

DRAFT CONTENTS OF THE 2017 UPDATE TO THE OECD MODEL TAX CONVENTION



11 July 2017

DRAFT 2017 UPDATE TO THE OECD MODEL TAX CONVENTION

This note includes the draft contents of the next update to the OECD Model Tax Convention (the 2017 update) prepared by Working Party 1 of the OECD Committee on Fiscal Affairs. It has not yet been approved by the CFA or the OECD Council, although, as noted below, significant parts of the 2017 update were previously approved as part of the BEPS Package (included in the 2015 final Reports on BEPS Actions 2, 6, 7 and 14). It will be submitted for the approval of the Committee on Fiscal Affairs (CFA) and of the OECD Council later in 2017. It therefore does not necessarily reflect the final views of the OECD and its member countries.

As explained more fully below, comments are requested at this time only with respect to certain parts of the 2017 update that have not previously been released for comments.

The 2017 update primarily comprises changes to the OECD Model Tax Convention that have been approved as part of the BEPS Package, were foreseen as part of the follow-up work on the treaty-related BEPS measures and/or were previously released for comments. Comments are accordingly not requested at this time with respect to these changes, which include the following:

- Changes to the Title and Preamble of the OECD Model Tax Convention, as well as to its Introduction, and related Commentary changes contained in the [Report on Action 6 \(Preventing the Granting of Treaty Benefits in Inappropriate Circumstances\)](#).
- The addition of new paragraph 2 to Article 1 (the transparent entity provision) and of related Commentary changes. These changes appear in Chapter 14 of the [Report on Action 2 \(Neutralising the Effects of Hybrid Mismatch Arrangements\)](#).
- The addition of new paragraph 3 to Article 1 (the “saving clause”) and of related Commentary changes. These changes appear in the [Report on Action 6](#).
- Changes to the section of the Commentary on Article 1 on “Improper use of the Convention”, which include optional provisions to deny treaty benefits with respect to income benefiting from “special tax regimes” and in cases of certain subsequent changes to the domestic law of a treaty partner after the conclusion of a tax treaty. Draft proposals for these optional provisions were included in the [Report on Action 6](#), which noted that the proposals would be reviewed in the light of similar proposals which had been released by the United States for public comment in September 2015. The optional provisions on “special tax regimes” and on subsequent changes to domestic law, as they will appear in the 2017 update, have been finalised accordingly.
- Changes to Articles 3 and 4, and related Commentary changes, concerning the treaty residence of pension funds. Paragraph 12 of the [Report on Action 6](#) called for additional work to ensure that a pension fund should be considered to be a resident of the State in which it is constituted regardless of whether that pension fund benefits from a limited or complete exemption from taxation in that State. The CFA released a [discussion draft](#) containing draft changes to Articles 3 and 4, and to the Commentaries on these Articles, on 29 February 2016.
- Changes to paragraph 2 of Article 3 and related changes to the Commentaries on Articles 3 and 25. The [Report on Action 14 \(Making Dispute Resolution Procedures More Effective\)](#) called for the development of these changes – which are intended to remove any doubt that, in a case where the competent authorities have agreed on a common meaning of an undefined term, the domestic law meaning of that term would not be applicable – as part of the follow-up work on Action 14 to

clarify the legal status of a competent authority mutual agreement.

- Changes to paragraph 3 of Article 4 (the tie-breaker rule for determining the treaty residence of dual-resident persons other than individuals) and related Commentary changes. These changes appear in the [Report on Action 6](#).
- Changes to Article 5 and its Commentary resulting from the [Report on Action 7 \(Preventing the Artificial Avoidance of Permanent Establishment Status\)](#) and follow-up work on those changes.
- Changes to the Commentary on Article 5 integrating the changes resulting from the work on BEPS Action 7 with previous work on the interpretation and application of Article 5. The proposals that resulted from that earlier work – which was based on the pre-2017 update version of Article 5 – were originally published in an [October 2011 discussion draft](#), discussed at a 7 September 2012 public consultation and subsequently released in a [revised October 2012 discussion draft](#).
- Changes to Article 8, related changes to subparagraph 1 *e*) of Article 3 (the definition of “international traffic”) and paragraph 3 of Article 15 (concerning the taxation of the crews of ships and aircraft operated in international traffic), and consequential changes to Articles 6, 13 and 22. These changes also include related Commentary changes. These proposed changes were released in a [November 2013 discussion draft](#).
- Changes to subparagraph 2 *a*) of Article 10, introducing a minimum holding period to access the 5 per cent rate applicable to dividends, and related Commentary changes. These changes appear in the [Report on Action 6](#).
- The replacement of paragraph 17 of the Commentary on Article 10 with a paragraph containing an alternative provision that would deny the benefit of the lower rate provided in Article 10(2) *a*) to certain collective investment vehicles that do not pay tax on their investment income. That alternative provision was contained in the [Report on Action 6](#).
- Changes to paragraph 4 of Article 13, addressing transactions that seek to circumvent the application of that provision, and related Commentary changes. These changes appear in the [Report on Action 6](#).
- Changes to Articles 23 A and 23 B and related changes to the Commentaries on Articles 10, 11, 21, and 23 A and 23 B. These changes address issues relating to the relief of double taxation that arose during the work on new paragraphs 2 and 3 of Article 1. Draft proposals for certain of these changes were included in the [Report on Action 6](#).
- Changes to Article 25 and to the Commentaries on Articles 2, 7, 9 and 25 contained in the [Report on Action 14](#) or which that Report indicated would be developed as part of the follow-up work on Action 14. These changes include changes to paragraph 5 of Article 25, related Commentary changes and amendments to the “Sample Mutual Agreement on Arbitration” contained in an Annex to that Commentary. The changes related to the OECD Model MAP arbitration provision and its Commentary are intended to reflect the MAP arbitration provision developed in the negotiation of [the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting](#) (the Multilateral Instrument or “MLI”) [adopted on 24 November 2016](#).
- The addition of a new Article 29 (Entitlement to Benefits) and related Commentary, which includes in the OECD Model Tax Convention a limitation-on-benefits (LOB) rule (simplified and detailed versions), an anti-abuse rule for permanent establishments situated in third States, and a principal purposes test (PPT) rule. These provisions were contained in the [Report on Action 6](#). As noted in that Report, the two versions of the LOB rule and the anti-abuse rule for permanent establishments situated in third States as presented in the Report were draft provisions subject to changes, in the light of the versions of those rules that would be included in the 2016 United States

Model Income Tax Convention, which had not been finalised at the time the Report on Action 6 was approved. Those provisions, as they will appear in the 2017 update, have been finalised accordingly. The Commentary on Article 29 also contains three additional examples on the application of the PPT rule to non-CIV funds (which were not included in the Report on Action 6) which were released in draft form in a [March 2016 discussion draft](#).

- Consequential changes (included in Part 2 of this document) required as a consequence of the contents of the 2017 update described above.

Comments are invited with respect to certain other changes to the OECD Model Tax Convention that have not been previously released for comments. These changes are as follows:

- Changes to paragraph 13 of the Commentary on Article 4 related to the issue whether a house rented to an unrelated person can be considered to be a “permanent home available to” the landlord for purposes of the tie-breaker rule in Article 4(2) *a*).
- Changes to paragraphs 17 and 19 of, and the addition of new paragraph 19.1 to, the Commentary on Article 4. These changes are intended to clarify the meaning of “habitual abode” in the tie-breaker rule in Article 4(2) *c*).
- The addition of new paragraph 1.1 to the Commentary on Article 5. That paragraph indicates that registration for the purposes of a value added tax or goods and services tax is, by itself, irrelevant for the purposes of the application and interpretation of the permanent establishment definition.
- Deletion of the parenthetical reference “(other than a partnership)” from subparagraph 2 *a*) of Article 10, which is intended to ensure that the reduced rate of source taxation on dividends provided by that subparagraph is applicable in the case where new Article 1(2) would have the effect that a dividend paid to a transparent entity would be considered to be income of a resident of a Contracting State because it is taxed either in the hands of the entity or in the hands of the members of that entity. That deletion is accompanied by new paragraphs 11 and 11.1 of the Commentary on Article 10.

As part of the 2017 update, a number of changes and additions will also be made to the observations, reservations and positions of OECD member countries and non-member economies. These changes and additions are in the process of being formulated and will be included in the final version of the 2017 update.

Comments should be sent electronically in Word format by **10 August 2017** to taxtreaties@oecd.org. Comments should be addressed to the Tax Treaties, Transfer Pricing and Financial Transactions Division, OECD/CTPA.

All responses to this consultation document will be made publicly available. Responses submitted in the name of a collective “grouping” or “coalition”, or by any person submitting responses on behalf of another person or group of persons, should identify all enterprises or individuals who are members of that collective group, or the person(s) on whose behalf the commentator(s) are acting.

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THE 2017 UPDATE AND CONSEQUENTIAL CHANGES TO THE OECD MODEL TAX CONVENTION

Introduction

1. Part 1 of this note includes the draft contents of the 2017 Update to the OECD Model Tax Convention (the 2017 Update). Part 2 includes the consequential changes to the rest of the Model Tax Convention that have been drafted by the Secretariat as a consequence of the contents of 2017 Update.

PART 1 - CONTENTS OF THE 2017 UPDATE TO THE OECD MODEL TAX CONVENTION

[The changes to the existing text of the Model Tax Convention appear in ~~strike through~~ for deletions and ***bold italics*** for additions]

A. CHANGES TO THE INTRODUCTION

1. Replace paragraphs 2 and 3 of the Introduction and add the following new paragraphs 15.1 to 15.6:

2. It has long been recognised among the member countries of the Organisation for Economic Co-operation and Development that it is desirable to clarify, standardise, and confirm the fiscal situation of taxpayers who are engaged in commercial, industrial, financial, or any other activities in other countries through the application by all countries of common solutions to identical cases of double taxation. ***These countries have also long recognised the need to improve administrative co-operation in tax matters, notably through exchange of information and assistance in collection of taxes, for the purpose of preventing tax evasion and avoidance.***

3. ***These are*** ~~this is~~ the main purposes of the OECD Model Tax Convention on Income and on Capital, which provides a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation. As recommended by the Council of the OECD,¹ member countries, when concluding or revising bilateral conventions, should conform to this Model Convention as interpreted by the Commentaries thereon and having regard to the reservations contained therein and their tax authorities should follow these Commentaries, as modified from time to time and subject to their observations thereon, when applying and interpreting the provisions of their bilateral tax conventions that are based on the Model Convention.

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

15.1 In 1997, the OECD Council adopted a recommendation that the Governments of member countries pursue their efforts to conclude bilateral tax treaties with those member countries, and where appropriate with non-member countries, with which they had not yet entered into such conventions. Whilst the question of whether or not to enter into a tax treaty with another country is for each State to decide on the basis of different factors, which include both tax and non-tax considerations, tax policy considerations will generally play a key role in that decision. The following paragraphs describe some of these tax policy considerations, which are relevant not

1 See Annex.

only to the question of whether a treaty should be concluded with a State but also to the question of whether a State should seek to modify or replace an existing treaty or even, as a last resort, terminate a treaty (taking into account the fact that termination of a treaty often has a negative impact on large number of taxpayers who are not concerned by the situations that result in the termination of the treaty).

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

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

15.4 Another tax policy consideration that is relevant to the conclusion of a tax treaty is the risk of excessive taxation that may result from high withholding taxes in the source State. Whilst mechanisms for the relief of double taxation will normally ensure that such high withholding taxes do not result in double taxation, to the extent that such taxes levied in the State of source exceed the amount of tax normally levied on profits in the State of residence, they may have a detrimental effect on cross-border trade and investment.

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

15.6 An important objective of tax treaties being the prevention of tax avoidance and evasion, States should also consider whether their prospective treaty partners are willing and able to implement effectively the provisions of tax treaties concerning administrative assistance, such as the ability to exchange tax information, this being a key aspect that should be taken into account

when deciding whether or not to enter into a tax treaty. The ability and willingness of a State to provide assistance in the collection of taxes would also be a relevant factor to take into account. It should be noted, however, that in the absence of any actual risk of double taxation, these administrative provisions would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.¹

2. Replace paragraph 16 of the Introduction and the headings preceding it by the following:

D€. Presentation of the Model Convention

Title of the Model Convention

16. In both the 1963 Draft Convention and the 1977 Model Convention, the title of the Model Convention included a reference to the elimination of double taxation. In recognition of the fact that the Model Convention does not deal exclusively with the elimination of double taxation but also addresses other issues, such as the prevention of tax evasion and *avoidance as well as non-discrimination*, it was ~~subsequently~~ *decided, in 1992*, to use a shorter title which did not include this reference. This change ~~has been~~ *was* made both on the cover page of this publication and in the Model Convention itself. However, it ~~is~~ *was* understood that the practice of many member countries ~~is~~ *was* still to include in the title a reference to either the elimination of double taxation or to both the elimination of double taxation and the prevention of fiscal evasion *since both approaches emphasised these important purposes of the Convention.*

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

16.2 Since the title and preamble form part of the context of the Convention² and constitute a general statement of the object and purpose of the Convention, they should play an important role in the interpretation of the provisions of the Convention. According to the general rule of treaty interpretation contained in Article 31(1) of the Vienna Convention on the Law of Treaties, “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.”

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

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

B. CHANGES TO THE CONVENTION

Title and Preamble

3. Replace the Title of the Convention (including its footnote) by the following:

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 ~~Convention between (State A) and (State B) with respect to taxes on income and on capital~~[†]

- ~~1. States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.~~

4. Replace the heading “Preamble to the Convention” (including its footnote) by the following:

PREAMBLE TO THE CONVENTION[†]

- ~~1. The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.~~

PREAMBLE TO THE CONVENTION

(State A) and (State B),

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

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

Have agreed as follows:

Article 1

5. Replace Article 1 by the following:

Article 1

PERSONS COVERED

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

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

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

Article 3

6. Replace subparagraph 1 e) of Article 3 by the following:
 - e) the term “international traffic” means any transport by a ship or aircraft ~~operated by an enterprise that has its place of effective management in a Contracting State~~, except when the ship or aircraft is operated solely between places in ~~the other~~ **a Contracting State and the enterprise that operates the ship or aircraft is not an enterprise of that State;**
7. Add the following definition of “recognised pension fund” to paragraph 1 of Article 3:
 - i) ***the term “recognised pension fund” of a State means an entity or arrangement established in that State that is treated as a separate person under the taxation laws of that State and:***
 - (i) ***that is established and operated exclusively or almost exclusively to administer or provide retirement benefits and ancillary or incidental benefits to individuals and that is regulated as such by that State or one of its political subdivisions or local authorities; or***
 - (ii) ***that is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in subdivision (i).***
8. Replace paragraph 2 of Article 3 by the following:
 2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires ***or the competent authorities agree to a different meaning pursuant to the provisions of Article 25***, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 4

9. Replace paragraph 1 of Article 4 by the following:
 1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof ***as well as a recognised pension fund of that State***. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
10. Replace paragraph 3 of Article 4 by the following:
 3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, ~~then it shall be deemed to be a resident only of the State in which its place of effective management is situated.~~ ***the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.***

Article 5

11. Replace Article 5 by the following:

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
 - a) a place of management;
 - b) a branch;
 - c) an office;
 - d) a factory;
 - e) a workshop, and
 - f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.
4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
 - a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;
 - b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
 - c) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
 - d) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
 - e) the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
 - f) the maintenance of a fixed place of business solely for any combination of activities mentioned in 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,

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

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

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

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

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

5. Notwithstanding the provisions of paragraphs 1 and 2 *but subject to the provisions of paragraph 6*, where a person —~~other than an agent of an independent status to whom paragraph 6 applies~~— is acting *in a Contracting State* on behalf of an enterprise and ~~has, and habitually exercises, in a Contracting State, an authority to conclude contracts,~~ *in doing so, habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are*

- a) *in the name of the enterprise, or*
- b) *for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or*
- c) *for the provision of services by that enterprise,*

that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business (*other than a fixed place of business to which paragraph 4.1 would apply*), would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. ~~An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.~~ *Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business. Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.*

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

8. *For the purposes of this Article, a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person or enterprise shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person or enterprise possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise or in the two enterprises.*

Article 6

12. Replace paragraph 2 of Article 6 by the following:

2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, ~~boats~~ and aircraft shall not be regarded as immovable property.

Article 8

13. Replace Article 8 by the following:

Article 8

INTERNATIONAL SHIPPING, ~~INLAND WATERWAYS TRANSPORT AND AIR~~ TRANSPORT

1. Profits *of an enterprise of a Contracting State* from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting *that* State ~~in which the place of effective management of the enterprise is situated.~~

~~2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~

~~3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.~~

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

Article 10

14. Replace subparagraph 2 a) of Article 10 by the following:

- a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (~~other than a partnership~~) which holds directly at least 25 per cent of the capital of the company paying the dividends *throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend);*

Article 13

15. Replace paragraph 3 of Article 13 by the following:

3. ~~Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~ ***Gains that an enterprise of a Contracting State that operates ships or aircraft in international traffic derives from the alienation of such ships or aircraft, or from movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.***

16. Replace paragraph 4 of Article 13 by the following:

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

Article 15

17. Replace paragraph 3 of Article 15 by the following:

3. ***Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic, other than aboard a ship or aircraft operated solely within the other Contracting State, or aboard a boat engaged in inland waterways transport, shall be taxable only in the first-mentioned State may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.***

Article 22

18. Replace paragraph 3 of Article 22 by the following:

3. ~~Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~ ***Capital of an enterprise of a Contracting State that operates ships or aircraft in international traffic represented by such ships or aircraft, and by movable property pertaining to the operation of such ships or aircraft, shall be taxable only in that State.***

Article 23 A

19. Replace paragraphs 1 and 2 of Article 23 A by the following:

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

resident of that State), ~~may be taxed in the other Contracting State~~, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which *may be taxed in the other Contracting State* in accordance with the provisions of Articles 10 and 11 (*except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State*), the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

Article 23 B

20. Replace paragraph 1 of Article 23 B by the following:

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

- a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
- b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

Article 25

21. Replace paragraph 1 of Article 25 by the following:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of ~~either the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national~~. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

22. Replace paragraph 5 of Article 25 by the following:

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

- b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the ~~presentation of the case to the competent authority of the other Contracting State~~ *date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities,*

any unresolved issues arising from the case shall be submitted to arbitration if the person so requests *in writing*. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both Contracting States and shall be implemented notwithstanding any time limits in the domestic laws of these States. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.¹

¹ ~~In some States, national law, policy or administrative considerations may not allow or justify the type of dispute resolution envisaged under this paragraph. In addition, some States may only wish to include this paragraph in treaties with certain States. For these reasons, the paragraph should only be included in the Convention where each State concludes that it would be appropriate to do so based on the factors described in paragraph 65 of the Commentary on the paragraph. As mentioned in paragraph 74 of that Commentary, however, other States may be able to agree to remove from the paragraph the condition that issues may not be submitted to arbitration if a decision on these issues has already been rendered by one of their courts or administrative tribunals.~~

Articles 29-31

23. Renumber Articles 29, 30 and 31 as Articles 30, 31 and 32 respectively and add the following new Article 29:

ARTICLE 29

ENTITLEMENT TO BENEFITS¹

1. *[Provision that, subject to paragraphs 3 to 5, restricts treaty benefits to a resident of a Contracting State who is a “qualified person” as defined in paragraph 2]*
2. *[Definition of situations where a resident is a qualified person, which covers*
 - *an individual;*
 - *a Contracting State, its political subdivisions and their agencies and instrumentalities;*
 - *certain publicly-traded companies and entities;*
 - *certain affiliates of publicly-listed companies and entities;*

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

- *certain non-profit organisations and recognised pension funds;*
 - *other entities that meet certain ownership and base erosion requirements;*
 - *certain collective investment vehicles.]*
3. *[Provision that provides treaty benefits to certain income derived by a person that is not a qualified person if the person is engaged in the active conduct of a business in its State of residence and the income emanates from, or is incidental to, that business]*
4. *[Provision that provides treaty benefits to a person that is not a qualified person if at least more than an agreed proportion of that entity is owned by certain persons entitled to equivalent benefits]*
5. *[Provision that provides treaty benefits to a person that qualifies as a “headquarters company”]*
6. *[Provision that allows the competent authority of a Contracting State to grant certain treaty benefits to a person where benefits would otherwise be denied under paragraph 1]*
7. *[Definitions applicable for the purposes of paragraphs 1 to 7]*
8. a) *Where*
- (i) *an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats such income as attributable to a permanent establishment of the enterprise situated in a third jurisdiction, and*
 - (ii) *the profits attributable to that permanent establishment are exempt from tax in the first-mentioned State,*
- the benefits of this Convention shall not apply to any item of income on which the tax in the third jurisdiction is less than the lower of [rate to be determined bilaterally] of the amount of that item of income and 60 per cent of the tax that would be imposed in the first-mentioned State on that item of income if that permanent establishment were situated in the first-mentioned State. In such a case any income to which the provisions of this paragraph apply shall remain taxable according to the domestic law of the other State, notwithstanding any other provisions of the Convention.*
- b) *The preceding provisions of this paragraph shall not apply if the income derived from the other State emanates from, or is incidental to, the active conduct of a business carried on through the permanent establishment (other than the business of making, managing or simply holding investments for the enterprise’s own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance enterprise or registered securities dealer, respectively).*
 - c) *If benefits under this Convention are denied pursuant to the preceding provisions of this paragraph with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.*

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

C. CHANGES TO THE COMMENTARY

Article 1

24. Replace the Commentary on Article 1 by the following:

Paragraph 1

1. Whereas ~~the earliest many~~ conventions in general *concluded in the first part of the 20th century* were applicable to “citizens” of the Contracting States, ~~more recent~~ *concluded afterwards almost always* usually apply to “residents” of one or both of the Contracting States irrespective of nationality. ~~Some conventions are of even wider scope because they apply more generally to “taxpayers” of the Contracting States; they are, therefore, also applicable to persons, who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. It has been deemed preferable for practical reasons to provide that the Convention is to apply to persons who are residents of one or both of the Contracting States.~~ *That approach is reflected in paragraph 1.* The term “resident” is defined in Article 4. *The fact that a person is a resident of a Contracting State does not mean, however, that the person is automatically entitled to the benefits of the Convention since some or all of these benefits may be denied under various provisions of the Convention, including those of Article 29.*

Paragraph 2

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

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

Whilst this may create practical difficulties with respect to a very limited number of partnerships, it is a more important problem in the case of other entities such as trusts. For this reason, the Committee decided to deal with this issue in the context of follow-up work to this report.

4. *Paragraph 2 addresses this particular situation by referring to entities that are “wholly or partly” treated as fiscally transparent. Thus, the paragraph not only serves to confirm the conclusions of the Partnership Report but also extends the application of these conclusions to situations that were not directly covered by the report (subject to the application of specific provisions dealing with collective investment vehicles, see paragraphs 22 to 48 below).*

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

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

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

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

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

8. *The word “income” must be given the wide meaning that it has for the purposes of the Convention and therefore applies to the various items of income that are covered by Chapter III of the Convention (Taxation of Income), including, for example, profits of an enterprise and capital gains.*

9. *The concept of “fiscally transparent” used in the paragraph refers to situations where, under the domestic law of a Contracting State, the income (or part thereof) of the entity or arrangement is not taxed at the level of the entity or the arrangement but at the level of the persons who have an interest in that entity or arrangement. This will normally be the case where the amount of tax payable on a share of the income of an entity or arrangement is determined separately in relation to the personal characteristics of the person who is entitled to that share so that the tax will depend on whether that person is taxable or not, on the other income that the*

person has, on the personal allowances to which the person is entitled and on the tax rate applicable to that person; also, the character and source, as well as the timing of the realisation, of the income for tax purposes will not be affected by the fact that it has been earned through the entity or arrangement. The fact that the income is computed at the level of the entity or arrangement before the share is allocated to the person will not affect that result.¹ States wishing to clarify the definition of “fiscally transparent” in their bilateral conventions are free to include a definition of that term based on the above explanations.

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

11. As with other provisions of the Convention, the provision applies separately to each item of income of the entity or arrangement. Assume, for example, that the document that establishes a trust provides that all dividends received by the trust must be distributed to a beneficiary during the lifetime of that beneficiary but must be accumulated afterwards. If one of the Contracting States considers that, in such a case, the beneficiary is taxable on the dividends distributed to that beneficiary but that the trustees are taxable on the dividends that will be accumulated, the paragraph will apply differently to these two categories of dividends even if both types of dividends are received within the same month.

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

13. Whilst the paragraph ensures that the various allocative rules of the Convention are applied to the extent that income of fiscally transparent entities is treated, under domestic law, as

¹ See paragraphs 37-40 of the Partnership Report.

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

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

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

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

2. — Domestic laws differ in the treatment of partnerships. These differences create various difficulties when applying tax Conventions in relation to partnerships. These difficulties are analysed in the report by the Committee on Fiscal Affairs entitled “The Application of the OECD Model Tax Convention to Partnerships”,¹ the conclusions of which have been incorporated below and in the Commentary on various other provisions of the Model Tax Convention.

3. — As discussed in that report, a main source of difficulties is the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries adopt what may be referred to as the fiscally transparent approach, under which the partnership is ignored for tax purposes and the individual partners are taxed on their respective share of the partnership’s income.

4. — A first difficulty is the extent to which a partnership is entitled as such to the benefits of the provisions of the Convention. Under Article 1, only persons who are residents of the Contracting States are entitled to the benefits of the tax Convention entered into by these States. While paragraph 2 of the Commentary on Article 3 explains why a partnership constitutes a person, a partnership does not necessarily qualify as a resident of a Contracting State under Article 4.

5. — Where a partnership is treated as a company or taxed in the same way, it is a resident of the Contracting State that taxes the partnership on the grounds mentioned in paragraph 1 of Article 4 and, therefore, it is entitled to the benefits of the Convention. Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not “liable to tax” in that State within the meaning of paragraph 1 of Article 4, and so cannot be a resident thereof for purposes of the Convention. In such a case, the application of the Convention to the partnership as such would be refused, unless a special rule covering partnerships were provided for in the Convention. Where the application of the Convention is so refused, the partners should be entitled, with respect to their share of the income of the partnership, to the benefits provided by the Conventions entered into by the States of which they are residents to the extent that the partnership’s income is allocated to them for the purposes of taxation in their State of residence (see paragraph 8.8 of the Commentary on Article 4).

6. — The relationship between the partnership’s entitlement to the benefits of a tax Convention and that of the partners raises other questions:

6.1 — One issue is the effect that the application of the provisions of the Convention to a partnership can have on the taxation of the partners. Where a partnership is treated as a resident of a Contracting State, the provisions of the Convention that restrict the other Contracting State’s right to tax the partnership on its income do not apply to restrict that other State’s right to tax the partners who are its own residents on their share of the income of the partnership. Some states may wish to include in their conventions a provision that expressly confirms a Contracting State’s right to tax resident partners on their share of the income of a partnership that is treated as a resident of the other State.

6.2 — Another issue is that of the effect of the provisions of the Convention on a Contracting State’s right to tax income arising on its territory where the entitlement to the benefits of one, or more than one, Conventions is different for the partners and the partnership. Where, for instance, the State of source treats a domestic partnership as fiscally transparent and therefore taxes the partners on their share of the income of the partnership, a partner that is resident of a State that taxes partnerships as companies would not be able to claim the benefits of the Convention between

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

the two States with respect to the share of the partnership's income that the State of source taxes in his hands since that income, though allocated to the person claiming the benefits of the Convention under the laws of the State of source, is not similarly allocated for purposes of determining the liability to tax on that item of income in the State of residence of that person.

6.3—The results described in the preceding paragraph should obtain even if, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes but as a separate taxable entity to which the income would be attributed, provided that the partnership is not actually considered as a resident of the State of source. This conclusion is founded upon the principle that the State of source should take into account, as part of the factual context in which the Convention is to be applied, the way in which an item of income, arising in its jurisdiction, is treated in the jurisdiction of the person claiming the benefits of the Convention as a resident. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

6.4—Where, as described in paragraph 6.2, income has “flowed through” a transparent partnership to the partners who are liable to tax on that income in the State of their residence then the income is appropriately viewed as “paid” to the partners since it is to them and not to the partnership that the income is allocated for purposes of determining their tax liability in their State of residence. Hence the partners, in these circumstances, satisfy the condition, imposed in several Articles, that the income concerned is “paid to a resident of the other Contracting State”. Similarly the requirement, imposed by some other Articles, that income or gains are “derived by a resident of the other Contracting State” is met in the circumstances described above. This interpretation avoids denying the benefits of tax Conventions to a partnership's income on the basis that neither the partnership, because it is not a resident, nor the partners, because the income is not directly paid to them or derived by them, can claim the benefits of the Convention with respect to that income. Following from the principle discussed in paragraph 6.3 the conditions that the income be paid to, or derived by, a resident should be considered to be satisfied even where, as a matter of the domestic law of the State of source, the partnership would not be regarded as transparent for tax purposes, provided that the partnership is not actually considered as a resident of the State of source.

6.5—Partnership cases involving three States pose difficult problems with respect to the determination of entitlement to benefits under Conventions. However, many problems may be solved through the application of the principles described in paragraphs 6.2 to 6.4. Where a partner is a resident of one State, the partnership is established in another State and the partner shares in partnership income arising in a third State then the partner may claim the benefits of the Convention between his State of residence and the State of source of the income to the extent that the partnership's income is allocated to him for the purposes of taxation in his State of residence. If, in addition, the partnership is taxed as a resident of the State in which it is established then the partnership may itself claim the benefits of the Convention between the State in which it is established and the State of source. In such a case of “double benefits”, the State of source may not impose taxation which is inconsistent with the terms of either applicable Convention; therefore, where different rates are provided for in the two Conventions, the lower will be applied. However, Contracting States may wish to consider special provisions to deal with the administration of benefits under Conventions in situations such as these, so that the partnership may claim benefits but partners could not present concurrent claims. Such provisions could ensure appropriate and simplified administration of the giving of benefits. No benefits will be available under the Convention between the State in which the partnership is established and the State of source if the partnership is regarded as transparent for tax purposes by the State in which it is established.

Similarly no benefits will be available under the Convention between the State of residence of the partner and the State of source if the income of the partnership is not allocated to the partner under the taxation law of the State of residence. If the partnership is regarded as transparent for tax purposes by the State in which it is established and the income of the partnership is not allocated to the partner under the taxation law of the State of residence of the partner, the State of source may tax partnership income allocable to the partner without restriction.

6.6 — Differences in how countries apply the fiscally transparent approach may create other difficulties for the application of tax Conventions. Where a State considers that a partnership does not qualify as a resident of a Contracting State because it is not liable to tax and the partners are liable to tax in their State of residence on their share of the partnership's income, it is expected that that State will apply the provisions of the Convention as if the partners had earned the income directly so that the classification of the income for purposes of the allocative rules of Articles 6 to 21 will not be modified by the fact that the income flows through the partnership. Difficulties may arise, however, in the application of provisions which refer to the activities of the taxpayer, the nature of the taxpayer, the relationship between the taxpayer and another party to a transaction. Some of these difficulties are discussed in paragraph 19.1 of the Commentary on Article 5 and paragraphs 6.1 and 6.2 of the Commentary on Article 15.

6.7 — Finally, a number of other difficulties arise where different rules of the Convention are applied by the Contracting States to income derived by a partnership or its partners, depending on the domestic laws of these States or their interpretation of the provisions of the Convention or of the relevant facts. These difficulties relate to the broader issue of conflicts of qualification, which is dealt with in paragraphs 32.1 ff. and 56.1 ff. of the Commentary on Article 23.

