 7(1) of the UN Model Treaty employs a limited force-of-attraction principle in determining the income attributable to a PE. Under that principle, if an enterprise has a PE in a contracting state, it is taxable by that state not only on the profits attributable to the PE, but also on profits derived from sales in that state of goods similar to those sold through the PE or from business activities in that state similar to the activities conducted through the PE. Although this limited force-of-attraction rule in the UN Model Treaty may appear to broaden the scope of Article 7 and reduce the opportunities for tax avoidance, the rule is easily avoided if profits unrelated to a PE are earned by a related nonresident entity.

The Definition of a Permanent Establishment

Under Article 5(1) of the OECD and UN Model Treaties, a PE is defined as "a fixed place of business through which the business of an enterprise is wholly or partly carried on." This language is used in essentially identical form in almost all tax treaties.

For an enterprise to have a "fixed place of business" in a contracting state, it must operate at a specific geographical location, and its activities at that location must continue for more than a temporary period (generally for more than six months). Thus, a taxpayer that does business at various locations in a country for an aggregate of more than six months does not have a fixed place of business PE in that country. The place where equipment, such as an oil pumping machine, is used can constitute a fixed place of business even if that machine is unattended by human agents of the enterprise. However, some countries take the position that human intervention is necessary for a place of business to constitute a PE.

For a place of business to be "fixed" in a geographical sense, it must have both geographical and commercial coherence. For example, a marketplace can be the fixed

place of business of an enterprise if the enterprise operates within that marketplace on a regular basis, even though it may use a different stall from time to time, because the marketplace has both geographical and commercial coherence. In contrast, if an interior designer provides services for a client in the client's office occupying a floor in a large office building for four months and then provides services for a different client with an office on a different floor in the same building for another four months, the office building cannot be considered to be the designer's PE. Although the building has geographical coherence (it is a fixed place), the offices where the designer works do not have commercial coherence because they are leased by different clients. Similarly, if the designer does work in two different buildings owned by the same person, those buildings are not the designer's PE, since the buildings do not have geographical coherence (they are different fixed places) although they do have commercial coherence. However, multiple buildings may have geographical coherence if they are part of a campus or office complex that constitutes a single location.

It is immaterial whether an enterprise rents or owns its premises in determining whether the premises constitute a PE, as long as the place is at its disposal (see paragraph 4 of the OECD Commentary). This concept of a place being at the taxpayer's disposal is problematic. It is clear that the taxpayer does need to have a legal right to use the place; on the other hand, it appears that the mere use of a place for more than six months is not sufficient to constitute a PE. For example, the OECD Commentary indicates that, if a salesperson employed by an enterprise visits a client's office every day to take orders, the client's office is not at the disposal of the enterprise and is not a PE of the enterprise. The OECD has proposed to amend the OECD Commentary to clarify that a taxpayer must have effective power over a place for it to be at the taxpayer's disposal (see OECD Discussion Draft, OECD, Discussion Draft, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (OECD 2011), www.oecd.org/dataoecd/23/7/48836726.pdf) and OECD, *Revised Proposals concerning the Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention* (OECD 2012), available at www.oecd.org/ctp/treaties/PermanentEstablishment.pdf).

Both the OECD and UN Model Treaties provide that a building site or construction or installation project constitutes a PE if the project continues for at least twelve months in the case of the OECD Model Treaty (Article 5(3)) and six months in the case of the UN Model Treaty (Article 5(3)(a)). Both provisions apply to assembly and supervisory activities conducted in connection with a building or assembly site. These activities are explicitly included in Article 5(3)(a) of the UN Model Treaty, but not in the OECD Model Treaty, where they are dealt with in the Commentary (paragraphs 17 and 20 of the Commentary on Article 5).

Developing countries typically adopt the six-month period in the UN Model Treaty (or an even shorter minimum period for construction sites) in their tax treaties; for example, the minimum period in the India-US treaty is four months. A few treaties between developed countries extend the minimum period beyond one year. The Japan-US treaty, for example, has a twenty-four month period.

The construction site provisions in the OECD and UN Model Treaties are commonly misunderstood as deeming provisions. They are properly interpreted as an

additional condition that must be met in order for a construction site to constitute a PE. In other words, a construction site must satisfy the conditions of a fixed place of business under Article 5(1) and must also last for at least twelve months (OECD) or six months (UN). Thus, a project that involves construction activities at different locations in a country for an aggregate of more than twelve months is not a PE if the activities at each location do not last for at least twelve months. Each place at which construction occurs must be treated as a separate place unless the places have geographical and commercial coherence, as discussed above.

If the definition of a PE were limited to fixed places of business, it would be too narrow and would not apply to many types of businesses that do not need to be carried on through a fixed place of business. Consequently, both the OECD and UN Model Treaties extend the definition of a PE to include certain dependent agents acting on behalf of an enterprise. Under Article 5(5) of both Model Treaties, a resident of one contracting state is deemed to have a PE in the other contracting state if a person (often referred to as a dependent agent) has and habitually exercises on behalf of the resident an authority to conclude contracts that are binding on the resident. The agent must have not only legal authority to conclude contracts "in the name of the enterprise" but it must also do so habitually, which means regularly or repeatedly. The phrase "in the name of the enterprise" is not intended to have a literal meaning; it is sufficient if the contracts are legally binding on the enterprise.

The deemed PE rule in Article 5(5) does not apply if the person acting on behalf of an enterprise is an agent of independent status who is acting in the ordinary course of business (Article 5(6) of the OECD Model Treaty and Article 5(7) of the UN Model Treaty). Whether a person is an independent agent depends on all the facts and circumstances, although the Commentary on Article 5(6) of the OECD Model indicates that a person must be both legally and economically independent. Thus, an employee is invariably a dependent agent and a person who acts exclusively for one enterprise is likely to be considered a dependent agent in most circumstances.

The agency rule in the UN Model Treaty is more expansive than the OECD rule; it extends to dependent agents that habitually maintain a stock of goods from which they make deliveries on behalf of an enterprise. In addition, under Article 5(7) of the UN Model Treaty, an agent cannot be independent if the agent acts exclusively or almost exclusively for one enterprise and the commercial and financial relations between them are not at arm's length.

Many multinational corporations have used **commissionaire arrangements** to avoid having a PE in a country. A commissionaire arrangement is a legal relationship recognized under the civil law, under which one person enters into contracts in the name of or on behalf of another person, but those contracts are not legally binding on that other person. Therefore, multinational corporations can structure their affairs so that a group company in a low-tax country sells its products through another group company in a high-tax country to customers in that country as a commissionaire for the low-tax group company. The commissionaire does not own the goods and the contracts it enters into with customers are not legally binding on the group company that owns the goods. The result is that the group company acting as a commissionaire earns only a small profit from its activities; that profit is taxable in the high-tax country in which

it is resident. However, the group company in the low-tax country earns most of the profit from the sale of the products, and that company is not taxable in the high-tax country because it does not have a PE there.

Dell computers used this type of commissionaire arrangement to avoid tax in several high-tax European countries. A Dell group company established in Ireland sold computers to another group company established in Norway that resold the computers to customers in Norway. The Norwegian Supreme Court held that Dell Ireland did not have a PE in Norway (see *Dell Products v. The State*, December 2, 2011 *(Tax East)*, HR-2011-02245-A (Case No. 2011.755), Tax Treaty Case Law IBFD). The French Conseil d'Etat reached the same result in the Zimmer case, (see *Société Zimmer Limited*, March 31, 2010, Case No. 304715 and No. 308525, Tax Treaty Case Law IBFD.)

The OECD's revised discussion draft on BEPS Action 7: *Preventing the Artificial Avoidance of PE Status*, May 2015, available at www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-7-pe-status.pdf, proposes to amend Articles 5(5) and (6) to prevent the use of commissionaire arrangements to avoid PE status. Article 5(5) will be amended to deem an enterprise of one contracting state to have a PE in the other state if a person habitually concludes contracts or negotiates the material elements of contracts on behalf of the enterprise and if the contracts are in the name of the enterprise, for the transfer of the ownership or use of property owned or leased by the enterprise, or for the provision of services by the enterprise. Thus, a typical commissionaire arrangement would be covered by this provision because the commissionaire negotiates the material elements of the contracts for the sale of the goods owned by the principal even though those contracts are not legally binding on the principal. Article 5(6) will be amended to provide that a person who deals exclusively or almost exclusively with one or more enterprises with which it is connected will not be considered to be an independent agent. Thus, commissionaires will not be able to argue that they are independent agents.

