Chapter VIII

A Preliminary Look at the New UN Model Tax Convention

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1. Introduction

In 1980, the UN published its Model Double Taxation Convention Between Developed and Developing Countries (hereafter UN Model 1980)[1028]. It was meant to be an alternative to the OECD Model Taxation Convention on Income and Capital (OECD Model) which puts most emphasis on residence- based taxation. Such a pattern, as the OECD itself pointed out, may not be equally appropriate in treaties between developing countries ("DCs") and industrialized countries ("ICs") because income flows are largely from DCs to ICs and the revenue sacrifice would be one-sided[1029]. Although the UN Model 1980 certainly introduced many provisions that are in the benefit of DCs[1030], it was also criticized for not going far enough[1031]. Certain DCs, unsatisfied with the UN Model 1980, have drafted additional provisions, such as a special article on "technical fees"[1032], which has in the mean time earned a

[1028] Model Double Taxation Convention Between Developed and Developing Countries, United Nations, 1980, New York.

[1029] OECD Report on Fiscal Incentives for Private Investment in Developing Countries, 1965, para. 163-165.

[1030] For an overview, see IFA Seminar Vol 15, "Double tax treaties between industrialized and developing countries", Kluwer, 1990.

[1031] Figueroa, IFA Seminar Vol. 15, Ibid, ft.1030, p. 9: ("On the other hand, however, they (industrialized countries; Edwin van der Bruggen) are victimizers when they harm the interests of developing countries by insisting on leveling the total tax burden by imposing this kind of model conventions that curb legitimate fiscal resources of poorer countries under the pretext of facilitating the establishment of an instrument to encourage flows to these countries"); Dornelles, F.N., "The tax treaty needs of developing countries with special reference to the UN Draft Model", IFA Seminar, 1979, p. 27-30.; ("However, in spite of the significant improvements provided for in the UN Draft, there still remain some substantial elements which do not reflect adequately all the special fiscal needs of developing countries"); Qureshi, N.M., "Tax treaty needs of developing countries", IFA Seminar 1979, p. 34 ("…the UN Model Draft Convention still does not fully meet the tax-treaty requirements of the developing countries…")

[1032] Such provision introduces a withholding tax on all income from technical, managerial, commercial and other services (either as a separate article of the treaty, or by assimilation with 'royalties'); Van der Bruggen, E., "Source taxation of consideration for technical services and know-how", *APTB*, 2001, p. 42-60.; Kawatra, G. Kumar, "India's approach to negotiating tax treaties", *T.N.I.*, 2000, p. 169.; Tandon

significant place in tax treaty practice[1033]. Also not inspired by the UN MC, but often found in treaties between DCs and ICs is an article about "income of visiting professors and teachers"[1034], for example, or a special rule on cultural exchanges[1035] with respect to art. 17 (artists and sportsmen). Many tax treaties, and not only those between DCs and DGCs, also include alienation of intellectual property in the royalty-article. Quite common also, although arguably not a real treaty provision, is the mention that nothing in the treaty interferes with the DGC levying a so-called "branch profit remittance tax"[1036]. Nevertheless, the importance of the role of the UN Model 1980 when drafting treaties between DCs and ICs has been well documented[1037].

As early as 1982, the Economic and Social Council of the UN drew the attention of the Ad Hoc Group of Experts ("Group") to continue its work by making appropriate proposals in the field of taxation, including its examination of the UN Model 1980[1038]. After more than 20 years, during

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Sandeep, "Taxability of royalties and technical fees arising in India", *Bull. I.F.D.*, 1997, p. 416.

[1033] Significant enough for the OECD Technical Advisory Group to include this non-OECD provision in its work on the tax treaty characterization of e-commerce payments (Revised Document for Comments, September 1st 2000).

[1034] Such article exempts income from visiting professors, teachers, sometimes even researchers from tax in the source state up to 2 years after coming from their residence-state to teach in the source state. Various conditions may be imposed (only recognized university, only certain income, …). The OECD Commentary (par. 11 of Commentary on art. 15) already asserts that many treaties contain an exemption of this nature, and notes that "The absence of specific rules (on Visiting Professors and Student Trainees; Edwin van der Bruggen) should not be interpreted as constituting an obstacle to the inclusion of such rules in bilateral conventions whenever this is felt desirable". The success of a special article containing a source state exemption is also discussed below.

[1035] This rule states that not the source state, but the residence state will retain taxing power over certain cultural performances. Also mentioned in the OECD Commentary as a possibility (par. 14 on art. 17 OECD MC), and quite widespread in tax treaties between ICs and DCs (Germany, for example, has included this exception in almost all of its treaties with DCs or countries in transition), but nonetheless not further discussed in the UN Commentary.

[1036] See for example the treaties between Mexico-US, Thailand-Japan, Thailand-Denmark, Norway-Philippines, Barbados-US, Netherlands-US, Austria-Ireland.

[1037] Wijnen, W.F.G. and Magenta, M., "The UN Model in practice", *Bull.I.F.D.*, 1997, p. 524-585.; See also the topic of discussion "Usefulness of the UN MC" at the proceedings of the IFA Seminar Vol. 15 Double Tax Treaties between Industrialized and Developing countries: OECD and UN Models, a Comparison, Kluwer Law and Taxation, Deventer-Boston, 1990, p. 9.

[1038] ECOSOC Resolution 1980/13 of April 1980 and 1982/45 of 27 July 1982.

which the process of discussion and examination continued[1039], the UN is on the verge of publishing its revised Model Double Taxation Convention Between Developed and Developing Countries (2001). The draft, which is the basis of this article and is here referred to as "UN Model 2001" was already adopted by the Group[1040]. In this article, the salient features of that new UN Model 2001 are reviewed.