Paragraph 3

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

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

19. The exceptions so listed are intended to cover all cases where it is envisaged in the Convention that a Contracting State may have to provide treaty benefits to its own residents (whether or not these or similar benefits are provided under the domestic law of that State). These provisions are:

- Paragraph 3 of Article 7, which requires a Contracting State to grant to an enterprise of that State a correlative adjustment following an initial adjustment made by the other Contracting State, in accordance with paragraph 2 of Article 7, to the amount of tax charged on the profits of a permanent establishment of the enterprise.*
- Paragraph 2 of Article 9, which requires a Contracting State to grant to an enterprise of that State a corresponding adjustment following an initial adjustment made by the other*

Contracting State, in accordance with paragraph 1 of Article 9, to the amount of tax charged on the profits of an associated enterprise.

- *Article 19, which may affect how a Contracting State taxes an individual who is resident of that State if that individual derives income in respect of services rendered to the other Contracting State or a political subdivision or local authority thereof.*
- *Article 20, which may affect how a Contracting State taxes an individual who is resident of that State if that individual is also a student who meets the conditions of that Article.*
- *Articles 23 A and 23 B, which require a Contracting State to provide relief of double taxation to its residents with respect to the income that the other State may tax in accordance with the Convention (including profits that are attributable to a permanent establishment situated in the other Contracting State in accordance with paragraph 2 of Article 7).*
- *Article 24, which protects residents of a Contracting State against certain discriminatory taxation practices by that State (such as rules that discriminate between two persons based on their nationality).*
- *Article 25, which allows residents of a Contracting State to request that the competent authority of that State consider cases of taxation not in accordance with the Convention.*
- *Article 28, which may affect how a Contracting State taxes an individual who is resident of that State when that individual is a member of the diplomatic mission or consular post of the other Contracting State.*

20. The list of exceptions included in paragraph 3 should include any other provision that the Contracting States may agree to include in their bilateral convention where it is intended that this provision should affect the taxation, by a Contracting State, of its own residents. For instance, if the Contracting States agree, in accordance with paragraph 27 of the Commentary on Article 18, to include in their bilateral convention a provision according to which pensions and other payments made under the social security legislation of a Contracting State shall be taxable only in that State, they should include a reference to that provision in the list of exceptions included in paragraph 3. Other examples include the alternative provisions in paragraphs 23, 30, 37, 38 and 68 of the Commentary on Article 18 because these provisions provide benefits that are typically intended to be granted to an individual who participated in a foreign pension scheme before becoming a resident of a Contracting State.

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

Cross-border issues relating to collective investment vehicles

22. Most countries have dealt with the domestic tax issues arising from groups of small investors who pool their funds in collective investment vehicles (CIVs). In general, the goal of such systems is to provide for neutrality between direct investments and investments through a CIV. Whilst those systems generally succeed when the investors, the CIV and the investment are all located in the same country, complications frequently arise when one or more of those parties or

the investments are located in different countries. These complications are discussed in the report by the Committee on Fiscal Affairs entitled “The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles”, the main conclusions of which have been incorporated below. For purposes of the Report and for this discussion, the term “CIV” is limited to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established.

Application of the Convention to CIVs

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

24. The determination of whether a CIV should be treated as a “person” begins with the legal form of the CIV, which differs substantially from country to country and between the various types of vehicles. In many countries, most CIVs take the form of a company. In others, the CIV typically would be a trust. In still others, many CIVs are simple contractual arrangements or a form of joint ownership. In most cases, the CIV would be treated as a taxpayer or a “person” for purposes of the tax law of the State in which it is established; for example, in some countries where the CIV is commonly established in the form of a trust, either the trust itself, or the trustees acting collectively in their capacity as such, is treated as a taxpayer or a person for domestic tax law purposes. In view of the wide meaning to be given to the term “person”, the fact that the tax law of the country where such a CIV is established would treat it as a taxpayer would be indicative that the CIV is a “person” for treaty purposes. Contracting States wishing to expressly clarify that, in these circumstances, such CIVs are persons for the purposes of their conventions may agree bilaterally to modify the definition of “person” to include them.

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

26. By contrast, in other States, a CIV is in principle liable to tax but its income may be fully exempt, for instance, if the CIV fulfils certain criteria with regard to its purpose, activities or operation, which may include requirements as to minimum distributions, its sources of income and sometimes its sectors of operation. More frequently, CIVs are subject to tax but the base for taxation is reduced, in a variety of different ways, by reference to distributions paid to investors. Deductions for distributions will usually mean that no tax is in fact paid. Other States tax CIVs but at a special low tax rate. Finally, some States tax CIVs fully but with integration at the investor level to avoid double taxation of the income of the CIV. For those countries that adopt the view, reflected in paragraph 8.*II* of the Commentary on Article 4, that a person may be liable to tax even if the State in which it is established does not impose tax, the CIV would be treated as a resident of the State in which it is established in all of these cases because the CIV is subject to comprehensive taxation in that State. Even in the case where the income of the CIV is taxed at a

zero rate, or is exempt from tax, the requirements to be treated as a resident may be met if the requirements to qualify for such lower rate or exemption are sufficiently stringent.

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

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

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

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

Policy issues raised by the current treatment of collective investment vehicles

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

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

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

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

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

Possible provisions modifying the treatment of CIVs

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

- a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the Convention to such income as an individual who is a resident of the Contracting State in which it is established and as the beneficial owner of the income it receives (provided that, if an individual who is a resident of the first-mentioned State had received the income in the same circumstances, such individual would have been considered to be the beneficial owner thereof), but only to the extent that the beneficial interests in the collective investment vehicle are owned by equivalent beneficiaries.
- b) For purposes of this paragraph:
 - (i) the term “collective investment vehicle” means, in the case of [State A], a [] and, in the case of [State B], a [], as well as any other investment fund, arrangement or entity established in either Contracting State which the competent authorities of the Contracting States agree to regard as a collective investment vehicle for purposes of this paragraph; and
 - (ii) the term “equivalent beneficiary” means a resident of the Contracting State in which the CIV is established, and a resident of any other State with which the Contracting State in which the income arises has an income tax convention that provides for effective and comprehensive information exchange who would, if he received the particular item of income for which benefits are being claimed under this Convention, be entitled under that convention, or under the domestic law of the Contracting State in which the income arises, to a rate of tax with respect to that item of income that is at least as low as the rate claimed under this Convention by the CIV with respect to that item of income.

36. It is intended that the Contracting States would provide in subdivision (i) of subparagraph b) specific cross-references to relevant tax or securities law provisions relating to CIVs. In deciding which treatment should apply with respect to particular CIVs, Contracting States should take into account the policy considerations discussed above. Negotiators may agree that economic differences in the treatment of CIVs in the two Contracting States, or even within the same Contracting State, justify differential treatment in the tax treaty. In that case, some combination of the provisions in this section might be included in the treaty.

37. The effect of allowing benefits to the CIV to the extent that it is owned by “equivalent beneficiaries” as defined in subdivision (ii) of subparagraph b) is to ensure that investors who would have been entitled to benefits with respect to income derived from the source State had they received the income directly are not put in a worse position by investing through a CIV located in a third country. The approach thus serves the goals of neutrality as between direct investments and investments through a CIV. It also decreases the risk of double taxation as between the source State and the State of residence of the investor, to the extent that there is a tax treaty between them. It is beneficial for investors, particularly those from small countries, who will consequently enjoy a greater choice of investment vehicles. It also increases economies of scale, which are a primary

economic benefit of investing through CIVs. Finally, adopting this approach substantially simplifies compliance procedures. In many cases, nearly all of a CIV's investors will be "equivalent beneficiaries", given the extent of bilateral treaty coverage and the fact that rates in those treaties are nearly always 10-15 per cent on portfolio dividends.

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

39. A source State may also be concerned about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis. Such States may be tempted to limit benefits to the CIV to the proportion of the CIV's investors who are currently taxable on their share of the income of the CIV. However, such an approach has proven difficult to apply to widely-held CIVs in practice. Those States that are concerned about the possibility of such deferral may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently. Other States may be less concerned about the potential for deferral, however. They may take the view that, even if the investor is not taxed currently on the income received by the CIV, it will be taxed eventually, either on the distribution, or on any capital gains if it sells its interest in the CIV before the CIV distributes the income. Those States may wish to negotiate provisions that grant benefits to CIVs even if they are not obliged to distribute their income on a current basis. Moreover, in many States, the tax rate with respect to investment income is not significantly higher than the treaty withholding rate on dividends, so there would be little, if any, residence State tax deferral to be achieved by earning such income through an investment fund rather than directly. In addition, many States have taken steps to ensure the current taxation of investment income earned by their residents through investment funds, regardless of whether the funds accumulate that income, further reducing the potential for such deferral. When considering the treatment of CIVs that are not required to distribute income currently, States may want to consider whether these or other factors address the concerns described above so that the type of limits described herein might not in fact be necessary.

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

- a) Notwithstanding the other provisions of this Convention, a collective investment vehicle which is established in a Contracting State and which receives income arising in the other Contracting State shall be treated for purposes of applying the

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

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

41. Although the purely proportionate approach set out in paragraphs **35** and **40** protects against treaty shopping, it may also impose substantial administrative burdens as a CIV attempts to determine the treaty entitlement of every single investor. A Contracting State may decide that the fact that a substantial proportion of the CIV’s investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be provided with respect to all income received by the CIV. Including such a threshold would also mitigate some of the procedural burdens that otherwise might arise. If desired, therefore, the following sentence could be added at the end of subparagraph *a*):

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

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

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

investment vehicle if the owner has itself made an individual claim for benefits with respect to income received by the collective investment vehicle.

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

This provision would, however, limit the CIV to making claims on behalf of residents of the same Contracting State in which the CIV is established. If, for the reasons described in paragraph 37, the Contracting States deemed it desirable to allow the CIV to make claims on behalf of treaty-eligible residents of third States, that could be accomplished by replacing the words “this Convention” with “any Convention to which the other Contracting State is a party” in subparagraph a). If, as anticipated, the Contracting States would agree that the treatment provided in this paragraph would apply only to specific types of CIVs, it would be necessary to ensure that the types of CIVs listed in subparagraph c) did not include any of the types of CIVs listed in a more general provision such as that in paragraph 31, 35 or 40 so that the treatment of a specific type of CIV would be fixed, rather than elective. Countries wishing to allow individual CIVs to elect their treatment, either with respect to the CIV as a whole or with respect to one or more classes of interests in the CIV, are free to modify the paragraph to do so.

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

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

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

46. An alternative approach would provide that a CIV that is publicly traded in the Contracting State in which it is established will be entitled to treaty benefits without regard to the residence of its investors. This provision has been justified on the basis that a publicly-traded CIV cannot be used effectively for treaty shopping because the shareholders or unitholders of such a CIV cannot individually exercise control over it. Such a provision could read:

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

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

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

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

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

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

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

52. The application of the Convention to each Contracting State, its political subdivisions, and local authorities (and their statutory bodies, agencies or instrumentalities in the case of bilateral treaties that apply to such entities) should not be interpreted, however, as affecting in any way the possible application by each State of the customary international law principle of sovereign immunity. According to this principle, a sovereign State (including its agents, its property and activities) is, as a general rule, immune from the jurisdiction of the courts of another sovereign State. There is no international consensus, however, on the precise limits of the sovereign immunity principle. Most States, for example, would not recognise that the principle applies to business activities and many States do not recognise any application of this principle in tax matters. There are therefore considerable differences between States as regards the extent, if any, to which that principle applies to taxation. Even among States that would recognise its possible application in tax matters, some apply it only to the extent that it has been incorporated into domestic law and others apply it as customary international law but subject to important limitations. The Convention does not prejudice the issues of whether and to what extent the principle of sovereign immunity applies with respect to the persons covered under Article 1 and the taxes covered under Article 2 and each Contracting State is therefore free to apply its own interpretation of that principle as long as the resulting taxation, if any, is in conformity with the provisions of its bilateral tax conventions.

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

Improper use of the Convention

54. The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. As confirmed in the preamble of the Convention, it is also part of the purposes of tax conventions to prevent tax avoidance and evasion. ~~The principal purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons. It is also a purpose of tax conventions to prevent tax avoidance and evasion.~~

55. The extension of the network of tax conventions increases the risk of abuse by facilitating the use of arrangements aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in these conventions. ~~7.1 Taxpayers may be tempted to abuse the tax laws of a State by exploiting the differences between various countries' laws. Such attempts may be countered by provisions or jurisprudential rules that are part of the domestic law of the State concerned. Such a State is then unlikely to agree to provisions of bilateral double taxation conventions that would have the effect of allowing abusive transactions that would otherwise be prevented by the provisions and rules of this kind contained in its domestic law. Also, it will not wish to apply its bilateral conventions in a way that would have that effect.~~

~~8. — It is also important to note that the extension of double taxation conventions increases the risk of abuse by facilitating the use of artificial legal constructions aimed at securing the benefits of both the tax advantages available under certain domestic laws and the reliefs from tax provided for in double taxation conventions.~~

56. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 5 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.

Addressing tax avoidance through tax conventions

57. Paragraph 9 of Article 29 and the specific treaty anti-abuse rules included in tax conventions are aimed at these and other transactions and arrangements entered into for the purpose of obtaining treaty benefits in inappropriate circumstances. Where, however, a tax convention does not include such rules, the question may arise whether the benefits of the tax convention should be granted when transactions that constitute an abuse of the provisions of that convention are entered into.

~~9.1 — This raises two fundamental questions that are discussed in the following paragraphs:~~

- ~~— whether the benefits of tax conventions must be granted when transactions that constitute an abuse of the provisions of these conventions are entered into (see paragraphs 9.2 and following below); and~~
- ~~— whether specific provisions and jurisprudential rules of the domestic law of a Contracting State that are intended to prevent tax abuse conflict with tax conventions (see paragraphs 22 and following below).~~

~~58.9.2~~ *Many States address that question by taking account* For many States, the answer to the first question is based on their answer to the second question. These States take account of the fact that taxes are ultimately imposed through the provisions of domestic law, as restricted (and in some rare cases, broadened) by the provisions of tax conventions. Thus, any abuse of the provisions of a tax convention could also be characterised as an abuse of the provisions of domestic law under which tax will be levied. For these States, the issue then becomes whether the provisions of tax conventions may prevent the application of the anti-abuse provisions of domestic law, which is the *question addressed in paragraphs 66 to 80 below* ~~second question above~~. As indicated in paragraph 22.1 below, the answer to that second question is that to the extent these anti-avoidance rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability, they are not addressed in tax treaties and are therefore not affected by them. Thus, *As explained in these paragraphs, as a general rule, there will be no conflict between such rules and the provisions of tax conventions.*

~~59.9.3~~ Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the Vienna Convention on the Law of Treaties).

~~60.9.4~~ Under both approaches, therefore, it is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.

~~61.9.5~~ It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. *That principle applies independently from the provisions of paragraph 9 of Article 29, which merely confirm it.*

~~62.9.6~~ The potential application of *these principles or of paragraph 9 of Article 29* ~~general anti-abuse provisions~~ does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy. Also, this will be necessary where a State which adopts the view described in paragraph 58 above believes that its domestic law lacks the anti-avoidance rules or principles necessary to properly address such strategy.

~~63-10.~~ For instance, some forms of tax avoidance have already been expressly dealt with in the Convention, e.g. by the introduction of the concept of “beneficial owner” (in Articles 10, 11, and 12) and of special provisions such as paragraph 2 of Article 17 dealing with so-called artiste-companies. Such problems are also mentioned in the Commentaries on Article 10 (paragraphs 17 and 22), Article 11 (paragraph 12) and Article 12 (paragraph 7).

~~64-10.1.~~ Also, in some cases, claims to treaty benefits by subsidiary companies, in particular companies established in tax havens or benefiting from harmful preferential regimes, may be refused where careful consideration of the facts and circumstances of a case shows that the place of

effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law purposes (this will be relevant where the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

~~65.10.2~~ Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits were properly attributable.

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

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

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

Specific legislative anti-abuse rules

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

69. *Many specific anti-abuse rules found in domestic law apply primarily in cross-border situations and may be relevant for the application of tax treaties. For instance, thin capitalisation rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure tax rules may prevent the avoidance of capital gains tax through a change of residence before the realisation of a treaty-exempt capital gain; dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains; and anti-conduit rules may prevent certain avoidance transactions involving the use of conduit arrangements.*

70. *Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of “pacta sunt servanda” which is incorporated in Article 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of specific anti-abuse rules found in domestic law were to result in a tax treatment that is not in accordance*

with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should prevail under public international law.¹

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

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

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

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

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

prevent the taxation of that individual by State A upon the alienation of the property, the Convention would prevent the application of that domestic rule unless the benefits of paragraph 5 of Article 13 could be denied, in that specific case, under paragraph 9 of Article 29 or the principles in paragraphs 60 and 61 above.

75. Fourth, the application of tax treaty provisions may be denied under judicial doctrines or principles applicable to the interpretation of the treaty (see paragraph 78 below). In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both a proper interpretation of the treaty and as result of the application of domestic specific anti-abuse rules. Assume, for example, that the domestic law of State A provides for the taxation of gains derived from the alienation of shares of a domestic company in which the alienator holds more than 25 per cent of the capital if that alienator was a resident of State A for at least seven of the 10 years preceding the alienation. In year 2, an individual who was a resident of State A for the previous 10 years becomes a resident of State B. Shortly after becoming a resident of State B, the individual sells the totality of the shares of a small company that he previously established in State A. The facts reveal, however, that all the elements of the sale were finalised in year 1, that an interest-free “loan” corresponding to the sale price was made by the purchaser to the seller at that time, that the purchaser cancelled the loan when the shares were sold to the purchaser in year 2 and that the purchaser exercised de facto control of the company from year 1. Although the gain from the sale of the shares might otherwise fall under paragraph 5 of Article 13 of the State A-State B treaty, the circumstances of the transfer of the shares are such that the alienation in year 2 constitutes a sham within the meaning given to that term by the courts of State A. In that case, to the extent that the sham transaction doctrine developed by the courts of State A does not conflict with the rules of interpretation of treaties, it will be possible to apply that doctrine when interpreting paragraph 5 of Article 13 of the State A-State B treaty, which will allow State A to tax the relevant gain under its domestic law rule.

General legislative anti-abuse rules

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

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

Judicial doctrines that are part of domestic law

*78. In the process of interpreting tax legislation in cases dealing with tax avoidance, the courts of many countries have developed a number of judicial doctrines or principles of interpretation. These include doctrines such as substance over form, economic substance, sham, business purpose, step-transaction, abuse of law and *fraus legis*. These doctrines and principles of interpretation, which vary from country to country and evolve over time based on refinements*

or changes resulting from subsequent court decisions, are essentially views expressed by courts as to how tax legislation should be interpreted. Whilst the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, these general rules do not prevent the application of similar judicial doctrines and principles to the interpretation of the provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach from being adopted with respect to the application of the provisions of a tax treaty to similar transactions. This is illustrated by the example in paragraph 75 above.

79. As a general rule and having regard to paragraph 61, therefore, the preceding analysis leads to the conclusion that there will be no conflict between tax conventions and judicial anti-abuse doctrines or general domestic anti-abuse rules. For example, to the extent that the application of a general domestic anti-abuse rule or a judicial doctrine such as “substance over form” or “economic substance” results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.

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

~~11. A further example is provided by two particularly prevalent forms of improper use of the Convention which are discussed in two reports from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Base Companies” and “Double Taxation Conventions and the Use of Conduit Companies”.¹ As indicated in these reports, the concern expressed in paragraph 9 above has proved to be valid as there has been a growing tendency toward the use of conduit companies to obtain treaty benefits not intended by the Contracting States in their bilateral negotiations. This has led an increasing number of member countries to implement treaty provisions (both general and specific) to counter abuse and to preserve anti-avoidance legislation in their domestic laws.~~

~~12. The treaty provisions that have been designed to cover these and other forms of abuse take different forms. The following are examples derived from provisions that have been incorporated in bilateral conventions concluded by member countries. These provide models that treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:~~

- ~~— the fact that these provisions are not mutually exclusive and that various provisions may be needed in order to address different concerns;~~
- ~~— the degree to which tax advantages may actually be obtained by a particular avoidance strategy;~~
- ~~— the legal context in both Contracting States and, in particular, the extent to which domestic law already provides an appropriate response to this avoidance strategy, and~~
- ~~— the extent to which bona fide economic activities might be unintentionally disqualified by such provisions.~~

¹ These two reports are reproduced in Volume II at pages R(5) 1 and R(6) 1.

Conduit company cases

13. — Many countries have attempted to deal with the issue of conduit companies and various approaches have been designed for that purpose. One solution would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a “look through” provision might have the following wording:

A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.

Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.

14. — The “look through approach” underlying the above provision seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard *bona fide* business activities.

15. — General subject to tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. Whilst this seems adequate with respect to a normal international relationship, a subject to tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

~~Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State~~

- ~~a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or~~
- ~~b) exercise directly or indirectly, alone or together, the management or control of such company;~~

~~any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last mentioned State under the ordinary rules of its tax law.~~

The concept of “substantial interest” may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.

16. — The subject to tax approach seems to have certain merits. It may be used in the case of States with a well developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting *bona fide* provisions in the treaty to provide for the necessary flexibility (see paragraph 19 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as “stepping stone strategies”.

~~17. The approaches referred to above are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use of conventions. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:~~

~~Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State~~

- ~~a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or~~
- ~~b) exercise directly or indirectly, alone or together, the management or control of such company~~

~~any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes).~~

~~18. A provision of this kind appears to be the only effective way of combatting “stepping stone” devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underly the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a *bona fide* clause.~~

~~19. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in *bona fide* cases. Such provisions could have the following wording:~~

~~a) *General bona fide provision*~~

~~“The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention.”~~

~~b) *Activity provision*~~

~~“The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations.”~~

~~e) *Amount of tax provision*~~

~~“The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident.”~~

d) Stock exchange provision

~~“The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned—directly or through one or more companies each of which is a resident of the first mentioned State—by a company which is a resident of the first mentioned State and the principal class of whose shares is so registered.”~~

e) Alternative relief provision

~~In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term “shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention.”~~

~~These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.~~

~~20. Whilst the preceding paragraphs identify different approaches to deal with conduit situations, each of them deals with a particular aspect of the problem commonly referred to as “treaty shopping”. States wishing to address the issue in a comprehensive way may want to consider the following example of detailed limitation of benefits provisions aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping:~~

~~1. Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a “qualified person” as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits.~~

~~2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:~~

~~a) an individual;~~

~~b) a qualified governmental entity;~~

~~c) a company, if~~

~~(i) the principal class of its shares is listed on a recognised stock exchange specified in subparagraph a) or b) of paragraph 6 and is regularly traded on one or more recognised stock exchanges, or~~

~~(ii) at least 50 per cent of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits under~~

subdivision (i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;

~~d) a charity or other tax exempt entity, provided that, in the case of a pension trust or any other organization that is established exclusively to provide pension or other similar benefits, more than 50 per cent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or~~

~~e) a person other than an individual, if:~~

~~(i) on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision e) (i) of this paragraph own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person, and~~

~~(ii) less than 50 per cent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States).~~

~~3. a) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income, derived from the other State, regardless of whether the resident is a qualified person, if the resident is actively carrying on business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), the income derived from the other Contracting State is derived in connection with, or is incidental to, that business and that resident satisfies the other conditions of this Convention for the obtaining of such benefits.~~

~~b) If the resident or any of its associated enterprises carries on a business activity in the other Contracting State which gives rise to an item of income, subparagraph a) shall apply to such item only if the business activity in the first-mentioned State is substantial in relation to business carried on in the other State. Whether a business activity is substantial for purposes of this paragraph will be determined based on all the facts and circumstances.~~

~~c) In determining whether a person is actively carrying on business in a Contracting State under subparagraph a), activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) or another person possesses, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be considered to be connected to another if, based on all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.~~

~~4. Notwithstanding the preceding provisions of this Article, if a company that is a resident of a Contracting State, or a company that controls such a company, has outstanding a class of shares~~

- ~~a) which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements (“the disproportionate part of the income”); and~~
- ~~b) 50 per cent or more of the voting power and value of which is owned by persons who are not qualified persons~~

~~the benefits of this Convention shall not apply to the disproportionate part of the income.~~

~~5. A resident of a Contracting State that is neither a qualified person pursuant to the provisions of paragraph 2 or entitled to benefits under paragraph 3 or 4 shall, nevertheless, be granted benefits of the Convention if the competent authority of that other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.~~

~~6. For the purposes of this Article the term “recognised stock exchange” means:~~

- ~~a) in State A~~;
- ~~b) in State B~~; and
- ~~c) any other stock exchange which the competent authorities agree to recognise for the purposes of this Article.~~

Provisions which are aimed at entities benefiting from preferential tax regimes

~~21. Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices. Where tax exempt (or nearly tax exempt) companies may be distinguished by special legal characteristics, the improper use of tax treaties may be avoided by denying the tax treaty benefits to these companies (the exclusion approach). As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause which would apply to the income received or paid by such companies and which could be drafted along the following lines:~~

~~No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention.~~

~~The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors’ fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (Non-Discrimination) and to the benefits of Article 25 (Mutual Agreement Procedure) and they would be subject to the provisions of Article 26 (Exchange of Information).~~

~~21.1 Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.~~

~~21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which enjoy, in that State, a preferential tax regime restricted to foreign held entities (i.e. not available to entities that belong to residents of that State):~~

~~Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State.~~

Provisions which are aimed at particular types of income

~~21.3 The following provision aims at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime:~~

~~1. The benefits of this Convention shall not apply to income which may, in accordance with the other provisions of the Convention, be taxed in a Contracting State and which is derived from activities the performance of which do not require substantial presence in that State, including:~~

- ~~a) such activities involving banking, shipping, financing, insurance or electronic commerce activities; or~~
- ~~b) activities involving headquarter or coordination centre or similar arrangements providing company or group administration, financing or other support; or~~
- ~~c) activities which give rise to passive income, such as dividends, interest and royalties~~

~~where, under the laws or administrative practices of that State, such income is preferentially taxed and, in relation thereto, information is accorded confidential treatment that prevents the effective exchange of information.~~

~~2. For the purposes of paragraph 1, income is preferentially taxed in a Contracting State if, other than by reason of the preceding Articles of this Agreement, an item of income:~~

- ~~a) is exempt from tax; or~~
- ~~b) is taxable in the hands of a taxpayer but that is subject to a rate of tax that is lower than the rate applicable to an equivalent item that is taxable in the hands of similar taxpayers who are residents of that State; or~~
- ~~c) benefits from a credit, rebate or other concession or benefit that is provided directly or indirectly in relation to that item of income, other than a credit for foreign tax paid.~~

Anti-abuse rules dealing with source taxation of specific types of income

~~21.4 The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main~~

purpose of obtaining these benefits. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

~~The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the [Article 10: “shares or other rights”; Article 11: “debt claim”; Articles 12 and 21: “rights”] in respect of which the [Article 10: “dividend”; Article 11: “interest”; Articles 12 “royalties” and Article 21: “income”] is paid to take advantage of this Article by means of that creation or assignment.~~

~~*Provisions which are aimed at preferential regimes introduced after the signature of the convention*~~

~~21.5 States may wish to prevent abuses of their conventions involving provisions introduced by a Contracting State after the signature of the Convention. The following provision aims to protect a Contracting State from having to give treaty benefits with respect to income benefiting from a special regime for certain offshore income introduced after the signature of the treaty:~~

~~The benefits of Articles 6 to 22 of this Convention shall not accrue to persons entitled to any special tax benefit under:~~

- ~~a) a law of either one of the States which has been identified in an exchange of notes between the States; or~~
- ~~b) any substantially similar law subsequently enacted.~~

~~22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including “substance over form”, “economic substance” and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties, which is the second question mentioned in paragraph 9.1 above.~~

~~22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict. For example, to the extent that the application of the rules referred to in paragraph 22 results in a recharacterisation of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the Convention will be applied taking into account these changes.~~

~~22.2 Whilst these rules do not conflict with tax conventions, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused.~~

Controlled foreign company provisions

~~81.23. A significant number of countries have adopted controlled foreign company provisions to address issues related to the use of foreign base companies. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of~~

Article 10, that this common feature of controlled foreign company legislation conflicted with these provisions. *Since such legislation results in a State taxing its own residents, paragraph 3 of Article 1 confirms that it does not conflict with tax conventions. The same conclusion must be reached in the case of conventions that do not include a provision similar to paragraph 3 of Article 1;* For the reasons explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10, *the interpretation according to which these Articles would prevent the application of controlled foreign company provisions*—that interpretation does not accord with the text of the provisions—*paragraph 1 of Article 7 and paragraph 5 of Article 10*. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign company legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign company legislation structured in this way is not contrary to the provisions of the Convention.

[24 and 25: previously deleted]

~~26.— States that adopt controlled foreign companies provisions or the anti-abuse rules referred to above in their domestic tax laws seek to maintain the equity and neutrality of these laws in an international environment characterised by very different tax burdens, but such measures should be used only for this purpose. As a general rule, these measures should not be applied where the relevant income has been subjected to taxation that is comparable to that in the country of residence of the taxpayer.~~

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

82. As indicated in paragraph 15.2 of the Introduction

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

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

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

States may wish to address these difficulties through specific treaty provisions. The following include examples of provisions that might be adopted for that purpose.

Provision on special tax regimes

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

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

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

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

- a) the term “special tax regime” means any statute, regulation or administrative practice in a Contracting State with respect to a tax described in Article 2 that meets all of the following conditions:*
 - (i) results in one or more of the following:*
 - A) a preferential rate of taxation for interest, royalties or any combination thereof as compared to income from sales of goods or services;*
 - B) a permanent reduction in the tax base with respect to interest, royalties or any combination thereof without a comparable reduction for income from sales of goods or services, by allowing:*
 - 1) an exclusion from gross receipts;*
 - 2) a deduction without regard to any corresponding payment or obligation to make a payment;*

- 3) *a deduction for dividends paid or accrued; or*
- 4) *taxation that is inconsistent with the principles of Article 7 or 9; or*
- C) *a preferential rate of taxation or a permanent reduction in the tax base of the type described in subclauses 1), 2), 3) or 4) of clause B) of this subdivision with respect to substantially all of a company's income or substantially all of a company's foreign source income, for companies that do not engage in the active conduct of a business in that Contracting State;*
- (ii) *in the case of any preferential rate of taxation or permanent reduction in the tax base for royalties, does not condition such benefits on*
 - A) *the extent of research and development activities that take place in the Contracting State; or*
 - B) *expenditures (excluding any expenditures which relate to subcontracting to a related party or any acquisition costs), which the person enjoying the benefits incurs for the purpose of actual research and development activities;*
- (iii) *is generally expected to result in a rate of taxation that is less than the lesser of either:*
 - A) *[rate to be determined bilaterally]; or*
 - B) *60 per cent of the general statutory rate of company tax applicable in the other Contracting State;*
- (iv) *does not apply principally to:*
 - A) *recognised pension funds;*
 - B) *organisations that are established and maintained exclusively for religious, charitable, scientific, artistic, cultural or educational purposes;*
 - C) *persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral), that hold a diversified portfolio of securities, that are subject to investor-protection regulation in the Contracting State and the interests in which are marketed primarily to retail investors; or*
 - D) *persons the taxation of which achieves a single level of taxation either in the hands of the person or the person's shareholders (with at most one year of deferral) and that hold predominantly immovable property; and*
- (v) *after consultation with the first-mentioned Contracting State, has been identified by the other Contracting State through diplomatic channels to the first-mentioned Contracting State as satisfying subdivisions (i) through (iv) of this subparagraph.*

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

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

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

- A. *a preferential rate of taxation for interest, royalties or any combination thereof as compared to income from sales of goods or services;*
- B. *certain permanent reductions in the tax base with respect to interest, royalties or any combination thereof without a comparable reduction for sales or services income; or*
- C. *a preferential rate of taxation or certain permanent reductions in the tax base with respect to substantially all income or substantially all foreign source income for companies that do not engage in the active conduct of a business in that Contracting State. This part of the definition is intended to identify regimes that, in general, tax mobile income more favourably than non-mobile income.*

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Provision on subsequent changes to domestic law

101. *Whilst the above suggested provision on special tax regimes would address the issue of targeted tax regimes, it would not deal with changes of a more general nature which could be introduced into the domestic law of a treaty partner after the conclusion of a tax treaty and which might have prevented the conclusion of the treaty if they had existed at that time. For instance, some Contracting States might be concerned if the overall tax rate that another State levies on corporate income falls below what they consider to be acceptable for the purposes of*

the conclusion of a tax treaty. Some States might also be concerned if a State that taxed most types of foreign income at the time of the conclusion of a tax treaty decided subsequently to exempt such income from tax when it is derived by a resident company. The following is an example of a provision that would address these concerns, it being understood that the features of that provision would need to be restricted or extended in order to deal adequately with the specific areas of concern of each State:

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

the Contracting States shall consult with a view to amending this Convention to restore an appropriate allocation of taxing rights between the Contracting States. If such consultations do not progress, the other State may notify the first-mentioned State through diplomatic channels that it shall cease to apply the provisions of Articles 10, 11, 12 and 21. In such case, the provisions of such Articles shall cease to have effect in both Contracting States with respect to payments to resident companies six months after the date that the other Contracting State issues a written public notification stating that it shall cease to apply the provisions of these Articles.