The deemed agency PE rule in Article 5(5) of both Model Treaties does not apply if an agent's activities are limited to the exempt activities (generally preparatory or auxiliary activities) listed in Article 5(4), which is discussed below.

Under Article 5(6) of the UN Model Treaty, an enterprise engaged in the sale of insurance in a contracting state is deemed to have a PE in that state if it collects premiums in that state or ensures risks located in that state. This rule does not apply, however, if these activities are conducted by an independent agent acting in the ordinary course of business.

Article 5(3)(b) of the UN Model Treaty provides that an enterprise is deemed to have a PE in a contracting state if it performs services in that state through employees or other personnel for a period of at least 183 days in any twelve-month period with respect to the same or a connected project. Whether projects are connected must be determined based on all the facts and circumstances. The OECD Model Treaty has no comparable provision, although the OECD Commentary contains an alternative services PE provision that countries may adopt (see paragraph 42.23 of the OECD Commentary on Article 5).

Under the UN Model Treaty, income from the performance of independent personal services is taxable under Article 14 and not under Article 7. This approach was also followed under the OECD Model Treaty until 2000, when Article 14 was deleted. The taxation of independent personal services is discussed in section 8.7.3.3 below.

Article 5(4) of the OECD and UN Model Treaties provides an exemption from the definition of a PE for fixed places of business that are used exclusively for certain preparatory or auxiliary activities. Under both models, a fixed place of business of an enterprise used solely for the following activities is deemed not to be a PE:

- the storage or display of goods owned by the enterprise;
- the maintenance of a stock of goods owned by the enterprise for storage or display or for processing by another enterprise;
- purchasing goods or collecting information for the enterprise; and
- other activities of a preparatory or auxiliary character.

In addition, a fixed place of business used solely for a combination of the activities set out above is deemed not to be a PE as long as the overall activity is preparatory or auxiliary. Article 5(4) of the OECD Model also applies to a fixed place of business used solely for the delivery of goods owned by an enterprise. Therefore, if an enterprise owns or rents a warehouse in a country that it uses to store goods owned by it and to deliver those goods to customers, the warehouse would not be a PE of the enterprise. In contrast, under the UN Model Treaty, the warehouse would be a PE because delivery of goods is not an exempt activity. (Note that under both Model Treaties, if a warehouse is used to store goods owned by other enterprises, it will be a PE.)

The OECD's BEPS Action 7: *Preventing the Artificial Avoidance of PE Status* (October 31, 2014), available at www.oecd.org/ctp/treaties/action-7-pe-staus-public-discussion-draft.pdf proposes that Article 5(4) should be revised to ensure that the exemption in that article is available for the listed activities only if they are truly preparatory or auxiliary. Thus, a large warehouse owned by an enterprise and used to store goods that are sold through online shopping websites would be considered to be a PE. An alternative would be to delete the exemptions for delivery of goods, purchasing, and collecting information.

According to Article 5(7) of the OECD Model Treaty and Article 5(8) of the UN Model Treaty, a subsidiary resident in a country or carrying on business in a country does not constitute a PE of its parent company in that country simply because the parent controls it. Similarly, a parent company is not a PE of its subsidiary. Thus, a company resident in Country A that owns a subsidiary resident or carrying on business in Country B does not have a PE in Country B simply because it controls the subsidiary. However, the parent company might have a PE in Country B if its subsidiary habitually enters into contracts binding on its parent or if facilities owned or leased by the subsidiary are at the disposal of the parent company and used by it for more than six months. The Commentary on both the OECD and UN Model Treaties indicates that, with respect to a multinational group, the determination whether a PE exists must be

made separately for each company in the group; just because one group company has a PE in a country does not mean that any other group company has a PE in that country.

International Shipping and Air Transportation

Under Article 8 of the OECD Model Treaty and Article 8 (Alternative A) of the UN Model Treaty, business profits derived by an enterprise resident in one contracting state from the operation of ships or aircraft in international traffic are taxable exclusively by the state in which the enterprise has its place of effective management. Some treaties assign the exclusive right to tax to the country of residence of the enterprise in order to avoid uncertainty about the meaning of the place of effective management of an enterprise. The definition of "international traffic" (Article 3(1)(e)) for purposes of Article 8 is extremely broad and includes all transport other than transport of goods or persons solely between places in a country. Thus, Article 8 does not permit a country to tax the profits derived by an enterprise whose place of effective management is located in the other contracting state from taking goods or passengers on board in the country or unloading goods or passengers in the country. For example, an airline with its place of effective management in Country A that starts flights outside Country B, stops in Country B to drop off passengers and take on passengers, and completes the flights outside Country B would not be subject to tax by Country B. However, if the airline operates a flight that stops in Country B to pick up passengers and then stops at another location in Country B, Country B is allowed to tax the profits from the portion of the flight that takes place solely in Country B.

Article 8 (Alternative B) of the UN Model Treaty permits the source country to tax income derived from shipping (but not air transportation) activities if such activities are "more than casual." According to the Commentary, more than casual means any planned trip to a country to pick up goods or passengers.

Income from Entertainment and Athletic Activities

Under Article 17 of both the OECD and UN Model Treaties, income derived by an entertainer or athlete resident in one contracting state from entertainment or athletic activities performed in the other state are taxable in that other state without any threshold requirement or any limitations. Thus, a country is entitled to tax an entertainer or athlete who is present in the country for only a short period on the gross amount received by the entertainer or athlete without any limit on the rate of tax.

Article 17 provides a sharp contrast with Article 7, under which a source country is entitled to tax a nonresident on business profits only if the nonresident has a PE in the source country and only if the net profits are attributable to the PE. It is difficult to justify Article 17 on any principled basis. Some entertainers and athletes can make large sums of money in a relatively short time, and countries want their share of that money. However, other taxpayers, such as consultants and celebrities, who can also earn large sums in a relatively short time, are not subject to tax if they earn income in another country without any PE or fixed base in that country. Also, many entertainers and athletes earn only modest amounts from their entertainment and athletic activities; nevertheless, under the terms of Article 17, they are subject to tax without any limitations by the country in which their activities are exercised.

Article 17(2) contains an anti-avoidance rule that allows a country to tax income from entertainment or athletic activities occurring in the country even if the income is assigned by the entertainer or athlete to another person. For example, an entertainer might perform in a country as an employee of a personal services corporation so that most of the income from the performance is derived by the corporation rather than the entertainer. Article 17(2) allows the country to tax both the entertainer and the corporation.

Leasing income

Rental income derived from leasing equipment is taxable in accordance with Article 7 of the OECD Model Treaty. Therefore, such income is subject to tax by a country only if the taxpayer has a PE in the country and the income is attributable to the PE. Until 1992, such rental income was included in the definition of royalties for purposes of Article 12, so that the source country was precluded from taxing the income unless the taxpayer had a PE in the source country and the equipment was effectively connected with the PE (in which case Article 7 applied). However, Article 12 of the UN Model Treaty, which permits taxation of royalties by the source country, continues to treat income from equipment rentals as royalties. As a result, under the OECD Model Treaty, income from equipment leasing is not taxable by the source country unless the taxpayer has a PE in the source country and the income is attributable to the PE. In contrast, under the UN Model Treaty, income from equipment leasing is subject to tax by the source country at a limited rate on the gross rental payments under Article 12 even if the taxpayer does not have a PE in the source country. If the taxpayer does have a PE in the source country and the leasing equipment is effectively connected with the PE, then Article 7 applies.

Rent derived from immovable property situated in a country is taxable by that country in accordance with Article 6 of the OECD and UN Model Treaties irrespective of whether the rent is derived from a business or the taxpayer has a PE in that country. For example, income derived from renting an apartment building would be taxable in the contracting state where the building is located. Article 6 is discussed in section 8.7.3.4 below.

Many difficult issues arise in determining whether an enterprise has a PE in a contracting state as a result of engaging in electronic commerce in that State. Those issues are addressed in Chapter 9, section 9.6.