2. Combination of Preparatory or Auxiliary Activities Excluded From PE Definition (Art. 5 par. 4 f)

In the UN Model 2001, a sub-paragraph f) was added to art. 5 par. 4 (f). The text is identical to the same sub-paragraph in the OECD Model:

> "(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character."

Art. 5 (4) of the OECD Model and the UN Model lists certain activities that, even in case a fixed place of business exists, are not considered a PE (the so called "negative cases"). The OECD Model further specifies in sub-paragraph f) of art. 5 (4) that a fixed place of business where a combination of several of those activities is carried out, is not deemed a PE either, as long as it still has a preparatory or auxiliary character. That specification did not feature in the UN Model 1980, perhaps indicating

[1039] Report of the Sec-General of the Seventh Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (UN Doc: E/1996/1); Report of the Sec-General of the Eighth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (UN Doc: E/1998/1); Report of the Sec-General of the Ninth Meeting (May 1999) of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (UN document: E/1999/84).

[1040] Ninth Meeting (May 1999) of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (UN document: E/1999/84). Most of the notes by the Group (and the Focus Group) can be found in a document entitled "Modifications to be made to the commentary on the UN Model pursuant to the changes made to the text of the articles during the first meeting of the focus group": UN document ST/SG/AC.8/1999/L.3.; Most of the text of the articles was adopted without changes, but not all. Of course, for the purpose of this article, only relevant Group commentary was used.

that a fixed place of business with a combination of such activities may be a PE after all[1041].

However, the question may be asked if that result can really be achieved by omitting sub-paragraph f). After all, by lack of the special exclusion for a combination of "negative" activities, the normal rules apply. That includes sub-paragraph e), which affirms that a fixed place of business solely for the purpose of carrying on *any other* activity of a preparatory or auxiliary character, is not considered to be a PE anyway[1042]. According to this interpretation, art. 5 (4) f) is actually just a clarification, and omitting it or not does not make any difference. On the other hand, from the mere fact that the Group took the trouble of taking it out, it must perhaps be concluded that a combination of negative activities may be a PE[1043]. Also, it must be considered that certain treaties, unlike the OECD or UN Model, specify in sub-paragraph 4 that those auxiliary or preparatory activities must be similar in nature to activities, supply of information and research[1044].

It is remarkable that countries do not seem to see it that way when conducting treaty negotiations. A look at tax treaty practice, particularly between ICs and DCs, demonstrates that omitting sub-paragraph f) like in the UN Model 1980 is considered a topic worth negotiating and not a mere technical clarification. France has for example only agreed to omit sub-paragraph f) in a handful of its tax treaties that were concluded with DCs since 1980,[1045] and the same can be said of Germany[1046], Korea[1047]

[1041] UN Model Commentary, art. 5 (4) at 68 only notes: "although there was a general consensus not to include the clause, some members of the Group indicated that the desirability of including it in a treaty could be left to bilateral negotiation".

[1042] Vogel, K., Double Taxation Conventions, 3rd ed., Kluwer, 1997, p. 322-324.

[1043] As does Skaar, Permanent Establishment : Erosion of a tax treaty principle, Kluwer, 1991, p. 297 ("The most likely solution is therefore that the deletion of the cumulation clause in a tax treaty based on the UN pattern indicates that any combination of excepted activities may constitute PE")

[1044] See for example DTAs Australia-China , Australia-Austria. Thailand-Australia, Thailand-Austria, Thailand- Belgium.

[1045] **France** (*Sub-paragraph not omitted*: Bangladesh, Bulgaria, India, Israel, Latvia, Lithuania, Namibia, Pakistan, Russia, south Africa, Ukraine, Uzbekistan, Venezuela and Vietnam. *Omitted*: China, Jamaica, Nigeria and Thailand.)

[1046] **Germany** (*Sub-paragraph not omitted*: Bangladesh, Bulgaria, China, Egypt, Estonia, India, Indonesia, Kuwait, Latvia, Lithuania, Namibia, Pakistan, Philippines, Russia, UAE, Venezuela and Vietnam. *Omitted*: Argentina, Bolivia, Uruguay and Thailand.)

[1047] **Korea** (*Sub-paragraph not omitted*: Bangladesh, Bulgaria, China, Egypt, Fiji, India, Israel, Kuwait, Malaysia, Morocco, Pakistan, Philippines, Romania, Russia,

and the UK[1048]. Italy has for omitted the sub-paragraph in *all* of its tax treaties[1049]. Some of the other ICs' treaty practice is irregular on this issue, though they have included it slightly more frequently[1050]. Admittedly, this alone is not conclusive, but these are at least strong indications that from the point of view of certain countries, omitting art. 5 (4) f) is not without relevance[1051].

3. New Arm's Length Exception for Independent Agents with one Principal (Art. 5 Par. 7)

In the UN Model 2001, art. 5 par. 7 (independent agents) was amended as follows (in italics):

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

South Africa, Sri Lanka, Ukraine, Uzbekistan and Vietnam. *Omitted*: Brazil, Indonesia and Thailand.).

[1048] **UK** (*Sub-paragraph not omitted*: Argentina, Bolivia, Bulgaria, China, India, Indonesia, Kuwait, Latvia, Malaysia, Pakistan, Russia, Ukraine, Uzbekistan, Venezuela and Vietnam. *Omitted*: Mauritius, Nigeria and Thailand.)

[1049] **Italy** (*Sub-paragraph omitted*: Albania, Algeria, Bangladesh, Bulgaria, China, Estonia, India, Indonesia, Israel, Kuwait, Latvia, Lithuania, Malaysia, Mauritius, Pakistan, Russia, South Africa, Sri Lanka, UAE, Venezuela, Vietnam and Thailand) .

