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United Nations Model Tax Convention update

Inclusion of Article 23A (4) of the OECD Model in Article 23A of the UN Model

Summary

1. On 9-10 June, UN-DESA organized an Ad Hoc Expert Group Meeting focusing on the 2011 revision of the UN Model Double Taxation Convention between Developed and Developing Countries (UN Model).

2. During the discussion of Article 23, the Meeting looked at the possibility of including in the 2011 revision of the UN Model paragraph 4 of Article 23 A of the OECD Model (conflicts of interpretation) in order to address situations of "unintended" double non-taxation. Differing views were expressed, however, and it was decided that Ms Devillet would draft for further consideration Commentary relevant for the inclusion of paragraph 4 of Article 23A. A draft Commentary was sent out to the informal group and gave rise to diverging views. Those views could not be reconciled. It was, therefore, decided to submit the issue to the Committee for further consideration and decision.

3. Section 1 of this note briefly describes the issues of conflicts of qualification (paragraphs 32.1 to 32.7 of

I. <u>Conflicts of interpretation versus conflicts of qualification</u>

6. The issues of conflicts of qualification (paragraphs 32.1 to 32.7 of the Commentary on Articles 23A and 23B of the OECD Model) and conflicts of interpretation (paragraph 4 of Article 23A of the OECD Model) are closely linked. Both issues are, therefore, shortly presented in the following paragraphs in order to identify the differences and possible overlap.

Conflicts of qualifications

7. Under paragraph 2 of Article 3 any term no defined therein has the meaning it has under the domestic law of the State applying the treaty (the source State where Articles 6 to 21 are applied to a particular item of income and the residence State where Article 23 is applied to the same item of income) unless the context otherwise

An employer terminates the employment of several of its employees who are residents of State A and have been working in State B for three years. He gives those employees an advance notice of termination of three months. He prefers that the employees stop working immediately rather than work during the period of three months covered by the notice. The remuneration for that period is paid in the form of a payment "in lieu" of notice.

Under the domestic law of State B, a payment "in lieu" of notice of termination is a taxable remuneration. A final court decision in State B considers, however, that such payments should be taxable only in State A (the State of residence of the employees) because they cannot relate to activities exercised within State B (application of the first sentence of Article 15(1)). The constant jurisprudence of State A considers, on the other hand, that a payment "in lieu" of notice of termination is made in consideration of the employment exercised when the notice of termination is given to the employee (application of the second sentence of Article 15(1)). According to that jurisprudence, the payment is therefore taxable in State B and State A must exempt the payment under Article 23A(1).

In the absence of Article 23A(4), a payment "in lieu" of notice of termination, which is taxable under the domestic law of both Contracting States, is not taxed in any of the Contracting States. Article 23A(4) avoids such double non taxation by allowing the residence State not to apply paragraph 1.

If State A applies Article 23B, no double non taxation will occur as there will be no foreign tax to credit.

Example 2

An enterprise of State A, Subcontractor SA, works consecutively on 7 different building sites within State B. Those building sites do not constitute connected projects. The activities of Subcontractor SA on each site last less than 6 months but its overall activities on all 7 sites in State B last 14 months. Under Article 5 of the treaty between State A and State B, a building site constitutes a PE only if it lasts more than 6 months.

State A considers that a series of consecutive short-term sites operated by a single contractor would give rise to the existence of a PE in State B and, therefore, that the profits attributable to those sites are taxable in State B. Following Article 23A(1) State A has the obligation to exempt the said profits.

On the other hand, State B follows paragraph [18] of the OECD Commentary on Article 5, which is quoted under paragraph 11 of the UN Model, and considers that the profits relating to the activities exercised by Subcontractor SA on its territory are not attributable to a PE situated on its territory and are therefore not taxable therein.

In the absence of Article 23A(4), business profits, even though taxable under the domestic law of both Contracting States, are not taxed in any Contracting

16. Where the source State applies the provisions of paragraph 2 of Article 10, 11 or 12 to an item of income, some countries may prefer not to deny the application of the provisions of paragraph 1 despite the fact that the source State must limit its tax on such income. The Commentary on paragraph 4 would allow those countries to limit the scope of paragraph 4 to cases where the source State applies the provisions of the Convention to exempt an item of income or capital from tax and to delete the part of paragraph 4 dealing with Articles 10, 11 and 12.

Option II: To include paragraph 4 in Article 23 A of the UN Model together with a new paragraph in the Commentary indicating that the Contracting States may consider that the inclusion of the provision is not appropriate.