8.7.3.3 Employment and Personal Services Income

Many provisions of the OECD and UN Model Treaties deal with a wide variety of income from services. The provisions differ significantly, and therefore it is important to distinguish between the various types of services. For example, the basic rule for the taxation of income from employment is Article 15. However, some types of income from employment - such as income from entertainment and athletic activities, directors' fees, remuneration of top-level managerial officials, pensions, and income from government service - are subject to special rules.

It is frequently necessary to distinguish between employment income and independent personal services income in order to determine whether the rules for the treatment of employment income under Article 15, or the rules for the treatment of independent personal services income under Article 14 (or Article 7 of the UN Model Treaty) apply in a particular case. This distinction is important because the rules differ significantly. For example, an individual resident in one contracting state who is employed by an employer resident in the other contracting state is taxable by that other state on any income derived from employment exercised in that state. In contrast, if the individual is an independent contractor, the individual is taxable by the other contracting state only if the individual has a regularly available fixed base or PE in that state or stays in that state for more than 183 days.

Under Article 14 (Independent Personal Services) of the UN Model Treaty, a resident of a contracting state who performs "professional services or other activities of an independent nature" in the other contracting state is not taxable in that State unless he or she has a "fixed base" in the state that is regularly available or stays in the state for more than 183 days in any twelve-month period. The term "professional services" includes the services of physicians, lawyers, engineers, architects, dentists, and accountants, as well as independent scientific, literary, artistic, educational, and teaching activities. Article 14 was included in the OECD Model Treaty until it was removed in 2000. As a result of this change in the OECD Model Treaty, individuals and companies engaged in the performance of independent personal services in a contracting state are taxable in that state only if they have a PE in that state and their income is attributable to the PE.

The concept of a fixed base contained in Article 14 of the UN Model Treaty and the pre-2000 version of the OECD Model Treaty is intended to be equivalent to the concept of a fixed place of business in the definition of a PE in Article 5. However, the deemed agency PE rules and the exception for preparatory and auxiliary activities in Article 5 are not applicable in determining whether an enterprise has a fixed base for purposes of Article 14.

Income from employment performed in a country may be taxable in the country under Article 15 (Dependent Personal Services) of the OECD and UN Model Treaties whether or not the employee has a fixed base in the country. However, such income is exempt from tax in the source country if an employee is paid by a nonresident employer without a PE in the source country and the employee is present in the source country for not more than 183 days in any twelve-month period.

The limitations on source country taxation of professionals and employees do not generally apply to entertainers and athletes (see Article 17 of the OECD and UN Model Treaties). Nor do they apply to nonresidents receiving fees as corporate directors of resident corporations (see Article 16 of the OECD and UN Model Treaties) or remuneration as top-level managers of resident corporations (see Article 16 of the UN Model Treaty). Under Article 16, it is immaterial whether the income of the directors or top-level officials of a company arises from services performed in the contracting state in which the company is resident.

With certain exceptions, individuals performing employment services for the government of a contracting state are taxable only by that state (see Article 19 of the OECD and UN Model Treaties). Diplomats and consular officials who work in a foreign country as members of their government's diplomatic missions are exempt from tax under special agreements or under the rules of international law. A tax treaty would not affect such exemptions (see Article 27 of the OECD and UN Model Treaties).

Under Article 18 of the OECD Model Treaty, individuals receiving pensions on account of past employment are generally taxable only by the contracting state in which they are resident. In contrast, the UN Model Treaty provides some limited scope for taxation by the country where the payer of the pension is resident. Government pensions generally are taxable by the contracting state making the pension payment unless the individual receiving the pension is both a resident and a national of the other contracting state (see Article 19(2) of the OECD and UN Model Treaties).

Students and certain business apprentices or trainees who visit a contracting state for educational or training purposes are generally not taxable in that contracting state on payments for their maintenance, education, or training received from persons resident in the other state (see Article 20 of the OECD and UN Model Treaties). Some tax treaties also provide reciprocal exemptions for visiting professors and teachers.

8.7.3.4 Income and Gains from Immovable Property

Most countries want to retain the right to tax income derived from the sale and rental of immovable property and from the extraction of natural resources located within their territory. Reflecting this consensus view, Article 6 of the OECD and UN Model Treaties allows the country of source to tax income derived from "immovable property" situated in the country. The meaning of the term "immovable property" is determined in accordance with the law of the country in which the property is situated; the term includes income from agriculture, forestry, mineral deposits, and other natural resources. Article 13 of both Model Treaties allows gains from the disposition of immovable property to be taxed by the source country.

Because the source country is entitled to tax both the income derived from immovable property and gains from the disposition of such property, it does not generally matter for purposes of the Model Treaties whether a gain from the disposition of immovable property is characterized as income or capital gain; this characterization issue is left to domestic law. The same approach is used under the OECD and UN Model Treaties for income and gains from property other than immovable property.

Article 13(4) of the OECD and UN Model Treaties provides that a source country is entitled to tax gains from the disposition of shares of a company or an interest in a partnership or other entity if the value of the company, partnership, or other entity is derived primarily from immovable property situated in the country. That provision is intended to prevent a taxpayer from avoiding source country taxation on gains derived from immovable property by transferring the property to a controlled corporation, partnership, or other entity and then disposing of the interests in the corporation, partnership, or entity in a transaction that would otherwise be exempt from source

taxation under the tax treaty. Under Article 13(5) of the UN Model Treaty, the country in which a company is resident is entitled to tax gains from the disposal of a substantial interest in the company.

8.7.3.5 Reduced Withholding Rates on Certain Investment Income

A major objective of most tax treaties is to provide for reduced rates of withholding tax levied by the source country on dividends, interest, and royalties paid to residents of the other contracting state. The goal of these reduced rates is to provide for some sharing of the tax revenue between the source country and the residence country.

The OECD Model Treaty provides that the withholding taxes imposed by a source country will be limited to the rates shown in the table below.

Table 8.1 Maximum Withholding Rates Endorsed by OECD Model Treaty

	Dividends Paid to Corporations with a Substantial Interest	*Dividends Paid to Other Persons*	*Interest*	*Royalties*
Maximum Rate	5%	15%	10%	0%

Source: OECD Model Treaty, Article 10 (Dividends), Article 11 (Interest), and Article 12 (Royalties).

The maximum rates proposed in the OECD Model Treaty, especially the zero rate on royalties, are unacceptable to most developing countries and to many developed countries. The UN Model Treaty does not provide any specific limits on withholding rates, leaving those limits to be negotiated by the contracting states. Most tax treaties with developing countries allow maximum withholding rates that are substantially in excess of the rates provided in the OECD Model Treaty; it is uncommon, for example, for developing countries to agree to a maximum withholding rate on royalties of lower than 15 percent.

Many tax treaties provide for a more complicated set of maximum withholding rates than the simple pattern proposed in the OECD Model Treaty. For example, it is common for tax treaties to impose separate limitations on the withholding rates applicable to industrial royalties, royalties paid with respect to copyrights of literary works, and royalties paid for the showing of motion picture films.

The rules for the taxation of dividends, interest, and royalties under Articles 10, 11, and 12 of the OECD and UN Model Treaties respectively take priority over the rules for the taxation of business profits in Article 7. For example, under Article 11, interest paid by a resident of one contracting state to a resident of the other contracting state is taxable by the first state even if the interest forms part of the business profits of the resident of the other state. However, if the resident of the other state has a PE in the first state and the debt-claim in respect of which the interest is paid is effectively connected with the PE, the interest is taxable by the first state in accordance with Article 7 rather than Article 11 (see Articles 7(4) and 11(4) of the OECD Model Treaty and Articles 7(6)

and 11(4) of the UN Model Treaty). The rules in Articles 10(4), 11(4), and 12(4) of the OECD and UN Model Treaties are known as "throwback rules" because, in the first instance, Article 7 applies to dividends, interest, and royalties that constitute business profits; Article 7 then gives priority to Articles 10, 11, or 12, but those articles then make Article 7 applicable once again.

8.7.3.6 Other Types of Income

Most tax treaties do not impose limits on the rights of the contracting states to tax income, other than those types of income discussed above, derived by their residents. Article 13 of the OECD and UN Model Treaties generally provides that capital gains, other than gains from the disposal of the assets of a PE in the source country, immovable property situated in the source country, ships and aircraft used in international traffic, and interests in corporations, partnerships, and other entities the value of which is derived primarily from immovable property situated in the country, are taxable exclusively by the residence country.