[1050] **Belgium** (*Sub-paragraph not omitted*: Argentina, Bangladesh, Bulgaria, Egypt, Indonesia, Latvia, Mauritius, Russia, Sri Lanka, South Africa, Uzbekistan, Venezuela and Vietnam. *Omitted*: India, Ivory Coast, Malaysia, Nigeria, Pakistan, Philippines, Romania, Singapore and Thailand); **The Netherlands** (*Sub-paragraph not omitted*: Argentina, Bangladesh, Bulgaria, China, Estonia, India, Latvia, Lithuania, Malaysia, Russia, Sri Lanka, Tunisia, Venezuela, and Vietnam; *Omitted*: Brazil, Indonesia, Israel, Nigeria, Pakistan, Philippines, South Africa and Thailand) ; **Norway** (*Sub-paragraph not omitted:* Albania, Argentina, Bulgaria, China, Estonia, Indonesia, Latvia, Lithuania, Nepal, Russia, South Africa, Sri Lanka, Venezuela and Vietnam . *Omitted* : Brazil, India, Pakistan, Philippines and Thailand) ; **Poland** (*Sub-paragraph not omitted*: Albania, Armenia, China, Croatia, Estonia, Egypt, Indonesia, Israel, Latvia, Lithuania, Marocco, Philippines, Russia, South Africa, Uruguay and Uzbekistan. *Omitted*: India, UAE, Vietnam and Thailand); **Singapore** (*Sub-paragraph not omitted*: Bulgaria, China, India, Latvia, Mauritius, South Africa and Vietnam. *Omitted*: Indonesia, Pakistan, UAE and Thailand.).

[1051] This observation is further supported by the fact that the Ad Hoc Group of Experts includes the provision in the UN Model 2001. If superfluous, why take the trouble? Would it not make more sense for the OECD to remove it from the OECD Model altogether in order to promote uniformity of the models where possible?

> of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, *and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises*, he will not be considered an agent of an independent status within the meaning of this paragraph."

An enterprise is not deemed to have a PE in another country when it carries on business by means of a so-called independent agent. This rule is included in both the OECD and the UN Model, but in the latter, a specification is added which provides that an agent who works wholly or almost wholly on behalf of one enterprise, cannot be deemed independent. Clearly, the intention is to increase the possibility for source taxation on business profit by making it more difficult to pass an agent of as being independent. In the UN Model 2001, another condition is added which *also* has to be satisfied before an agent may be regarded as "not-independent" in the sense of the treaty. It must be proven that the commercial and financial relations between the enterprise and the agent differ from those which would have been made between independent enterprises.

This reference to the agreement between the agent and the enterprise is consistent with earlier notes in the UN Commentary that "*the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise*"[1052]. In other words, according to this statement in the commentary of the UN Model 1980, it is not sufficient that an agent only works with one enterprise. It is furthermore required that such exclusivity is the *result of an agreement* with that enterprise. That commercial or other circumstances happened to emanate in a practical exclusivity, would not be sufficient. It is not clear, however, if that interpretation is followed by the tax authorities of most developing countries.

By making the loss of an agent's independent character subject to an additional arm's length test, the Group aims to eliminate what it considers to be anomalous consequences of the old provision. "There was to believe that as worded, wherever the number of enterprises for which an agent of an independent status was working was reduced to one, such an agent's

[1052] UN Commentary on art. 5 (4), 74.

status was changed to dependent. It was considered necessary to remove this anomaly and doubt by rephrasing the second sentence"[1053].

The onus of proof for tax authorities to show that a broker, general commission agent or another agent of an independent status, is not independent at all, is thus made harder. Under treaties that follow the UN Model 2001, an independent agent will no longer be a PE even if he is working wholly or almost wholly on behalf of one enterprise, as long as the commercial and financial relations between the agent and the enterprise are at arm's length. The new rule obviously takes over the terminology from art. 9 (1), and not that of art. 7 (2) by the way, indicating that the relationship between the enterprise and the agent must be scrutinized along the same lines.

The intention of the Group is clear and understandable, but in the opinion of this author, there is a hidden danger in referring to existing notions of art. 9. That article was written to be applied only to conditions that exist between associated enterprises and not for enterprises that just have commercial agreements with one another such as may be the case for brokers, agents and the like. The basic philosophy behind art. 9 is that conditions between actual unassociated enterprises are *ipso facto* at arm's length. This basic philosophy has given the article the shape it has today. It is a pre-condition for applying art. 9 that the enterprises are indeed associated. With respect to agents in the sense of art. 5 (7) UN Model 2001 however, that pre-condition or basic philosophy does not exist at all. In other words, both art. 9 and art. 5(7) of the UN Model 2001 use the same terminology but with an entirely different approach and an entirely different purpose. The approach is different because art. 5 (7) must also be applied to unassociated enterprises. The purpose is different because art. 9 addresses taxable sum, while art. 5 discusses taxable presence. How can the same standard be used if the standard was meant for an entirely different situation? This leads to an illogical reasoning. The agent (who works wholly or almost wholly on behalf of one enterprise) is only independent if the conditions do not differ from those between independent enterprises. But if he *is* an unassociated enterprise, the conditions *are* necessarily like those between independent enterprises. If the basic philosophy of art. 9 is to be applied in art. 5 (7) as well, it may come down to saying that the agent is only independent if he is independent. The arm's length test as formulated in art. 5 (7) can therefore be applied, but not in the same way as in art. 9. Is it in that case

[1053] UN document ST/SG/AC.8/1999/L.3

not confusing to have exactly the same words on two places in the treaty, but with quite a different meaning and purpose?