- 2. For the purposes of determining the general statutory rate of company tax:*
 - a) the allowance of generally available deductions based on a percentage of what otherwise would be taxable income, and other similar mechanisms to achieve a reduction in the overall rate of tax, shall be taken into account; and*
 - b) the following shall not be taken into account:*
 - (i) a tax that applies to a company only upon a distribution by such company, or that applies to shareholders; and*
 - (ii) the amount of a tax that is refundable upon the distribution by a company of a dividend.*

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

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

need to be determined bilaterally or 60 per cent of the general rate of company tax applicable in the other State.

104. For the purposes of paragraph 1, the “general statutory rate of company tax” refers to the general rate of company tax provided by legislation; if rates of company taxes are graduated, it refers to the highest marginal rate, provided that such rate applies to a significantly large portion of corporate taxpayers and was not established merely to circumvent the application of this Article. A general statutory rate of company tax that is applicable to business profits generally or to so-called “trading income” (broadly defined to include income from manufacturing, services or dealing in goods or commodities) shall be treated as applying to substantially all of the income of resident companies, even if narrow categories of income (including income from portfolio investments or other passive activities) are excluded. A reduced rate of tax that applies only with respect to capital gains would not fall within the scope of this Article; the distinction between business profits and capital gains shall be made according to the domestic laws of the residence State. Paragraph 2 addresses specific issues that may arise in determining what is a State’s general statutory rate of company tax. Subparagraph a) of paragraph 2 provides that paragraph 1 applies equally to reductions to the general statutory company tax rate, as well as to other changes in domestic law that would have the same effect using a different mechanism. For example, if the statutory company tax rate in a Contracting State was 20 per cent, but, after the signing of the Convention, companies resident in the Contracting State are permitted to claim deductions representing 50 per cent of what otherwise would be their taxable income, the general statutory rate of company tax would be 10 per cent (20 - (20 x 0.50)). Similarly, if the statutory company tax rate in a Contracting State was 20 per cent, but after the signing of the Convention, companies resident in the Contracting State are allowed to deduct an amount equal to a percentage of their equity up to 50 per cent of what otherwise would be their taxable income, and in general, most companies are able to utilize the maximum available deduction, the general rate of company tax would be 10 per cent. Subparagraph b) of paragraph 2 sets forth taxes that shall not be taken into account for purposes of determining the general statutory rate of company tax. First, as provided in subdivision (i) of subparagraph b), taxes imposed at either the company or shareholder level when the company distributes earnings shall not be taken into account when determining the general rate of company tax (e.g. if resident companies are not subject to any taxation at the company level until a distribution is made, the tax levied upon distribution would not be considered part of the general rate of company tax). Second, as provided in subdivision (ii) of subparagraph b), any amounts of corporate tax that under a country’s domestic law would be refundable upon a company’s distribution of earnings shall not be taken into account for purposes of determining the general statutory rate of company tax.

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

106. When either type of subsequent domestic law change occurs, the Contracting States shall first consult with a view to concluding amendments to the Convention to restore an appropriate

allocation of taxing rights between the two Contracting States. In the event that such amendments are agreed, or that the Contracting States agree, after such consultation, that the allocation of taxing rights in the Convention is not disrupted by the relevant change made to the domestic law of one of the States, paragraph 1 has no further application. If, however, after a reasonable period of time, such consultations do not progress, the other State may notify the State whose domestic law has changed, through diplomatic channels, that it shall cease to apply the provisions of Articles 10, 11, 12 and 21. Once such diplomatic notification has been made, in order for paragraph 1 to apply, the source State must announce by written public notice that it shall cease to apply the provisions of these Articles. Six months after the date of such written public notification, the provisions of these Articles shall cease to have effect in both Contracting States with respect to payments to companies that are residents of either State.

Provision on notional deductions for equity

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

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

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

Remittance-based taxation *Provision on remittance based taxation*

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

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

In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and

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

Limitations of source taxation: procedural aspects

~~109.26.2~~ A number of Articles of the Convention limit the right of a State to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention. As a general rule, in order to ensure expeditious implementation of taxpayers' benefits under a treaty, the first approach is the highly preferable method. If a refund system is needed, it should be based on observable difficulties in identifying entitlement to treaty benefits. Also, where the second approach is adopted, it is extremely important that the refund be made expeditiously, especially if no interest is paid on the amount of the refund, as any undue delay in making that refund is a direct cost to the taxpayer.

Article 2

25. Replace paragraph 4 of the Commentary on Article 2 by the following:

4. Clearly a State possessing *the right to tax an item of income or capital under the Convention* ~~taxing powers—and it alone—~~ may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, *penalties* etc. It has not been considered necessary to specify this in the Article, as it is obvious that ~~in the levying of the tax~~ *a Contracting State that has the right to levy a tax may also levy* the accessory duties or charges *related to* ~~depend on the same rule as the principal duty.~~ *Most States, however, do not consider that interest and penalties accessory to taxes covered by Article 2 are themselves included within the scope of Article 2 and, accordingly, would generally not treat such interest and penalties as payments to which all the provisions concerning the rights to tax of the State of source (or situs) or of the State of residence are applicable, including the limitations of the taxation by the State of source and the obligation for the State of residence to eliminate double taxation. Nevertheless, where taxation is withdrawn or reduced in accordance with a mutual agreement under Article 25, interest and administrative penalties accessory to such taxation should be withdrawn or reduced to the extent that they are directly connected to the taxation (i.e. a tax liability) that is relieved under the mutual agreement.* ~~Practice among member countries varies with respect to the treatment of interest and penalties. Some countries never treat such items as taxes covered by the Article. Others take the opposite approach, especially in cases—~~ *This would be the case, for example,* where the additional charge is computed with reference to the amount of the underlying tax. ~~Countries are free to clarify the point in their bilateral negotiations.~~ *liability and the competent authorities agree that all or part of the underlying taxation is not in accordance with the provisions of the Convention. This would also be the case, for example, where administrative penalties are imposed by reason of a transfer pricing adjustment and that adjustment is withdrawn because it is considered not in accordance with paragraph 1 of Article 9.*

Article 3

26. Replace paragraphs 5 to 6.3 of the Commentary on Article 3 by the following:

5. The definition of the term “international traffic” is based on the principle set forth in paragraph 1 of Article 8 that the right to tax profits ***of an enterprise of a Contracting State*** from the operation of ships or aircraft in international traffic resides only in ~~the Contracting~~***that State*** ~~in which the place of effective management is situated~~ in view of the special nature of the international traffic business. However, as stated in the Commentary on paragraph 1 of Article 8, the Contracting States are free on a bilateral basis to insert in subparagraph *e*) a reference to ***the State in which the place of effective management of the enterprise is situated*** residence, in order to be consistent with the general pattern of the other Articles. In such a case, the words “an enterprise that has its place of effective management in a Contracting State” should be replaced by “” or “an enterprise of a Contracting State” or “a resident of a Contracting State” ***definition should read: “the term ‘international traffic’ means any transport by a ship or aircraft except when the ship or aircraft is operated solely between places in a Contracting State in which the enterprise that operates the ship or aircraft does not have its place of effective management”.***

6. The definition of the term “international traffic” is broader than is normally understood. The broader definition is intended to preserve for the State ***of the enterprise*** ~~of the place of effective management~~ the right to tax purely domestic traffic as well as international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders. This intention may be clarified by the following illustration. Suppose an enterprise of a Contracting State ~~or an enterprise that has its place of effective management in a Contracting State~~, through an agent in the other Contracting State, sells tickets for a passage that is confined wholly within the first-mentioned State or alternatively, within a third State. The Article does not permit the other State to tax the profits of either voyage. The other State is allowed to tax such an enterprise of the first-mentioned State only where the operations are confined solely to places in that other State.

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

6.2~~4~~ A ship or aircraft is operated solely between places in ~~the other a Contracting State~~ in relation to a particular voyage if the place of departure and the place of arrival of the ship or aircraft are both in that ~~other Contracting State~~. However, the definition applies where the journey of a ship or aircraft between places in ~~the other Contracting a State~~ forms part of a longer voyage of that ship or aircraft involving a place of departure or a place of arrival which is outside that ~~other Contracting State~~. For example, where, as part of the same voyage, an aircraft first flies between a place in one Contracting State to a place in the other Contracting State and then continues to another destination also located in that other Contracting State, the first and second legs of that trip will both be part of a voyage regarded as falling within the definition of “international traffic”.

6.3~~2~~ Some States take the view that the definition of “international traffic” should rather refer to a transport as being the journey of a passenger or cargo so that any voyage of a passenger or cargo solely between two places in the same Contracting State should not be considered as covered by the definition even if that voyage is made on a ship or plane that is used for a voyage in international traffic. Contracting States having that view may agree bilaterally to delete the

reference to “the ship or aircraft” in the *first part of the* exception included in the definition, so as to use the following definition:

- e) the term “international traffic” means any transport by a ship or aircraft ~~operated by an enterprise that has its place of effective management in a Contracting State, except~~ when such transport is solely between places in ~~the other~~ a Contracting State *and the enterprise that operates the ship or aircraft is not an enterprise of that State*;

6.43 The definition of “international traffic” does not apply to a transport by an enterprise which has its place of effective management in one Contracting State when ~~at~~ the ship or aircraft is operated between two places in ~~the other States~~ a Contracting State *and the enterprise that operates the ship or aircraft is not an enterprise of that State*, even if part of the transport takes place outside that State. Thus, for example, a cruise beginning and ending in that ~~other~~ State without a stop in a foreign port does not constitute a transport of passengers in international traffic. Contracting States wishing to expressly clarify that point in their conventions may agree bilaterally to amend the definition accordingly.

27. Add the following paragraphs 10.3 to 10.7 to the Commentary on Article 3:

The term “recognised pension fund”

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

10.4 The effect of the definition of “recognised pension fund” and of the reference to that term in paragraph 1 of Article 4 will depend to a large extent on the domestic law and on the legal characteristics of the pension funds established in each Contracting State as well as on the other provisions of the Convention where the definition might be relevant.

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

10.6 There are also some States where a fund established for the main purpose of providing retirement benefits to individuals does not formally constitute a separate person under the taxation laws of the State in which it is established but where these taxation laws provide that the investment assets of the fund constitute a separate and distinct patrimony the income of

which is not allocated to any person for tax purposes. These States may want to ensure that their domestic law and the definition of “person” in subparagraph a) are broad enough to include such a fund in order to make sure that the Convention, which applies to persons that are residents of the Contracting States, is applicable to the income derived through these funds.

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

- the fund may constitute a person for the purposes of Article 1 and of all the relevant provisions of the Convention;*
- the assets and income of the fund are considered those of a separate person and not those of the person within which the fund is established so that, for example, for the purposes of subparagraph a) of paragraph 2 of Article 10, any part of the capital of a company paying dividends to the fund that is held through the fund would not be aggregated with the capital of the same company that is held by the person within which the fund is established but that is not held through the fund;*
- for the purposes of Articles 6 to 21, the income of the fund would be treated as derived, received and beneficially owned by the fund itself and not by the person within which the fund is established;*
- the fund’s entitlement to treaty benefits under the limitation-on-benefits provisions of Article 29 is determined without consideration of the entitlement to treaty benefits of the person within which the fund is established.*

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

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

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

not necessary to deal with the issue of the residence of the pension fund itself as the income of that fund is treated as the income of another person for tax purposes (see paragraph 10.5 above).

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

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

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

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

- payments made as a result of the death or disability of an individual;*
- pension or other types of payments made to surviving members of the family of a deceased individual who was entitled to retirement benefits;*
- payments made to an individual suffering from a terminal illness;*

- *income substitution payments made in the case of long-term sickness or unemployment;*
- *housing benefits, such as a loan at a preferential rate granted from accumulated pension contributions to a pension contributor for the acquisition of a principal residence;*
- *education benefits, such as the withdrawal of accumulated pension contributions that a pension contributor would be allowed to make for the purpose of financing her education or that of her children;*
- *the provision of financial advice to pension contributors.*

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

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

10.16 Subparagraph (i) of the definition applies regardless of whether the benefits to which it refers are provided to individuals who are residents of the State in which the entity or arrangement is established or are residents of other States. Whilst the general anti-abuse rule in paragraph 9 of Article 29 addresses possible treaty-shopping concerns that may arise from that aspect of the rule, States that do not include that general anti-abuse rule in their treaties or for which this is a particular concern are free to include in the definition of “recognised pension fund” conditions similar to those found in subdivision (ii) of subparagraph e) of paragraph 2 of the detailed version of the limitation-on-benefits rule found in the Commentary on Article 29.

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

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

28. Replace paragraph 12 to 13.1 of the Commentary on Article 3 by the following:

12. However, paragraph 2 specifies that the domestic law meaning of an undefined term applies only if the context does not require an alternative interpretation *and the competent authorities do not agree to a different meaning pursuant to the provisions of Article 25*. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).

13.1 Paragraph 2 was amended in 1995 to conform its text more closely to the general and consistent understanding of member states. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws. *[rest of the paragraph is moved to new paragraph 13.2]*

13.2 The Commentary was also amended in 1995 to provide that States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms. In 2017, the wording of paragraph 2 was amended to

remove any doubt that in a case where a mutual agreement reached under Article 25 indicates that the competent authorities have agreed on a common meaning of an undefined term, the domestic law meaning of that term would not be applicable, as is the case when a term is defined in the Convention or when the context requires a meaning that is different from the domestic law meaning. Some States, however, consider that this exception should only be applicable in the case of agreements reached under paragraph 3 of Article 25; these States are free to replace the phrase “pursuant to the provisions of Article 25” by “pursuant to the provisions of paragraph 3 of Article 25”. Other States consider that, under their law, the competent authorities cannot be given the power to agree on a meaning of a term that would prevent recourse to the domestic law meaning of that term; these States are free to omit the phrase “or the competent authorities agree to a different meaning pursuant to the provisions of Article 25”.

Article 4

29. Replace paragraph 8.6 of the Commentary on Article 4 by the following (and renumber paragraphs 8.7 and 8.8 as paragraphs 8.12 and 8.13 respectively):

8.6 Paragraph 1 also refers expressly to a “recognised pension fund”. Most member countries have long considered that a pension fund established in a Contracting State is a resident of that State regardless of the fact that it may benefit from a limited or complete exemption from taxation in that State. Until 2017, that view was reflected in the previous version of paragraph 8.11, which referred to “pension funds, charities and other organisations” as entities that most States viewed as residents. Paragraph 1 of the Article was modified in 2017 to remove any doubt about the fact that a pension fund that meets the definition of “recognised pension fund” in paragraph 1 of Article 3 constitutes a resident of the Contracting State in which it is established. [existing text of paragraph 8.6 is moved to new paragraph 8.10]

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

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

8.9 Contracting States are of course free to omit the reference to “recognised pension funds” in paragraph 1 if they conclude that the income of the pension arrangements established in both States is derived by persons that otherwise qualify as residents of the Contracting States,

although they might prefer to keep that reference in the paragraph simply to remove any uncertainty.

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

8.611 Paragraph 1 refers to persons who are “liable to tax” in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for purposes of the Convention (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11).

30. Replace paragraph 13 of the Commentary on Article 4 by the following:

13. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.). ***For instance, a house owned by an individual cannot be considered to be available to that individual during a period when the house has been rented out and effectively handed over to an unrelated party so that the individual no longer has the possession of the house and the possibility to stay there.***

31. Replace paragraphs 16 to 19 of the Commentary on Article 4 by the following:

16. Subparagraph *b*) establishes a secondary criterion for two quite distinct and different situations:

- a*) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
- b*) the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

17. In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State ~~rather than~~ ***but not*** in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

18. The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

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

19.1 ~~In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, sSubparagraph b) does not specify over what length of time the comparison~~*the determination of whether an individual has an habitual abode in one or both States must be made. The comparison*~~determination~~ *must cover a sufficient length of time for it to be possible to ascertain the frequency, duration and regularity of stays that are part of the settled routine of the individual’s life*~~determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.~~*Care should be taken, however, to consider a period of time during which there were no major changes of personal circumstances that would clearly affect the determination (such as a separation or divorce). The relevant period for purposes of the determination of whether an individual has an habitual abode in one or both States will not always correspond to the period of dual-residence, especially where the period of dual-residence is very short. This is illustrated by the following example. Assume that an individual resident of State C moves to State D to work at different locations for a period of 190 days. During that 190-day period, he is considered a resident of both States C and D under their respective domestic tax laws. The individual lived in State C for many years before moving to State D, remains in State D for the entire period of his employment there and returns to State C to live there permanently at the end of the 190-day period. During the period of his employment in State D, the individual does not have a permanent home available to him in either State C or State D. In this example, the determination of whether the individual has an habitual abode in one or both States would appropriately consider a period of time longer than the 190-day period of dual-residence in order to ascertain the frequency, duration and regularity of stays that were part of the settled routine of the individual’s life.*

32. Replace paragraphs 21 to 24.1 of the Commentary on Article 4 by the following:

21. This paragraph concerns companies and other bodies of persons, irrespective of whether they are or not legal persons. Cases where a company, etc. is subject to tax as a resident in more than one State may occur if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc., also, special rules as to the preference must be established.

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

23. The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the “place of management” of the enterprise is situated; other conventions attach importance to its “place of effective management”, others again to the “fiscal domicile of the operator”. *In 2017, however, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax avoidance cases involving dual resident companies. It therefore concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis.*

24. As a result of these considerations, *the current version of paragraph 3 provides that the competent authorities of the Contracting States shall endeavour to resolve by mutual agreement cases of dual residence of a person other than an individual.* the “place of effective management” has been adopted as the preference criterion for persons other than individuals. The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity’s business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time.

24.1 Some countries, however, consider that cases of dual residence of persons who are not individuals are relatively rare and should be dealt with on a case by case basis. Some countries also consider that such a case by case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing the paragraph by the following provision:

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting State.

24.1 Competent authorities having to apply *paragraph 3* such a provision to determine the residence of a legal person for purposes of the Convention would be expected to take account of

various factors, such as where the meetings of *the person's* ~~its~~ board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. [*the next sentence has been moved to new paragraph 24.2; the last sentence of the paragraph has been moved to new paragraph 24.3*]

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

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

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

24.5 *Some States, however, consider that it is preferable to deal with cases of dual residence of entities through the rule based on the "place of effective management" that was included in the Convention before 2017. These States also consider that this rule can be interpreted in a way that prevents it from being abused. States that share that view and that agree on how the concept of "place of effective management" should be interpreted are free to include in their bilateral treaty the following version of paragraph 3:*

Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Article 5

33. Replace the Commentary on Article 5 by the following:

COMMENTARY ON ARTICLE 5 CONCERNING THE DEFINITION OF PERMANENT ESTABLISHMENT

1. The main use of the concept of a permanent establishment is to determine the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Under Article 7 a Contracting State cannot tax the profits of an enterprise of the other Contracting State unless it carries on its business through a permanent establishment situated therein.

2. Before 2000, income from professional services and other activities of an independent character was dealt under a separate Article, i.e. Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.

3. *In 2017, a number of changes were made to this Commentary. Some of these changes were intended to clarify the interpretation of the Article and, as such, should be taken into account for the purposes of the interpretation and application of conventions concluded before their adoption because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations (see paragraph 35 of the Introduction).*

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

5. *In many States, a foreign enterprise may be allowed or required to register for the purposes of a value added tax or goods and services tax (VAT/GST) regardless of whether it has in that State a fixed place of business through which its business is wholly or partly carried on or whether it is deemed to have a permanent establishment in that State under paragraph 5 of Article 5. By itself, however, treatment under VAT/GST is irrelevant for the purposes of the interpretation and application of the definition of permanent establishment in the Convention; when applying that definition, one should not, therefore, draw any inference from the treatment of a foreign enterprise for VAT/GST purposes.*

Paragraph 1

6. Paragraph 1 gives a general definition of the term “permanent establishment” which brings out its essential characteristics of a permanent establishment in the sense of the Convention, i.e. a

distinct “situs”, a “fixed place of business”. The paragraph defines the term “permanent establishment” as a fixed place of business, through which the business of an enterprise is wholly or partly carried on. This definition, therefore, contains the following conditions:

- the existence of a “place of business”, i.e. a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be “fixed”, i.e. it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

7. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a “productive character” it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (see Commentary on paragraph 4).

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

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

10. The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the

case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

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

12. Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. *Whether a location may be considered to be at the disposal of an enterprise in such a way that it may constitute a “place of business through which the business of [that] enterprise is wholly or partly carried on” will depend on that enterprise having the effective power to use that location as well as the extent of the presence of the enterprise at that location and the activities that it performs there. This is illustrated by the following examples. Where an enterprise has an exclusive legal right to use a particular location which is used only for carrying on that enterprise’s own business activities (e.g. where it has legal possession of that location), that location is clearly at the disposal of the enterprise. This will also be the case where an enterprise is allowed to use a specific location that belongs to another enterprise or that is used by a number of enterprises and performs its business activities at that location on a continuous basis during an extended period of time. This will not be the case, however, where the enterprise’s presence at a location is so intermittent or incidental that the location cannot be considered a place of business of the enterprise (e.g. where employees of an enterprise have access to the premises of associated enterprises which they often visit but without working in these premises for an extended period of time). Where an enterprise does not have a right to be present at a location and, in fact, does not use that location itself, that location is clearly not at the disposal of the enterprise; thus, for instance, it cannot be considered that a plant that is owned and used exclusively by a supplier or contract-manufacturer is at the disposal of an enterprise that will receive the goods produced at that plant merely because all these goods will be used in the business of that enterprise (see also paragraphs 65, 66 and 121 below). It is also important to remember that even if a place is a place of business through which the activities of an enterprise are partly carried on, that place will be deemed not to be a permanent establishment if paragraph 4 applies to the business activities carried on at that place. [the rest of existing paragraph 4.2 is moved to new paragraphs 13 and 14]*

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

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

15. A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g. a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business

of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a “fixed place of business” (see paragraphs 28 to 34) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

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

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

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

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

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

21. According to the definition, the place of business has to be a “fixed” one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is

immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but see paragraph 57 below).

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

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

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

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

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

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

28. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, *i.e.* if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). *[the rest of the paragraph is moved to new paragraphs 29 to 31]*

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

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

where a company resident of State R which operates various catering facilities in State R would operate a cafeteria in State S during a four month production of a documentary. In that case, the company's business, which is permanently carried on in State R, is only temporarily carried on in State S.

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

32. As mentioned in paragraphs *44 and 55*, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

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

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

35. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 7 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

36. Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example, participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may

constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months applies. Other cases have to be determined according to the circumstances.

37. The leasing of containers is one particular case of the leasing of industrial or commercial equipment which does, however, have specific features. The question of determining the circumstances in which an enterprise involved in the leasing of containers should be considered as having a permanent establishment in another State is more fully discussed in a report entitled “The Taxation of Income Derived from the Leasing of Containers.”¹

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

39. *There are different ways in which an enterprise may carry on its business. In most cases, the business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business of the enterprise (see paragraph 100 below). [the rest of the existing paragraph 10 is moved to new paragraph 41] As explained in paragraph 8.11 of the Commentary on Article 15, however, there may be cases where individuals who are formally employed by an enterprise will actually be carrying on the business of another enterprise and where, therefore, the first enterprise should not be considered to be carrying on its own business at the location where these individuals will perform that work. Within a multinational group, it is relatively common for employees of one company to be temporarily seconded to another company of the group and to perform business activities that clearly belong to the business of that other company. In such cases, administrative reasons (e.g. the need to preserve seniority or pension rights) often prevent a change in the employment contract. The analysis described in paragraphs 8.13 to 8.15 of the Commentary on Article 15 will be relevant for the purposes of distinguishing these cases from other cases where employees of a foreign enterprise perform that enterprise’s own business activities.*

40. *An enterprise may also carry on its business through subcontractors, acting alone or together with employees of the enterprise. In that case, a permanent establishment will only exist for the enterprise if the other conditions of Article 5 are met (this, however, does not address the separate question of how much profit is attributable to such a permanent establishment). In the context of paragraph 1, the existence of a permanent establishment in these circumstances will require that these subcontractors perform the work of the enterprise at a fixed place of business*

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

that is at the disposal of the enterprise. Whether a fixed place of business where subcontractors perform work of an enterprise is at the disposal of that enterprise will be determined on the basis of the guidance in paragraph 12; in the absence of employees of the enterprise, however, it will be necessary to show that such a place is at the disposal of the enterprise on the basis of other factors showing that the enterprise clearly has the effective power to use that site, e.g. because the enterprise owns or has legal possession of that site and controls access to and use of the site. Paragraph 54 illustrates such a situation in the case of a construction site; this could also happen in other situations. An example would be where an enterprise that owns a small hotel and rents out the hotel's rooms through the Internet has subcontracted the on-site operation of the hotel to a company that is remunerated on a cost-plus basis.

41. ~~But~~ *Also, a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.*

42. *It follows from the definition of “enterprise of a Contracting State” in Article 3 that this term, as used in Article 7, and the term “enterprise” used in Article 5, refer to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form. Different enterprises may collaborate on the same project and the question of whether their collaboration constitutes a separate enterprise (e.g. in the form of a partnership) is a question that depends on the facts and the domestic law of each State. Clearly, if two persons each carrying on a separate enterprise decide to form a company in which these persons are shareholders, the company constitutes a legal person that will carry on what becomes another separate enterprise. It will often be the case, however, that different enterprises will simply agree to each carry on a separate part of the same project and that these enterprises will not jointly carry on business activities, will not share the profits thereof and will not be liable for each other's activities related to that project even though they may share the overall output from the project or the remuneration for the activities that will be carried on in the context of that project. In such a case, it would be difficult to consider that a separate enterprise has been set up. Although such an arrangement would be referred to as a “joint venture” in many countries, the meaning of “joint venture” depends on domestic law and it is therefore possible that, in some countries, the term “joint venture” would refer to a distinct enterprise.*

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

44. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the

place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

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

46. The term "place of management" has been mentioned separately because it is not necessarily an "office". However, where the laws of the two Contracting States do not contain the concept of "a place of management" as distinct from an "office", there will be no need to refer to the former term in their bilateral convention.

47. Subparagraph *f)* provides that mines, oil or gas wells, quarries or any other place of extraction of natural resources are permanent establishments. The term "any other place of extraction of natural resources" should be interpreted broadly. It includes, for example, all places of extraction of hydrocarbons whether on or off-shore.

48. Subparagraph *f)* refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

- shall be deemed not to have a permanent establishment in that other State; or
- shall be deemed to carry on such activities through a permanent establishment in that other State; or
- shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

Paragraph 3

49. The paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than twelve months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed through that office or workshop, taking into account the assets used and the risks assumed through that office or workshop, are attributed to the permanent establishment. This could include profits attributable to functions performed in relation to the various construction sites but only to the extent that these functions are properly attributable to the office.

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

51. The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (*e.g.* for a row of houses). *[rest of the paragraph is moved to paragraph 52]*

52. The twelve month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period of less than twelve months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, ~~countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.~~ ***these abuses could also be addressed through the application of the anti-abuse rule of paragraph 9 of Article 29, as shown by example J in paragraph 182 of the Commentary on Article 29. Some States may nevertheless wish to deal expressly with such abuses. Moreover, States that do not include paragraph 9 of Article 29 in their treaties should include an additional provision to address contract splitting. Such a provision could, for example, be drafted along the following lines:***

For the sole purpose of determining whether the twelve month period referred to in paragraph 3 has been exceeded,

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

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

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

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

- whether the contracts covering the different activities were concluded with the same person or related persons;*
- whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;*
- whether the activities would have been covered by a single contract absent tax planning considerations;*
- whether the nature of the work involved under the different contracts is the same or similar;*
- whether the same employees are performing the activities under the different contracts.*

54. *A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. [the six subsequent sentences have been moved to new paragraph 55] If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts **all or** parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project **for purposes of determining whether a permanent establishment exists for the general contractor. In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period.** The subcontractor himself has a permanent establishment at the site if his activities there last more than twelve months.*

55. *[previously included in paragraph 19] In general, ~~it~~**a construction site** continues to exist until the work is completed or permanently abandoned. **The period during which the building or its facilities are being tested by the contractor or subcontractor should therefore generally be***

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

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

57. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within

the country for final assembly, this is part of a single project. In such cases, the fact that the work force is not present for twelve months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months.

Paragraph 4

58. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which ~~are not~~, ***when carried on through fixed places of business, are not sufficient for these places to constitute*** permanent establishments; even if the activity is carried on through a fixed place of business. ***The final part of the paragraph provides that these exceptions only apply if the listed activities have a preparatory or auxiliary character.*** The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in *Since* subparagraph e) ***applies to any activity that is not otherwise listed in the paragraph (as long as that activity has a preparatory or auxiliary character), the provisions of the paragraph,*** which actually amounts to a general restriction of the scope of the definition of ***permanent establishment*** contained in paragraph 1 and, when read with that paragraph, provide a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree, ***these provisions*** ~~it~~ limits that definition ***in paragraph 1*** and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business ~~fixed places of business which~~, ***because the business activities exercised through these places are merely preparatory or auxiliary***, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. *[the last two sentences and the last part of the preceding one have been moved from existing paragraph 23 to this paragraph]* Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of business shall be deemed not to be a permanent establishment, ***subject to the condition, expressed in the final part of the paragraph,*** provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it ***only*** carries on ~~in that other State~~, activities of a purely preparatory or auxiliary character in that State. ***The provisions of paragraph 4.1 (see below) complement that principle by ensuring that the preparatory or auxiliary character of activities carried on at a fixed place of business must be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or closely related enterprises carry on in the same State.***

59. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise; does not exercise a preparatory or auxiliary activity.