The residual rule contained in Article 21 (Other Income) of the OECD Model Treaty similarly provides that items of income not dealt with in other articles of the treaty are taxable exclusively by the residence country. In contrast, Article 21 of the UN Model Treaty allows the source country to tax other income that arises in the source country. Article 21 of the OECD Model is important with respect to income derived from financial instruments. A tax treaty following the OECD Model Treaty precludes taxation at source of income items that may resemble various traditional types of income, but which are modified by contractual arrangements to constitute a type of income that is not mentioned in the treaty.

8.7.4 Administrative Cooperation

Several provisions in the OECD and UN Model Treaties are designed to promote administrative cooperation between the contracting states. Article 24 (Non-Discrimination) of the OECD and UN Model Treaties requires each contracting state not to discriminate unfairly against the residents and nationals of the other contracting state. Although nondiscrimination is a worthy objective, it is not easily attained. Issues arising under the nondiscrimination article are addressed in section 8.8.1 below.

Article 25 (Mutual Agreement Procedure) of the OECD and UN Model Treaties establishes a mechanism for resolving disputes that arise from the interaction of the tax systems of the contracting states or from the operation of the treaty itself. The mutual agreement procedure, including arbitration of tax disputes, is discussed in section 8.8.3 below.

Virtually all tax treaties provide for some cooperation between the contracting states in the administration of the tax treaty and their domestic tax systems. Article 26 (Exchange of Information) of the OECD and UN Model Treaties provides for the exchange of "such information as is foreseeably relevant for carrying out the provisions of this Convention or of the domestic laws of the contracting states concerning taxes

covered by the Convention." Article 27 (Assistance in the Collection of Taxes) is a recent addition to both the OECD Model and the UN Model Treaty, which provides for mutual assistance in the collection or enforcement of taxes. Exchange of information and mutual assistance are dealt with in section 8.8.4 below.

8.8 SPECIAL TREATY ISSUES

8.8.1 Nondiscrimination

In general, there are no significant legal restrictions on a country's jurisdiction to tax, and consequently, a country could consider taxing nonresidents more harshly than residents. In fact, however, most countries generally treat nonresidents in the same way as, or better than, residents for tax purposes. Probably the most important constraints on the unequal treatment of nonresidents are the possibility of retaliation by other countries and the need to attract investment by nonresidents.

The most important type of legal protection against discrimination for tax purposes is the nondiscrimination article of bilateral tax treaties. The nondiscrimination provisions of the GATT, the GATS, and other trade and investment treaties generally provide that tax discrimination is to be dealt with in accordance with bilateral tax treaties. Article 24 of the OECD and UN Model Treaties prohibits the contracting states from imposing tax consequences on the citizens or residents of the treaty partner that are less favorable or more adverse than the tax consequences imposed on their own citizens or residents. The treaties do not define discrimination or nondiscrimination. In general, however, discrimination means distinguishing between persons adversely on grounds that are unreasonable, irrelevant, or arbitrary. Conversely, nondiscrimination means equal (functionally equivalent) or neutral treatment. In any nondiscrimination case, the crucial issue is to determine the precise situations that are to be compared.

Article 24 of the OECD and UN Model Treaties prohibits discrimination against foreign nationals and nonresidents in several respects:

(1) Article 24(1) prohibits discrimination on the basis of nationality. Because most countries do not tax individuals on the basis of nationality (the US is a major exception), this provision is primarily important with respect to legal entities.
(2) Article 24(3) prohibits discrimination against nonresidents carrying on business in a country through a PE. Such nonresidents must be treated no less favorably than residents of the treaty country engaged in similar activities.
(3) Article 24(4) requires countries to allow the deduction of amounts paid by residents of a contracting state to residents of the other contracting state on the same basis as amounts paid to residents of the first state. In effect, this provision provides protection against discrimination indirectly because the direct beneficiaries of the legal protection are domestic enterprises. Thin

capitalization rules, which are discussed in Chapter 7, section 7.2, are widely considered to violate this aspect of a nondiscrimination article.

(4) Article 24(5) ensures that corporations, partnerships, and other entities resident in a contracting state whose capital is owned or controlled by residents of the other contracting state must be treated no less favorably than enterprises owned or controlled by residents. As with Article 24(4), the protection against discrimination is provided directly to resident entities and only indirectly to the nonresident owners of those entities.

Article 24 of the OECD and UN Model Treaties provides important but limited protection against tax discrimination. Some countries, such as Canada, refuse to treat nonresidents the same as residents (**national treatment**) for tax purposes. Instead, they agree in their tax treaties to provide **most-favored-nation treatment** to the residents of a particular treaty country. Most-favored-nation treatment ensures that the residents of a treaty country are treated the same as residents of other foreign countries. It does not guarantee that they will be treated the same or as well as resident taxpayers.

8.8.2 Treaty Abuse

8.8.2.1 Introduction

In general, tax treaties limit the taxes imposed by the contracting states. Not surprisingly, therefore, tax treaties have been widely used by taxpayers to avoid tax. This section examines the ways in which countries protect themselves from the abuse or improper use of their tax treaties. Section 8.8.2.2 deals with one particular aspect of treaty abuse, the problem of treaty shopping. Section 8.8.2.3 describes the OECD BEPS Action 6 proposals for dealing with treaty abuse.

As discussed in section 8.5 above, the two most obvious purposes of tax treaties based on the OECD and UN Model Treaties are the elimination of double taxation and the prevention of tax avoidance and evasion. Although the Model Treaties contain several explicit provisions aimed at eliminating or preventing double taxation, they have few provisions dealing with tax avoidance. Article 9 dealing with transfer pricing, Article 13(4) (allowing source countries to tax gains from the disposal of interests in land-rich enterprises), and Article 17(2) (allowing source countries to tax income from entertainment and athletic activities that accrue to a person other than the entertainer or athlete) are the only specific anti-abuse rules found in the Model Treaties. Nevertheless, the Commentary on Article 1 of both Model Treaties deals reasonably comprehensively with the topic of treaty abuse.

The Commentary on Article 1 of the OECD Model Treaty was revised in 2003 pursuant to the OECD's Harmful Tax Competition Project, which is described in Chapter 9, section 9.2.2. The 2003 Commentary states explicitly that "[I]t is also a purpose of tax conventions to prevent tax avoidance and evasion." Until that time, the only explicit statement found in the Treaty or the Commentary was that the purpose of tax treaties was to eliminate double taxation and prevent fiscal evasion (preventing tax

avoidance was not mentioned). Thus, taxpayers were able to argue that tax treaties could not be interpreted to prevent tax avoidance because there was no strong evidence that the prevention of tax avoidance was one of the purposes of tax treaties.

In addition, the 2003 Commentary on the OECD Model Treaty dealt with the interpretation of the provisions of tax treaties to prevent the granting of treaty benefits in abusive cases, and the relationship between domestic anti-avoidance rules and tax treaties. With respect to the first issue, the Commentary (paragraph 9.5) adopted, in effect, a general anti-abuse rule in the guise of the following "guiding principle":

> A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

With respect to the second issue, the Commentary (paragraph 22.1) indicates explicitly that domestic anti-avoidance rules are used to determine the underlying facts on which tax liability is based and, as such, they are not dealt with in tax treaties and are not affected by tax treaties. In general, therefore, there is no conflict between domestic anti-avoidance rules and the provisions of tax treaties, with the result that tax treaties do not prevent the application of domestic anti-avoidance rules.

Although the main points of the Commentary on Article 1 of the OECD Model Treaty are reasonably clear, as summarized above, that Commentary is somewhat disorganized and makes some distinctions between different types of domestic anti-avoidance rules, such as substance-over-form rules and CFC rules, that are difficult to justify. In contrast, the Commentary on Article 1 of the United Nations Model, which was revised as part of the 2011 update of that Model, provides a better organized and more comprehensive discussion of treaty abuse.

The UN Commentary on Article 1 (paragraph 10) identifies and discusses the following seven approaches for dealing with treaty abuse:

- specific anti-avoidance rules in domestic law;
- general anti-avoidance rules in domestic law;
- judicial anti-abuse rules;
- specific anti-avoidance rules in tax treaties;
- general anti-avoidance rules in tax treaties; and
- the interpretation of treaty provisions to prevent abuse.