17. Under this option, the following paragraph 24 could be added in the Commentary on Article 23 A:

> *"24. As a matter of policy, some countries consider, however, that, where the State of residence adopts an interpretation under which an item of income or of capital falls under a provision of the Convention that allows the State of source to tax that income or capital, the State of residence should not have the right to take away the exemption provided for under paragraph 1 in a situation dealt with by paragraph 4. Where the State of source adopts a different interpretation, under which the item of income or capital falls under a provision of the Convention that does not allow taxation in the State of source or only allows limited taxation therein, those countries consider that it would be detrimental to the interest of the State of source if the State of residence could arrogate such taxes to its jurisdiction in contradiction with its own interpretation. Those countries should not include paragraph 4 in their tax treaties."*

Option III: To include no paragraph 4 in Article 23 A of the UN Model.

18. Under this option, the Commentary will, however, propose an alternative provision similar to the one proposed under option I for those countries wishing to eliminate the double non-taxation dealt with under paragraph 4.

IV. Pros and Cons of including Article 23 (4) in the UN Model

Arguments raised against including Article 23 (4) in the UN Model

19. Including paragraph 4 in the UN Model would result in including the avoidance of double non-taxation as a treaty objective in the UN Model. Although some countries regard double non-taxation as undesirable, very few countries

- While the OECD Model focuses on the avoidance of double taxation, many developing countries consider that the main purpose of a tax treaty is to ensure an equitable allocation of taxing rights.

- The policy underlying the OECD Model is primarily to limit the taxing rights of the source State and to preserve the rights of the residence State. The UN Model should ensure that, once the treaty has allocated taxing rights to the source State, that State is free to use them or not. Any attempt by the residence State to recapture taxing rights that the source State has not used, for whatever reason, would affect the interests of the source State.

- Developed countries are concerned primarily with the avoidance of double taxation (and now double non-taxation) from a purely fiscal perspective. Developing countries negotiate treaties for both fiscal and non-fiscal (e.g. economic, social or political) considerations. It is not uncommon for those

25. Article 23A(4) is not acceptable to the Courts of some countries and may be unconstitutional in some countries (e.g. United Kingdom, Sweden, Greece, Germany, Hungary, Switzerland). It should not be the objective of the UN Model to recommend a provision that does not comply with the domestic laws of countries and affects their sovereign taxing rights. Countries attempt to align their treaties with their domestic law and they are not going to change this just because the UN Model says so. The UN Model should permit each country to retain its fiscal sovereignty and to follow its own domestic law interpretations.

26. The problems solved under paragraph 4 are quite complex and rarely occur in real life. Paragraph 4 should be excluded from the UN Model in order to keep the treaty simple unless the Committee can find more cases involving developing countries. IFA 2004 General Report on double non-taxation notes that, so far, countries have been quite reluctant to introduce the provision of Article 23A(4) in their bilateral treaties. It considers that this reluctance can probably be attributed to the fact that Article 23A(4) of the OECD Model is perceived as not being matured or balanced. Many countries obviously have other priorities than to adopt as soon as possible an OECD proposal for the prevention of double non-taxation. This situation has not evolved and nowadays still very few countries include Article 23A(4) in their treaties.

Arguments raised in favour of including Article 23A(4) in the UN Model

Committee is invited to choose one of the three proposed options so that the chosen option may be included in the next update of the UN Model.

ANNEX

Paragraph 4 of Article 23 A

"4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11 or 12 to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2."

Commentary on paragraph 4 of Article 23 A

Paragraph 4

17. The Committee considers that the following Commentary on paragraph 4 of Article 23 A of the OECD Model Convention (as it read on 22 October 2010) is applicable to paragraph 4 (the additional comments that appear in italics between square brackets, which are not part of the Commentary on the OECD Model, have been inserted in order to reflect the fact that paragraph 4 also applies where the State of source applies the provisions of paragraph 2 of Article 12 to an item of income):

> [56.1] The purpose of this paragraph is to avoid double non taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or on the interpretation of the provisions of the Convention. The paragraph applies where, on the one hand, the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that eliminates its right to tax that item or limits the tax that it can impose while, on the other hand, the State of residence adopts a different interpretation of the facts or of the provisions of the Convention and thus considers that the item may be taxed in the State of source in accordance with the Convention, which, absent this paragraph, would lead to an obligation for the State of residence to give exemption under the provisions of paragraph 1.

> [56.2] The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or