60. ***As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in***

preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

61. *Subparagraphs a) to e) refer to activities that are carried on for the enterprise itself. A permanent establishment, however, would therefore exist if such activities were performed on behalf of other enterprises at the same fixed place of business—the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency enterprise that maintained an office for the advertising of its own products or services were also to engage in advertising for on behalf of other enterprises at that location, that office would be regarded as a permanent establishment of the enterprise by which it is maintained.*

62. *Subparagraph a) relates only to the case in which an enterprise acquires the use of to a fixed place of business constituted by facilities used by an enterprise for storing, displaying or delivering its own goods or merchandise. Whether the activity carried on at such a place of business has a preparatory or auxiliary character will have to be determined in the light of factors that include the overall business activity of the enterprise. Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise's sale/distribution business and do not have, therefore, a preparatory or auxiliary character. Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Subparagraph c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first mentioned enterprise. The reference to the collection of information in subparagraph d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".*

63. *Subparagraph a) would cover, for instance, a bonded warehouse with special gas facilities that an exporter of fruit from one State maintains in another State for the sole purpose of storing fruit in a controlled environment during the customs clearance process in that other State. It would also cover a fixed place of business that an enterprise maintained solely for the delivery of spare parts to customers for machinery sold to those customers. Paragraph 4 would not apply, however, where a permanent establishment could also be constituted if an enterprise maintained a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers and, in addition, where, in addition, it for the maintenance or repairs of such machinery, as this would go beyond the pure delivery mentioned in subparagraph a) of paragraph 4 and would not constitute preparatory or auxiliary activities since these after-sale activities constitute organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones [the preceding two sentences have been moved from existing paragraph 25 to this paragraph].*

64. Issues may arise concerning the application of the definition of permanent establishment to ~~Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where ~~they~~ these facilities constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether ~~subparagraph a) paragraph 4~~ applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph a), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph e) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph a) would be applicable. ~~An additional~~ **A separate** question is whether the cable or pipeline could also constitute a permanent establishment for the customer of the operator of the cable or pipeline, *i.e.* the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.~~

65. Subparagraph b) relates to the *maintenance of a stock of goods or merchandise belonging to the enterprise* ~~stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. This subparagraph is irrelevant in cases where a stock of goods or merchandise belonging to an enterprise is maintained by another person in facilities operated by that other person and the enterprise does not have the facilities at its disposal as the place where the stock is maintained cannot therefore be a permanent establishment of that enterprise. Where, for example, a logistics company operates a warehouse in State S and continuously stores in that warehouse goods or merchandise belonging to an enterprise of State R to which the logistics company is not closely related, the warehouse does not constitute a fixed place of business at the disposal of the enterprise of State R and subparagraph b) is therefore irrelevant. Where, however, that enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, subparagraph b) is applicable and the question of whether a permanent establishment exists will depend on whether these activities constitute a preparatory or auxiliary activity.~~

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

property and would not cover, for example, immovable property and data (although the subparagraphs would apply to tangible products that include data such as CDs and DVDs).

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

68. *The first part of subparagraph d) relates to the case where premises are used solely for the purpose of purchasing goods or merchandise for the enterprise. Since this exception only applies if that activity has a preparatory or auxiliary character, it will typically not apply in the case of a fixed place of business used for the purchase of goods or merchandise where the overall activity of the enterprise consists in selling these goods and where purchasing is a core function in the business of the enterprise. The following examples illustrate the application of paragraph 4 in the case of fixed places of business where purchasing activities are performed:*

- Example 1: RCO is a company resident of State R that is a large buyer of a particular agricultural product produced in State S, which RCO sells from State R to distributors situated in different countries. RCO maintains a purchasing office in State S. The employees who work at that office are experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type/quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products by RCO. In this example, although the only activity performed through the office is the purchasing of products for RCO, which is an activity covered by subparagraph d), paragraph 4 does not apply and the office therefore constitutes a permanent establishment because that purchasing function forms an essential and significant part of RCO's overall activity.*
- Example 2: RCO, a company resident of State R which operates a number of large discount stores, maintains an office in State S during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow RCO to establish stores in State S. During that period, employees of RCO occasionally purchase supplies for their office. In this example, paragraph 4 applies because subparagraph f) applies to the activities performed through the office (since subparagraphs d) and e) would apply to the purchasing, researching and lobbying*

activities if each of these was the only activity performed at the office) and the overall activity of the office has a preparatory character.

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

70. ~~Subparagraph e) applies to—provides that a fixed place of business maintained solely for the purpose of carrying on, for the enterprise, any activity that is not expressly listed in subparagraphs a) to d); as long as that activity through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, that place of business is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions—the activities to which the paragraph may apply, the examples listed in subparagraphs a) to d) being merely common examples of activities that are covered by the paragraph because they often have a preparatory or auxiliary character. Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1—(the following part of the paragraph has been moved to paragraph 58) and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of business activities which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.] Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character. [that last sentence has been moved to paragraph 71]~~

71. ~~It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity [the preceding three sentences have been moved to paragraph 59]. Examples of places of business covered by subparagraph e) are fixed places of business used solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character [this sentence currently appears at the end of paragraph 23]. Paragraph 4 would not apply, however, This would not be the case, where, for example, if a fixed place of business used for the supply of information would~~

~~does not only give information but **would** also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case **apply** if a research establishment were to concern itself with manufacture [these two sentences currently appear at the end of paragraph 25]. **Similarly, ~~Where, for example,~~** the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of **paragraph 4-subparagraph e)**. A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If **an** enterprises with international ramifications establishes a so-called “management office” in **a** States in which ~~they~~**it** maintains subsidiaries, permanent establishments, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, **subparagraph e) will not apply to that “management office” because** a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. ~~Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so called polycentric enterprises), the regional management offices even have to be regarded as a “place of management” within the meaning of subparagraph a) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4.~~~~

72. Also, where an enterprise that sells goods worldwide establishes an office in a State and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State without habitually concluding contracts or playing the principal role leading to the conclusion of contracts (e.g. by participating in decisions related to the type, quality or quantity of products covered by these contracts), such activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment. ~~A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph a) of paragraph 4. Since these after sale organisations perform an essential and significant part of the services of an enterprise vis à vis its customers, their activities are not merely auxiliary ones. Subparagraph e) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.~~

~~26. Moreover, subparagraph e) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph e).~~

~~26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from~~

their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a)*, which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e)* also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a)* would be applicable. An additional question is whether the cable or pipeline could also constitute a permanent establishment for the customer of the operator of the cable or pipeline, *i.e.* the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.

26. ~~[Deleted]~~

73. As already mentioned in paragraph 58 above, paragraph 4 is designed to provide ~~for~~ exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph *f)* ~~of paragraph 4~~, the fact that one fixed place of business combines any of the activities mentioned in subparagraphs *a)* to *e)* ~~of paragraph 4~~ does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary, a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion “preparatory or auxiliary character” is to be interpreted in the same way as is set out for the same criterion of subparagraph *e)* (see paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a)* to *e)*, disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words “provided” to “character” in subparagraph *f)*.

74. *Unless the anti-fragmentation provisions of paragraph 4.1 are applicable (see below),* Subparagraph *f)* is of no *relevance* ~~importance~~ in a case where an enterprise maintains several fixed places of business ~~within the meaning of~~ *to which* subparagraphs *a)* to *e)* *apply* ~~provided that they are separated from each other locally and organisationally,~~ as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

75. The fixed places of business ~~mentioned into~~ *to which* paragraph 4 *applies do not* ~~cannot be deemed to constitute permanent establishments so long as~~ *the business activities performed through those fixed places of business* are restricted to the *activities referred to in that paragraph*

~~functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on these business *activities* are concluded by those in charge of the places of business themselves. **The conclusion of such contracts by these employees will not constitute a permanent establishment of the enterprise under** The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5 **as long as the conclusion of these contracts satisfies the conditions of paragraph 4 (see paragraph 97 below).** A case in point would be a research institution **An example would be where** the manager of ~~which~~ **a place of business where preparatory or auxiliary research activities are conducted** of which is authorised to conclude the contracts necessary for **establishing and maintaining that place of business** the institution and who exercises this authority within the framework **as part of the activities carried on at that location** functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.~~

76. If, **under paragraph 4**, a fixed place of business ~~under paragraph 4~~ is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity **at that place** in such installation (see paragraph 44 above and paragraph 2 of Article 13). ~~Since~~ **Where**, for example, the display of merchandise during a trade fair **or convention** is excepted under subparagraphs *a*) and *b*), the sale of ~~that~~ merchandise at the termination of ~~the~~ a trade fair or convention is covered by **subparagraph e**) **as such sale is merely an auxiliary activity** ~~this exception~~. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

77. **Where paragraph 4 does not apply because a** fixed place of business used **by an enterprise** both for activities **that are listed in that** which rank as exceptions (paragraph 4) **is also used** and for other **activities that go beyond what is preparatory or auxiliary, that place of business** constitutes a single permanent establishment **of the enterprise and the profits attributable to the permanent establishment with respect to** as regards both types of activities **may be taxed in the State where that permanent establishment is situated**. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

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

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

- a) the use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;**
- b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;**

- c) *the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;*
- d) *the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;*
- e) *the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any activity not listed in subparagraphs a) to d), provided that this activity has a preparatory or auxiliary character, or*
- f) *the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.*

Paragraph 4.1

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

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

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

- *Example A: RCO, a bank resident of State R, has a number of branches in State S which constitute permanent establishments. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of RCO in State R where other employees analyse the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (i.e. any of the other branches where the loan applications are made) constitutes a permanent establishment of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e. providing loans to clients in State S).*
- *Example B: RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering*

it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse. In this case, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph a) thereof, applies to the warehouse. The conditions for the application of paragraph 4.1 are met because

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

Paragraph 5

82. It is a generally accepted principle that an enterprise should be treated as having a permanent establishment in a State if there is under certain conditions a person acting for it, even though the enterprise may not have a fixed place of business in that State within the meaning of paragraphs 1 and 2. This provision intends to give that State the right to tax in such cases. Thus paragraph 5 stipulates the conditions under which an enterprise is deemed to have a permanent establishment in respect of any activity of a person acting for it. ~~The paragraph was redrafted in the 1977 Model Convention to clarify the intention of the corresponding provision of the 1963 Draft Convention without altering its substance apart from an extension of the excepted activities of the person.~~

83. Persons whose activities may create a permanent establishment for the enterprise are so-called dependent agents i.e. persons, whether or not employees of the enterprise, who *act on behalf of the enterprise and* are not *doing so in the course of carrying on a business as an* independent agents falling under paragraph 6. Such persons may be either individuals or companies and need not be residents of, nor have a place of business in, the State in which they act for the enterprise. It would not have been in the interest of international economic relations to provide that ~~the maintenance of any dependent person~~ *any person undertaking activities on behalf of the enterprise* would lead to a permanent establishment for the enterprise. Such treatment is to be limited to persons who in view of ~~the scope of their authority or the nature of their activity~~ involve the enterprise to a particular extent in business activities in the State concerned. Therefore, paragraph 5 proceeds on the basis that only persons *habitually concluding contracts that are in the name of the enterprise or that are to be performed by the enterprise, or habitually playing the principal role leading to the conclusion of such contracts which are routinely concluded without material modification by the enterprise,* ~~having the authority to conclude contracts~~ can lead to a permanent establishment for the enterprise ~~maintaining them~~. In such a case the person's *actions on behalf of the enterprise, since they result in the conclusion of such contracts and go beyond mere promotion or advertising, are sufficient to conclude that* ~~has sufficient authority to bind the enterprise's participation in~~ the business activity in the State concerned. The use of the term "permanent establishment" in this context presupposes, of course, that *the conclusion of contracts by that person, or as a direct result of the actions of that person,* ~~makes use of this authority~~ *takes place* repeatedly and not merely in isolated cases.

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

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

85. *Even if these conditions are met, however, paragraph 5 will not apply if the activities performed by the person on behalf of the enterprise are covered by the independent agent exception of paragraph 6 or are limited to activities mentioned in paragraph 4 which, if exercised through a fixed place of business, would be deemed not to create a permanent establishment. This last exception is explained by the fact that since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for the purposes of preparatory or auxiliary activities is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes should not create a permanent establishment either. Where, for example, a person acts solely as a buying agent for an enterprise and, in doing so, habitually concludes purchase contracts in the name of that enterprise, paragraph 5 will not apply even if that person is not independent of the enterprise as long as such activities are preparatory or auxiliary (see paragraph 68 above).*

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

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

88. *The phrase “or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise” is aimed at situations where the conclusion of a contract directly results from the actions that the person performs in a Contracting State on behalf of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State. Whilst the phrase “concludes contracts” provides a*

relatively well-known test based on contract law, it was found necessary to supplement that test with a test focusing on substantive activities taking place in one State in order to address cases where the conclusion of contracts is clearly the direct result of these activities although the relevant rules of contract law provide that the conclusion of the contract takes place outside that State. The phrase must be interpreted in the light of the object and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of the enterprise. The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. *The words “contracts that are routinely concluded without material modification by the enterprise” clarify that where such principal role is performed in that State, the actions of that person will fall within the scope of paragraph 5 even if the contracts are not formally concluded in the State, for example, where the contracts are routinely subject, outside that State, to review and approval without such review resulting in a modification of the key aspects of these contracts. [rest of the paragraph is moved to new paragraph 89]*

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

90. The following is another example that illustrates the application of paragraph 5. RCO, a company resident of State R, distributes various products and services worldwide through its websites. SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO’s employees send emails, make telephone calls to, or visit large organisations in order to convince them to buy RCO’s products and services and are therefore responsible for large accounts in State S; SCO’s employees, whose remuneration is partially based on the revenues derived by RCO from the holders of these accounts, use their relationship building skills to try to anticipate the needs of these account holders and to convince them to acquire the products and services offered by RCO. When one of these account holders is persuaded by an employee of SCO to purchase a given quantity of goods or services, the employee indicates the price that will be payable for that quantity, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO’s contracts, including the fixed price structure used by RCO, which the employee is not authorised to modify. The account holder subsequently concludes that contract online for the quantity discussed with SCO’s employee and in accordance with the price structure presented by that employee. In this example, SCO’s employees play the principal role leading to the conclusion of the contract between the account holder and RCO and such contracts are routinely concluded without material modification by the enterprise. The fact that SCO’s employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to

accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and RCO.

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

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

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

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

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

96. The cases to which paragraph 5 applies must be distinguished from situations where a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises or arranges for other enterprises to deliver such goods or services. In these cases, the person is not acting “on behalf” of these other enterprises and the contracts concluded by the person are neither in the name of these enterprises nor for the transfer to third parties of the ownership or use of property that these enterprises own or have the right to use or for the provision of services by these other

enterprises. Where, for example, a company acts as a distributor of products in a particular market and, in doing so, sells to customers products that it buys from an enterprise (including an associated enterprise), it is neither acting on behalf of that enterprise nor selling property that is owned by that enterprise since the property that is sold to the customers is owned by the distributor. This would still be the case if that distributor acted as a so-called “low-risk distributor” (and not, for example, as an agent) but only if the transfer of the title to property sold by that “low-risk” distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold) so that the distributor would derive a profit from the sale as opposed to a remuneration in the form, for example, of a commission.

~~32.1 Also, the phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.~~

~~97. The authority to conclude contracts referred to in paragraph 5 must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to concluded employment contracts engage employees for the enterprise to assist that person’s activity for the enterprise or if the person were authorised to concluded, in the name of the enterprise, similar contracts relating to internal operations only. Moreover, whether or not a the authority has to be person habitually exercised concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise in the other State; should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority “in that State”, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to concluded contracts or played the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.~~

~~98. The requirement that an agent must “habitually” exercise an authority to conclude contracts or play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is “habitually exercising” concluding contracts or playing the principal role leading to the~~

conclusion of contracts that are routinely concluded without material modification by the enterprise contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination

99. Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, *i.e.* not only to the extent that such a person ~~exercises the authority to conclude contracts~~ *or plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise* in the name of the enterprise.

100. Under paragraph 5, only those persons who meet the specific conditions may create a permanent establishment; all other persons are excluded. It should be borne in mind, however, that paragraph 5 simply provides an alternative test of whether an enterprise has a permanent establishment in a State. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to show that the person in charge is one who would fall under paragraph 5.

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

Paragraph 6

102. Where an enterprise of a Contracting State carries on business dealings through a ~~broker, general commission agent or any other agent of an independent status~~ *agent carrying on business as such*, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his ~~that~~ business (see paragraph 83 above). ~~Although it stands to reason that~~ *The activities of* such an agent, *who* represents a separate *and independent* enterprise, ~~cannot constitute a~~ *should not result in the finding of a* permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis.

37. — A person will come within the scope of paragraph 6, *i.e.* he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

- he is independent of the enterprise both legally and economically, and
- he acts in the ordinary course of his business when acting on behalf of the enterprise.

103. *The exception of paragraph 6 only applies where a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent. It would therefore not apply where a person acts on behalf of an enterprise in a different capacity, such as where an employee acts on behalf of her employer or a partner acts on behalf of a partnership. As*

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

104. Whether a person *acting as an agent* is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. *In any event, the last sentence of paragraph 6 provides that in certain circumstances a person shall not be considered to be an independent agent (see paragraphs 119 to 121 below).* 38.2—The following considerations should be borne in mind when determining whether an agent *to whom that last sentence does not apply* may be considered to be independent.

105. ~~In relation to the test of legal dependence, it should be noted that, where the last sentence of paragraph 6 does not apply because a subsidiary does not act exclusively or almost exclusively for closely related enterprises, the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5 (see also paragraph 113 below). But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.~~

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

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

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

109. Another factor to be considered in determining independent status is the number of principals represented by the agent. As indicated in paragraph 111, independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one

enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent, legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

110. *An independent agent* ~~Persons cannot be said to act in the ordinary course of their own~~ *its business as agent when it performs activities that are unrelated to that agency business.* Where, for example, a ~~commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5~~ *company that acts on its own account as a distributor for a number of companies also acts as an agent for another enterprise, the activities that the company undertakes as a distributor will not be considered to be part of the activities that the company carries on in the ordinary course of its business as an agent for the purposes of the application of paragraph 6. Activities that are part of the ordinary course of a business that an enterprise carries on as an agent will, however, include intermediation activities which, in line with the common practice in a particular business sector, are performed sometimes as agent and sometimes on the enterprise's own account, provided that these intermediation activities are, in substance, indistinguishable from each other. Where, for example, a broker-dealer in the financial sector performs a variety of market intermediation activities in the same way but, informed by the needs of the clients, does it sometimes as an agent for another enterprise and sometimes on its own account, the broker-dealer will be considered to be acting in the ordinary course of its business as an agent when it performs these various market intermediation activities.*

~~38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.~~

111. *The last sentence of paragraph 6 provides that a person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is closely related. That last sentence does not mean, however, that paragraph 6 will apply automatically where a person acts for one or more enterprises to which that person is not closely related. Paragraph 6 requires that the person must be carrying on a business as an independent agent and be acting in the ordinary course of that business. Independent status is less likely if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are closely related to each other) over the lifetime of that person's business or over a long period of time. Where, however, a person is acting exclusively for one enterprise, to which it is not closely related, for a short period of time (e.g. at the beginning of that person's business operations), it is possible that paragraph 6 could apply. As indicated in paragraph 109 above, all the facts and circumstances*

would need to be taken into account to determine whether the person's activities constitute the carrying on of a business as an independent agent.

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

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

*114. According to the definition of the term “permanent establishment” an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD member countries **before 2017** include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. **Also, the changes to paragraphs 5 and 6 made in 2017 have addressed some of the concerns that such a provision is intended to address.** Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.*

Paragraph 7

115. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

116. A parent company may, however, be found, under the rules of paragraph 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company (see paragraphs **10 to 17** above) and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraphs 3 and 4 of the Article (see for instance, the example in paragraph **15** above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if *the conditions of that paragraph are met* (see paragraphs **82 to 99** above), unless paragraph 6 of the Article applies.

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

118. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (*e.g.* management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

Paragraph 8

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

120. *The first part of paragraph 8 includes the general definition of a person or enterprise closely related to an enterprise. It provides that a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. This general rule would cover, for example, situations where a person or enterprise controls an enterprise by virtue of a special*

arrangement that allows that person or enterprise to exercise rights that are similar to those that it would hold if it possessed directly or indirectly more than 50 per cent of the beneficial interests in the enterprise. As in most cases where the plural form is used, the reference to the “same persons or enterprises” at the end of the first sentence of paragraph 8 covers cases where there is only one such person or enterprise.

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

Electronic commerce

122. There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

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

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

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

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

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

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

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

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

130. What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business

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

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

The taxation of services

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

133. One of the administrative considerations referred to above is that the extension of the cases where source taxation of profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State would be allowed would increase the compliance and administrative burden of enterprises and tax administrations. This would be especially problematic with respect to services provided to non-business consumers, which would not need to be disclosed to the source country’s tax administration for purposes of claiming a business expense deduction.

Since the rules that have typically been designed for that purpose are based on the amount of time spent in a State, both tax administrations and enterprises would need to take account of the time spent in a country by personnel of service enterprises and these enterprises would face the risk of having a permanent establishment in unexpected circumstances in cases where they would be unable to determine in advance how long personnel would be present in a particular country (*e.g.* in situations where that presence would be extended because of unforeseen difficulties or at the request of a client). These cases create particular compliance difficulties as they require an enterprise to retroactively comply with a number of administrative requirements associated with a permanent establishment. These concerns relate to the need to maintain books and records, the taxation of the employees (*e.g.* the need to make source deductions in another country) as well as other non-income tax requirements.

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

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

136. These States may consider that profits from services performed in a given state should be taxable in that state on the basis of the generally-accepted policy principles for determining when business profits should be considered to have their source within a jurisdiction. They consider that, from the exclusive angle of the pure policy question of where business profits originate, the State where services are performed should have a right to tax even when these services are not attributable to a permanent establishment as defined in Article 5. They would note that the domestic law of many countries provides for the taxation of services performed in these countries even in the absence of a permanent establishment (even though services performed over very short periods of time may not always be taxed in practice).

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

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

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

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

141. Also, member States agree that it is appropriate, for compliance and other reasons, not to allow a State to tax the profits from services performed in their territory in certain circumstances (e.g. when such services are provided during a very short period of time).

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

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

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

Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

- a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
- b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State,

unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business (*other than a fixed place of business to which paragraph 4.1 would apply*), would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

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

146. The provision has the effect of deeming a permanent establishment to exist where one would not otherwise exist under the definition provided in paragraph 1 and the examples of paragraph 2. It therefore applies notwithstanding these paragraphs. As is the case of paragraph 5 of the Article, the provision provides a supplementary basis under which an enterprise may be found to have a permanent establishment in a State; it could apply, for example, where a consultant provides services over a long period in a country but at different locations that do not meet the conditions of paragraph 1 to constitute one or more permanent establishments. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to apply the provision in order to find a permanent establishment. Since the provision simply creates a permanent establishment when none would otherwise exist, it does not provide an alternative definition of the concept of permanent establishment and obviously cannot limit the scope of the definition in paragraph 1 and of the examples in paragraph 2.

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

148. Another example is that of a large construction enterprise that carries on a single construction project in a country. If the project is carried on at a single site, the provision should not have a significant impact as long as the period required for the site to constitute a permanent establishment is not substantially different from the period required for the provision to apply. States that wish to use the alternative provision may therefore wish to consider referring to the

same periods of time in that provision and in paragraph 3 of Article 5; if a shorter period is used in the alternative provision, this will reduce, in practice, the scope of application of paragraph 3.

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

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

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

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

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

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

subparagraph *b*) looks at the duration of the activities of the individuals through whom the services are performed.

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

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

- the individual through whom the services are performed be present in a State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and
- more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during the period or periods of presence be derived from the services performed in that State through that individual.

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

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

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

- *Example 1:* W, a resident of State R, is a consultant who carries on her business activities in her own name (*i.e.* that enterprise is a sole proprietorship). Between 2 February 00 and 1 February 01, she is present in State S for a period or periods of 190 days and during that period all the revenues from her business activities are derived from services that she performs in State S. Since subparagraph *a*) applies in that situation, these services shall be deemed to be performed through a permanent establishment in State S.
- *Example 2:* X, a resident of State R, is one of the two shareholders and employees of XCO, a company resident of State R that provides engineering services. Between 20 December

00 and 19 December 01, X is present in State S for a period or periods of 190 days and during that period, 70 per cent of all the gross revenues of XCO attributable to active business activities are derived from the services that X performs in State S. Since subparagraph *a)* applies in that situation, these services shall be deemed to be performed through a permanent establishment of XCO in State S.

- *Example 3:* X and Y, who are residents of State R, are the two partners of X&Y, a partnership established in State R which provides legal services. For tax purposes, State R treats partnerships as transparent entities. Between 15 July 00 and 14 July 01, Y is present in State S for a period or periods of 240 days and during that period, 55 per cent of all the fees of X&Y attributable to X&Y's active business activities are derived from the services that Y performs in State S. Subparagraph *a)* applies in that situation and, for the purposes of the taxation of X and Y, the services performed by Y are deemed to be performed through a permanent establishment in State S.
- *Example 4:* Z, a resident of State R, is one of 10 employees of ACO, a company resident of State R that provides accounting services. Between 10 April 00 and 9 April 01, Z is present in State S for a period or periods of 190 days and during that period, 12 per cent of all the gross revenues of ACO attributable to its active business activities are derived from the services that Z performs in State S. Subparagraph *a)* does not apply in that situation and, unless subparagraph *b)* applies to ACO, the alternative provision will not deem ACO to have a permanent establishment in State S.

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

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

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

- whether the projects are covered by a single master contract;
- where the projects are covered by different contracts, whether these different contracts were concluded with the same person or with related persons and whether the conclusion of the additional contracts would reasonably have been expected when concluding the first contract;

- whether the nature of the work involved under the different projects is the same;
- whether the same individuals are performing the services under the different projects.

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

164. As indicated in paragraph **153** *above*, for the purposes of the alternative provision, the individuals through whom an enterprise provides services will be the individuals referred to in paragraph **39** *above*. If, however, an individual is providing the services on behalf of one enterprise, the exception included in the last sentence of the provision clarifies that the services performed by that individual will only be taken into account for another enterprise if the work of that individual is exercised under the supervision, direction or control of the last-mentioned enterprise. Thus, for example, where a company that has agreed by contract to provide services to third parties provides these services through the employees of a separate enterprise (*e.g.* an enterprise providing outsourced services), the services performed through these employees will not be taken into account for purposes of the application of subparagraph *b)* to the company that entered into the contract to provide services to third parties. This rule applies regardless of whether the separate enterprise is associated to, or independent from, the company that entered into the contract.

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

- *Example 1:* X, a company resident of State R, has agreed with company Y to carry on geological surveys in various locations in State S where company Y owns exploration rights. Between 15 May 00 and 14 May 01, these surveys are carried on over 185 working days by employees of X as well as by self-employed individuals to whom X has sub-contracted part of the work but who work under the direction, supervision or control of X. Since subparagraph *b)* applies in that situation, these services shall be deemed to be performed through a permanent establishment of X in State S.
- *Example 2:* Y, a resident of State T, is one of the two shareholders and employees of WYCO, a company resident of State R that provides training services. Between 10 June 00 and 9 June 01, Y performs services in State S under a contract that WYCO has concluded with a company which is a resident of State S to train the employees of that company. These services are performed in State S over 185 working days. During the period of Y's presence in State S, the revenues from these services account for 40 per cent of the gross revenues of WYCO from its active business activities. Whilst subparagraph *a)* does not apply in that situation, subparagraph *b)* applies and these services shall be deemed to be performed through a permanent establishment of WYCO in State S.
- *Example 3:* ZCO, a resident of State R, has outsourced to company OCO, which is a resident of State S, the technical support that it provides by telephone to its clients. OCO operates a call centre for a number of companies similar to ZCO. During the period of 1 January 00 to 31 December 00, the employees of OCO provide technical support to various clients of ZCO. Since the employees of OCO are not under the supervision, direction or

control of ZCO, it cannot be considered, for the purposes of subparagraph *b*), that ZCO is performing services in State S through these employees. Additionally, whilst the services provided by OCO's employees to the various clients of ZCO are similar, these are provided under different contracts concluded by ZCO with unrelated clients: these services cannot, therefore, be considered to be rendered for the same or connected projects.

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

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

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

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

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

Article 7

34. Add the following paragraph 59.1 to the Commentary on Article 7:

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

35. Replace paragraph 62 of the Commentary on Article 7 by the following:

62. Like paragraph 2 of Article 9, paragraph 3 leaves open the question whether there should be a period of time after the expiration of which a State would not be obliged to make an appropriate adjustment to the profits attributable to a permanent establishment following an upward revision of these profits in the other State. Some States consider that the commitment should be open-ended — in other words, that however many years the State making the initial adjustment has gone back, the enterprise should in equity be assured of an appropriate adjustment in the other State. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. This problem has not been dealt with in the text of either paragraph 2 of Article 9 or paragraph 3 but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which a State should be obliged to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25). *Contracting States may also wish to address this issue through a provision limiting the length of time during which an adjustment may be made pursuant to paragraph 2 of Article 7; such a solution avoids the double taxation that may otherwise result where there is no adjustment in the other State pursuant to paragraph 3 of the Article following the first State's adjustment pursuant to paragraph 2. Contracting States that wish to achieve that result may agree bilaterally to add the following paragraph after paragraph 4:*

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

Article 8

36. Replace paragraphs 1, 2, 3 and 15 to 23 of the Commentary on Article 8, and the headings above these paragraphs, by the following:

**COMMENTARY ON ARTICLE 8 CONCERNING THE TAXATION OF PROFITS FROM
INTERNATIONAL SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR
TRANSPORT**

Paragraph 1

1. The object of paragraph 1 concerning profits from the operation of ships or aircraft in international traffic is to secure that such profits will be taxed in one State alone. The provision is based on the principle that the taxing right shall be left to the Contracting State ~~in which the place of effective management of~~ *of* the enterprise ~~is situated~~. The term “international traffic” is defined in subparagraph e) of paragraph 1 of Article 3.

2. ~~In certain circumstances the Contracting State in which the place of effective management is situated may not be the State of which an enterprise operating ships or aircraft is a resident, and~~ *Until 2017, paragraph 1 provided that the taxing right would be left to the Contracting State in which the place of effective management of the enterprise was situated. A review of the treaty practices of OECD and non-OECD countries revealed, however, that the majority of these States preferred to assign the taxing right to the State of the enterprise and the Article was changed accordingly. Some States, however, therefore prefer to continue to use the previous formulation and to confer the exclusive taxing right on the State of *in which the place of effective management of the enterprise is situated*. Such States are free to substitute a rule on the following lines:*

~~Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that~~ *the Contracting State in which the place of effective management of the enterprise is situated*.

3. *States wishing to use the alternative formulation in paragraph 2 above may also want to deal with the particular case where the place of effective management of the enterprise is aboard a ship, which could be done by adding the following provision:*

If the place of effective management of a shipping enterprise is aboard a ship, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship is a resident.

~~Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:~~

~~Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the other Contracting State, shall be taxable only in the first mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from~~

~~the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first mentioned State, may be taxed in that other State.~~

Operation of boats engaged in inland waterways transport

~~15. The rules with respect to the taxing right of the State of residence as set forth in paragraphs 2 and 3 above apply also to this paragraph of the Article. States wishing to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic can do so by including the following provision in their bilateral treaties:~~

Profits of an enterprise of a Contracting State from the operation of boats engaged in inland waterways transport shall be taxable only in that State.