The Commentary explains that, although tax treaties generally prevail over domestic law in the event of a conflict between them, conflicts between domestic anti-avoidance rules and tax treaties can often be avoided. Sometimes the provisions of the treaty (Article 9 with respect to transfer pricing is an example) may explicitly allow the application of domestic anti-avoidance rules; sometimes the treaty may depend on the application of domestic law, including domestic anti-avoidance rules; and sometimes the interpretation of the treaty will result in the denial of the benefits of the treaty consistent with the denial of such benefits under domestic anti-avoidance rules.

The UN Commentary on Article 1 also endorses the OECD guiding principle (quoted above) as to what constitutes an abuse of a treaty. Further, it indicates that, for countries that prefer not to rely on a non-binding statement of the guiding principle in the Commentary, the guiding principle could form the basis for a general anti-abuse rule to be included in the treaty. One difficulty with the inclusion of such a general anti-abuse rule is that it may create a negative implication that treaties without such a rule cannot be interpreted to prevent treaty abuse. This is particularly problematic for countries that have a large number of tax treaties because of the time needed to renegotiate all the treaties. The OECD BEPS project has proposed to deal with this difficulty through the negotiation of a multilateral treaty, which would amend existing bilateral treaties with respect to the BEPS recommendations for changes to the OECD Model Treaty. The OECD BEPS Action 6 proposals with respect to treaty abuse are discussed in section 8.8.2.3.

Finally, the UN Commentary on Article 1 provides several useful examples to illustrate the wide variety of potential treaty abuses and the rules necessary to deal with them.

8.8.2.2 Treaty Shopping

Only residents and (in some cases) nationals of a contracting state are entitled to benefits under an income tax treaty. Article 1 of the OECD and UN Model Treaties provides that a treaty applies to persons who are residents of one or both of the contracting states. Taxpayers who are not residents or nationals of a contracting state have frequently sought to obtain the benefits of a tax treaty by organizing a corporation or other legal entity in one of the contracting states to serve as a conduit for income earned in the other contracting state. This practice is commonly referred to as treaty shopping. Although a taxpayer may engage in treaty shopping to obtain any treaty benefit not otherwise available, most treaty shopping involves attempts by taxpayers to obtain reduced withholding rates on dividends, interest, and royalties. Treaty shopping is just one form of treaty abuse.

One classic form of treaty shopping involves the use of an unrelated financial intermediary located in a treaty country to make investments for taxpayers who are not themselves eligible for treaty benefits. For example, assume that T is a resident of Country TH, a tax haven jurisdiction that does not have a tax treaty with Country A. However, Country A has a tax treaty with Country B, under which Country A reduces its normal withholding tax rate from 30 percent to zero on interest paid to residents of Country B. T invests 1 million with BCo, an independent financial intermediary that is resident in Country B. BCo uses the 1 million to purchase a bond issued by ACo, an unrelated corporation resident in Country A. ACo pays BCo 100,000 of interest on the bond. BCo claims that the 100,000 is exempt from County A's withholding tax under the treaty with Country B. BCo pays 100,000 to T, minus some commission, as a return on T's original investment.

This example utilizes what is commonly referred to as a back-to-back arrangement to minimize taxes. BCo, the financial intermediary, avoids tax in Country A under

the tax treaty with Country B and avoids paying significant tax in Country B because the 100,000 of interest received from ACo is offset by the deduction of the amount paid to T.

Another classic form of treaty shopping involves the use of a controlled corporation organized in a treaty country. For example, assume that T, in the example above, organizes a wholly owned corporation, CCo, in Country C. T subscribes 2 million for shares of CCo, and CCo uses that money to purchase shares of stock in various companies resident in Country A and listed on Country A's stock exchange. CCo receives dividends of 400,000 on the shares. Country A has a tax treaty with Country C that reduces Country A's withholding tax on dividends paid to residents of Country C from 30 percent to 15 percent. As a resident of Country C, CCo claims the benefit of the treaty to reduce its tax otherwise payable on the 400,000 of dividends from 120,000 to 60,000. Assuming that CCo is exempt from tax in Country C because Country C does not tax foreign dividends under its domestic tax law, this simple type of treaty shopping results in a tax saving of 60,000.

The international tax community has been slow to take action to curtail treaty shopping. The OECD and UN Model Treaties do not contain any specific provisions designed to combat the types of treaty shopping abuses illustrated in the above examples. Indeed, some countries apparently have concluded that tolerance of treaty shopping is in their national interest. The US has been the leading proponent of aggressive international action to curtail treaty shopping. The problem of treaty shopping is exacerbated for countries, like the US, that enter into tax treaties with countries that have widely varying withholding rates because taxpayers have an incentive to take advantage of the most favorable treaty.

All recent tax treaties entered into by the US include a **"limitation-on-benefits"** *article* intended to curtail treaty shopping. The basic policy of the limitation-on-benefits article is to deny treaty benefits to a corporation that is resident in one of the contracting states, but is in effect serving as a conduit for residents of some third country. One way of thinking about a limitation-on-benefits provision is to consider it an attempt to limit treaty benefits to genuine residents of a contracting state.

The specific provisions of the limitation-on-benefits article contained in US tax treaties vary from treaty to treaty. However, the limitation-on-benefits provision in the US Model Treaty gives a good idea of the general US approach. In general, a corporation resident in a contracting state is not denied treaty benefits if it derives income from the active conduct of a trade or business (other than the business of making investments) in the other contracting state.

A corporation that fails to meet this active-business test must satisfy both of the following conditions to qualify for treaty benefits:

(1) the corporation's gross income must not be used in substantial part to pay interest, royalties, or other liabilities to persons not entitled to treaty benefits; and
(2) over 50 percent of the shares of the corporation (determined by reference to both the voting rights attached to the shares and the value of the shares) must

be owned, directly or indirectly, by certain qualified persons – typically, individuals who are residents of one of the contracting states.

The first of these conditions is intended to combat treaty shopping of the type illustrated in the first example above. The second condition addresses treaty shopping of the type illustrated in the second example.

The limitation-on-benefits article contained in US tax treaties is invariably more complex than the discussion above might suggest. Much of the complexity involves the definition of a qualified person. In general, the list of qualified persons includes individuals resident in a contracting state, US citizens, publicly traded companies (and certain of their subsidiaries), charitable foundations, and the contracting states themselves (including their political subdivisions and local authorities).

8.8.2.3 OECD BEPS Action 6: Preventing Treaty Abuse

The OECD issued a Discussion Draft on BEPS Action 6: *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* in March 2014 and a Revised Discussion Draft in May 2015. It is anticipated that the proposals will be finalized by the end of 2015 and the changes incorporated into the next update of the OECD Model Treaty. The Discussion Draft presents a comprehensive set of proposals to deal with treaty abuse, ranging from amendments to the title and preamble of the OECD Model to the addition of a general anti-abuse rule to the Model. Although the Commentary on Article 1 (paragraph 7) was revised in 2003 to establish that one of the purposes of tax treaties is to prevent tax avoidance, the OECD proposes to amend the title to the OECD Model Treaty to include specific references to the elimination of double taxation and the prevention of tax evasion and avoidance.

In addition to the revised title, the preamble to the OECD Model Treaty will include a statement that the intentions of the contracting states are to eliminate double taxation and prevent tax evasion and avoidance, including tax avoidance "through treaty shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States" (see section 8.5 above for the full preamble). The intention behind these changes to the title and preamble is to elevate the prevention of tax avoidance to a main purpose of tax treaties, along with the elimination of double taxation, so that national courts will take this purpose into account in interpreting the provisions of actual bilateral treaties that adopt the OECD recommendations.

The changes to the title and preamble will be reinforced by revisions to the Introduction to the OECD Model Treaty. Most importantly, the Introduction will state that the elimination of double taxation and the prevention of tax evasion and avoidance are the main purposes of the OECD Model Treaty. Currently, the Introduction indicates that the elimination of double taxation is the main purpose of the OECD Model Treaty.

The Discussion Draft makes a conceptual distinction between the circumvention of the provisions of a treaty itself and the use of a treaty to circumvent domestic law. The most obvious example of the first type of tax avoidance is treaty shopping. The

Discussion Draft proposes to deal with treaty shopping by including a new article (Entitlement to Treaty Benefits) containing a detailed US-style limitation-on-benefits provision (see section 8.8.2.2 above), supplemented by a general anti-abuse rule.