In the opinion of this author, the anomalies the Group is trying to remedy (losing one's independent character just because the number of enterprises the agent works for has been reduced to one) could have been solved by providing in the treaty what the UN commentary already says: the exclusivity must be the consequence of an agreement between the enterprise and the agent, and not the coincidental result of other circumstances. This criterion is also much easier to apply in practice than a possibly endless discussion on the arm's length character of the commercial and financial conditions. Furthermore, it has the advantage of being based upon existing commentary and it does not create confusion between art. 9 and art. 5.

Another observation is that art. 5 (7) has not been amended to meet earlier criticism about being easy to circumvent. As Qureshi noted: "However, given the wide range of operations of multinational corporations, it would de desirable to modify the provisions of par. 5 of art. 5 of the UN draft so as to cover the activities of independent agents exclusively or almost exclusively devoted to a group of centrally controlled enterprises"[1054]. Dividing contracts between related enterprises of the principal would, *prima facie*, render art. 5 (7) inoperable. In art. 5 (3) b) (furnishing of services) such has been recognized, and it therefore includes a reference to the project, and not to the principal[1055]. Tax treaty practice has also recognized this problem. The protocol between Japan and Thailand for instance, provides that:

> "With reference to paragraph 7 of Article 5 of the Convention, the term "a broker, general commission agent or any other agent of an independent status" is understood not to include a person who is engaged in one of the Contracting States in such activities as prescribed in sub-paragraphs (a), (b) or (c) of paragraph 6 of the said Article wholly or almost wholly for or on behalf of an enterprise of the other Contracting State or for or on behalf of such enterprise *and other enterprises which are controlled by or have a controlling interest in such enterprise* (author's italics)"[1056].

[1054] Qureshi, IFA Seminar. 1979, ibid, ft.1031, p. 35.
[1055] Van der Bruggen, E. , "PE Implications when furnishing consulting services under the OECD and UN model treaties", *T.N.I.*, May 2001, p. 2623 (2635).
[1056] Protocol Japan-Thailand 1990, clause 1.

4. No Corresponding Adjustments in Case of Fraud (Art 9 Par. 3)

A new, third paragraph was added to art. 9 in the UN Model 2001:

> "3. The provision of par. 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under par. 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or willful default."

Art. 9 of the OECD and UN Model allows a correction of the profit of an enterprise in case of transactions between associated enterprises which are not at arm's length. Paragraph 2 introduces the obligation for the other state to carry out a so-called corresponding adjustment. The UN Model 2001 adds a third paragraph to art. 9, providing that the corresponding adjustment is not required in case of tax evasion.

The intention of this amendment is clear: to exclude corresponding adjustments for manipulations that exceed "acceptable" transfer pricing and are actually plain fraud[1057]. In a transfer pricing dispute therefore, the enterprise will not be entitled to a corresponding adjustment if the other state has imposed a penalty (after at least some kind of a legal proceeding) on one of the two enterprises involved. Trying to diminish the possibilities for having to carry out a corresponding adjustment would, so it is thought, be in the interest of DCs. After all, transfer pricing corrections are the most likely to occur in countries where the tax authorities have strong audit resources and highly trained officials. Consequently, it is more likely that DCs will find themselves on the other, corresponding end of the transaction, and are required to carry out adjustments under art. 9(2)[1058]. Limiting the scope for that corresponding adjustment would, in theory, be more to the advantage of DCs.

The addition to the UN Model 2001 can be associated with a similar provision in the EU Arbitration Convention. Art. 8 of that convention reads as follows: (par. 1) "The competent authority of a Contracting State shall not be obliged to initiate the mutual agreement procedure or to set up the advisory commission referred to in Article 7 where legal or administrative proceedings have resulted in a final ruling that by actions given rise to an adjustment of transfers of profits under Article 4 one of the enterprises concerned is liable to a serious penalty."

[1057] UN document ST/SG/AC.8/1999/L.3, p. 18.

[1058] Qureshi, IFA Seminar, 1979, ibid, ft.1031, p. 40.

Curbing tax evasion is of course one of the purposes of tax treaties, and transfer pricing is often seen as an important source of revenue loss of DCs[1059]. Be that as it may, the new exception for corresponding adjustments will not be welcomed by all countries with the same level of enthusiasm. There are those who are of the opinion that double taxation which is the consequence of transfer pricing adjustments, serves the taxpayer right[1060]. Other countries see it differently however, and point out that fines and other administrative or even judicial measures exist to penalize the taxpayer, and double taxation should not play any role in that process.

It is indeed hard to see the logic of the new paragraph from that perspective. Art. 9 (3) UN Model 2001 connects the "*guilt*" of one enterprise to the *tax base* of the second taxpayer, and it is the first time that those entirely different concepts are put in relationship to one another in a tax treaty. One of the basic premises of the tax treaty is that countries will (only) tax profit which is realized on an at arm's length basis. This in itself, arguably even without art. 9 (2) saying so explicitly, is enough to ensure that a country should carry out corresponding adjustments if it turns out it has taxed an amount which was higher than arm's length. One could say that because the transaction was manipulated to such an extent it has given rise to administrative or judicial penalties, chances are that the profit taxed in the other country was *far above arm's length*, and a profit adjustment in the other country is consequently even more called for. The fact that the first enterprise becomes liable to such penalties still does not change that the second enterprise's profit is higher than arm's length, and that with art. 9 (3), the other country has a right to deviate from that arm's length standard. In the opinion of this author, allowing deviations from the arm's length standard is always dangerous and, what is more, incompatible with the object and purpose of the tax treaty. Doing so can only be done with extreme caution, and within conditions that are clearly defined.

Furthermore, the wording of the provision evokes many questions with respect to its application and interpretation. Most of the terms used in this provision are namely not defined in the UN Model 2001, and must be explained under the law of the state that applies the treaty, any meaning

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[1059] Tanzi, V., "Tax reform in economies in transition", *IMF*, 1991.