~~16. The object of this paragraph is to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic. The provision applies not only to inland waterways transport between two or more countries, but also to inland waterways transport carried on by an enterprise of one country between two points in another country. The above provision would apply not only to inland waterways transport between two or more countries (in which case it would overlap with paragraph 1), but also to inland waterways transport carried on by an enterprise of one State between two points in another State. The alternative formulation set forth in paragraph 2 above according to which the taxing right would be granted to the State in which the place of effective management of the enterprise is situated also applies to the above provision. If this alternative provision is used, it would be appropriate to add a reference to “boats engaged in inland waterways transport” in paragraph 3 of Articles 13 and 22 in order to ensure that such boats are treated in the same way as ships and aircraft operated in international traffic (see also paragraph 9.3 of the Commentary on Article 15). Also, the principles and examples included in paragraphs 4 and 14 above would be applicable, with the necessary adaptations, for purposes of determining which profits may be considered to be derived from the operation of boats engaged in inland waterways transport. Specific tax problems which may arise in connection with inland waterways transport, in particular between adjacent countries, could also be settled specially by bilateral agreement.~~

~~16.1 Paragraphs 4 to 14 above provide guidance with respect to the profits that may be considered to be derived from the operation of ships or aircraft in international traffic. The principles and examples included in these paragraphs are applicable, with the necessary adaptations, for purposes of determining which profits may be considered to be derived from the operation of boats engaged in inland waterways transport.~~

~~17. The provision does not prevent specific tax problems which may arise in connection with inland waterways transport, in particular between adjacent countries, from being settled specially by bilateral agreement.~~

17. Whilst the above alternative provision uses the word “boat” with respect to inland waterways transport, this reflects a traditional distinction that should not be interpreted to restrict in any way the meaning of the word “ship” used throughout the Convention, which is intended to be given a wide meaning that covers any vessel used for water navigation.

~~187.4 It may also be agreed bilaterally that profits from the operation of vessels engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this Article.~~

Enterprises not exclusively engaged in shipping or air transport

198. It follows from the wording of paragraphs 1 ~~and 2~~ that enterprises not exclusively engaged in shipping, ~~inland waterways transport~~ or air transport nevertheless come within the provisions of that paragraphs as regards profits arising to them from the operation of ships, ~~boats~~ or aircraft belonging to them.

2049. If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping, ~~inland waterways transport~~ or air transport.

210. Nor does any difficulty arise in applying the provisions of paragraphs 1 ~~and 2~~ if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, ~~inland waterways transport~~ or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be taxed in the State where the permanent establishment is situated. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g. consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g. staff costs). In this case, even though certain functions related to the operation of ships and aircraft in international traffic may be performed by the permanent establishment, the profits attributable to these functions are taxable exclusively in the State ~~where the place of effective management of to~~ **which** the enterprise **belongs** ~~is situated~~. Any expenses, or part thereof, incurred in performing such functions must be deducted in computing that part of the profit that is not taxable in the State where the permanent establishment is located and will not, therefore, reduce the part of the profits attributable to the permanent establishment which may be taxed in that State pursuant to Article 7.

224. Where ships or aircraft are operated in international traffic, **the application of the alternative formulation in paragraph 2 above** ~~Article~~ to the profits arising from such operation will not be affected by the fact that the ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise; thus, even if such profits could be attributed to the permanent establishment under Article 7, they will only be taxable in the State in which the place of effective management of the enterprise is situated (a result that is confirmed by paragraph 4 of Article 7).

~~22. — This paragraph deals with the particular case where the place of effective management of the enterprise is aboard a ship or a boat. In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident.~~

Paragraph 24

23. Various forms of international co-operation exist in shipping or air transport. In this field international co-operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business.

Article 9

37. Add the following new paragraph 6.1 to the Commentary on Article 9:

6.1 Under the domestic laws of some countries, a taxpayer may be permitted under appropriate circumstances to amend a previously-filed tax return to adjust the price for a transaction between associated enterprises in order to report a price that is, in the taxpayer's opinion, an arm's length price. Where they are made in good faith, such adjustments may facilitate the reporting of taxable income by taxpayers in accordance with the arm's length principle. However, economic double taxation may occur, for example, if such a taxpayer-initiated adjustment increases the profits of an enterprise of one Contracting State but there is no appropriate corresponding adjustment to the profits of the associated enterprise in the other Contracting State. The elimination of such double taxation is within the scope of paragraph 2. Indeed, to the extent that taxes have been levied on the increased profits in the first-mentioned State, that State may be considered to have included in the profits of an enterprise of that State, and to have taxed, profits on which an enterprise of the other State has been charged to tax. In these circumstances, Article 25 enables the competent authorities of the Contracting States to consult together to eliminate the double taxation; the competent authorities may accordingly, if necessary, use the mutual agreement procedure to determine whether the initial adjustment met the conditions of paragraph 1 and, if that is the case, to determine the amount of the appropriate adjustment to the amount of the tax charged in the other State on those profits so as to relieve the double taxation.

38. Replace paragraph 10 of the Commentary on Article 9 by the following:

10. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended — in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment (see on this point paragraphs 39, 40 and 41 of the Commentary on Article 25). *Contracting States may also wish to address this issue through a provision limiting the length of time during which a primary adjustment may be made pursuant to paragraph 1; such a solution avoids the economic double taxation that may otherwise result where there is no corresponding adjustment following the primary adjustment. Contracting States that wish to achieve that result may agree bilaterally to add the following paragraph after paragraph 2:*

3. A Contracting State shall not include in the profits of an enterprise, and tax accordingly, profits that would have accrued to the enterprise but by reason of the conditions referred to in paragraph 1 have not so accrued, after [bilaterally agreed period] from the end of the taxable year in which the profits would have accrued to the enterprise. The provisions of this paragraph shall not apply in the case of fraud, gross negligence or wilful default.

Article 10

39. Replace paragraph 8 of the Commentary on Article 10 by the following:

8. The Article deals only with dividends paid by a company which is a resident of a Contracting State ~~to a resident of the other Contracting State. It~~ *and* does not, therefore, apply to dividends paid by a company which is a resident of a third State. ~~or to a~~ Dividends paid by a company which is a resident of a Contracting State which are attributable to a permanent

establishment which an enterprise of that State has in the other Contracting State *may be taxed by the first-mentioned State under paragraph 2 but may also be taxed by the other State under paragraph 1 of Article 7 (see paragraphs 9 and 9.1 of the Commentary on Articles 23 A and 23 B concerning relief of double taxation in such cases).* ~~(for these cases, see paragraphs 4 to 6 of the Commentary on Article 21).~~

40. Replace paragraph 11 of the Commentary on Article 10 by the following:

11. *Before 2017, subparagraph a) of paragraph 2 referred to a company “other than a partnership”. That exception was deleted in recognition of the fact that if a partnership is treated as a company for tax purposes by the Contracting State in which it is established, it is appropriate for the other State to grant the benefits of subparagraph a) to that partnership. Indeed, ~~if a partnership is treated as a body corporate under the domestic laws applying to it, the two Contracting States may agree to modify subparagraph a) of paragraph 2 in a way to give the benefits of the reduced rate provided for parent companies also to such partnership.~~an entity or arrangement (e.g. a partnership) that is treated as a company for tax purposes qualifies as a company under the definition in subparagraph b) of paragraph 1 of Article 3 and, to the extent that it is a resident of a Contracting State, is therefore entitled to the benefits of subparagraph a) of paragraph 2 with respect to dividends paid by a company resident of the other State, as long as it holds directly at least 25 per cent of the capital of that company. This conclusion holds true regardless of the fact that the State of source of the dividends may regard that entity or arrangement as fiscally transparent. That conclusion is confirmed by the provision on fiscally transparent entities in paragraph 2 of Article 1.*

11.1 That provision also ensures that the part of the dividend received by a fiscally transparent entity or arrangement that is treated as the income of a member of that entity or arrangement for purposes of taxation by the State of residence of that member will be considered as a dividend paid to that member for the purposes of Article 10 (see paragraph 12 of the Commentary on Article 1). Where, for example, a company resident of State A pays a dividend to a partnership that State B treats as a transparent entity, the part of that dividend that State B treats as the income of a partner resident of State B, will, for the purposes of paragraph 2 of the convention between States A and B, be treated as a dividend paid to a resident of State B. Also, for the purposes of the application of subparagraph a) of paragraph 2 in such a case, a member that is a company should be considered to hold directly, in proportion to its interest in the fiscally transparent entity or arrangement, the part of the capital of the company paying the dividend that is held through that entity or arrangement and, in order to determine whether the member holds directly at least 25 per cent of the capital of the company paying the dividends, that part of the capital will be added to other parts of that capital that the member may otherwise hold directly. In that case, for the purposes of the application of the requirement that at least 25 per cent of the capital of the company paying the dividends be held throughout a 365 day period, it will be necessary to take account of both the period during which the member held the relevant interest in the fiscally transparent entity or arrangement and the period during which the part of the capital of the company paying the dividend was held through that entity or arrangement: if either period does not satisfy the 365 day requirement, subparagraph a) will not apply and subparagraph b) will therefore apply to the relevant part of the dividend. States are free to clarify the application of subparagraph a) in these circumstances by adding a provision drafted along the following lines:

To the extent that a dividend paid by a company which is a resident of a Contracting State is, under paragraph 2 of Article 1, considered to be income of another company resident of the other Contracting State because that other company is a member of a fiscally transparent entity or arrangement referred to in that paragraph, that other

company shall be deemed, for the purposes of the application of subparagraph a) of paragraph 2 of Article 10, to hold directly that part of the capital of the company paying the dividend that is held by the transparent entity or arrangement which corresponds to the proportion of the capital of that fiscally transparent entity or arrangement that is held by that other company.

41. Replace paragraph 17 of the Commentary on Article 10 by the following:

17. Under the domestic law of some States, it is possible to make portfolio investments in shares of companies of that State through certain collective investment vehicles established in that State which do not pay tax on their investment income. In such cases, a non-resident company that would own at least 25 per cent of the capital of such a vehicle could be able to access the lower rate provided by subparagraph a) with respect to dividends paid by that vehicle even though the vehicle did not own at least 25 per cent of the capital of any company from which it received dividends. States for which this is an issue could prevent that result by including in paragraph 2 a rule drafted along the following lines (see also paragraph 67.4 below applicable to distributions by a REIT):

Subparagraph a) shall not apply to dividends paid by a company which is a resident of [name of the State] that is a [description of the type of collective investment vehicle to which that rule should apply].

Article 11

42. Replace paragraph 6 of the Commentary on Article 11 by the following:

*6. The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It **and** does not, therefore, apply to interest arising in a third State or to. Interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State **may be taxed by the first-mentioned State under paragraph 2 but may also be taxed by the other State under paragraph 1 of Article 7 (see paragraphs 9 and 9.1 of the Commentary on Articles 23 A and 23 B concerning relief of double taxation in such cases).** (~~for these cases, see paragraphs 4 to 6 of the Commentary on Article 21).~~*

Article 13

43. Add the following new paragraph 28.9 immediately before existing paragraph 28.9 of Commentary on Article 13 and renumber existing paragraphs 28.9 to 28.12 as paragraphs 28.10 to 28.13 respectively:

28.9 Since the paragraph applies in any case where, at any time during the 365 days preceding the alienation of shares or comparable interests, these shares or comparable interests derive more than 50 per cent of their value directly or indirectly from immovable property, the paragraph would apply when shares are alienated within a period of 365 days after the day when immovable property, the value of which is taken into account for the purposes of that paragraph, has itself been alienated by the company or other entity. Some States consider that in such a case, since the alienation of the immovable property is taxable under paragraph 1 in the State where it is situated, it would be inappropriate to take account of the value of that property when determining whether paragraph 4 should apply to the gain on the subsequent alienation of the shares or comparable interests. Assume, for example, that individual X, a resident of State R, owns all the shares of XCO, a company resident of State R. The main asset

of XCO is an immovable property situated in State S. In January 00, the property is sold by XCO and State S taxes the gain in accordance with paragraph 1. At the end of 00, X dies, which, under the domestic law of State S, triggers an alienation of the shares of XCO for tax purposes. In that case, some States consider that the value of the immovable property that has been alienated should not be taken into account when applying paragraph 4 to the shares that are alienated as a result of the death of X. These States may agree bilaterally to replace paragraph 4 by a provision drafted along the following lines:

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State (except immovable property, or part thereof, that was alienated between that time and the time of the alienation of the shares or comparable interests, as long as no part of the value of these shares or comparable interests is derived directly or indirectly from that immovable property, or the part thereof that was alienated, at the time of that subsequent alienation).

States that are concerned that the exception provided in that suggested provision could be abused by arranging sales between related parties may consider restricting its scope to alienations taking place between unrelated parties. Also, States whose domestic tax law does not recognise capital gains upon certain types of alienations are free to exclude such alienations from the scope of the exception included in the suggested provision.

Article 15

44. Replace paragraph 9 of the Commentary on Article 15 by the following:

9. Paragraph 3 applies to the remuneration of crews of ships or aircraft operated in international traffic, ~~or of boats engaged in inland waterways transport, a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport, that is, to tax them in the Contracting State in which the place of effective management of the enterprise concerned is situated~~ *and provides that such remuneration shall be taxable only in the State of residence of the employee. The principle of exclusive taxation in the State of residence of the employee was incorporated in the paragraph through a change made in 2017. The purpose of that amendment was to provide a clearer and administratively simpler rule concerning the taxation of the remuneration of these crews. [rest of existing paragraph 9 has been moved to paragraphs 9.3 and 9.4]*

9.1 At the same time, the definition of international traffic was modified to ensure that it also applied to a transport by a ship or aircraft operated by an enterprise of a third State. As explained in paragraph 6.1 of the Commentary on Article 3, this last change allows the application of paragraph 3 of Article 15 to a resident of a Contracting State who derives remuneration from employment exercised aboard a ship or aircraft operated by an enterprise of a third State.

9.2 Where, however, the employment is exercised by a resident of a Contracting State aboard a ship or aircraft operated solely within the other State, it would clearly be inappropriate to grant an exclusive right to tax to the State of residence of the employee. The phrase “other than aboard a ship or aircraft operated solely within the other Contracting State” ensures that the

paragraph does not apply to such an employee, which means that the taxation of the remuneration of that employee is covered by the provisions of paragraphs 1 and 2 of the Article.

9.3 As indicated in paragraph 9 above, paragraph 3 applies to the crews of ships or aircraft. This is made clear by the reference to employment exercised “as a member of the regular complement of a ship or aircraft”. These words are broad enough to cover any employment activities performed in the course of the usual operation of the ship or aircraft, including, for example, the activities of employees of restaurants aboard a cruise ship or the activities of a flight attendant who would only work on a single flight before leaving his employment; they would not cover, however, employment activities that may be performed aboard a ship or aircraft but are unrelated to its operation (e.g. an employee of an insurance company that sells home and auto insurance to the passengers of a cruise ship).

9.4 As explained in paragraph 15 of the Commentary on Article 8, States wishing to apply the same treatment to transport on rivers, canals and lakes as to shipping and air transport in international traffic may extend the scope of Article 8 to cover profits from the operation of boats engaged in inland waterways transport. These States could then wish to apply paragraph 3 of Article 15 to the remuneration of employees working on these boats. In the case of the remuneration derived by an employee working aboard a boat engaged in inland waterways transport, however, paragraph 3 should only apply to the extent that the boat is operated by an enterprise of the State of residence of the employee. It would indeed be inappropriate for one Contracting State to be required to exempt remuneration derived by an employee who is a resident of the other State but is employed by an enterprise of the first-mentioned State (or of a third State with which the first-mentioned State did not agree to exempt profits derived from the operation of boats engaged in inland waterways transport) where that remuneration relates to activities exercised solely in that first-mentioned State. Contracting States wishing to address this issue could do so by including in their bilateral treaty a separate provision dealing with crews of boats engaged in inland waterways transport that would be drafted as follows:

Notwithstanding the preceding provisions of this Article and of Article 1, remuneration derived by an individual, whether a resident of a Contracting State or not, in respect of an employment, as a member of the regular complement of a boat, that is exercised aboard a boat engaged in inland waterways transport in a Contracting State and operated by an enterprise of the other State shall be taxable only in that other State. However, such remuneration may also be taxed in the first-mentioned State if it is derived by a resident of that State.

9.5 [the following deleted part is currently in existing paragraph 9] In the Commentary on Article 8, it is indicated that Contracting States may agree to confer the right to tax such income on the State of the enterprise operating the ships, boats or aircraft. The reasons for introducing that possibility in the case of profits income from shipping, inland waterways and air transport operations are valid also in respect of remuneration of the crew. Accordingly Contracting States are left free to agree on a provision which gives the right to tax such remuneration to the State of the enterprise. Such a provision, as well as that of paragraph 3 of Article 15, assumes that the domestic laws of the State on which the right to tax is conferred allows it to tax the remuneration of a person in the service of the enterprise concerned, irrespective of his residence. As indicated in paragraph 2 of the Commentary on Article 8, some States may prefer to attribute the exclusive right to tax profits from shipping and air transport to the State in which the place of effective management of the enterprise is situated rather than the State of residence. Where the Contracting States follow that approach, a similar change should be made to the alternative provisions included in paragraphs 9.4 above and 9.6 below if these provisions are used.

9.6 *Some States prefer to allow taxation of the remuneration of an employee who works aboard a ship or aircraft operated in international traffic both by the State of the enterprise that operates such ship or aircraft and the State of residence of the employee. States wishing to do so may draft paragraph 3 along the following lines:*

3. *Notwithstanding the preceding provisions of this Article and Article 1, remuneration derived by an individual, whether a resident of a Contracting State or not, in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic by an enterprise of a Contracting State shall be taxable only in that Contracting State. Where, however, such remuneration is derived by a resident of the other Contracting State, it may also be taxed in that other State.*

9.7 *Some States wishing to apply that approach may also wish to restrict the application of paragraph 3 to employees who are residents of one of the Contracting States, which could be done by using the following wording:*

3. *Notwithstanding the preceding provisions of this Article, remuneration derived by a resident of a Contracting State in respect of an employment, as a member of the regular complement of a ship or aircraft, that is exercised aboard a ship or aircraft operated in international traffic shall be taxable only in that State. Where, however, the ship or aircraft is operated by an enterprise of the other Contracting State, such remuneration may also be taxed in the other State.*

9.8 *According to the alternative provision in paragraph 9.6 above, the Contracting State of the enterprise has the primary right to tax the remuneration of the employee. Where the employee is a resident of the other Contracting State, the remuneration may also be taxed in that other State, subject to the obligation of that State to provide relief of double taxation under the provisions of Article 23 A or 23 B.*

9.9 *Since that alternative provision allows taxation in the State of the enterprise that operates the ship or aircraft, it may help to address the situation of employees who work extensively aboard ships or aircraft operated in international traffic and who may find it advantageous to establish their residence in States that levy no or little tax on the employment income derived from such work performed outside their territory. The provision assumes, however, that the Contracting States have the possibility, under their domestic law, to tax the remuneration of employees working aboard ships or aircraft operated in international traffic solely because the enterprises that operate these ships or aircraft are enterprises of these States. Where this is not the case, the use of that provision in combination with the exemption method for the elimination of double taxation would create a risk of non-taxation. Assume, for instance, that the above provision has been included in a treaty between States R and S, that State R follows the exemption method and that an employee who is a resident of State R works on flights between State R and third States operated by an airline that is an enterprise of State S. In that case, if the domestic law of State S does not allow State S to tax the remuneration of employees of the airline who are not residents of, and do not work in, State S, State S will be unable to exercise the taxing right that has been allocated to it but State R will be required to exempt such remuneration because, under the provisions of the Convention, State S has the right to tax that remuneration.*

9.10 *[the following is the last part of existing paragraph 9] As explained in paragraph 3.1 of the Commentary on Article 8, it may be provided that the reference to the “place of effective management” in the alternative provision in paragraph 2 of that Commentary is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport*

~~enterprise~~ is aboard a ship or a boat. According to the domestic laws of some ~~member~~ countries, tax is levied on remuneration received by non-resident members of the crew in respect of employment aboard ships only if the ship has the nationality of such a State. For that reason conventions concluded between these States provide that the right to tax such remuneration is given to the State of the nationality of the ship. On the other hand many States cannot make use of such a taxation right and the provision could in such cases lead to *a non-taxation situation similar to the one described in the preceding paragraph*. However, States having that taxation principle in their domestic laws may agree bilaterally to confer the right to tax remuneration in respect of employment aboard ships on the State of the nationality of the ship.

Article 21

45. Replace paragraph 5 of the Commentary on Article 21 by the following:

5. The paragraph also covers the cases *not dealt with in the previous Articles of the Convention* where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment is situated. Where double taxation occurs, the State of residence should give relief under the provisions of Article 23 A or 23 B (*see paragraph 9 of the Commentary on these Articles*). ~~However, a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.~~

Articles 23 A and 23 B

46. Replace paragraph 9 of the Commentary on Articles 23 A and 23 B by the following:

9. Where a resident of the Contracting State R derives income from the same State R through a permanent establishment which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment (*paragraph 1 of Article 7 and paragraph 2 of Article 21*). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment situated in State E, notwithstanding the fact that the income in question originally arises in State R (see *also* paragraph 5 of the Commentary on Article 21). However, where the Contracting States agree to give to State R ~~which applies the exemption method~~ a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Article 10 or 11 (~~see paragraph 5 of the Commentary on Article 21~~), then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.

9.1 [the following is a slightly modified version of what is currently found in paragraph 5 of the Commentary on Article 21] **Where, however, State R applies the exemption method,** a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, ~~the first State~~ **State R**, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11 **notwithstanding the fact that it applies the exemption method.** The State where the permanent establishment is situated would give a credit for such tax along the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit ~~should~~**would** not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.

47. Add the following new paragraphs 11.1 to 11.2 to the Commentary on Articles 23 A and 23 B:

11.1 In some cases, the same income or capital may be taxed by each Contracting State as income or capital of one of its residents. This may happen where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income. The phrase “(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State or because the capital is also capital owned by a resident of that State)” clarifies that in such cases, both States are not reciprocally obliged to provide relief for each other’s tax levied exclusively on the basis of the residence of the taxpayer and that each State is therefore only obliged to provide relief of double taxation to the extent that taxation by the other State is in accordance with provisions of the Convention that allow taxation of the relevant income or capital as the State of source or as a State where there is a permanent establishment to which that income or capital is attributable, thereby excluding taxation that would solely be the result of the residence of a person in that other State. Whilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect.

11.2 The principles put forward in the preceding paragraph are illustrated by the following examples:

- **Example A: An entity established in State R constitutes a resident of State R and is therefore taxed on its worldwide income in that State. State S treats that entity as fiscally transparent and taxes the members of the entity on their respective share of the income derived through the entity. All the members of the entity are residents of State S. All the income of the entity constitutes business profits attributable to a permanent establishment situated in State R. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Articles 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S, on the other hand, will be required to provide relief under Articles 23 A or 23 B with respect to the entire income of the entity as that income may be taxed in State R in accordance with the provisions of Article 7 regardless of the fact that State R considers that the income is derived by an entity resident of State R. In determining the amount of income tax paid in State R for the purposes of providing**

relief from double taxation to the members of the entity under Article 23 B, State S will need to take account of the tax paid by the entity in State R.

- *Example B: Same facts as in example A except that 30 per cent of the income derived through the entity is interest arising in State S that is attributable to a permanent establishment in State R, the rest of the income being business profits attributable to the same permanent establishment. In that case, relief of double taxation with respect to the business profits other than the interest will be provided as described in example A. In the case of the interest, however, State R will be required to provide a credit to the entity under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State S by all the members of the entity without exceeding the lower of 10% of the gross amount of interest (which is the maximum amount of tax that may be paid in State S in accordance with paragraph 2 of Article 11) or the tax payable in State R on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, on the other hand, will also be required to provide relief under Articles 23 A or 23 B to the members of the entity that are residents in State S because that income may be taxed by State R in accordance with the provisions of paragraph 1 of Article 7. If State S applies the exemption method of Article 23 A, that suggests that State S will need to exempt the share of the interest attributable to the members that are residents of State S (see paragraph 5 of the Commentary on Article 21 and paragraph 9 of the Commentary on Article 23 A and 23 B). If State S applies the credit method of Article 23 B, the credit should only be applicable against the part of the tax payable in State S that exceeds the amount of tax that State S would be entitled to levy under paragraph 2 of Article 11 and that credit should be given for the amount of tax paid in State R after deduction of the credit that State R itself must grant for the tax payable in State S under paragraph 2 of Article 11.*
- *Example C: Same facts as in example A except that all the income of the entity is derived from immovable property situated in State S. In that case, in determining the tax payable by the entity, State R will be required to provide relief under Articles 23 A or 23 B with respect to the entire income of the entity as that income may be taxed in State S in accordance with the provisions of Article 6 regardless of the fact that State S considers that the income is derived by the members who are residents of State S. State S, on the other hand, is not required to provide relief under Articles 23 A and 23 B because the only reason why State R may tax the income in accordance with the provisions of the Convention is because of the residence of the entity (the result would be the same even if the income were attributable to a permanent establishment situated in State R: see the first sentence of paragraph 9 of the Commentary on Articles 23 A and 23 B).*
- *Example D: Same facts as in example A except that all the income of the entity is interest arising in State S which is not attributable to a permanent establishment. In that case, in determining the tax payable by the entity, State R will be required to provide a credit to the entity under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State S by all the members of the entity without exceeding the lower of 10 per cent of the gross amount of the interest (which is the maximum amount of tax that may be paid in State S in accordance with paragraph 2 of Article 11) or the tax payable in State R on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, on the other hand, will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity since that income does not arise in State R and is not attributable to a permanent establishment in State R and the only reason why State R may tax the income is because*

the income is also income derived by a resident of State R. Paragraph 1 of Article 11 confirms State R's taxing right of the interest as income derived by an entity resident of State R.

- *Example E: Same facts as in example D except that all the income of the entity is interest arising in State R. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Articles 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S, on the other hand, will be required to provide a credit to the members under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State R by the entity without exceeding the lower of 10 per cent of the gross amount of the interest (which is the maximum amount of tax that may be paid in State R in accordance with paragraph 2 of Article 11) or the tax payable in State S on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, however, will not be obliged to provide relief under Article 23 A or 23 B with respect to tax paid in State R in excess of the maximum amount of tax that may be paid in accordance with paragraph 2 of Article 11 since the interest is not attributable to a permanent establishment in State R and the only reason why State R may levy such additional tax is because the income is also income derived by a resident of State R. Paragraph 1 of Article 21 confirms State R's right to tax the interest as income derived by an entity resident of State R.*
- *Example F: Same facts as in example D except that all the income of the entity is interest arising in a third State. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Articles 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S will also not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity since that income does not arise in State R and is not attributable to a permanent establishment in State R and the only reason why State R may tax the income is because the income is also income derived by a resident of State R. Paragraph 1 of Article 21 confirms State R's right to tax the interest as income derived by an entity resident of State R. Paragraph 1 of Article 21 also confirms State S' taxing right of the interest as income derived by the entity's members who are residents of State S.*

Article 24

48. Replace paragraph 71 of the Commentary on Article 24 by the following:

71. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure

as this procedure would provide useful information for audit purposes. Another question that arises with triangular cases is that of abuses. *For example, if a Contracting State applies the exemption method of Article 23 A to the profits attributable to a permanent establishment situated in a third State which does not tax passive income that arises in the other Contracting State but that is attributable to such permanent establishment, there is risk that such income might not be taxed in any of the three States. Paragraph 8 of Article 29 addresses this issue.* ~~If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.~~

Article 25

49. Add the following new paragraph 5.1 to the Commentary on Article 25:

5.1 *The undertaking to resolve by mutual agreement cases of taxation not in accordance with the Convention is an integral part of the obligations assumed by a Contracting State in entering into a tax treaty and must be performed in good faith. In particular, the requirement in paragraph 2 that the competent authority “shall endeavour” to resolve the case by mutual agreement with the competent authority of the other Contracting State means that the competent authorities are obliged to seek to resolve the case in a fair and objective manner, on its merits, in accordance with the terms of the Convention and applicable principles of international law on the interpretation of treaties.*

50. Add the following new paragraphs 6.1 to 6.3 to the Commentary on Article 25:

6.1 *Through Article 25, the Contracting States have delegated to the competent authorities broad powers concerning the application and interpretation of the provisions of the Convention. Paragraph 2 authorises the competent authorities to resolve by mutual agreement cases presented by taxpayers in order to avoid taxation which could otherwise result from domestic laws but would not be in accordance with the Convention. Paragraph 3 similarly authorises the competent authorities to resolve by mutual agreement difficulties or doubts concerning the interpretation or application of the Convention, both in individual cases (e.g. with respect to a single taxpayer’s case) and more generally (e.g. through the joint interpretation of a provision of the treaty applicable to a large number of taxpayers). Under paragraph 3, the competent authorities can, in particular, enter into a mutual agreement to define a term not defined in the Convention, or to complete or clarify the definition of a defined term, where such an agreement would resolve difficulties or doubts arising as to the interpretation or application of the Convention. Such circumstances could arise, for example, where a conflict in meaning under the domestic laws of the two States creates difficulties or leads to an unintended or absurd result. As expressly recognised in paragraph 2 of Article 3, an agreement reached under paragraph 3 concerning the meaning of a term used in the Convention prevails over each State’s domestic law meaning of that term.*

6.2 *More generally, whilst the status under domestic law of a mutual agreement reached pursuant to Article 25 may vary between States, it is clear that the principles of international law*

for the interpretation of treaties, as embodied in Articles 31 and 32 of the Vienna Convention on the Law of Treaties, allow domestic courts to take account of such an agreement. The object of Article 25 is to promote, through consultation and mutual agreement between the competent authorities, the consistent treatment of individual cases and the same interpretation and/or application of the provisions of the Convention in both States. Article 25 also authorises the competent authorities to resolve, by mutual agreement, difficulties or doubts as to the interpretation or application of the Convention; such a mutual agreement, reached pursuant to the express mandate contained in paragraph 3 of the Article, represents objective evidence of the competent authorities' mutual understanding of the meaning of the Convention and its terms. For these reasons, an agreement reached by the competent authorities under Article 25 must be taken into account for purposes of the interpretation of the Convention.

6.3 In addition, there are some cases where the application of certain treaty provisions has been expressly delegated by the Contracting States to the competent authorities and the agreements reached by the competent authorities in these matters legally govern the application of these provisions. Subparagraph d) of paragraph 2 of Article 4, for example, provides that the competent authorities shall resolve by mutual agreement certain cases where an individual is a resident of both Contracting States under paragraph 1 of that Article. Some treaties similarly delegate to the competent authorities the power to determine jointly the status of various entities or arrangements for the purposes of certain treaty provisions (see, for example, subdivision (i) of subparagraph b) of the suggested provision in paragraph 35 of the Commentary on Article 1) or the power to supplement or modify lists of entities, arrangements or domestic law provisions referred to in these treaties.

51. Replace paragraph 7 of the Commentary on Article 25 by the following:

7. The rules laid down in paragraphs 1 and 2 provide for the elimination in a particular case of taxation which does not accord with the Convention. As is known, in such cases it is normally open to taxpayers to litigate in the tax court, either immediately or upon the dismissal of their objections by the taxation authorities. When taxation not in accordance with the Convention arises from an incorrect application of the Convention in both States, taxpayers are then obliged to litigate in each State, with all the disadvantages and uncertainties that such a situation entails. So paragraph 1 makes available to taxpayers affected, without depriving them of the ordinary legal remedies available, a procedure which is called the mutual agreement procedure because it is aimed, in its second stage, at resolving the dispute on an agreed basis, *i.e.* by agreement between competent authorities, the first stage being conducted exclusively ***in one of the Contracting States***~~the State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national)~~ from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter.