The detailed limitation-on-benefits provision denies treaty benefits based on the legal nature, ownership and control, and activities of a resident of a contracting state. The inclusion of a derivative benefits provision in the limitation on benefits is still under consideration. A derivative provision would allow an entity to qualify for treaty benefits to the extent that the owners of the interests in the entity would be entitled to equivalent or more favorable benefits if they received the payments or income directly.

Since the proposed limitation-on-benefits provision would not cover all transactions involving treaty shopping (e.g., conduit financing arrangements), the Discussion Draft recommends that a general anti-abuse rule should be added to the OECD Model Treaty as follows:

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

In effect, the guiding principle in paragraph 9.5 of the Commentary on Article 1, discussed in section 8.8.2.1 above, would be incorporated into the Model itself. The inclusion of such a general anti-abuse rule in actual bilateral tax treaties will have significant impact. Although the Commentary is considered to be of persuasive value, it is clearly not binding on domestic courts; however, a rule contained in the treaty itself cannot be easily ignored.

The proposed general anti-abuse rule consists of a two-part test. First, one of the main purposes of a transaction or arrangement must be to obtain treaty benefits and second, obtaining treaty benefits in the particular circumstances must be contrary to the object and purpose of the relevant provisions of the treaty. If the purpose test is met, the onus is on the taxpayer to establish that obtaining the treaty benefits would be in accordance with the purpose of the treaty.

The Discussion Draft also proposes to add several specific anti-abuse rules to the OECD Model Treaty, as follows:

- A holding-period requirement will be added for purposes of the application of the 5 percent tax rate on dividends in Article 10(2) and the taxation of capital gains from the alienation of shares in land-rich companies under Article 13(4). For the latter purpose, the alternative provision in the Commentary, which extends the provision to interests in other entities such as partnerships and trusts, will be incorporated into Article 13. The length of the holding period has yet to be determined.
- The tie-breaker rule for entities based on the place of effective management in Article 4(3) will be replaced by a determination by the competent authorities

on a case-by-case basis. If the competent authorities cannot agree, the entity will not be entitled to any treaty benefits.

- Treaty benefits will be denied with respect to income attributable to a permanent establishment (PE) in a third state. The type of rule that would be used to accomplish this result has not been decided. The Discussion Draft suggests a possible approach based on the rule in some US treaties, under which treaty benefits are denied where the income is subject to a preferential rate of tax (taking into account the taxes in both the residence country and the PE country) that is less than 60 percent of the corporate tax rate in the residence country.

The Discussion Draft proposes to clarify the Commentary on Article 1 with respect to the relationship between tax treaties and specific anti-avoidance rules in domestic law by adopting the approach used in the Commentary on Article 1 of the UN Model Treaty (2011). The OECD Commentary is confusing because portions of it were adopted at different times in response to different concerns. As discussed in section 8.8.2.1, the UN Commentary on Article 1 is much clearer than the OECD Commentary in this regard.

The final proposal in the Discussion Draft is the addition of a **saving clause** to the OECD Model to prevent residents of a country from relying on the provisions of a tax treaty to avoid residence country tax. The saving clause is a standard feature of US tax treaties and provides that, subject to certain exceptions, the treaty does not affect the taxation by a state of its own residents. The exceptions to the saving clause are the benefits provided under Articles 7(3), 9(2), 19, 20, 23, 24, 25, and 28.

The addition of a saving clause to the OECD Model is a good idea in principle because tax treaties are not generally intended to prevent a country from taxing its residents, and it will put other countries on the same footing as the US. Because of the saving clause, the US does not need to worry about applying its transfer pricing rules, CFC rules, or other anti-avoidance rules to its residents. In my view, it does not make sense for the US to be able to apply its domestic anti-avoidance rules without regard to its tax treaties, but not for other countries to do so, except to the extent permitted by the Commentary on Article 1, by specific provisions in their treaties, or by virtue of a treaty override.

In summary, the Discussion Draft presents a fairly comprehensive list of proposed changes to the OECD Model to deal with treaty abuse. The list is not completely comprehensive yet because it will be supplemented by other proposals stemming from other BEPS actions. For example, a new provision, Article 1(2), will be added to the OECD Model Treaty, indicating that income derived through a transparent entity will be considered to be income of a resident of a contracting state for purposes of the treaty only to the extent that it is treated as income of a resident of that state for purposes of taxation by that state.

It will take a long time for a country with numerous tax treaties to renegotiate all its treaties to include the proposed general anti-abuse rule and the other proposed changes. In the meantime, if the changes are included in only some of a country's tax treaties, a negative implication may arise that treaties without those provisions cannot

be interpreted to prevent treaty abuse. Therefore, the key issue with respect to the OECD proposals on treaty abuse is that their effectiveness depends on the conclusion of a multilateral treaty. Although the Discussion Draft on treaty abuse does not make any reference to BEPS Action 15: *Developing a Multilateral Instrument to Modify Bilateral Tax Treaties*, if OECD member countries (and possibly other countries as well) can agree to a multilateral treaty that provides for the amendment of all their existing treaties to incorporate the changes aimed at preventing treaty abuse, the changes could be implemented relatively quickly.

Therefore, a multilateral treaty is critical to the effective implementation of the OECD proposals dealing with treaty abuse, but a multilateral tax treaty has been an elusive dream since the beginning. Negotiations for the multilateral treaty are planned to commence early in 2016.

8.8.3 Resolution of Disputes

Most tax treaties provide a mutual agreement procedure for resolving disputes that arise under the treaty. A person resident in a contracting state who believes that the actions of one or both contracting states will cause the payment of tax not in accordance with the treaty may request relief from the "competent authority" of the state of which the person is a resident. The competent authority is typically a senior official in the country's tax department who is responsible for international tax matters. The competent authority will make a determination whether the taxpayer's request appears justified and, if so, will attempt to provide an appropriate remedy. If the competent authority does not have the power to resolve a dispute on its own, it may attempt to resolve the dispute through consultations with the competent authority of the other contracting state.

The dispute-resolution mechanism of the OECD and UN Model Treaties is set forth in Article 25 (Mutual Agreement Procedure). This article provides that the competent authorities "shall endeavor" to resolve matters referred to them. Thus, it is notable that the competent authorities are not required to reach an agreement, even if the result is that a taxpayer is subject to double taxation. For this reason, mandatory arbitration was added to Article 25 of the OECD Model Treaty in 2008 for the resolution of issues that the competent authorities are unable to agree on within two years. Arbitration is discussed in Chapter 9, section 9.5.

Although a taxpayer is entitled to make its case to the competent authority of its country of residence, it is not allowed to participate directly in the consultative procedure between the competent authorities of the two contracting states. However, a few treaties contemplate that the taxpayer is entitled to present its case independently to both competent authorities.

A variety of disputes may be referred to the competent authorities. Some of these disputes involve the proper interpretation of treaty language, while others involve disputes over the facts on which a taxpayer's tax liability is based. The most common and complex disputes referred to the competent authorities involve the proper application of the arm's-length standard to transfer prices in cross-border transactions.

These disputes are sometimes difficult to resolve for a variety of reasons, including the large amounts of tax revenue frequently at stake. Article 9(2) of the OECD and UN Model Treaties provides that if one country adjusts the transfer prices used by related corporations in accordance with the arm's-length standard (and the other country agrees with the adjustment), the other country must make a corresponding adjustment to the profits of the related corporation in order to avoid double taxation. Transfer pricing is discussed in Chapter 6.

Under the domestic laws of many countries, multinational companies may request formal advance approval from the tax authorities of their methodology for establishing prices in their inter-group transactions. An administrative ruling entered into under this procedure is commonly referred to as an Advance Pricing Agreement (APA). In many situations, multinational enterprises prefer, if possible, to use the competent authority procedure to arrange for the joint issuance of an APA by several of the countries in which they do business.

8.8.4 Administrative Cooperation

The tax authorities of a country often experience difficulty in obtaining information concerning the foreign activities of residents and verifying that the information is correct. In the past, this difficulty was exacerbated by bank secrecy laws in many countries and the unwillingness of tax havens to exchange information with high-tax countries.