[1060] Namely countries who do not agree to including art. 9 (2) in the tax treaty: Czech Republic, Finland, Hungary, Mexico, Norway, Switzerland made a reservation to the OECD Model on this issue. Belgium, France, Hungary, Poland and Portugal reserved the right to specify in their conventions that they will proceed to a correlative adjustment if they consider this adjustment justified.

in tax law having precedence over a meaning given to the term under other laws. Terms such as “gross negligence” and “willful default” may not as such exist in the tax law of all states. In addition, even if “negligence” is a term that may be used with respect to taxation (such as “neglecting to file a tax return”[1061]), “gross negligence” is mostly associated with private law, and not public law. It is defined in Black’s Law Dictionary as “a conscious, voluntary act or omission in reckless disregard of a legal duty and of the consequences to another party, who may typically recover exemplary damages”. With respect to “willful default” it may be noted that “default” (with respect to liability) is mostly used in civil law and can be defined as “intentional omission or failure to perform a legal or contractual duty”. Arguably, the context of both terms in the added paragraph to the UN Model 2001 indicates that some lack of good faith must play a role, but it is unfortunate that both terms are within civil law mostly used with respect to torts and not with respect to public law. The term “fraud” clearly *is* appropriate within the context of tax law, and might be in itself sufficient to achieve the purpose of the paragraph.

In addition, “proceeding” is not defined, which can lead to interpretation problems. Is it still a “proceeding”, for example, if the tax authorities impose a fine pursuant to an audit that the enterprise agrees to pay without discussion? If that course of events is not considered a proceeding, and this author believes it does not, then the other state may not refuse to carry out the corresponding adjustments, which is an illogical result.

5. Changes with Respect to Capital Gains on Real Estate Companies (Art. 13 Par. 4)

Amendment of art. 13 par. 4 itself (amended text in italics):

> “4. Gains form the alienation of shares of the capital stock of a company, *or of an interest in a partnership, trust or estate,* the property of which consists directly or indirectly principally of immovable property situated in a contracting state, may be taxed in that state”

A new sub-paragraph is added to art. 13 par. 4:

[1061] Black’s Law Dictionary has an entry for “tax negligence” for which reference is made to sec. 6651 et seq. of the US IRC.

"(1) Nothing in this paragraph shall apply to a company, partnership, trust or estate, other than a company partnership, trust or estate engaged in the business of management of immovable properties, the property of which directly or indirectly principally consists of immovable property used by such company, partnership trust or estate in its business activities"

A new second sub-paragraph is added to art. 13 par.4:

"(2) For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty percent of the aggregate value of all assets owned by the company, partnership, trust or estate"

Capital gains on shares of a company follow the same allocation rules as all other property for which no special rules exist under the OECD Model, and are taxable only in the sate where the alienator is resident. The UN Model 1980 determines however that if the participation exceeds a certain percentage, it is the state where the company is established which may (also) tax. Furthermore, art. 13 (4) UN Model 1980 provides that if the property of the company consists directly or indirectly principally out of immovable property, the state where the company is established may tax capital gains on the shares. From all the articles in the UN Model 2001, the rules with respect to capital gains on real estate shares, has been changed the most, namely with three amendments.

5.1 <u>Including "interest in a partnership, trust or estate" in the scope of art. 13 (4)</u>

The scope of art. 13 (4) has been broadened to include interests in partnerships, trusts or estates. Such entities do not have shares, and it was pointed out that without a special mention, art. 13 would not apply[1062]. It is the first time that this provision is included in a model treaty, but it already exists in a large number of tax treaties[1063].

"Interests" must be explained with reference to domestic law and differences are bound to occur between civil law countries and common law countries on the issue of who has an interest in a real estate trust, for example. The potential for this amendment is considerable. Real Estate

[1062] UN document ST/SG/AC.8/1999/L.3, p. 25

[1063] See for example: Netherlands-Canada, Japan-Vietnam, Canada-Indonesia, Canada-Bangladesh, Canada-Malaysia, Canada-South Africa, Canada-Uzbekistan, US-Argentina, US-Austria.

Investment Trusts (Reit's), investment funds, and certain non-profit juristic entities that are used as investment vehicles[1064], now all seem to fall under the scope of the article.

5.2 Exclusion of immovable property used for business purpose (art. 13 par. 4).

The purpose of this amendment is to narrow the scope of the provision on real estate companies by excluding companies that use the immovable property for their business activities, such as a hotel[1065]. This rule could already be found in several tax treaties[1066]. Property management companies, however, are excluded from being regarded as companies "that use immovable property for their business activity", and remain subject to the normal rules.

Under the new sub-paragraph, *any* company (or partnership, trust or estate) except one that is engaged in the business of management of immovable properties, and which uses immovable property for its business purpose, falls out of the scope of paragraph 4 of art. 13. The obvious examples are a hotel, a golf course, a zoo or a theme park. A company whose real estate turns out to be the principal asset, for example because of financial difficulties, will however also qualify. It seems that mere management of immovable properties may not be regarded as a "business activity" for the purpose of this paragraph. The "management of immovable properties" includes, in the opinion of this author, buying properties, maintenance, letting the property and possibly selling it again. However, does it also include speculation, project development, etc.? It would seem so, and consequently shares in real estate development companies continue to fall, in the opinion of this author, under the application of art. 13 (4) UN Model.

It can be noted that the same result could have been achieved by providing that immovable property that is used for business purposes (by any kind of company), shall not be counted for the 50%-rule that is now featuring in sub-paragraph 2 (which is further discussed below).

[1064] "Anstalt", "Stiftung", "Stichting", etc.
[1065] UN document ST/SG/AC.8/1999/L.3, p. 26.
[1066] e.g. US-Argentina, Netherlands-Canada.