52. Replace paragraph 14 of the Commentary on Article 25 by the following:

14. It should be noted that the mutual agreement procedure, unlike the disputed claims procedure under domestic law, can be set in motion by a taxpayer without waiting until the taxation considered by him to be “not in accordance with the Convention” has been charged against or notified to him. To be able to set the procedure in motion, he must, and it is sufficient if he does, establish that the “actions of one or both of the Contracting States” will result in such taxation, and that this taxation appears as a risk which is not merely possible but probable. Such actions mean all acts or decisions, whether of a legislative or a regulatory nature, and whether of general or individual application, having as their direct and necessary consequence the charging of

tax against the complainant contrary to the provisions of the Convention. Thus, for example, if a change to a Contracting State's tax law would result in a person deriving a particular type of income being subjected to taxation not in accordance with the Convention, that person could set the mutual agreement procedure in motion as soon as the law has been amended and that person has derived the relevant income or it becomes probable that the person will derive that income. Other examples include filing a return in a self assessment system or the active examination of a specific taxpayer reporting position in the course of an audit, to the extent that either event creates the probability of taxation not in accordance with the Convention (*e.g.* where the self assessment reporting position the taxpayer is required to take under a Contracting State's domestic law would, if proposed by that State as an assessment in a non-self assessment regime, give rise to the probability of taxation not in accordance with the Convention, or where circumstances such as a Contracting State's published positions or its audit practice create a significant likelihood that the active examination of a specific reporting position such as the taxpayer's will lead to proposed assessments that would give rise to the probability of taxation not in accordance with the Convention). Another example might be a case where a Contracting State's transfer pricing law requires a taxpayer to report taxable income in an amount greater than would result from the actual prices used by the taxpayer in its transactions with a related party, in order to comply with the arm's length principle, and where there is substantial doubt whether the taxpayer's related party will be able to obtain a corresponding adjustment in the other Contracting State in the absence of a mutual agreement procedure. *Such actions may also be understood to include the bona fide taxpayer-initiated adjustments which are authorised under the domestic laws of some countries and which permit a taxpayer, under appropriate circumstances, to amend a previously-filed tax return in order to report a price in a controlled transaction, or an attribution of profits to a permanent establishment, that is, in the taxpayer's opinion, in accordance with the arm's length principle (see paragraph 6.1 of the Commentary on Article 9 and paragraph 59.1 of the Commentary on Article 7).* As indicated by the opening words of paragraph 1, whether or not the actions of one or both of the Contracting States will result in taxation not in accordance with the Convention must be determined from the perspective of the taxpayer. Whilst the taxpayer's belief that there will be such taxation must be reasonable and must be based on facts that can be established, the tax authorities should not refuse to consider a request under paragraph 1 merely because they consider that it has not been proven (for example to domestic law standards of proof on the "balance of probabilities") that such taxation will occur.

53. Replace paragraphs 16 to 19 of the Commentary on Article 25 by the following:

16. To be admissible objections presented under paragraph 1 must first meet a twofold requirement expressly formulated in that paragraph: ~~in principle,~~ they must be presented to the competent authority of *either Contracting State* ~~the taxpayer's State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national),~~ and they must be so presented within three years of the first notification of the action which gives rise to taxation which is not in accordance with the Convention. The Convention does not lay down any special rule as to the form of the objections. The competent authorities may prescribe special procedures which they feel to be appropriate. If no special procedure has been specified, the objections may be presented in the same way as objections regarding taxes are presented to the tax authorities of the State concerned.

17. ~~The requirement laid on~~ *option provided to* the taxpayer to present his case to the competent authority of *either Contracting State is intended to reinforce the general principle that access to the mutual agreement procedure should be as widely available as possible and to provide flexibility. This option is also intended to ensure that the decision as to whether a case should proceed to the second stage of the mutual agreement procedure (i.e. be discussed by the*

competent authorities of both Contracting States) is open to consideration by both competent authorities. Paragraph 1 permits a person to present his case to the competent authority of either Contracting State; it does not preclude a person from presenting his case to the competent authorities of both Contracting States at the same time (see paragraph 75 below). Where a person presents his case to the competent authorities of both Contracting States, he should appropriately inform both competent authorities, in order to facilitate a co-ordinated approach to the case. of which he is a resident (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) is of general application, regardless of whether the taxation objected to has been charged in that the other State and regardless of whether it has given rise to double taxation or not. If the taxpayer should have transferred his residence to the other Contracting State subsequently to the measure or taxation objected to, he must nevertheless still present his objection to the competent authority of the State in which he was a resident during the year in respect of which such taxation has been or is going to be charged.

18. ~~However, in the case already alluded to where a person who is a national of one State but a resident of the other complains of having been subjected in that other State to an action or taxation which is discriminatory under paragraph 1 of Article 24, it appears more appropriate for obvious reasons to allow him, by way of exception to the general rule set forth above, to present his objection to the competent authority of the Contracting State of which he is a national. Finally, it is to the same competent authority that an objection has to be presented by a person who, while not being a resident of a Contracting State, is a national of a Contracting State, and whose case comes under paragraph 1 of Article 24.~~

19.—~~On the other hand, Contracting States may, if they consider it preferable, give~~*that taxpayers should not have the option of presenting their cases to the competent authority of either State, but should, in the first instance, be required to present their cases to the competent authority of the State of which they are resident. However, where a person who is a national of one State but a resident of the other complains of having been subjected in that other State to taxation (or any requirement connected therewith) which is discriminatory under paragraph 1 of Article 24, it appears more appropriate for obvious reasons to allow him, by way of exception to the alternative rule which obliges the taxpayer to present his case to the competent authority of his State of residence, to present his objection to the competent authority of the Contracting State of which he is a national. Similarly, it appears more appropriate that*Finally, it is ~~would be~~ to the same competent authority that an objection ~~has to~~*should* be presented by a person who, while not being a resident of a Contracting State, is a national of a Contracting State, and whose case comes under paragraph 1 of Article 24. *To accommodate the alternative rule and the exception for cases coming under paragraph 1 of Article 24,* paragraph 1 would have to be modified as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of ~~either~~*the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national.* The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

Contracting States that prefer this alternative rule should take appropriate measures to ensure broad access to the mutual agreement procedure and that the decision as to whether a case should proceed to the second stage of the mutual agreement procedure is appropriately considered by both competent authorities.

19. If the taxpayer becomes a resident of a State subsequently to the taxation he considers not in accordance with the Convention, he must, under the alternative rule in paragraph 18 above, nevertheless still present his objection to the competent authority of the other State of which he was a resident during the period in respect of which such taxation has been or will be charged.

54. Replace paragraph 23 of the Commentary on Article 25 by the following:

23. In self assessment cases, there will usually be some notification effecting that assessment (such as a notice of a liability or of denial or adjustment of a claim for refund), and generally the time of notification, rather than the time when the taxpayer lodges the self-assessed return, would be a starting point for the three year period to run. **Where a taxpayer pays additional tax in connection with the filing of an amended return reflecting a bona fide taxpayer-initiated adjustment (as described in paragraph 14 above), the starting point of the three year time limit would generally be the notice of assessment or liability resulting from the amended return, rather than the time when the additional tax was paid.** There may, however, be cases where there is no notice of a liability or the like. In such cases, the relevant time of “notification” would be the time when the taxpayer would, in the normal course of events, be regarded as having been made aware of the taxation that is in fact not in accordance with the Convention. This could, for example, be when information recording the transfer of funds is first made available to a taxpayer, such as in a bank balance or statement. The time begins to run whether or not the taxpayer actually regards the taxation, at that stage, as contrary to the Convention, provided that a reasonably prudent person in the taxpayer’s position would have been able to conclude at that stage that the taxation was not in accordance with the Convention. In such cases, notification of the fact of taxation to the taxpayer is enough. Where, however, it is only the combination of the self assessment with some other circumstance that would cause a reasonably prudent person in the taxpayer’s position to conclude that the taxation was contrary to the Convention (such as a judicial decision determining the imposition of tax in a case similar to the taxpayer’s to be contrary to the provisions of the Convention), the time begins to run only when the latter circumstance materialises.

55. Replace paragraph 26 of the Commentary on Article 25 by the following:

26. Some States may deny the taxpayer the ability to initiate the mutual agreement procedure under paragraph 1 of Article 25 in cases where the transactions to which the request relates are regarded as abusive. This issue is closely related to the issue of “improper use of the Convention” discussed in paragraph 54 and the following paragraphs of the Commentary on Article 1. In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement. However, where serious violations of domestic laws resulting in significant penalties are involved, some States may wish to deny access to the mutual agreement procedure. The circumstances in which a State would deny access to the mutual agreement procedure ~~should~~ **must** be made clear in the Convention.

56. Replace paragraphs 31 to 35 of the Commentary on Article 25 by the following:

31. In the first stage, which opens with the presentation of the taxpayer’s objections, the procedure takes place exclusively at the level of dealings between the taxpayer and the competent authorities of ~~his~~ **the State to which the case was presented** ~~of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national).~~ The provisions of paragraph 1 give the taxpayer concerned the

right to apply to the competent authority of ~~the~~**either** State of which he is a resident, whether or not all the remedies available under the domestic law of each of the two States have been exhausted. On the other hand, the competent authority is under an obligation to consider whether the objection is justified and, if it appears to be justified, take action on it in one of the two forms provided for in paragraph 2.

31.1 The determination whether the objection “appears ... to be justified” requires the competent authority to which the case was presented to make a preliminary assessment of the taxpayer’s objection in order to determine whether the taxation in both Contracting States is consistent with the terms of the Convention. It is appropriate to consider that the objection is justified where there is, or it is reasonable to believe that there will be, in either of the Contracting States, taxation not in accordance with the Convention.

32. If the competent authority duly approached recognises that the complaint is justified and considers that the taxation complained of is due wholly or in part to a measure taken in ~~that the taxpayer’s State of residence~~, it must give the complainant satisfaction as speedily as possible by making such adjustments or allowing such reliefs as appear to be justified. In this situation, the issue can be resolved without **moving beyond the first (unilateral) stage of** ~~resort to the mutual agreement procedure~~. On the other hand, it may be found useful to exchange views and information with the competent authority of the other Contracting State, in order, for example, to confirm a given interpretation of the Convention.

33. If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed, it will be its duty – as clearly appears by the terms of paragraph 2 – to set in motion the **second (bilateral) stage of the** mutual agreement procedure ~~proper~~. It is important that the **competent** authority in question carry out this duty as quickly as possible, especially in cases where the profits of associated enterprises have been adjusted as a result of transfer pricing adjustments.

34. A taxpayer is entitled to present his case under paragraph 1 to the competent authority of ~~either the State of which he is a resident~~ whether or not he may also have made a claim or commenced litigation under the domestic law of **one (or both) of the** ~~that~~ States. If litigation is pending **in the State to which the claim is presented**, the competent authority of ~~that the State of residence~~ should not wait for the final adjudication, but should say whether it considers the case to be eligible for the mutual agreement procedure. If it so decides, it has to determine whether it is itself able to arrive at a satisfactory solution or whether the case has to be submitted to the competent authority of the other Contracting State. An application by a taxpayer to set the mutual agreement procedure in motion should not be rejected without good reason.

35. If a claim has been finally adjudicated by a court in ~~either the State of residence~~, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, the competent authority may be able to arrive at a satisfactory solution which departs from the court decision. In other States, the competent authority is bound by the court decision (***i.e. it is obliged, as a matter of law, to follow the court decision***) or will not depart from the court decision as a matter of administrative policy or practice. It may nevertheless present the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation.

57. Add the following new paragraphs 38.1 to 38.5 to the Commentary on Article 25:

38.1 The combination of bilateral tax conventions concluded among several States may allow the competent authorities of these States to resolve multilateral cases by mutual agreement under paragraphs 1 and 2 of Article 25 of these conventions. A multilateral mutual agreement may be achieved either through the negotiation of a single agreement between all the competent authorities of the States concerned or through the negotiation of separate, but consistent, bilateral mutual agreements.

38.2 This may, for instance, be the case to determine an appropriate allocation of profits between the permanent establishments that an enterprise has in two different States with which the State of the enterprise has tax conventions. In such case an adjustment made with respect to dealings between the two permanent establishments may affect the taxation of the enterprise in the State of residence. Based on paragraphs 1 and 2 of Article 25 of the tax conventions between the State of the enterprise and the States in which the permanent establishments are situated, the competent authority of the State of the enterprise clearly has the authority to endeavour to resolve the case by mutual agreement with the competent authorities of the States in which the permanent establishments are situated and to determine the appropriate attribution of profits to the permanent establishments of its resident in accordance with both tax conventions. Where the tax conventions between the State of the enterprise and the States in which the permanent establishments are situated contain different versions of Article 7 (e.g. the version included in the OECD Model in 2010 in one convention and the previous version of Article 7 in the other convention), the competent authorities may have regard to considerations of equity as mentioned under paragraph 38 above in order to find an appropriate solution with a view to ensuring taxation in accordance with the provisions of the applicable conventions.

38.3 This may, for instance, also be the case where a number of associated enterprises of different States are involved in a series of integrated controlled transactions and there are bilateral tax conventions among the States of all the enterprises. Such a series of integrated controlled transactions could exist, for example, where intellectual property is licensed in a controlled transaction between two members of a multinational enterprise (MNE) group and is then used by the licensee to manufacture goods sold by the licensee to other members of the MNE group. Based on paragraphs 1 and 2 of Article 25 of these tax conventions, the competent authorities of the States of these enterprises clearly have the authority to endeavour to determine the appropriate arm's length transfer prices for the controlled transactions in accordance with the arm's length principle of Article 9.

38.4 As recognised in paragraph 55 below, in the multilateral case described in paragraph 38.2, paragraph 3 of Article 25 of the tax convention between the States in which the permanent establishments are situated enables those two States to consult together to ensure that the convention operates effectively and that the double taxation that can occur in such a situation is appropriately eliminated.

38.5 The desire for certainty may result in taxpayers seeking multilateral advance pricing arrangements ("APAs") to determine, in advance, the transfer pricing of controlled transactions between associated enterprises of several States. Where there exist bilateral tax conventions among all these States and it appears that the actions of at least one of these States are likely to result for the taxpayer in taxation not in accordance with the provisions of a convention, Article 25 of these conventions allows the competent authorities of these States to negotiate on a multilateral basis an appropriate set of criteria for the determination of the transfer pricing for the controlled transactions. A multilateral APA may be achieved either through the negotiation of a single agreement between all the competent authorities of the States concerned or through the negotiation of separate, but consistent, bilateral mutual agreements.

58. Replace paragraph 42 of the Commentary on Article 25 by the following:

42. The case may arise where a mutual agreement is concluded in relation to a taxpayer who has brought a suit for the same purpose in the competent court of either Contracting State and such suit is still pending. In such a case, there would be no grounds for rejecting a request by a taxpayer that he be allowed to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court had delivered its judgment in that suit. Also, a view that competent authorities might reasonably take is that where the taxpayer's suit is ongoing as to the particular issue upon which mutual agreement is sought by that same taxpayer, discussions of any depth at the competent authority level should await a court decision. If the taxpayer's request for a mutual agreement procedure applied to different tax years than the court action, but to essentially the same factual and legal issues, so that the court outcome would in practice be expected to affect the treatment of the taxpayer in years not specifically the subject of litigation, the position might be the same, in practice, as for the cases just mentioned. In either case, awaiting a court decision or otherwise holding a mutual agreement procedure in abeyance whilst formalised domestic recourse proceedings are underway will not infringe upon, or cause time to expire from, the two year period referred to in paragraph 5 of the Article. Of course, if competent authorities consider, in either case, that the matter might be resolved notwithstanding the domestic law proceedings (because, for example, the competent authority where the court action is taken will not be *legally* bound or constrained by the court decision) then the mutual agreement procedure may proceed as normal. *A competent authority may be precluded as a matter of law from maintaining taxation where a court has decided that such taxation is not in accordance with the provisions of a tax treaty. In contrast, in some countries a competent authority would not be legally precluded from granting relief from taxation notwithstanding a court decision that such taxation was in accordance with the provisions of a tax treaty. In such a case, nothing (e.g. administrative policy or practice) should prevent the competent authorities from reaching a mutual agreement pursuant to which a Contracting State will relieve taxation considered by the competent authorities as not in accordance with the provisions of the tax treaty, and thus depart from a decision rendered by a court of that State.*

59. Add the following new paragraph 45.1 to the Commentary on Article 25:

45.1 In some States, audit settlements may be used as a mechanism to promote the closing of audit files. As the word "settlement" implies, there are usually concessions made by both the taxpayer and the tax administration involved, which may create difficult issues where an audit involves questions related to the interpretation or application of a tax treaty which could potentially be resolved through the mutual agreement procedure. One concession tax administrations sometimes seek is a limit on further recourse by the taxpayer, which in some cases may include an agreement by the taxpayer not to initiate the mutual agreement procedure with respect to issues covered by the audit settlement. Double taxation can often be a consequence of such arrangements, which preclude the competent authorities from reaching a bilateral resolution through the mutual agreement procedure, and may indeed cause the other Contracting State to deny relief under its domestic law for the tax paid to the first Contracting State upon settlement of the audit. A taxpayer should thus not be required, as part of an audit settlement, to give up the right provided by paragraph 1 of Article 25 to present its case to a competent authority since this may impede the proper application of a tax treaty. For the purposes of this paragraph, however, an "audit settlement" does not include the settlement of a treaty dispute that is the result of an administrative or statutory dispute settlement/resolution process that is independent from the audit and examination functions and that can only be accessed through a request by the taxpayer. Countries should inform their treaty partners of such administrative or statutory processes and should expressly address the effects of those

processes with respect to the MAP in their public guidance on such processes and in their public MAP programme guidance.

60. Replace paragraphs 47 and 48 of the Commentary on Article 25 by the following:

47. Article 25 gives no absolutely clear answer as to whether a taxpayer initiated mutual agreement procedure may be denied on the basis that there has not been the necessary payment of all or part of the tax in dispute. However, whatever view is taken on this point, in the implementation of the Article it should be recognised that the mutual agreement procedure supports the substantive provisions of the Convention and that the text of Article 25 should therefore be understood in its context and in the light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance. [*the rest of the paragraph has been moved to new paragraph 47.1*]

47.1 Unlike disputes that involve solely the application of a Contracting State's domestic law, the disputes that are addressed through the mutual agreement procedure will in most cases involve double taxation. States therefore should as far as possible take into account ~~the cash flow and possible double taxation~~ issues in requiring advance payment of an amount that the taxpayer contends was at least in part levied contrary to the terms of the relevant Convention. [*the following three sentences are currently in paragraph 48 of the Commentary on Article 25*] ***Even if a mutual agreement procedure ultimately eliminates any double taxation or other taxation not in accordance with the Convention, the requirement to pay tax prior to the conclusion of the mutual agreement procedure may permanently cost the taxpayer the time value of the money represented by the amount inappropriately imposed for the period prior to the mutual agreement procedure resolution, at least in the fairly common case where the respective interest policies of the relevant Contracting States do not fully compensate the taxpayer for that cost. Thus, this means that in such cases the mutual agreement procedure would not achieve the goal of fully eliminating, as an economic matter, the burden of the double taxation or other taxation not in accordance with the Convention. Moreover, even if that economic burden is ultimately removed, a requirement that the taxpayer pay taxes on the same income to two Contracting States can impose cash flow burdens that are inconsistent with the Convention's goals of eliminating barriers to cross border trade and investment.*** As a minimum, payment of outstanding tax should not be a requirement to initiate the mutual agreement procedure if it is not a requirement before initiating domestic law review. *States may wish to provide so expressly in the Convention by adding the following text to the end of paragraph 2:*

The suspension of assessment and collection procedures during the period that any mutual agreement proceeding is pending shall be available under the same conditions as apply to a person pursuing a domestic administrative or judicial remedy.

It also appears, as a minimum, that if the mutual agreement procedure is initiated prior to the taxpayer's being charged to tax (such as by an assessment), a payment should only be required once that charge to tax has occurred.

48. ~~There are several reasons described in the preceding paragraph, why suspension of the collection of tax pending resolution of a mutual agreement procedure can be a desirable policy, although many States may require legislative changes for the purpose of its implementation.~~ ***Moreover,*** ~~A~~ any requirement to pay a tax assessment specifically as a condition of obtaining access to the mutual agreement procedure in order to get relief from that very tax would generally be inconsistent with the policy of making the mutual agreement procedure broadly available to resolve such disputes. [*the following three sentences have been moved to paragraph 47.1*] ~~Even if a mutual agreement procedure ultimately eliminates any double taxation or other taxation not in~~

accordance with the Convention, the requirement to pay tax prior to the conclusion of the mutual agreement procedure may permanently cost the taxpayer the time value of the money represented by the amount inappropriately imposed for the period prior to the mutual agreement procedure resolution, at least in the fairly common case where the respective interest policies of the relevant Contracting States do not fully compensate the taxpayer for that cost. Thus, this means that in such cases the mutual agreement procedure would not achieve the goal of fully eliminating, as an economic matter, the burden of the double taxation or other taxation not in accordance with the Convention. Moreover, even if that economic burden is ultimately removed, a requirement on the taxpayer to pay taxes on the same income to two Contracting States can impose cash flow burdens that are inconsistent with the Convention's goals of eliminating barriers to cross border trade and investment. Finally, another unfortunate complication *of such a requirement* may be delays in the resolution of cases if a country is less willing to enter into good faith mutual agreement procedure discussions when a probable result could be the refunding of taxes already collected. *[the rest of the paragraph has been moved to new paragraph 48.1]* ***In many States, the suspension of the assessment and/or collection of tax pending the resolution of a mutual agreement procedure may require legislative changes for the purpose of its implementation. States may also wish to provide expressly in the Convention for the suspension of assessment and collection procedures by adding the following text to the end of paragraph 2:***

Assessment and collection procedures shall be suspended during the period that any mutual agreement proceeding is pending.

In connection with any suspension of collection of tax pending the resolution of a mutual agreement procedure, it is important to recall the availability of measures of conservancy pursuant to paragraph 4 of Article 27.

48.1 As there may be substantial differences in the domestic law assessment and collection procedures of the Contracting States, it may be important to verify, during the course of bilateral negotiations, how those procedures will operate in each State pending the resolution of a mutual agreement procedure, in order to address any obstacles such procedures may present to the effective implementation of the Article. For example, Where a States takes the view that payment of outstanding tax is a precondition to the taxpayer initiated mutual agreement procedure, this should be notified to the treaty partner during negotiations on the terms of a Convention. Where both Contracting States party to a Convention take this view, there is a common understanding, but also the particular risk of the taxpayer's being required to pay an amount twice. Where domestic law (or a treaty provision such as that in the preceding paragraph) allows it, one possibility which States might consider to deal with this would be for the higher of the two amounts to be held in trust, escrow or similar, pending the outcome of the mutual agreement procedure. Alternatively, a bank guarantee provided by the taxpayer's bank could be sufficient to meet the requirements of the competent authorities. As another approach, one State or the other (decided by time of assessment, for example, or by residence State status under the treaty) could agree to seek a payment of no more than the difference between the amount paid to the other State, and that which it claims, if any. Which of these possibilities is open will ultimately depend on the domestic law (including administrative requirements) of a particular State and the provisions of the applicable treaty, but they are the sorts of options that should as far as possible be considered in seeking to have the mutual agreement procedure operate as effectively as possible. Where States require some payment of outstanding tax as a precondition to the taxpayer initiated mutual agreement procedure, or to the active consideration of an issue within that procedure, they should have a system in place for refunding an amount of interest on any underlying amount to be returned to the taxpayer as the result of a mutual agreement reached by the competent authorities. Any such interest payment should sufficiently reflect the value of the underlying amount and the period of time during which that amount has been unavailable to the taxpayer.

61. Replace paragraph 49 of the Commentary on Article 25 by the following:

49. Paragraph 4 of the Commentary on Article 2 clarifies that whilst most States do not consider interest and administrative penalties accessory to the taxes covered under Article 2 to themselves be covered by Article 2, where such interest and administrative penalties are directly connected to taxes covered under Article 2, they should be appropriately reduced or withdrawn to the same extent as the underlying covered tax is reduced or withdrawn pursuant to the mutual agreement procedure. Consequently, a Contracting State that has applied interest or an administrative penalty that is computed with reference to an underlying tax liability (or with reference to some other amount relevant to the determination of tax, such as the amount of an adjustment or an amount of taxable income) and that has subsequently agreed pursuant to a mutual agreement procedure under paragraphs 1 and 2 of Article 25 to reduce or withdraw that underlying tax liability should proportionally reduce the amount of or withdraw such interest or administrative penalty. States take differing views as to whether administrative interest and penalty charges are treated as taxes covered by Article 2 of the Convention. Some States treat them as taking the character of the underlying amount in dispute, but other States do not. It follows that there will be different views as to whether such interest and penalties are subject to a taxpayer initiated mutual agreement procedure.

62. Add the following new paragraphs 49.1 to 49.3 to the Commentary on Article 25:

49.1 In contrast, other administrative penalties (for example, a penalty for failure to maintain proper transfer pricing documentation) may concern domestic law compliance issues that are not directly connected to a tax liability that is the object of a mutual agreement procedure request. Such administrative penalties would generally not fall within the scope of the mutual agreement procedure under paragraphs 1 and 2 of the Article. Under paragraph 3 of Article 25, however, the competent authorities may consult together and agree, in a specific case, that a penalty not directly connected with taxation not in accordance with the Convention was not or is no longer justified. For instance, where an administrative penalty for negligence, wilful conduct or fraud has been levied at a fixed amount and it is subsequently agreed in the mutual agreement procedure that there was no fraudulent intent, wilful conduct or negligence, the competent authorities may agree that the Contracting State that applied such penalty will withdraw it. Under paragraph 3 of the Article, the competent authorities may also enter into a general mutual agreement pursuant to which they will endeavour through the mutual agreement procedure to resolve under paragraphs 1 and 2 issues related to interest and administrative penalties that give rise to difficulties or doubts as to the application of the Convention. Contracting States may, if they consider it preferable, expressly provide in paragraph 2 of Article 25 for the application of that paragraph to interest and administrative penalties in mutual agreement procedure cases presented in accordance with paragraph 1 by adding the following as a second sentence:

The competent authorities shall also endeavour to agree on the application of domestic law provisions regarding interest and administrative penalties related to the case.

49.2 Criminal penalties imposed by a public prosecutor or a court would generally not fall within the scope of the mutual agreement procedure. In many States, competent authorities would have no legal authority to reduce or withdraw those penalties.

49.3 A mutual agreement will often result in a tax liability being maintained in one Contracting State whilst the other Contracting State has to refund all or part of the tax it has levied. In such cases, the taxpayer may suffer a significant economic burden if there are asymmetries with respect to how interest accrues on tax liabilities and refunds in the two

Contracting States. This will, for instance, be the case where the first Contracting State has charged late payment interest on the tax that was the object of the mutual agreement procedure request and the second Contracting State does not grant overpayment interest on the amount it has to refund to the taxpayer. Therefore, Contracting States should seek to adopt flexible approaches to provide relief from interest accessory to the tax liability that is the object of a mutual agreement procedure request. Relief from interest would be especially appropriate for the period during which the taxpayer is in the mutual agreement process, given that the amount of time it takes to resolve a case through the mutual agreement procedure is, for the most part, outside the taxpayer's control. Changes to the domestic law of a Contracting State may be required to permit the competent authority to provide interest relief agreed upon under the mutual agreement procedure.

63. Replace paragraph 52 of the Commentary on Article 25 by the following:

52. Under this provision the competent authorities can, in particular:

- Where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty.
- Where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes.
- Determine whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when provision for such relief is made in the relevant bilateral convention).
- *Conclude bilateral advance pricing arrangements (APAs) as well as conclude multilateral APAs with competent authorities of third States with which each of the Contracting States has concluded a bilateral tax convention in cases where difficulties or doubts exist as to the interpretation or application of the conventions (especially in cases where no actions of the Contracting States are likely to result in taxation not in accordance with the provisions of a convention). A multilateral APA may be concluded either through the negotiation of a single agreement between all the competent authorities of the concerned States or through the negotiation of separate, but consistent, bilateral mutual agreements.*
- *Determine appropriate procedures, conditions and modalities for the application of paragraphs 1 and 2 as well as the second sentence of this paragraph to multilateral cases (see paragraphs 38.1 to 38.5 above and paragraphs 55 to 55.2 below) and for the involvement of third States in the mutual agreement procedure where the resolution of the case may affect or be affected by taxation in third States.*

64. Replace paragraph 55 of the Commentary on Article 25 by the following:

55. The second sentence of paragraph 3 enables the competent authorities to deal also with such cases of double taxation as do not come within the scope of the provisions of the Convention. Of special interest in this connection is the case of a resident of a third State having permanent establishments in both Contracting States. *[rest of existing paragraph 55 is moved to new paragraph 55.1] The second sentence of paragraph 3 allows the competent authorities of the Contracting States to consult with each other in order to eliminate double taxation that may*

occur with respect to dealings between the permanent establishments. This could for instance be the case where one or both of the Contracting States have no bilateral tax convention with the third State. Where both Contracting States have a convention with the third State, the combination of these two conventions may, however, allow the competent authorities of all three States to resolve the case by mutual agreement under paragraphs 1, 2 and 3 of Article 25 of these conventions (see paragraphs 38.2 and 38.4 above). A multilateral agreement between the competent authorities of all involved States is the best way of ensuring that any double taxation can be eliminated.

65. Add the following new paragraphs 55.1 and 55.2 to the Commentary on Article 25:

*55.1 It is not merely desirable, but in most cases also will particularly reflect the role of Article 25 and the mutual agreement procedure in providing that the competent authorities may consult together as a way of ensuring the Convention as a whole operates effectively, that the mutual agreement procedure should result in the effective elimination of the double taxation which can occur in such a situation. The opportunity for such matters to be dealt with under the mutual agreement procedure becomes increasingly important as Contracting States seek more coherent frameworks for issues of profit allocation involving branches, and this is an issue that could usefully be discussed at the time of negotiating conventions or protocols to them. There will be Contracting States whose domestic law prevents the Convention from being complemented on points which are not explicitly or at least implicitly dealt with in the Convention. However, and in these situations the Convention could be complemented by a protocol dealing with this issue. In most cases, however, the terms of the Convention itself, as interpreted in accordance with accepted tax treaty interpretation principles, will sufficiently support issues involving two branches of a third state entity being subject to the paragraph 3 procedures. **The second sentence of paragraph 3 does not, however, allow the Contracting States to eliminate double taxation where the provision of such relief would contravene their respective domestic laws or is not authorised by the provisions of other applicable tax treaties. That sentence only allows the Contracting States, in cases not provided for in the Convention, to consult each other in order to eliminate double taxation in accordance with their respective domestic laws or in accordance with a tax treaty one of the Contracting States has concluded with a third State. Thus, for instance, in the case of an enterprise of a third State having permanent establishments in both Contracting States, the second sentence of paragraph 3 allows the competent authorities of the Contracting States to agree on the facts and circumstances of a case in order to apply their respective domestic tax laws in a coherent manner, in particular with respect to any dealings between those permanent establishments; the Contracting States could provide relief from any double taxation of the profits of such permanent establishments, however, only to the extent allowed by their respective domestic laws or by the provisions of a tax treaty concluded between a Contracting State and that third State (i.e. applying the provisions of Article 7 and Article 23 of a tax treaty between a Contracting State and the third State). As shown by these examples, paragraph 3 therefore plays a crucial role to allow competent authority consultation to ensure that tax treaties operate in a co-ordinated and effective manner.***

55.2 Under the first sentence of paragraph 3, the competent authorities may agree on a general basis that they shall endeavour to resolve a case presented under paragraph 1 with the competent authority of any third State in circumstances where taxation on income or on capital in that third State is likely to affect or be affected by the resolution of the case. Contracting States that wish to make express provision for multilateral mutual agreement procedures may agree to use the following alternative formulation of paragraph 2:

- 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual*

agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Where the resolution of the case may affect or be affected by taxation on income or on capital in any third State, the competent authorities shall endeavour to resolve the case by mutual agreement with the competent authority of any such third State provided there is a tax convention in force between each of the Contracting States and that third State and the competent authority of that third State agrees within the three-year period provided in paragraph 1 to consult with the competent authorities of the Contracting States to resolve the case by mutual agreement. In order to resolve the case, the competent authorities shall take into consideration the relevant provisions of this Convention together with the relevant provisions of the tax conventions between the Contracting States and any third State involved in the procedure. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

66. Replace paragraphs 63 to 85 and the Annex of the Commentary on Article 25 by the following:

Paragraph 5

63. This paragraph provides that, in ~~the~~ cases where the competent authorities are unable to reach an agreement under paragraph 2 within two years, the unresolved issues will, at the *written* request of the person who presented the case, be solved through an arbitration process. This process is not dependent on a prior authorisation by the competent authorities: once the requisite procedural requirements have been met, the unresolved issues that prevent the conclusion of a mutual agreement must be submitted to arbitration.