Article 26 (Exchange of Information) of the OECD and UN Model Treaties provides for an exchange of "such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration and enforcement of the domestic laws of the contracting states concerning taxes of every kind and description." Article 26 of the OECD Model Treaty was revised in 2005 to change the standard for exchanging information from "necessary" to "foreseeably relevant" and to require the exchange of information with respect to all taxes imposed by the contracting states, and not just the taxes covered by the treaty. These changes were intended to clarify the meaning of the Article, but not to change its substance.

Under the OECD and UN Model Treaties, an exchange of information may take place as a result of a specific request from a treaty partner, through an arrangement for an automatic exchange of information, or by the initiative of a contracting state acting spontaneously. Information requested by one state must be provided by the other state despite the fact that the information may not be necessary or relevant for the purposes of the other state's own taxes (i.e., the other state may have no domestic interest in the information).

Information obtained by the tax department of a contracting state under an exchange-of-information article must be kept confidential, although release of the information in court proceedings is generally allowed. Under the exchange-of-information article, a contracting state is not obligated to carry out administrative procedures on behalf of its treaty partner that are contrary to its own laws or practices, to supply information that is not obtainable under its domestic laws or in the normal

course of administration of both states, or that would result in the disclosure of trade secrets or similar information. An escape clause generally allows a contracting state not to provide requested information if its disclosure would be "contrary to public policy." However, under Article 26(5), a country cannot refuse to provide information solely because the information is held by a financial institution, a nominee or agent, or because it relates to ownership interests in a corporation or other person. Since most countries have been required to eliminate their bank secrecy laws, this provision is not as important as it would otherwise be.

Exchanges of information between tax authorities can take place only pursuant to international agreements between countries; therefore, in the absence of a bilateral tax treaty, it is usually impossible for the tax authorities to share information. Before this century, it was impossible for high-tax countries to get information from tax havens or low-tax countries with which they did not have a bilateral tax treaty. As a result, the practice developed for TIEAs to be concluded on a bilateral basis between OECD member countries and low-tax countries with which there was no need for a comprehensive income tax treaty. The US has been the leader in this regard; several OECD member countries have also concluded or are negotiating TIEAs with low-tax countries. TIEAs provide for countries to exchange information on a basis similar to Article 26 of the OECD Model Treaty.

As part of the OECD's Harmful Tax Competition Project in the late 1990s, the OECD proposed that tax havens should be required to obtain information about the beneficial ownership of companies and other entities formed under their laws and to require the companies to maintain financial accounts in accordance with generally accepted accounting standards and make those accounts available for the regulatory or tax authorities. In 2002, the OECD issued a *Model Agreement on Exchange of Information on Tax Matters*. Article 26 of the OECD Model Treaty was revised in 2005 to override any bank secrecy or other confidentiality laws of the country requested to provide information, and to delete the necessity for any domestic tax interest in the requested information. In 2011, Article 26 of the UN Model Treaty was revised to conform to Article 26 of the OECD Model, although Article 26 of the UN Model Treaty is broader in certain respects. For example, Article 26(1) includes the statement that information that is helpful in preventing tax avoidance or evasion shall be exchanged. In addition, Article 26(6), which authorizes the competent authorities to establish procedures for the exchange of information, has no counterpart in Article 26 of the OECD Model Treaty.

In 2001, the OECD established a Global Forum on Taxation to discuss exchange-of-information issues with non-member countries. This Global Forum, which is now known as the Global Forum on Transparency and Exchange of Information, has been very successful in ensuring that international standards for the exchange of information are implemented effectively. The Global Forum, which currently consists of 127 countries, engages in peer review exercises of both the legal and administrative capacity of countries to exchange information and of their actual performance in exchanging information. Countries are given ratings (which are available to the public) based on their compliance with the international standard for exchange of information.

Until recently, the international standard for exchanges of information between tax authorities has required only exchanges on request. In other words, one country was required to provide information only if the tax authorities of the other country specifically requested that information. However, in 2014 the OECD formulated a new *Standard for Automatic Exchange of Financial Information in Tax Matters*, (available at www.oecd.org) which provides for certain financial information (e.g., information about dividends, interest, proceeds of sale of financial products, and balances of certain accounts) obtained from a country's financial institutions to be provided automatically (i.e., without the necessity for a request by the tax authorities of another country) to the tax authorities of other countries on an annual basis. Over ninety countries have agreed to this new standard. In addition, over sixty countries have signed a *Multilateral Competent Authority Agreement* (available at ww.oecd.org) to implement automatic exchanges of information.

Often, the tax authorities of a country will audit the international affairs of taxpayers in addition to requesting information from other countries. Under international custom, however, the tax officials of one country cannot visit another country for the purpose of auditing a taxpayer's records unless invited to do so by the foreign government. Some governments consider it inappropriate for tax officials to make such visits without also obtaining the concurrence of the taxpayer. Several countries have addressed this problem by conducting joint audit programs, under which a particular taxpayer (and its affiliates) is audited by the tax authorities of both countries.

Once the tax authorities of a country have conducted an audit and assessed a tax deficiency against a taxpayer, they must collect any taxes owing. Tax authorities often encounter severe difficulties in enforcing tax liability in another country. Under the domestic law of most countries, the tax judgments of a foreign country generally are not enforceable, in accordance with the "revenue rule." Article 27 (Assistance in the Collection of Taxes) of the OECD and UN Model Treaties overcomes the limitations of the revenue rule by requiring each country to provide assistance in the collection of the other country's taxes. Like Articles 24 (Nondiscrimination) and 26 (Exchange of Information), Article 27 is not limited to the taxes covered by the tax treaty, but extends to all taxes imposed by the contracting states.

A request for assistance must be accepted by the requested state if the taxpayer cannot resist the collection of the taxes under the laws of the requesting state. In addition, the requested state must collect the taxes of the requesting state as if those taxes were its own. However, it is not required to provide assistance unless the requesting state has exhausted all the measures for the collection or conservancy of the taxes available under its domestic law and administrative practices, or the administrative burden to collect the taxes is disproportionate to the benefit to the requesting state. A taxpayer is not entitled to contest the existence, validity, or amount of the taxes owing in the courts or administrative bodies of the requested state. In providing assistance in the collection of the taxes owing to the other state, a state is not required to take any measures that are inconsistent with its own laws or administrative practices or contrary to public policy.

8.8.5 Attribution of Profits to Permanent Establishments

As discussed above in Chapter 5, section 5.8.1.2, an entity resident in one country may engage in substantial business activities in another country through a branch or PE in that country or through an entity (such as a subsidiary) established in that country. Unlike a subsidiary, a branch or PE is not a legal entity and cannot take actions on its own. The property and activities of a branch or PE are actually the property and activities of the entity of which it is a part.

When an enterprise resident in one country is engaged in business activities through a branch or PE in another country, it is necessary for both countries to determine the amount of income of the branch or PE. The source country requires this information in order to determine the amount of the nonresident enterprise's profits subject to source country tax. The country in which the enterprise is resident requires the information in order to provide relief from double taxation – by way of exemption or a foreign tax credit – of the profits earned by the enterprise through the foreign branch or PE. The domestic rules used by countries to compute the profits earned by a nonresident vary considerably, as discussed in Chapter 5, section 5.8.1.1.

Under Article 7(1) of both the OECD and UN Model Treaties, a resident of one country is taxable with respect to business profits by the other country only if it carries on business in the other country through a PE located in that country. Under the OECD Model Treaty, a resident carrying on business through a PE in the other country is taxable only on the profits attributable to the PE. Under the UN Model Treaty, such a resident is also taxable on profits from sales of goods similar to those sold through the PE and from other business activities similar to those carried out through the PE. This limited force-of-attraction rule in the UN Model Treaty is not very important because it is so easy to avoid.

Article 7(2) of both Model Treaties requires the profits attributable to a PE to be determined on the assumption that the PE is a separate enterprise dealing independently with the rest of the enterprise of which it is a part. (The rest of the enterprise means the head office of the enterprise and any other PEs of the enterprise.) This assumption is generally considered to make the transfer pricing rules of Article 9 applicable in determining the profits attributable to a PE.