5.3 Definition of "principally": the "50%-rule" (art. 13 par. 4)

The UN Model 2001 defines "principally" as exceeding 50% of the assets. Note that *such* immovable property must be taken into account, not *all* immovable property. Therefore, only the immovable property in the source state may be reckoned with. Earlier, a 75% threshold was considered, but the Group decided to adopt 50%[1067].

In tax treaty practice, other phrases have sometimes been used such as "shares the value of which is derived principally from immovable property"[1068]. In connection with the first amendment to art. 13 (4) (inclusion of interests in a partnership, trust or an estate), the 50%-rule may be very difficult to use in practice. Companies usually have a legal obligation to draft annual accounts and undergo independent audits. It is not at all certain if the same applies to all partnerships, trusts or estates. Some entities, in particular those used for personal investment, will not be able to supply independently audited accounts with respect to the exact total of their assets, nor the exact value of the immovable property in the source country. Note that for the calculation of the 50% rule, the sales price of neither the shares nor the capital gain realized, is of any importance.

6 Changes with Respect to Independent Personal Services (Art. 14 Par. 1 c).

Art. 14 par. 1 c is deleted. In the 1980 UN Model, art. 14 par.1 c read as follows:

> *"(c) If the remuneration for his activities in the other Contracting State is paid by a resident of that Contracting State or is borne by a permanent establishment or a fixed base situated in that Contracting State and exceeds in the fiscal year . . . (the amount is to be established through bilateral negotiations)."*

6.1 The OECD example to remove the article was not followed

A first observation about art. 14 is that it is still there. The example of the OECD Model 2000 to remove the article in favor of source taxation as business profits, has not been followed. This must have been a conscious

[1067] UN document ST/SG/AC.8/1999/L.3, p. 28

[1068] e.g. Netherlands-Canada, US-Canada, US-Australia.

decision, because some of the other changes that were implemented in the OECD Model of 2000 *were* reproduced[1069].

The question may be asked why. After all, one could say that the deletion of sub-paragraph c) in art. 14 of the UN Model 1980 (source tax if income exceeds a certain amount) is yet another step bringing the models closer together. What is more, the UN Model 1980 already includes a source taxation possibility for *all* services performed in the source country during at least 6 months in art. 5 (3) b, closely resembling the 183 days-rule of art. 14 (1) b UN Model 1980 and 2001. "Moving" the income from independent personal services to art. 7 (and 5) would therefore not entail any loss in taxing power.

However, as this author has argued before[1070], actual tax treaty practice shows that developed countries are much more reluctant to accept source taxation on all services, than only on independent personal services[1071]. Consequently, in most treaties, the theoretically similar conditions (6 months/183 days, etc.) for source taxation between independent services income, and all other services, do not exist very often in practice. Some flexibility is indeed necessary, and it seems that the Group has tried to maintain that.

6.2 Deletion of art. 14 par. 1 c (source tax if income exceeds a certain amount).

As briefly mentioned above, subparagraph c) has been deleted from the first paragraph of art. 14. This rule allowed source taxation if the amount is paid by a resident (or PE) and exceeds a certain amount. This possibility has not become widespread, as the Group of Experts points

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[1069] In art. 2 (4), for example. See also below.

[1070] Van der Bruggen, E., "Developing Countries and the Removal of Art. 14 from the OECD Model", *BIFD*, 2001, p. 601-607 (ad 606).

[1071] **Italy**, for instance, is quite selective about agreeing to a furnishing of services PE. in its treaties with Albania, Algeria, Bangladesh, Estonia, India, Lithuania and Malaysia (DTC's with developing countries since 1980), Italy did not include such a provision. all those treaties do however include the 183 days-rule with respect to independent services. the same (no furnishing of services PE in art 5 but a 183 days-rule in art 14) can be said for **Belgium's** treaties with Bangladesh, India, Ivory Coast, Latvia, Mauritius and Tunisia; the **UK's** treaties with China, Kuwait, Latvia and Pakistan; **France's** treaties with Bangladesh, India, Latvia, Lithuania and Pakistan; **Germany's** treaties with Bangladesh, Egypt, Estonia, India, Indonesia, Latvia, Lithuania, Namibia, Pakistan, Philippines and Uruguay and the **Dutch** treaties with Bangladesh, Estonia, India, Latvia, Lithuania, Malaysia, and Tunisia.

out, referring to a study carried out by Prof. Wijnen in 1997[1072]. It was also noted that because of inflation, amounts in currency eventually become meaningless anyway[1073].

It is true that only a few countries have made this rule a permanent feature of its tax treaties. As far as this author is aware, *Thailand* is the only country that has included it in most of its (41 in force) tax treaties, without minimum amount. *Malaysia* has also included it in many of its important tax treaties (Australia, Canada, the Czech Republic, France, and Korea). *The Philippines* have also included the "borne" rule in certain important treaties including those with Australia, Canada, Italy, Malaysia, Singapore and the US. *Sri Lanka* has also adopted the "borne rule" in a few of its treaties (Denmark, Sweden and Switzerland).

7 Equal Treatment for Students (Art. 20 Par. 2)

Deletion of art.20 par. 2 which read as follows in the UN Model 1980:

> "2. In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting."

The OECD Model provides that payments that a student, trainee or an apprentice receives from outside the state, shall not be taxed in that state under certain conditions. UN Model 1980 contained a second paragraph which guarantees that the student will receive the same reductions, exemptions etc. as residents of the state where he is studying with respect to the taxation of grants, scholarships and remuneration. In the UN Model 2001, that paragraph has been deleted. It may be pointed out in this respect that the same "equal treatment" could also be derived by nationals from art. 24 (1), reducing the practical importance of art. 20 (2) UN Model 1980 considerably[1074].