64. The arbitration process provided for by the paragraph is not an alternative or additional recourse: where the competent authorities have reached an agreement that does not leave any unresolved issues as regards the application of the Convention, there are no unresolved issues that can be brought to arbitration even if the person who made the mutual agreement request does not consider that the agreement reached by the competent authorities provides a correct solution to the case. The paragraph is, therefore, an extension of the mutual agreement procedure that serves to enhance the effectiveness of that procedure by ensuring that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Thus, under the paragraph, the resolution of the case continues to be reached through the mutual agreement procedure, whilst the resolution of a particular issue which is preventing agreement in the case is handled through an arbitration process. This distinguishes the process established in paragraph 5 from other forms of commercial or government-private party arbitration where the jurisdiction of the *arbitration* panel extends to resolving the whole case.

65. *Before 2017, a footnote to paragraph 5 indicated* ~~It is recognised, however, that in some States, national law, policy or administrative considerations may not allow or justify the type of arbitration process provided for in the paragraph and gave the. For example, there may be of constitutional barriers preventing arbitrators from deciding tax issues. In addition, some countries may only be in a position to include this paragraph in treaties with particular States. For these reasons, the paragraph should only be included in the Convention where each State concludes that the process is capable of effective implementation. The footnote was deleted, however, in recognition of the importance of including an arbitration mechanism that ensures the resolution of disputes between the competent authorities where these disputes would otherwise prevent the mutual agreement procedure from playing its role.~~

65.1 Paragraph 5 includes the essential conditions of the arbitration process. The last sentence of the paragraph expressly requires the competent authorities to agree on the mode of application of that process and it is therefore expected that most of the procedural aspects of the process will be determined in an agreement between the competent authorities (see paragraph 85 below and the sample “mutual agreement on arbitration” included in the Annex). Some States, however, may prefer to incorporate into the Convention itself certain of these procedural aspects. Whilst this increases the complexity of the arbitration provision, a State may consider that the importance of some of these aspects (such as the rules concerning the appointment of the arbitrators and the confidentiality of information communicated to them) is such that these issues should be addressed in the Convention itself. Part VI of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (the “Multilateral Instrument”), which was opened for signature on 31 December 2016, provides a good example of a convention that includes many of the procedural aspects of the arbitration process.

66. ~~In addition,~~ Some States may wish to include paragraph 5 but limit its application to a more restricted range of cases. For example, access to arbitration could be restricted to cases involving issues which are primarily factual in nature. It could also be possible to provide that arbitration would always be available for issues arising in certain classes of cases, for example, highly factual cases such as those related to transfer pricing or the question of the existence of a permanent establishment, whilst extending arbitration to other issues on a case-by-case basis. **States wishing to limit the application of paragraph 5 should be mindful that any significant restriction in the scope of an arbitration provision may limit its effectiveness in ensuring the resolution of unresolved issues arising in a mutual agreement procedure case.**

66.1 Where paragraph 5 is included in a new convention that replaces provisions of a previous convention that included an arbitration provision or to which Part VI of the Multilateral Instrument applied, the Contracting States should clarify whether paragraph 5 of the new convention applies to cases related to the provisions of that previous convention. If that is not the case, the Contracting States should ensure that the arbitration provision of the previous convention or of Part VI of the Multilateral Instrument, as the case may be, continues to apply in order to ensure the arbitration of unresolved issues arising under the provisions of that previous convention.

67. ~~Also,~~ States which are members of the European Union **may want to** co-ordinate the scope of paragraph 5 with their obligations under **legal instruments applicable to these members—the European Arbitration Convention**. **Such co-ordination should ensure that arbitration under such a legal instrument is possible even if paragraph 5 has a narrower scope. This could be done, for example, by including in Article 25 an additional paragraph drafted along the following lines:**

Paragraph 5 shall not affect the fulfilment of wider obligations that result from any other legal instrument applicable to the Contracting States and that relate to the arbitration of unresolved issues referred to in that paragraph.

The co-ordination should also ensure that unresolved issues within the scope of application of paragraph 5 are not subject to arbitration procedures under both that paragraph and under any other legal instrument.

68. The taxpayer should be able to request arbitration of unresolved issues in all cases dealt with under the mutual agreement procedure that have been presented under paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for a person in taxation not in accordance with the provisions of this Convention. Where the mutual agreement procedure is not

available, for example because of the existence of serious violations involving significant penalties (see paragraph 26), it is clear that paragraph 5 is not applicable.

69. Where two Contracting States that have not included the paragraph in their Convention wish to implement an arbitration process for general application or to deal with a specific case, it is still possible for them to do so by mutual agreement. In that case, the competent authorities can conclude a mutual agreement along the lines of the sample wording presented in the Annex, to which they would add the following first paragraph:

1. Where,

- a) under paragraph 1 of Article 25 of the Convention, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and
- b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 of the Article within two years from the ***date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities*** ~~the presentation of the case to the competent authority of the other Contracting State,~~

any unresolved issues arising from the case shall be submitted to arbitration in accordance with the following paragraphs if the person so requests ***in writing***. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, the competent authorities hereby agree to consider themselves bound by the arbitration decision and to resolve the case pursuant to paragraph 2 of Article 25 on the basis of that decision.

This agreement would go on to address the various structural and procedural issues discussed in the Annex. Whilst the competent authorities would thus be bound by such process, such agreement would be given as part of the mutual agreement procedure and would therefore only be effective as long as the competent authorities continue to agree to follow that process to solve cases that they have been unable to resolve through the traditional mutual agreement procedure.

70. Paragraph 5 provides that a person who has presented a case to the competent authority of a Contracting State pursuant to paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention may request ***in writing*** that any unresolved issues arising from the case be submitted to arbitration. This request may be made at any time after a period of two years that begins on the ***date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities*** ~~when the case is presented to the competent authority of the other Contracting State~~. Recourse to arbitration is therefore not automatic; the person who presented the case may prefer to wait beyond the end of the two year period (for example, to allow the competent authorities more time to resolve the case under paragraph 2) or simply not to pursue the case. [*rest of the paragraph moved to new paragraph 70.1*]

70.1 States that consider that the two year period is too short may amend the provision to allow an arbitration request to be made only after three years. Also, States are free to provide that, in certain circumstances, a longer period of time will be required before the request can be made in a specific case. This could be done, for example, by allowing the competent authorities to agree,

on a case-by-case basis, to a different time period before the expiration of the two years; this could be done by drafting subparagraph b) as follows:

b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within two years from the date when all the information required by the competent authorities in order to address the case has been provided to both competent authorities (unless, prior to the expiration of that period, the competent authorities of the Contracting States have agreed to a different time period with respect to that case and have notified the person who presented the case of such agreement).

70.2 States may also wish to provide that the two year period will be suspended in circumstances in which the mutual agreement procedure itself is suspended. This may be the case, for example, where the mutual agreement procedure case concerns one or more issues that are also pending before a court or administrative tribunal and a Contracting State will not allow a taxpayer to pursue simultaneously both a mutual agreement procedure and proceedings before a court or administrative tribunal (see paragraph 76). It may also be the case where one competent authority agrees with the person who presented the case to suspend the mutual agreement procedure (e.g. because of serious illness or some other personal hardship). The following provision could be added to paragraph 5 to deal with such cases:

Where a competent authority has suspended the mutual agreement procedure referred to in paragraph 1 because a case with respect to one or more of the same issues is pending before a court or administrative tribunal, the period provided in subparagraph b) shall stop running until the case pending before a court or administrative tribunal has been suspended or withdrawn. Also, where a person who presented a case and a competent authority have agreed to suspend the mutual agreement procedure, the period provided in subparagraph b) will stop running until the suspension has been lifted.

70.3 In some cases, after a taxpayer has provided the initial information needed to undertake substantive consideration of the case, the competent authorities may need to request additional information from the taxpayer. For example, after the period provided in subparagraph b) has begun and after further analysis of the case, a competent authority may determine that it needs additional information in order to reach agreement on how to resolve a remaining issue. In such cases, a failure by a person directly affected by the case to provide such additional information in a timely manner may delay or prevent the competent authorities from being able to resolve the case. This issue may be dealt with by using the alternative formulation of subparagraph b) suggested in paragraph 70.1 above, which allows the competent authorities to agree to a different period of time on a case-by-case basis. Alternatively, it could be dealt with in the mutual agreement that will settle the mode of application of the arbitration provision, e.g. by providing that the two year period will be extended where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start of the period provided in subparagraph b) (see Article 7 of the sample mutual agreement in the Annex; a similar provision could instead be added to the Convention itself if the alternative provision in paragraph 70.1 is not used).

71. Under paragraph 2 of Article 25, the competent authorities must endeavour to resolve a case presented under paragraph 1 with a view to the avoidance of taxation not in accordance with the Convention. For the purposes of paragraph 5, a case should therefore not be considered to have been resolved as long as there is at least one issue on which the competent authorities disagree and which, according to one of the competent authorities, indicates that there has been taxation not in accordance with the Convention. One of the competent authorities could not, therefore, unilaterally

decide that such a case is closed and that the person involved cannot request the arbitration of unresolved issues; similarly, the two competent authorities could not consider that the case has been resolved and deny the request for arbitration if there are still unresolved issues that prevent them from agreeing that there has not been taxation not in accordance with the Convention. Where, however, the two competent authorities agree that taxation by both States has been in accordance with the Convention, there are no unresolved issues and the case may be considered to have been resolved, even in the case where there might be double taxation that is not addressed by the provisions of the Convention.

72. The arbitration process is only available in cases where the person considers that taxation not in accordance with the provisions of the Convention has actually resulted from the actions of one or both of the Contracting States; it is not available, however, in cases where it is argued that such taxation will eventually result from such actions even if the latter cases may be presented to the competent authorities under paragraph 1 of the Article (see paragraph 70 above). For that purpose, taxation should be considered to have resulted from the actions of one or both of the Contracting States as soon as, for example, tax has been paid, assessed or otherwise determined or even in cases where the taxpayer is officially notified by the tax authorities that they intend to tax him on a certain element of income.

73. As drafted, paragraph 5 only provides for arbitration of unresolved issues arising from a request made under paragraph 1 of the Article. States wishing to extend the scope of the paragraph to also cover mutual agreement cases arising under paragraph 3 of the Article are free to do so. In some cases, a mutual agreement case may arise from other specific treaty provisions, such as subparagraph 2 d) of Article 4. Under that subparagraph, the competent authorities are, in certain cases, required to settle by mutual agreement the question of the status of an individual who is a resident of both Contracting States. As indicated in paragraph 20 of the Commentary on Article 4, such cases must be resolved according to the procedure established in Article 25. If the competent authorities fail to reach an agreement on such a case and this results in taxation not in accordance with the Convention (according to which the individual should be a resident of only one State for purposes of the Convention), the taxpayer's case comes under paragraph 1 of Article 25 and, therefore, paragraph 5 is applicable.

74. In some States, it may be possible for the competent authorities to deviate from a court decision on a particular issue arising from the case presented to the competent authorities. Those States should therefore be able to omit the second sentence of the paragraph *and, if they wish to use the alternative provision in paragraph 70.2 above, should amend it to read:*

Where a competent authority has suspended the mutual agreement procedure referred to in paragraph 1 because a case with respect to one or more of the same issues is pending before a court or administrative tribunal, the period provided in subparagraph b) will stop running until either a final decision has been rendered by the court or administrative tribunal or the case has been suspended or withdrawn. Also, where a person who presented a case and a competent authority have agreed to suspend the mutual agreement procedure, the period provided in subparagraph b) will stop running until the suspension has been lifted.

75. ~~The presentation of the case to the competent authority of the other State, which is the beginning of the two year period referred to in the paragraph, may be made by the person who presented the case to the competent authority of the first State under paragraph 1 of Article 25 (e.g. by presenting the case to the competent authority of the other State at the same time or at a later time) or by the competent authority of the first State, who would contact the competent authority of the other State pursuant to paragraph 2 if it is not itself able to arrive at a satisfactory solution of~~

~~the case.~~ For the purpose of determining the start of the two year period, *it will be considered that all the information required by the competent authorities in order to address the case has been provided to both competent authorities* ~~a case will only be considered to have been presented to the competent authority of the other State~~ *only* if sufficient information has been presented to ~~that~~ *both* competent authorities to allow ~~them~~ *them* to decide whether the objection underlying the case appears to be justified. The mutual agreement providing for the mode of application of paragraph 5 ~~(see the Annex)~~ *should clarify the process that will be used to determine that start date and* should specify which type of information will normally be sufficient for that purpose. *The sample mutual agreement included in the Annex suggests a process that is similar to the one used in Part VI of the Multilateral Instrument. States that consider that rules for the determination of the start date for the two year period should be included directly in the Convention are free to do so, e.g. by including provisions similar to those of paragraphs 5 to 9 of Article 19 of the Multilateral Instrument.*

76. The paragraph also deals with the relationship between the arbitration process and rights to domestic remedies. For the arbitration process to be effective and to avoid the risk of conflicting decisions, a person should not be allowed to pursue the arbitration process if the issues submitted to arbitration have already been resolved through the domestic litigation process of either State (which means that any court or administrative tribunal of one of the Contracting States has already rendered a decision that deals with these issues and that applies to that person). This is consistent with the approach adopted by most countries as regards the mutual agreement procedure and according to which:

- a) A person cannot pursue simultaneously the mutual agreement procedure and domestic legal remedies. Where domestic legal remedies are still available, the competent authorities will generally either require that the taxpayer agree to the suspension of these remedies or, if the taxpayer does not agree, will delay the mutual agreement procedure until these remedies are exhausted.
- b) Where the mutual agreement procedure is first pursued and a mutual agreement has been reached, the taxpayer and other persons directly affected by the case are offered the possibility to reject the agreement and pursue the domestic remedies that had been suspended; conversely, if these persons prefer to have the agreement apply, they will have to renounce the exercise of domestic legal remedies as regards the issues covered by the agreement.
- c) Where the domestic legal remedies are first pursued and are exhausted in a State, a person may only pursue the mutual agreement procedure in order to obtain relief of double taxation in the other State. Indeed, once a legal decision has been rendered in a particular case, most countries consider that it is impossible to override that decision through the mutual agreement procedure and would therefore restrict the subsequent application of the mutual agreement procedure to trying to obtain relief in the other State.

The same general principles should be applicable in the case of a mutual agreement procedure that would involve one or more issues submitted to arbitration. It would not be helpful to submit an issue to arbitration if it is known in advance that one of the countries is limited in the response that it could make to the *arbitration* ~~arbitral~~ decision. This, however, would not be the case if the country could, in a mutual agreement procedure, deviate from a court decision (see paragraph 74) and in that case paragraph 5 could be adjusted accordingly.

77. A second issue involves the relationship between existing domestic legal remedies and arbitration where ~~the taxpayer has not undertaken (or has not exhausted)~~ these legal remedies *have*

not been exhausted. In that case, the approach that would be the most consistent with the basic structure of the mutual agreement procedure would be to apply the same general principles when arbitration is involved. Thus, the legal remedies would be suspended pending the outcome of the mutual agreement procedure involving the arbitration of the issues that the competent authorities are unable to resolve and a tentative mutual agreement would be reached on the basis of that decision. As in other mutual agreement procedure cases, that agreement would then be presented to the taxpayer who would have to choose to accept the agreement, which would require abandoning any remaining domestic legal remedies, or reject the agreement to pursue these remedies.

78. This approach is in line with the nature of the arbitration process set out in paragraph 5. The purpose of that process is to allow the competent authorities to reach a conclusion on the unresolved issues that prevent an agreement from being reached. When that agreement is achieved through the aid of arbitration, the essential character of the mutual agreement remains the same.

79. In some cases, this approach will mean that the parties will have to expend time and resources in an arbitration process that will lead to a mutual agreement that will not be accepted by the taxpayer. As a practical matter, however, experience shows that there are very few cases where the taxpayer rejects a mutual agreement to resort to domestic legal remedies. Also, in these rare cases, one would expect the domestic courts or administrative tribunals to take note of the fact that the taxpayer had been offered an administrative solution to his case that would have bound both States.

79.1 As noted in paragraph 76 a) above, most States will not allow a person to pursue simultaneously the mutual agreement procedure and domestic legal remedies. Some States, however, may permit a person simultaneously to pursue both the mutual agreement procedure and proceedings before a court or administrative tribunal with respect to the same issues; in these States, the possibility exists that a decision concerning an issue or issues submitted to arbitration may be rendered by a court or administrative tribunal after a request for arbitration has been made and before the arbitration panel has delivered its decision. Such States may wish to provide expressly that the arbitration process will terminate in such a circumstance, in order to avoid the difficulties that may then arise with the application of the mutual agreement implementing a subsequent arbitration decision (see paragraph 76 above). The following language could be added to paragraph 5 for this purpose:

If, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities of the Contracting States, a decision concerning the issue is rendered by a court or administrative tribunal of one of the Contracting States, the arbitration process shall terminate.

80. In some States, unresolved issues between competent authorities may only be submitted to arbitration if domestic legal remedies are no longer available. In order to implement an arbitration approach, these States could consider the alternative approach of requiring a person to waive the right to pursue domestic legal remedies before arbitration can take place. This could be done by replacing the second sentence of the paragraph by “these unresolved issues shall not, however, be submitted to arbitration if any person directly affected by the case is still entitled, under the domestic law of either State, to have courts or administrative tribunals of that State decide these issues or if a decision on these issues has already been rendered by such a court or administrative tribunal.” To avoid a situation where a taxpayer would be required to waive domestic legal remedies without any assurance as to the outcome of the case, it would then be important to also modify the paragraph to include a mechanism that would guarantee, for example, that double taxation would in fact be relieved. Also, since the taxpayer would then renounce the right to be

heard by domestic courts, the paragraph should also be modified to ensure that sufficient legal safeguards are granted to the taxpayer as regards his participation in the arbitration process to meet the requirements that may exist under domestic law for such a renunciation to be acceptable under the applicable legal system (e.g. in some countries, such renunciation might not be effective if the person were not guaranteed the right to be heard orally during the arbitration).

80.1 Some States consider that taxpayers and their advisors should not disclose any information received in the course of arbitration proceedings. States that share that view are free to include the following provision, which is based on paragraph 5 of Article 23 of the Multilateral Instrument:

Prior to the beginning of arbitration proceedings, the competent authorities of the Contracting States shall ensure that each person that presented the case and their advisors agree in writing not to disclose to any other person any information received during the course of the arbitration proceedings from either competent authority or the arbitration panel. The mutual agreement procedure and the arbitration proceedings related to the case shall terminate if, at any time after a request for arbitration has been made and before the arbitration panel has delivered its decision to the competent authorities, a person that presented the case or one of that person's advisors materially breaches that agreement.

81. Paragraph 5 provides that, unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both States. Thus, the taxation of any person directly affected by the case will have to conform with the decision reached on the issues submitted to arbitration and the decisions reached in the *arbitration* process will be reflected in the mutual agreement that will be presented to these persons. ***Where, however, an arbitration decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or of any procedural rule, that arbitration decision will not be binding on either State (see also Article 11 of the sample mutual agreement, which deals with this issue).***

82. As noted in subparagraph 76 b) above, where a mutual agreement is reached before domestic legal remedies have been exhausted, it is normal for the competent authorities to require, as a condition for the application of the agreement, that the persons affected renounce the exercise of domestic legal remedies that may still exist as regards the issues covered by the agreement. Without such renunciation, a subsequent court decision could indeed prevent the competent authorities from applying the agreement. Thus, for the purpose of paragraph 5, if a person to whom the mutual agreement that implements the arbitration decision has been presented does not agree to renounce the exercise of domestic legal remedies, that person must be considered not to have accepted that agreement. ***Where the mutual agreement is not accepted, or is considered not to have been accepted, the case shall not be eligible for any further consideration by the competent authorities.***

82.1 For greater certainty, some States may wish to reflect the conclusions of paragraphs 81 and 82 above into the text of their conventions, which could be done by adding an additional paragraph drafted along the following lines:

For the purposes of paragraph 5

- a) the mutual agreement that implements the arbitration decision on the case shall be considered not to be accepted by a person directly affected by the case if any person directly affected by the case does not, within 60 days after the date on which notification of the mutual agreement is sent to the person, withdraw all issues***

resolved in the mutual agreement implementing the arbitration decision from consideration by any court or administrative tribunal or otherwise terminate any pending court or administrative proceedings with respect to such issues in a manner consistent with that mutual agreement; and

b) the decision shall not be binding on the Contracting States if:

(i) a final decision of the courts of one of the Contracting States holds that the arbitration decision is invalid. In such a case, the request for arbitration under paragraph 5 shall be considered not to have been made, and the arbitration process shall be considered not to have taken place (except with respect to any applicable provisions dealing with confidentiality of information and payment of the costs related to the arbitration). In such a case, a new request for arbitration may be made unless the competent authorities agree that such a new request should not be permitted; or

(ii) a person directly affected by the case pursues litigation in any court or administrative tribunal concerning the issues that were resolved in the mutual agreement implementing the arbitration decision.

83. The arbitration decision is only binding with respect to the specific issues submitted to arbitration. Whilst nothing would prevent the competent authorities from solving other similar cases (including cases involving the same persons but different taxable periods) on the basis of the decision, there is no obligation to do so and each State therefore has the right to adopt a different approach to deal with these other cases.

84. Some States may wish to allow the competent authorities to depart from the arbitration decision, provided that they can agree on a different solution *that would settle all outstanding issues that prevented the resolution of the mutual agreement procedure case* (this, for example, is allowed under Article 12 of the EU Arbitration Convention). States wishing to do so are free to amend the third sentence of the paragraph as follows:

... Unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision or the competent authorities ~~and the persons directly affected by the case~~ agree on a different solution *resolution of all unresolved issues arising from the case* within ~~six~~ *three* months after the decision has been communicated to them, the arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States.

85. The last sentence of the paragraph leaves the mode of application of the arbitration process to be settled by mutual agreement. *As indicated in paragraph 65.1 above, some States may prefer to incorporate into the Convention itself certain of the procedural aspects of the arbitration process; other States may want to deal with them through* ~~Some aspects could also be covered in the Article itself,~~ a protocol or through an exchange of diplomatic notes. *It should be noted, however, that addressing these issues through a mutual agreement allows more flexibility with respect to subsequent changes that could become necessary as the Contracting States gain experience in applying the arbitration provisions.* Whatever form the agreement takes, it should set out the structural and procedural rules to be followed in applying the paragraph, taking into account the paragraph's requirement that the arbitration decision be binding on both States. Ideally, that agreement should be drafted at the same time as the Convention so as to be signed, and to apply, immediately after the paragraph becomes effective. Also, since the agreement will provide the details of the process to be followed to bring unresolved issues to arbitration, it would be important that this agreement be made public. A sample form of such a *procedural mutual*

agreement is provided in the Annex together with comments on the procedural rules that it puts forward.

Annex — Sample Mutual Agreement on Arbitration

1. The following is a sample form of agreement that the competent authorities may use as a basis for a mutual agreement to implement the arbitration process provided for in paragraph 5 of the Article (see paragraph 85 above). Paragraphs 2 to ~~4843~~ below discuss the various provisions of the agreement and, in some cases, put forward alternatives. Competent authorities are of course free to modify, add or delete any provisions of this sample agreement when concluding their bilateral agreement.

Mutual agreement on the implementation of paragraph 5 of Article 25

The competent authorities of [State A] and [State B] have entered into the following mutual agreement to establish the mode of application of the arbitration process provided for in paragraph 5 of Article 25 of the [title of the Convention], which entered into force on [date of entry into force]. The competent authorities may modify or supplement this agreement by an exchange of letters between them.

1. *Request for submission of case to arbitration*

A request that unresolved issues arising from a mutual agreement case be submitted to arbitration pursuant to paragraph 5 of Article 25 of the Convention (the “request for arbitration”) shall be made in writing and sent to one *or both* of the competent authorities. The request shall contain sufficient information to identify the case. The request shall also be accompanied by a written statement by each of the persons who either made the request or is directly affected by the case that no decision on the same issues has already been rendered by a court or administrative tribunal of the States. Within 10 days *after* the receipt of the request, *a* competent authority who received it *without any indication that it was also sent to the other competent authority* shall send a copy of *that* request and the accompanying statements to the other competent authority.

2. *Start date of the two-year period*

1. ~~A request for arbitration may only be made after two years from the date on which a case presented to the competent authority of one Contracting State under paragraph 1 of Article 25 has also been presented to the competent authority of the other State~~ *when all the information required by the competent authorities in order to address the case has been provided to both competent authorities (hereinafter referred to as the “start date”).* For this purpose, ~~a case shall be considered to have been presented to the competent authority of the other State only if the following information has been presented~~ *the information required by the competent authorities in order to address the case shall include: [the necessary information and documents will be specified in the agreement].*

2. *The following rules shall apply in order to determine the start date:*

- a) *The competent authority that received the initial request for a mutual agreement procedure under paragraph 1 of Article 25 of the Convention shall, within 60 days after receiving the request:*
 - (i) *send a notification to the person who presented the case that it has received the request; and*
 - (ii) *send a notification of that request, along with a copy of the request, to the competent authority of the other Contracting State.*
- b) *Within 90 days after receiving the request for a mutual agreement procedure (or a copy thereof from the competent authority of the other Contracting State), each competent authority shall either:*
 - (i) *notify the person who has presented the case and the other competent authority that it has received the information necessary*

to undertake substantive consideration of the case; or

(ii) request additional information from that person for that purpose.

- c) Where, pursuant to subdivision (ii) of subparagraph b) above, one or both of the competent authorities have requested from the person who presented the case additional information necessary to undertake substantive consideration of the case, the competent authority that requested the additional information shall, within 90 days after receiving the additional information from that person, notify that person and the other competent authority either:*
- (i) that it has received the requested information; or*
 - (ii) that some of the requested information is still missing.*
- d) Where neither competent authority has requested additional information pursuant to subdivision (ii) of subparagraph b) above, the start date shall be the earlier of:*
- (i) the date on which both competent authorities have notified the person who presented the case pursuant to subdivision (i) of subparagraph b) above; and*
 - (ii) the date that is 90 days after the notification to the competent authority of the other Contracting State pursuant to subdivision (ii) of subparagraph a) above.*
- e) Where additional information has been requested pursuant to subdivision ii) of subparagraph b) above, the start date shall be the earlier of:*
- (i) the latest date on which the competent authorities that requested additional information have notified the person who presented the case and the other competent authority pursuant to subdivision (i) of subparagraph c) above; and*
 - (ii) the date that is 90 days after both competent authorities have received all information requested by either competent authority from the person who presented the case.*
- If, however, one or both of the competent authorities send the notification referred to in subdivision (ii) of subparagraph c) above, such notification shall be treated as a request for additional information under subdivision (ii) of subparagraph b).*

~~3.—Terms of Reference~~*[Terms of Reference: as explained in paragraphs 15.1 to 15.5 of the explanations that follow this sample agreement, the agreement could also provide for the adoption of “terms of reference”]*

~~Within three months after the request for arbitration has been received by both competent authorities, the competent authorities shall agree on the questions to be resolved by the arbitration panel and communicate them in writing to the person who made the request for arbitration. This will constitute the “Terms of Reference” for the case. Notwithstanding the following paragraphs of this agreement, the competent authorities may also, in the Terms of Reference, provide procedural rules that are additional to, or different from, those included in these paragraphs and deal with such other matters as are deemed appropriate.~~

~~4. Failure to communicate the Terms of Reference~~

~~If the Terms of Reference have not been communicated to the person who made the request for arbitration within the period referred to in paragraph 3 above, that person and each competent authority may, within one month after the end of that period, communicate in writing to each other a list of issues to be resolved by the arbitration. All the lists so communicated during that period shall constitute the tentative Terms of Reference. Within one month after all the arbitrators have been appointed as provided in paragraph 5 below, the arbitrators shall communicate to the competent authorities and the person who made the request for arbitration a revised version of the tentative Terms of Reference based on the lists so communicated. Within one month after the revised version has been received by both of them, the competent authorities will have the possibility to agree on different Terms of Reference and to communicate them in writing to the arbitrators and the person who made the request for arbitration. If they do so within that period, these different Terms of Reference shall constitute the Terms of Reference for the case. If no different Terms of Reference have been agreed to between the competent authorities and communicated in writing within that period, the revised version of the tentative Terms of Reference prepared by the arbitrators shall constitute the Terms of Reference for the case.~~

35. *Selection and appointment of arbitrators*

1. The arbitration panel shall consist of three individual arbitrators with expertise or experience in international tax matters. Each arbitrator appointed to the arbitration panel must be impartial and independent of the competent authorities, tax administrations, and ministries of finance of the Contracting States and of all persons directly affected by the case (as well as their advisors) at the time of accepting an appointment, maintain his or her impartiality and independence throughout the proceedings, and avoid any conduct for a reasonable period of time thereafter which may damage the appearance of impartiality and independence of the arbitrators with respect to the proceedings.

2. Within 60 days three months after the Terms of Reference have been received by the person who made the request for arbitration or, where paragraph 4 applies, within four months after the request for arbitration (or a copy thereof) has been received by both competent authorities, the competent authorities shall each appoint one arbitrator. Within two months 60 days after the latter appointment, the arbitrators so appointed will appoint a third arbitrator who will function as Chair. The Chair shall not be a national or resident of either Contracting State.

3. If any appointment is not made within the required time period, the arbitrator(s) not yet appointed shall be appointed by the Director of the OECD Centre for Tax Policy and Administration highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development who is not a national of either Contracting State within 10 days after receiving a request to that effect from the person who made the request for arbitration. The same procedure shall apply with the necessary adaptations if for any reason it is necessary to replace an arbitrator after the arbitration process has begun. Unless the Terms of Reference provide otherwise, the remuneration of all arbitrators [the mode of remuneration should be

described here; one possibility would be to refer to the method used in the Code of Conduct on the EC Arbitration Convention].

4. An arbitrator will be considered to have been appointed when a letter confirming that appointment and signed by both the arbitrator and the person or persons who have the power to appoint that arbitrator has been communicated to both competent authorities.

46. Streamlined Arbitration process

If the competent authorities so indicate in the Terms of Reference (provided that these have not been agreed to after the selection of arbitrators pursuant to paragraph 4 above), the following rules shall apply to a particular case notwithstanding paragraphs 5, 11, 15, 16 and 17 of this agreement:

1. Within 60 days after the appointment of the Chair of the arbitration panel (unless, before the end of that period, the competent authorities agree on a different period or agree to use the approach described in Article 5 with respect to the relevant case), the competent authority of each Contracting State shall submit to each arbitrator and to the other competent authority a proposed resolution which addresses all unresolved issue(s) in the case (taking into account all agreements previously reached in that case between the competent authorities). The proposed resolution shall be limited to a disposition of specific monetary amounts (for example, of income) or, where specified, the maximum amount of tax that may be charged pursuant to the provisions of the Convention, for each adjustment or similar issue in the case. In a case in which the competent authorities of the Contracting States have been unable to reach agreement on an issue regarding the conditions for application of a provision of the Convention (hereinafter referred to as a "threshold question"), such as whether an individual is a resident or whether a permanent establishment exists, the competent authorities may submit alternative proposed resolutions with respect to issues the determination of which is contingent on resolution of such threshold questions.