Article 7 of the OECD Model Treaty was substantially revised in 2010 pursuant to a decade-long project, which culminated in 2008 with a report, *Attribution of Profits to Permanent Establishments*, and a new chapter dealing with PEs in the OECD's Transfer Pricing Guidelines. This new chapter was developed largely by economists working through Working Party 6, which did not take into account any of the constraints imposed by the wording of the existing Article 7 of the treaty. In effect, Working Party 6 took the separate-entity assumption in Article 7(2) to its logical conclusion; thus, a PE was required to be treated as a separate entity for all purposes in computing its profits. This new approach required a complete overhaul of the wording of Article 7.

Article 7(2) of the OECD Model Treaty was revised to provide that the profits attributable to a PE must be computed as if the PE were a separate entity "taking into account the functions performed, assets used and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise."

Paragraph 3 through 6 of Article 7, discussed below, were deleted and a new corresponding adjustment similar to Article 9(2) was added to Article 7(3). Article 7(3) requires a contracting state to make an adjustment to the profits of an enterprise if the other contracting state makes an adjustment in accordance with Article 7 to the profits of a PE of the enterprise in that other state.

The changes to Article 7 have been controversial. Seven OECD member countries have entered reservations on the new Article, indicating that they reject the new Article 7 and intend to adhere to the former version of the article. In addition, the UN Committee of Experts refused to adopt the OECD's new version of Article 7 in the 2011 revision of the UN Model Treaty.

Serious conceptual and practical difficulties arise in applying the transfer pricing rules to PEs, as described in Chapter 6. The transfer pricing rules in Article 9 apply to transactions between related persons. They do not apply to PEs because a PE is not a person; it is merely part of a legal enterprise, and transactions do not take place between parts of the same enterprise. As a legal matter, a transfer requires a change in ownership from one person to another, and a PE cannot own property. What is often described metaphorically as a transfer of property between the head office and a PE of an enterprise or between two PEs of the same enterprise is merely a change in the use or location of property owned by that corporation, and not a genuine transfer.

Therefore, in order to apply transfer pricing rules to PEs, it is necessary to treat a PE as if it were a separate legal entity and to construct some hypothetical transactions between the PE and the rest of the enterprise of which the PE is a part. Assume, for example, that ACo, resident in Country A, manufactures goods in Country A and sells those goods through a sales outlet in Country B. To apportion the income of ACo between the two countries by reference to the transfer pricing rules, ACo's sales activities through its PE in Country B would be treated as if they were carried on by a subsidiary corporation resident in Country B (e.g., BCo). ACo would be treated as if it had made a transfer of goods, either by sale or consignment, to the assumed BCo. The transfer pricing rules would then be applied to that notional transfer. An assumption would have to be made as to whether BCo was operating in Country B as an independent distributor or as an agent of ACo because the income earned by distributors and agents in the marketplace might not be the same.

Under Article 7(2) of the OECD Model Treaty, the determination of the profits attributable to a PE is a two-step process. The first step involves a functional and factual analysis of the PE in order to determine the functions performed by the PE, the economic ownership of assets by the PE, the risks assumed by the PE, the capital of the PE, and the hypothetical "dealings" between the PE and the other parts of the enterprise. The second step involves the application of the transfer pricing rules, by analogy, to those dealings in order to establish an arm's-length price.

Because of the necessity to invent dealings between a PE and another part of the enterprise, the application of the OECD's transfer pricing rules to PEs is even more difficult, uncertain, and less reliable than their application to transactions between associated enterprises. As noted above, several countries have rejected the OECD's new approach, and many countries will be unable to apply those rules effectively.

Most existing tax treaties contain a business-profits article that is similar to the former version of Article 7 of the OECD Model Treaty and the current version of Article 7 of the UN Model Treaty. As noted above, under Article 7(2), the profits of a PE are required to be computed on the assumption that a PE is a separate entity dealing independently with the rest of the enterprise of which it is a part. Thus, this version of Article 7(2) is not significantly different from the new OECD version of Article 7(2). However, the Commentary on the former version did not take the separate-entity assumption to its logical conclusion; instead, it provided a series of ad hoc practical rules for computing the profits attributable to a PE. Sometimes the Commentary required the PE to be treated as a separate entity; for example, if a PE transferred assets to the head office of the enterprise, the profits of the PE were computed as if the PE had sold the assets for their fair market value at the time of the transfer and the head office had acquired the assets for the same amount at the same time. In contrast, sometimes the Commentary rejected treating the PE as a separate entity; for example, notional payments of interest or royalties were not deductible in computing the profits of a PE under the former version of Article 7 (except in the case of financial institutions), whereas they are deductible under the new OECD Article 7.

Consider the following example, which illustrates the different approaches under the two versions of Article 7. ACo is an enterprise resident in Country A that commences to carry on business through a PE in Country B. ACo borrows 200,000 with interest at 10 percent, which it transfers to the PE to finance the establishment of the business carried on in Country B. ACo also advances an additional 1 million to the PE to finance the PE's business. Under the new Article 7, it would be necessary to determine how much debt and equity a separate entity would have if it performed the functions of the PE, owned the assets of the PE, and assumed the risks of the PE. Thus, if such a separate entity would have debt equal to twice its equity, the PE would be assumed to have 400,000 of equity and 800,000 of debt; thus, interest at 10 percent (assuming that 10 percent is an arm's-length interest rate) would be deductible in computing the profits attributable to the PE. In contrast, under the former version of Article 7 of the OECD Model Treaty and the current version of Article 7 of the UN Model Treaty (see Article 7(3), which explicitly denies any deduction for notional payments of interest or royalties), only interest on 200,000 (the actual interest expense incurred by the ACo in respect of debt used for the purposes of the PE) would be deductible in computing the profits of the PE.

Allowing the deduction of notional payments of interest and royalties is problematic. Where actual payments of interest and royalties are made and those payments are deductible in computing the profits of a PE, under Article 11 or 12 of the Model Treaties, the source country is entitled to impose withholding tax on the payments. However, notional payments of interest and royalties are not subject to source country withholding tax.

International banks, insurance companies, and other financial services companies often operate their global businesses through branches. Often the reason for using a branch is to satisfy capital reserve requirements imposed in many countries to protect investors and customers. Under the Commentary on former Article 7(3) of the OECD Model Treaty (paragraph 49) and the Commentary on Article 7 (3) of the UN Model

Treaty (paragraph 41), a financial institution is allowed to deduct notional interest payments in computing the profits of a PE. According to the Commentary, the special treatment of banks and other financial institutions is appropriate "in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises."

Article 7(3) of the UN Model Treaty (and former Article 7(3) of the OECD Model Treaty) provides that expenses incurred by an enterprise for the purposes of a PE must be allowed as deductions in computing the profits of the PE irrespective of where the expenses are incurred and whether they are incurred wholly on behalf of the PE. Thus, the PE country cannot deny the deduction of expenses because they are incurred outside the source country or because only a portion of the expenses relates to the PE. For example, head office expenses, such as accounting and legal expenses, which are incurred by the head office on behalf of a PE, must be allowed as deductions in computing the profits of the PE. However, it must be emphasized that the deductibility of expenses is a matter for domestic law. Therefore, for example, if only a portion of entertainment expenses is deductible under the domestic law of the source country, the source country is not required by Article 7 to allow the full amount to be deductible in computing the profits of the PE.

Article 7(4) of the UN Model Treaty (and former Article 7(4) of the OECD Model Treaty) provides that the profits of a PE may be computed in accordance with a formulary apportionment of the profits of the enterprise as a whole as long as that has been the customary practice of the country in which the PE is located. However, any such formulary apportionment must produce a result that is consistent with the principles of Article 7; in other words, it must be consistent with the profits that the PE would be expected to make if it were a separate entity.

Article 7(5) of the UN Model Treaty (and former Article 7(5) of the OECD Model Treaty) provides that the profits of a PE must be determined on a consistent basis from year to year unless there is some good and sufficient justification for a change in the method for computing PE profits.

No country has developed detailed and comprehensive domestic rules for extending transfer pricing rules to branches. In practice, most countries compute the profits of a PE on the basis of the profits shown in the taxpayer's books of account and make ad hoc adjustments if those books do not produce a reasonable result. However, since the books and records of a PE are within the control of the enterprise, they may not be reliable, and the tax authorities must scrutinize them carefully to ensure that they accurately reflect the profits of the PE.