[1072] Report of the Sec-General of the Eighth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters: UN Doc: E/1998/1. Wijnen, W., and Magenta, M., "The UN Model in Practice", *Bull. I.F.D.*, 1997, p. 581.

[1073] UN doc: E/1996/1 p. 4-5

[1074] Not entirely, because non-discrimination is only extended to nationals, while art. 20 (2) UN Model 1980 mentions residents.

8 Adaptations to the OECD Model.

One of the purposes of revising the UN Model 1980 was to implement the changes that were in the meantime found in the OECD Model[1075]. Most of the amendments on the OECD Model between 1992 and 1997 have been taken over by the UN Model 2001, but not before careful consideration[1076]. Only a few modifications of the OECD Model 2000 have also been carried out, because most of those relate to the removal of art. 14, which was not followed by the UN.

(a) Replacing "Personal Scope" with "Persons Covered" in the title of Article 1 UN Model 2001 (=OECD Model 1995)
(b) Moved the definition of "national" from art. 24(2) art. 3 UN Model 2001 (=OECD 1992)
(c) Deleting "at the end of each year" and "respective" from art. 2(4) UN Model 2001 (=OECD Model 2000)
(d) Adding "at that time" and "any meaning under the applicable tax laws prevailing over a meaning given to the term under the other laws of that State" to art. 3(2) UN Model 2001 (=OECD Model 1995 and 2000)
(e) Adding "also includes states and any political subdivision" to art. 4(1) UN Model 2001 (=OECD Model 1995)
(f) Adding "only" in art. 4(2) a to UN Model 2001 (=OECD Model 1995)
(g) Replace "the recipient is the beneficial owner of the dividends" by "the beneficial owner of the dividends is a resident of the other Contracting State" in art. 10(2) UN Model 2001 (=OECD Model 1995) and a similar amendment to art. 11.
(h) Adding "commencing or ending in the fiscal year concerned" in art. 15(2) a UN Model 2001 (=OECD Model 1992)
(i) Changing "athlete" into "sportsperson" in art. 17(1) UN Model 2001 (similar to "sportsman" as in the OECD Model 1992)
(j) Adding "other similar remuneration" in art. 19(1) and (2) UN Model 2001 (=OECD Model 1994 and 1995)

[1075] UN doc: E/1998/1 p. 12 (para. 38)
[1076] Wijnen, W.F.G., "Towards a New UN Model?", *BIFD*, 1998, 135 (140).

9 The Absentees: Provisions That were *Not* Included in the UN Model 2001

Some observations can be made with respect to provisions that are conspicuously absent from the UN Model 2001.

9.1 Tax sparing credit

In first instance, it is noteworthy that tax sparing, which since 1980 has often been the subject of suggestions to include it in the UN Model[1077], has once again been left out. During the Ninth Meeting of the Group of Experts, the possible inclusion of a clause on tax sparing credits was debated, but without leading to the introduction into the UN Model 2001:

> "One of the major points of discussion at the Ninth meeting concerned the treatment to be accorded to the subject of 'tax sparing' in the commentary on the article 23 of the UN Model on methods for the elimination of double taxation. Tax sparing is the practice of adjusting home country taxation of foreign investment income to permit investors to receive the full benefits of host country tax reductions. There was considerable difference of opinion among members from the Group of Experts about the impact of the grant of tax sparing to foreign investors on the flow of foreign direct investment towards developing countries and transitional economies. It was decided by the Group of Experts to note the discussions on the subject without drawing any conclusions in the matter"[1078].

This is remarkable because nearly every IC has in the meantime accepted this in tax treaties with DCs, with the well-known exception of the United States. From the perspective of DCs the fact that a provision on tax sparing credits is again absent from the UN Model must come as a disappointment.

9.2 Branch profits tax

Certain DCs (and some ICs as well)[1079], impose a withholding tax on profit remitted from a branch or other kind of PE to the head office.

[1077] Qureshi, ibid, ft. 1054, p. 37.

[1078] Report of the Sec-General, Ninth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, UN doc: E/1999/84, p. 6 (para. 39).

[1079] e.g. Brazil, Indonesia, Canada, Thailand, US. See: Adonnino, A.P., IFA General Report , *Cah. Dr. F. Int.,* 1993, p. 61.

Although the OECD Model and the Commentary is silent on this matter, there is very persuasive evidence that a branch profits tax is contrary to tax treaty provisions (notably art. 10 par. 5 and/or art. 23 par. 3)[1080]. In order to safeguard that tax from provisions of the tax treaty a specific exception to that effect can be included, and many countries have proceeded to do so.

The inclusion of a branch profits tax-provision was a key issue at the 1987 and 1992 meetings of the Group. Most DCs supported the possibility of a branch profits tax, even when their domestic law did not (yet) provide for one[1081]. It was noted that a branch profits tax would restore neutrality between locally incorporated and unincorporated forms of doing business. Notably, the branch profits tax is compared with withholding tax on dividend distributions. Tillinghast, D. and Ault, H point out however, that a branch profits tax affects the PE, while a withholding tax affects the corporate shareholder[1082]. Furthermore, nothing guarantees that the head office will distribute the profits it derived from the branch to the shareholder, and withholding tax (in the other country) may be due as well.

In 1997, the Group included a 6th paragraph in art. 10 in the Manual for Negotiating Tax Treaties Between Developed and Developing Countries, with the following text:

> "Notwithstanding any other provision of this Convention, where a company which is a resident of a Contracting State has a PE in the other Contracting State, the profits attributable to the PE may be subject to an additional tax in that other State, in accordance with its laws, but the additional charge shall not exceed (   ) per cent of the amount of these profits"[1083]

[1080] Adonnino, A.P., IFA General Report , Cah. Dr. F. Int., 1993, 61; Shannon, Doernberg, Vogel, Van Raad, (looseleaf) art. 10, p. 163.; Harrision, S., "Branch profits tax under the UK-Kazachstan tax treaty", *E.T.*, 1996, p. 373.; US Treasury, General Explanation of the Tax Reform Act of 1986, May 4th 1987, p. 1043.

[1081] UN Doc: ST/SG/Ac.8/1997/L.12, p. 67.

[1082] Tillinghast, D. and Ault, H., Study of US income tax treaties, part. IV, American Law Institute, 1991, p. 269.

[1083] The Group also considered that a special addition to art. 24 may be in order, and even suggested a text, but also pointed out that the language of their art. 10 par. 6 ("Notwithstanding *any* other provision of this Convention") made it superfluous. Eighth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, Geneva 15-19 December 1997, UN Doc: ST/SG/AC.8/L12.

The Focus Group (members delegated by the Ad Hoc Group of Experts) observed that

> "Branch tax was not applied by most countries, (so) it may usefully be placed in the commentaries and not in the main text"[1084]

9.3 <u>Visiting professors</u>

Another provision that is conspicuously absent from the UN Model 2001 is a special rule for visiting professors and teachers. Such an article exempts income from visiting professors, teachers and sometimes researchers from tax in the source state up to 2 years. A provision along these lines has found its way into a very large number of tax treaties concluded by DCs and ICs alike. During the Seventh Meeting of the Group in 1996, the inclusion of such a rule was discussed, but it is not mentioned in the UN Model 2001[1085]. It is however mentioned in the OECD Commentary and in the Dutch Model Treaty[1086].

10. Final Observations

One must bear in mind that the UN Model 2001 is the result of a compromise between ICs and DCs, and that the resources of the UN in this respect cannot be compared with those of the OECD, an organization with more homogenous members. What is more, meetings are conducted in large groups that only meet every couple years. In other words, the conditions are much less favorable to reach any result at all, let alone accomplish a highly ambitious agenda on international tax cooperation between developed and developing countries.

Despite those less than desirable conditions, the Group has still booked some interesting results. The synchronism of the two models (except with respect to art. 14), has been drastically improved by the Group of Experts and that is undoubtedly beneficial for the development of international tax law. The OECD and the UN Model should, in the opinion of this author, only be different if there is a very good reason for them to be different. From that perspective, including sub-paragraph f) in art. 5 (4) and adopting most of the changes of the OECD Model since 1980, is

[1084] UN document ST/SG/AC.8/1999/L.3, p. 19.
[1085] Report of the Sec-General on the Seventh Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, UN Doc: E/1996/1, p. 5 (par. 19-26).
[1086] "Nederlands Standaard Verdrag", art. 20.

certainly a positive development. Furthermore, the UN Model 2001 now offers some important clarifications and improvements on provisions that are typical for the UN Model, such as a definition of "principally" in relation to immovable property in art. 13 (4), and an exclusion for shares of companies that use immovable property for their business activity. Finally, the UN Model 2001 contains some interesting new provisions (such as art. 9 par. 3), which may raise some interpretation questions (as new tax rules always do), but certainly represent fresh ideas that contribute to new insights and discussions between tax treaty partners.

However, those who were expecting the UN Model 2001 to include additional provisions to the benefit of developing countries, may be disappointed with the result of the Ad Hoc Group of Experts. As was mentioned above, even the UN Model of 1980 was at the time received with mixed emotions[1087]. Certain DCs argued that the compromise did not go far enough in terms of source taxation possibilities. Those DCs are likely to be even more unhappy with the revised UN Model 2001. Far from increasing source tax possibilities, there is no important modification that is clearly in the interest of DCs at all. In fact, several of the new additions are actually to the disadvantage of DCs. The arm's length condition with respect to independent agents, for example, will make it significantly harder for DCs to prove that a *prima facie* independent agent may be deemed a PE. The exclusion of a combination of "negative" activities from the PE-definition, and the abolishing of subparagraph c) in art. 14 (1) are also detrimental from a DC's point of view. Furthermore, there is the conspicuous absence of a tax sparing credit. Most of the other modifications all have merit of course, but cannot be explained as being in the interest of DCs, and creating provisions to the specific benefit of DCs is the *raison d'etre* of the UN Model Tax Convention.

Prof. Wijnen, who observed the revision proceedings for the IBFD, pointed out in 1998 which factors presented difficulties for reaching results at the Group:

> "A group of 75 does not easily lend itself to an efficient discussion, (…) particularly if that group meets for only one week every two years. In these circumstances there is little opportunity for Group members to develop new ideas and even less chance that their points of view will gradually converge. (…) The obvious solution

[1087] Ibid, ft.1031.

> seems to be that the Group should concentrate its energies on the subjects of direct interest to developing countries"[1088]

The introduction of the UN Model 2001 may be a good time to reflect on the role the UN should play for the development of international tax law in the 21st century. Maybe the rather limited original contributions to the UN Model 2001 illustrate that in terms of compromise between ICs and DCs, the limit of what can be achieved in a the context of a model treaty, has been reached. The UN may consider how best to continue it's important contribution to international tax cooperation, particularly keeping the interests of DCs in mind that are faced with the challenges of a quickly changing economical and financial environment. The meetings of the Group have already produced plenty of possible new approaches and interesting fields of study, unrelated to the revision of the UN Model, including those that have special facets for DCs. The Group discussed for example the exchange of information and tax havens, transfer pricing, technical training of tax officials and new financial instruments[1089]. It is now a matter for the UN to determine how to continue its future contribution to the development of international tax law.

[1088] Wijnen, W.F.G., "Towards a New UN Model?", *BIFD*, 1998, p. 142-143.
[1089] Report of the Sec-General of the Eighth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters: UN Doc: E/1998/1.