2. The competent authority of each Contracting State may also submit to the arbitrators and to the other competent authority, within the period of time provided for in paragraph 1, a supporting position paper for consideration by the arbitrators.

3. Each competent authority may also submit to the arbitrators and to the other competent authority, within 120 days after the appointment of the Chair of the arbitration panel, a reply submission with respect to the proposed resolution and supporting position paper submitted by the other competent authority.

4. As far as possible, the arbitrators will use tele- and videoconferencing to communicate between themselves and with both competent authorities. If a face-to-face meeting involving additional costs is necessary, the Chair will contact the competent authorities who will decide when and where the meeting should be held and will communicate that information to the arbitrators.

5. The arbitration panel shall select as its decision one of the proposed resolutions for the case submitted by the competent authorities with respect to each

issue and any threshold questions, and shall not include a rationale or any other explanation of the decision. The arbitration decision will be adopted by a simple majority of the arbitrators. Unless the competent authorities agree otherwise, the arbitration decision shall be delivered to the competent authorities of the Contracting States in writing within 60 days after the reception by the arbitrators of the last reply submission or, if no reply submission has been submitted, within 150 days after the appointment of the Chair of the arbitration panel. The arbitration decision shall have no precedential value.

- ~~a) within one month after the Terms of Reference have been received by the person who made the request for arbitration, the two competent authorities shall, by common consent, appoint one arbitrator. If, at the end of that period, the arbitrator has not yet been appointed, the arbitrator will be appointed by the Director of the OECD Centre for Tax Policy and Administration within 10 days of receiving a request to that effect from the person who made the request referred to in paragraph 1. The remuneration of the arbitrator shall be determined as follows ... [the mode of remuneration should be described here; one possibility would be to refer to the method used in the Code of Conduct on the EC Arbitration Convention].~~
- ~~b) Within two months from the appointment of the arbitrator, each competent authority will present in writing to the arbitrator its own reply to the questions contained in the Terms of Reference.~~
- ~~e) Within one month from having received the last of the replies from the competent authorities, the arbitrator will decide each question included in the Terms of Reference in accordance with one of the two replies received from the competent authorities as regards that question and will notify the competent authorities of the choice, together with short reasons explaining that choice. Such decision will be implemented as provided in paragraph 19.~~

5. Optional arbitration process

1. If, within 60 days after the appointment of the Chair of the arbitration panel, the competent authorities agree to use the approach described in this Article with respect to a given case, each competent authority must provide to the arbitration panel and to the other competent authority, within 120 days after that election, any information that it considers necessary for the panel to reach its decision. That information should include a description of the facts and of the unresolved issues to be decided together with the position of the competent authority concerning these issues and the arguments supporting that position. Unless the competent authorities agree otherwise, the arbitration panel may not take into account any information that was not available to both competent authorities before both competent authorities received the request for arbitration (or a copy thereof).

2. [previously Article 10 of the sample mutual agreement]The person who made the request for arbitration may, either directly or through his representatives, present his position to the arbitrators in writing to the same extent that he can do so during the mutual agreement procedure. In addition, with the permission of the arbitrators if the competent authorities and arbitrators all agree, the person may present his

position orally during the arbitration proceedings.

3. *Within 30 days after the Chair has informed the competent authorities that a meeting of the arbitration panel should be held, the competent authorities will decide when and where the meeting will be held and will communicate that information to the arbitrators.*

4. *The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the Convention and, subject to these provisions, of those of the domestic laws of the Contracting States. The arbitrators shall also consider any other sources which the competent authorities of the Contracting States may by mutual agreement expressly identify.*

5. *[previously Article 11 of the sample mutual agreement] Subject to the provisions of the Convention and of this agreement and the Terms of Reference, the arbitrators shall adopt those procedural and evidentiary rules that they deem necessary to **provide a decision concerning the unresolved issues submitted to arbitration.** answer the questions set out in the Terms of Reference. They will have access to all information necessary to decide the issues submitted to arbitration, including confidential information. Unless the competent authorities agree otherwise, any information that was not available to both competent authorities before the request for arbitration was received by both of them shall not be taken into account for purposes of the decision.*

6. *Unless the competent authorities agree otherwise, the arbitration decision shall be delivered to the competent authorities of the Contracting States in writing within 365 days after the date of the appointment of the Chair and shall indicate the sources of law relied upon and the reasoning which led to its result. The arbitration decision shall be adopted by a simple majority of the arbitrators. The arbitration decision shall have no precedential value.* With the permission of the person who made the request for arbitration and both competent authorities, the decision of the *arbitration* panel will be made public in redacted form without mentioning the names of the parties involved or any details that might disclose their identity and with the ~~understanding~~ *mention* that the decision has no formal precedential value.

~~7. Eligibility and appointment of arbitrators~~

~~Any person, including a government official of a Contracting State, may be appointed as an arbitrator, unless that person has been involved in prior stages of the case that results in the arbitration process. An arbitrator will be considered to have been appointed when a letter confirming that appointment has been signed both by the person or persons who have the power to appoint that arbitrator and by the arbitrator himself.~~

68. *Communication of information and confidentiality*

1. For the sole purposes of the application of the provisions of Articles 25 and 26, and of the domestic laws of the Contracting States, concerning the communication and the confidentiality of the information related to the case that results in the arbitration process, each arbitrator *and a maximum of three staff*

per arbitrator (and prospective arbitrators solely to the extent necessary to verify their ability to fulfil the requirements of arbitrators) shall be designated as authorised representatives of the competent authority that has appointed that arbitrator or, if that arbitrator has not been appointed ~~exclusively by one~~ a competent authority, of ~~the both competent authorities of the Contracting State to which the case giving rise to the arbitration was initially presented.~~ For the purposes of this agreement, where a case giving rise to arbitration was initially presented simultaneously to both competent authorities, “the competent authority of the Contracting State to which the case giving rise to the arbitration was initially presented” means the competent authority referred to in paragraph 1 of Article 25.

2. In designating a person as its authorised representative pursuant to paragraph 1, the competent authority of a Contracting State shall ensure that the person agrees in writing to treat any information relating to the arbitration proceeding consistently with the confidentiality requirements of the Convention and of the applicable laws of that Contracting State.

79. Suspension of time in the case of failure to provide information in a timely manner

~~Notwithstanding paragraphs 5 and 6, where both competent authorities agree that the failure to resolve an issue within the two year period provided in paragraph 5 of Article 25 is mainly attributable to the failure of a person directly affected by the case to provide relevant information in a timely manner, the competent authorities may postpone the nomination of the arbitrator for a period of time corresponding to the delay in providing that information. Where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start date of the two year period referred to in paragraph 1 of Article 2, the period provided in that paragraph shall be extended for an amount of time equal to the period beginning on the date by which the information was requested and ending on the date on which that information was provided.~~

~~10. Procedural and evidentiary rules~~

~~Subject to this agreement and the Terms of Reference, the arbitrators shall adopt those procedural and evidentiary rules that they deem necessary to answer the questions set out in the Terms of Reference. They will have access to all information necessary to decide the issues submitted to arbitration, including confidential information. Unless the competent authorities agree otherwise, any information that was not available to both competent authorities before the request for arbitration was received by both of them shall not be taken into account for purposes of the decision.~~

~~11. Participation of the person who requested the arbitration~~

~~The person who made the request for arbitration may, either directly or through his representatives, present his position to the arbitrators in writing to the same extent that he can do so during the mutual agreement procedure. In addition, with the permission of the arbitrators, the person may present his position orally during the~~

arbitration proceedings.

~~12.~~ *Logistical arrangements*

~~Unless agreed otherwise by the competent authorities, the competent authority to which the case giving rise to the arbitration was initially presented will be responsible for the logistical arrangements for the meetings of the arbitral panel and will provide the administrative personnel necessary for the conduct of the arbitration process. The administrative personnel so provided will report only to the Chair of the arbitration panel concerning any matter related to that process.~~

~~813.~~ *Costs*

Unless agreed otherwise by the competent authorities:

- a) each competent authority and the person who requested the arbitration will bear the costs related to his own participation in the arbitration proceedings (including travel costs and costs related to the preparation and presentation of his views);
- b) each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority, or appointed by the ***highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development that is not a national of either Contracting State*** ~~Director of the OECD Centre for Tax Policy and Administration~~ because of the failure of that competent authority to appoint that arbitrator, together with that arbitrator's travel, telecommunication and secretariat costs;
- c) the remuneration of the ~~other arbitrators~~ ***Chair of the arbitration panel*** and ~~the~~ ***that Chair's*** travel, telecommunication and secretariat costs will be borne ~~equally~~ ***in equal shares*** by the two competent authorities;
- d) ***other*** costs related to ~~the any~~ meetings of the ***arbitration*** panel and to the administrative personnel necessary for the conduct of the arbitration process will be borne by the competent authority to which the case giving rise to the arbitration was initially presented, or if presented in both States, will be shared ~~equally~~ ***competent authority that hosts that meeting***;
- e) all other costs (including costs of translation and of recording the proceedings) related to expenses that both competent authorities have agreed to incur, will be borne ~~equally~~ ***in equal shares*** by the two ***competent authorities*** ~~Contracting States~~.

~~14.~~ *Applicable Legal Principles*

~~The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the treaty and, subject to these provisions, of those of the domestic laws of the Contracting States. Issues of treaty interpretation will be decided by the arbitrators in the light of the principles of interpretation incorporated in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, having regard to the Commentaries of the OECD Model Tax Convention as~~

periodically amended, as explained in paragraphs 28 to 36.1 of the Introduction to the OECD Model Tax Convention. Issues related to the application of the arm's length principle should similarly be decided having regard to the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. The arbitrators will also consider any other sources which the competent authorities may expressly identify in the Terms of Reference.

15. Arbitration decision

Where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators. Unless otherwise provided in the Terms of Reference, the decision of the arbitral panel will be presented in writing and shall indicate the sources of law relied upon and the reasoning which led to its result. With the permission of the person who made the request for arbitration and both competent authorities, the decision of the arbitral panel will be made public in redacted form without mentioning the names of the parties involved or any details that might disclose their identity and with the understanding that the decision has no formal precedential value.

16. Time allowed for communicating the arbitration decision

The arbitration decision must be communicated to the competent authorities and the person who made the request for arbitration within six months from the date on which the Chair notifies in writing the competent authorities and the person who made the request for arbitration that he has received all the information necessary to begin consideration of the case. Notwithstanding the first part of this paragraph, if at any time within two months from the date on which the last arbitrator was appointed, the Chair, with the consent of one of the competent authorities, notifies in writing the other competent authority and the person who made the request for arbitration that he has not received all the information necessary to begin consideration of the case, then

- a)* if the Chair receives the necessary information within two months after the date on which that notice was sent, the arbitration decision must be communicated to the competent authorities and the person who made the request for arbitration within six months from the date on which the information was received by the Chair, and
- b)* if the Chair has not received the necessary information within two months after the date on which that notice was sent, the arbitration decision must, unless the competent authorities agree otherwise, be reached without taking into account that information even if the Chair receives it later and the decision must be communicated to the competent authorities and the person who made the request for arbitration within eight months from the date on which the notice was sent.

17. Failure to communicate the decision within the required period

In the event that the decision has not been communicated to the competent authorities within the period provided for in paragraphs 6 e) or 16 5 of Article 4 or **paragraph 6 of Article 5, as the case may be, or within any other period agreed to**

~~by the competent authorities, the competent authorities may agree to extend that period for a period not exceeding six months or, if they fail to do so within one month from the end of the period provided for in paragraph 6 e) or 16, they shall appoint a new arbitrator or arbitrators in accordance with paragraph 5 or 6 a), as the case may be Article 3. The date of such agreement shall, for the purposes of the subsequent application of Article 3, be deemed to be the date when the request for arbitration has been received by both competent authorities.~~

~~1020.~~ *Where no arbitration decision will be provided*

~~Notwithstanding paragraphs 6, 15, 16 and 17, w~~Where, at any time after a request for arbitration has been made and before the arbitrators have delivered a decision to the competent authorities ~~and the person who made the request for arbitration~~, the competent authorities notify in writing the arbitrators ~~and that person~~

- ~~a)~~ that they have solved all the unresolved issues *that were subject to arbitration* ~~described in the Terms of Reference, or~~
- ~~b)~~ *that the person who presented the case has withdrawn the request for arbitration or the request for a mutual agreement procedure*

~~the case shall be considered as solved under the mutual agreement procedure and no arbitration decision shall be provided and the mutual agreement procedure shall be considered to have been completed.~~

~~1148.~~ *Final decision*

The arbitration decision shall be final, unless that decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or *for any other reasons* ~~of any procedural rule included in the Terms of Reference or in this agreement that may reasonably have affected the decision~~. If a decision is found to be unenforceable ~~for one of these reasons~~, the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place (except for the purposes of *Articles 6* “Communication of information and confidentiality” and *8* “Costs”).

~~1249.~~ *Implementing the arbitration decision*

The competent authorities will implement the arbitration decision within ~~six months~~ **180 days after** the communication of the decision to them by reaching a mutual agreement on the case that led to the arbitration.

This agreement applies to any request for arbitration made pursuant to paragraph 5 of Article 25 of the Convention after that provision has become effective.

[Date of signature of the agreement]

[Signature of the competent authority of each Contracting State]

General approach of the sample agreement

2. ~~A number of~~ **There are two main** approaches **that** can be taken to structuring ~~followed when~~ **designing** the **arbitration** process ~~which is~~ **that will be** used to supplement the mutual agreement procedure. Under one approach, ~~[rest of the sentence moved from paragraph 3]~~ under the so-called “last best offer” or “final offer” approach, each competent authority would be required to give to the **arbitration** panel a proposed resolution of the issue involved and the **arbitration** panel would choose between the two proposals which were presented to it. **Alternatively**, ~~which under~~ what might be referred to as the “independent opinion” approach, the arbitrators would be presented with the facts and arguments by the parties based on the applicable law, and would then reach their own independent decision which would be based on a written, reasoned analysis of the facts involved and applicable legal sources.

3. ~~Alternatively, under the so-called “last best offer” or “final offer” approach, each competent authority would be required to give to the arbitral panel a proposed resolution of the issue involved and the arbitral panel would choose between the two proposals which were presented to it.~~ **Each of the two approaches has advantages and disadvantages and the choice of the approach depends on a number of policy considerations that are often specific to each State. In addition,** ~~There are~~ obviously a number of variations **of these two approaches** ~~these two positions~~. For example, the arbitrators could reach an independent decision but would not be required to submit a written decision but simply their conclusions. To some extent, the appropriate method **may also** depends on the type of issue to be decided.

4. The above sample agreement takes as its starting point the “**last best offer** ~~independent opinion~~” approach which is thus the generally applicable process but, in recognition of the fact that ~~many~~ **in some** cases, especially those which involve ~~primarily factual~~ **complex legal** questions, ~~may be best handled differently~~ **the competent authorities may prefer to receive a more elaborate decision**, it also provides for an alternative “~~streamlined~~ **independent opinion**” process, ~~based on the “last best offer” or “final offer” approach~~. Competent authorities can therefore agree to use that ~~streamlined~~ **independent opinion** process on a case-by-case basis. Competent authorities may of course adopt this combined approach, adopt the **independent opinion approach** ~~streamlined~~ process as the generally applicable process with the **last best offer approach** ~~independent opinion~~ as an option ~~in some circumstances~~ or limit themselves to only one of the two approaches.

The request for arbitration

5. ~~Paragraph~~ **Article** 1 of the sample agreement provides the manner in which a request for arbitration should be made. Such request should be presented in writing to one of the competent authorities involved in the case. That competent authority should then inform the other competent authority within 10 days **after** the receipt of the request.

6. In order to determine that the conditions of paragraph 5 of Article 25 have been met (see paragraph 76 of the Commentary on this Article) the request should be accompanied by statements indicating that no decision on these issues has already been rendered by domestic courts or administrative tribunals in either Contracting State.

7. Since the arbitration process is an extension of the mutual agreement procedure that is intended to deal with cases that cannot be solved under that procedure, it would seem inappropriate to ask the person who makes the request to pay in order to make such request or to reimburse the expenses incurred by the competent authorities in the course of the arbitration proceedings. Unlike taxpayers’ requests for rulings or other types of advance agreements, where a charge is sometimes

made, providing a solution to disputes between the Contracting States is the responsibility of these States for which they in general should bear the costs.

Start date of the two-year period

8. A request for arbitration may not be made before two years from the date when *all the information required by the competent authorities in order to address the case has been provided to both competent authorities*—a mutual agreement case presented to the competent authority of a Contracting State has also been presented to the competent authority of the other Contracting State. Paragraph 1 of Article 2 of the sample agreement *refers to the information that is required for this that purpose*, a case shall only be considered to have been presented to the competent authority of that other State if the information specified in that paragraph has been so provided. That paragraph should therefore include a list of the information required *by the competent authorities*; in general, that information will correspond to the information and documents that were required to initiate the mutual agreement procedure begin the consideration of the case. *Ordinarily, a Contracting State's published guidance would indicate the information that would be required for that purpose. In such cases, it is assumed that the competent authorities would generally mutually agree to list or otherwise identify the information included in that guidance as the information that would be required by each Contracting State.*

9. *Paragraph 2 of Article 2 describes the process to be followed in order to determine the precise date on which the two year period begins.*

10. *Subparagraph a) provides that the competent authority that received the initial request for a mutual agreement procedure must, within 60 days after receiving that request, notify the person who presented the case that the request has been received, and send a notification of the request, along with a copy of the request, to the other competent authority.*

11. *Under subparagraph b), a competent authority must notify the person that presented the case and the other competent authority that it has received all information necessary to undertake substantive consideration of the case, or request additional information for that purpose from the person that presented the case, within 90 days after the date on which it received the initial request or was notified of the request, as the case may be.*

12. *Where one or both competent authorities request additional information, subparagraph c) provides that after receiving such information, the competent authority requesting the information would have 90 days to notify the person presenting the case and the other competent authority that it has received all necessary information, or that requested information is still missing.*

13. *The start date of the two year period depends on whether such additional information has been requested. Where no request for additional information has been made, subparagraph d) provides that the start date is the earlier of: i) the date on which both competent authorities have notified the person who presented the case that all necessary information was received (i.e., the date on which the second of the two competent authorities has made that notification), and ii) 90 days after the date on which the competent authority to which the request for a mutual agreement procedure was initially made notified the other competent authority of the request.*

14. *Where additional information was requested, subparagraph e) provides that, in general, the start date is the earlier of: i) the latest date on which the competent authorities that requested additional information have notified the taxpayer and the other competent authority that the*

information has been received; and ii) the date that is 90 days after both competent authorities have received the additional information from the person who presented the case. If either competent authority notifies the taxpayer and the other competent authority that some of the requested information is still missing, such notification shall be treated as a request for additional information.

15. In some cases, after a taxpayer has provided the initial information needed to undertake substantive consideration of the case, the competent authorities may need to request additional information from the taxpayer. In such cases, a failure by a person directly affected by the case (i.e. the person who made the initial request for a mutual agreement procedure or a person whose tax liability is directly affected by the case) to provide such additional information in a timely manner may delay or prevent the competent authorities from being able to resolve the case. To address such cases, Article 7 of the sample agreement provides that the two year period provided shall be extended where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start of that period. In that case the period will be extended for an amount of time equal to the period beginning on the date by which the information was requested and ending on the date on which that information was ultimately provided.

Terms of Reference

15.1 Although the sample agreement does not expressly include provisions on the adoption of “terms of reference” as the first step of the arbitration process, the competent authorities may find it useful to include such provisions in the mutual agreement implementing the arbitration process. These provisions could be drafted as follows:

Terms of reference

1. Within 60 days after the request for arbitration (or a copy thereof) has been received by both competent authorities, the competent authorities shall agree on the questions to be resolved by the arbitration panel and communicate them in writing to the person who made the request for arbitration. This will constitute the “Terms of Reference” for the case. Notwithstanding the following paragraphs of this agreement, the competent authorities may also, in the Terms of Reference, provide procedural rules that are additional to, or different from, those included in these paragraphs and deal with such other matters as are deemed appropriate.
2. If the Terms of Reference have not been communicated to the person who made the request for arbitration within the period referred to in paragraph 1 above, that person and each competent authority may, within 30 days after the end of that period, communicate in writing to each other a list of issues to be resolved by the arbitration. All the lists so communicated during that period shall constitute the tentative Terms of Reference. Within 30 days after all the arbitrators have been appointed as provided in the following paragraphs of this agreement, the Chair shall communicate to the competent authorities and the person who made the request for arbitration a revised version of the tentative Terms of Reference based on the lists so communicated. Within 30 days after the revised version has been received by both of them, the competent authorities will have the possibility to agree on different Terms of Reference and to communicate them in writing to the arbitrators and the person who made the request for arbitration. If they do so within that period, these different Terms of Reference shall constitute the Terms of Reference for the case. If no different Terms of Reference have been agreed to between the competent authorities and

communicated in writing within that period, the revised version of the tentative Terms of Reference prepared by the arbitrators shall constitute the Terms of Reference for the case.

15.2 If such provisions are included in the agreement, it would be necessary to extend the period of time within which, under Article 3 of the sample mutual agreement, each competent authority shall appoint an arbitrator. That period could, for example, be extended to 90 days, which would allow the competent authorities the possibility of taking into account the agreed Terms of Reference in selecting their respective arbitrators.

15.3. The “Terms of Reference” would be the document that would set forth the questions to be resolved by the arbitrators. It would establish the jurisdictional basis for the issues which are to be decided by the arbitration panel. It would be established by the competent authorities who might wish in that connection to consult with the person who made the request for arbitration. If the competent authorities cannot agree on the Terms of Reference within the period provided for in the suggested paragraph 1 above, some mechanism would be necessary to ensure that the procedure goes forward. The suggested paragraph 2 above provides for that eventuality.

15.4 Whilst the Terms of Reference would generally be limited to a particular issue or set of issues, it would be possible for the competent authorities, given the nature of the case and the interrelated nature of the issues, to draft the Terms of Reference so that the whole case (and not only certain specific issues) be submitted to arbitration.

15.5 As indicated in the suggested paragraph 1 above, the procedural rules provided for in the sample agreement would apply unless the competent authorities provide otherwise in the Terms of Reference. It would therefore be possible for the competent authorities, through the Terms of Reference, to depart from any of these rules (including, for example, the rules for the nomination and remuneration of the arbitrators) or to provide for additional rules in a particular case.

Streamlined process

~~12.—The normal process provided for by the sample agreement allows the consideration of questions of either law or fact, as well as of mixed questions of law and fact. Generally, it is important that the arbitrators support their decision with the reasoning leading to it. Showing the method through which the decision was reached may be important in assuring acceptance of the decision.~~

~~13.—In some cases, however, the unresolved issues will be primarily factual and the decision may be simply a statement of the final disposition, for example a determination of the amount of adjustments to the income and deductions of the respective related parties. Such circumstances will often arise in transfer pricing cases, where the unresolved issue may be simply the determination of an arm’s length transfer price or range of prices (although there are other transfer pricing cases that involve complex factual issues); there are also cases in which an analogous principle may apply, for example, the determination of the existence of a permanent establishment. In some cases, the decision may be a statement of the factual premises on which the appropriate legal principles should then be applied by the competent authorities. Paragraph 6 of the sample agreement provides a streamlined process which the competent authorities may wish to apply in these types of cases. That process, which will then override other procedural rules of the sample agreement, takes the form of the so called “last best offer” or “final offer” arbitration, under which each competent authority is required to give to an arbitrator appointed by common consent that competent authority’s own reply to the questions included in the Terms of Reference and the arbitrator simply chooses one of the submitted replies. The competent authorities may, as for most procedural rules,~~

amend or supplement the streamlined process through the Terms of Reference applicable to a particular case.

Selection and appointment of arbitrators

~~1614. Paragraph 5~~**Article 3** of the sample agreement describes how arbitrators will be selected unless the Terms of Reference drafted for a particular case provide otherwise (for instance, by opting for the streamlined process described in the preceding paragraph or by providing for more than one arbitrator to be appointed by each competent authority). Normally, the two competent authorities will each appoint one arbitrator. These appointments must be made within **60 days after the request for arbitration has been received by both competent authorities** ~~three months after the Terms of Reference have been received by the person who made the request for arbitration (a different deadline is provided for cases where the competent authorities do not agree on the Terms of Reference within the required period)~~. The arbitrators thus appointed will select a Chair who must be appointed within two months of the time at which **60 days after the date on which** the last of the initial appointments was made. If the competent authorities do not appoint an arbitrator during the required period, or if the arbitrators so appointed do not appoint the third arbitrator within the required period, the paragraph provides that the appointment will be made by the **highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development who is not a national of either Contracting State** ~~Director of the OECD Centre for Tax Policy and Administration~~. The competent authorities may, of course, provide for other ways to address these rare situations but it seems important to provide for an independent appointing authority to solve any deadlock in the selection of the arbitrators.

~~15. — There is no need for the agreement to stipulate any particular qualifications for an arbitrator as it will be in the interests of the competent authorities to have qualified and suitable persons act as arbitrators and in the interests of the arbitrators to have a qualified Chair. However, it might be possible to develop a list of qualified persons to facilitate the appointment process and this function could be developed by the Committee on Fiscal Affairs. It is important that the Chair of the panel have experience with the types of procedural, evidentiary and logistical issues which are likely to arise in the course of the arbitral proceedings as well as having familiarity with tax issues. There may be advantages in having representatives of each Contracting State appointed as arbitrators as they would be familiar with this type of issue. Thus it should be possible to appoint to the panel governmental officials who have not been directly involved in the case. Once an arbitrator has been appointed, it should be clear that his role is to decide the case on a neutral and objective basis; he is no longer functioning as an advocate for the country that appointed him.~~

17. Paragraph 1 of Article 3 provides the requirements that each arbitrator must satisfy. The arbitrators must have expertise or experience in international tax matters, though, unless the competent authorities agree otherwise, there is no requirement that each arbitrator have experience as a judge or an arbitrator. In addition, each arbitrator must, at the time of accepting his or her appointment, be impartial and independent of the competent authorities, tax administrations, and ministries of finance (or relevant equivalent ministries or departments, regardless of their name) of the Contracting States, as well as all persons directly affected by the case and their advisors. Each arbitrator must also maintain his or her impartiality and independence throughout the proceedings, and must, for a reasonable period of time thereafter, avoid conduct that may damage the appearance of impartiality and independence of the arbitrators with respect to the proceedings. Such conduct would include, for example, accepting employment with one of the persons directly affected by the case soon after delivering the arbitration decision with respect to the case. The competent authorities

are free to agree on additional details with respect to the applicable standards for impartiality and independence. For example, the competent authorities may wish to require that any prospective arbitrator disclose to the competent authorities any fact or circumstance likely to call into question that prospective arbitrator's impartiality or independence. The competent authorities may also wish to agree to rules addressing the situation in which an arbitrator is unable to perform his or her duties, as a result of illness or incapacity, failing to meet standards for impartiality and independence, or any other reason.

~~16. Paragraph 9 of the sample agreement provides that the appointment of the arbitrators may be postponed where both competent authorities agree that the failure to reach a mutual agreement within the two year period is mainly attributable to the lack of cooperation by a person directly affected by the case. In that case, the approach taken by the sample agreement is to allow the competent authorities to postpone the appointment of the arbitrators by a period of time corresponding to the undue delay in providing them with the relevant information. If that information has not yet been provided when the request for arbitration is submitted, the period of time corresponding to the delay in providing the information continues to run until such information is finally provided. Where, however, the competent authorities are not provided with the information necessary to solve a particular case, there is nothing that prevents them from resolving the case on the basis of the limited information that is at their disposal, thereby preventing any access to arbitration. Also, it would be possible to provide in the agreement that if within an additional period (e.g. one year), the taxpayer still had not provided the necessary information for the competent authorities to properly evaluate the issue, the issue would no longer be required to be submitted to arbitration.~~

18. Paragraph 4 of Article 3 clarifies when an arbitrator shall be considered to have been appointed, which is relevant for the purposes of other provisions that make reference to the date of appointment of one or more arbitrators. The appointment shall be considered to have been made when a letter confirming that appointment and signed both by the arbitrator and by the person or persons who have the power to appoint that arbitrator pursuant to paragraphs 2 and 3 of the Article has been communicated to both competent authorities.

The arbitration process

19. Article 4 provides the rules that will apply to the arbitration process unless, within 60 days after the appointment of the Chair of the arbitration panel, the competent authorities agree to use the optional approach of Article 5 with respect to the relevant case.

20. As indicated in paragraph 4 above, the arbitration process proposed in the sample agreement follows the "last best offer" approach. Paragraph 1 of the Article provides that the first step of that process is for the competent authority of each Contracting State to submit to each arbitrator, within 60 days after the appointment of the Chair (or any different period agreed to by the competent authorities before the end of that 60 day period), a proposed resolution which addresses all the unresolved issues of the case in a manner that is consistent with any previous agreements that have been reached in that case by the competent authorities. For each adjustment or similar issue in the case, the proposed resolution will include only the disposition of specific monetary amounts (for example, of income) or the maximum amount of tax that may be charged pursuant to the provisions of the Convention. In some cases, however, unresolved issues will include questions regarding whether the conditions for applying a provision of the Convention have been met. Where the unresolved issues in a case include such a "threshold question", such as whether a person is a resident of a Contracting State or whether an enterprise of a Contracting State has a permanent establishment in the

other Contracting State, the competent authorities may submit their proposed answers to the threshold question (i.e. yes or no). If there are other unresolved issues the disposition of which is contingent on the answer reached with respect to the threshold question, it is expected that the competent authorities would also submit alternative proposed resolutions of those remaining issues.

21. As explained in paragraph 2 of the Article, the proposed resolutions submitted by the competent authorities of each Contracting State may be supported by a position paper to be provided within the same period of time.

22. Paragraph 3 provides that each competent authority may also submit, within 120 days after the appointment of the Chair, a reply submission with respect to the proposed resolution and supporting position paper submitted by the other competent authority. The reply submission and its supporting position paper are meant to address only the positions and arguments of the other competent authority, and are not intended as an opportunity for a competent authority to advance additional arguments in favour of its own position.

23. Given the nature of the “last best offer” process, a face-to-face meeting of the arbitrators will typically not be necessary and the arbitrators will be able to liaise between themselves and with both competent authorities by telephone or videoconference. This is provided in paragraph 4 which adds that if a face-to-face meeting involving additional costs is necessary, the Chair will first contact the competent authorities who will then decide when and where the meeting should be held.

24. Paragraph 5 provides that the arbitration panel will select as its decision one of the proposed resolutions submitted by the competent authorities. In a case involving one or more threshold questions, the arbitration panel will decide the threshold questions, and then adopt one of the alternative proposed resolutions submitted by the competent authorities. The decision will be adopted by a simple majority of the arbitrators, and will not include any rationale or explanation. In light of the purpose of arbitration to act as a streamlined method for resolving disputes between the competent authorities, the decision will be delivered in writing to the competent authorities and may not be used as precedent with respect to any other cases. Unless the competent authorities agree otherwise, the arbitration decision will be delivered within 60 days after the reception by the arbitrators of the last reply submission or, if no reply submission has been submitted, within 150 days after the appointment of the Chair.

The optional arbitration process

25. Article 5 provides the rules for the “independent opinion” process which, under the sample agreement, the competent authorities may elect to use on a case-by-case basis. That election must be exercised within 60 days after the appointment of the Chair of the arbitration panel.

26. Paragraph 1 of the Article provides that if the competent authorities have made that election, each competent authority must provide to the arbitration panel and to the other competent authority, within 120 days after that election, any information that it considers necessary for the panel to reach its decision. It is assumed that this information will include a description of the facts and of the issues to be decided, the position of the competent authority on these issues and the arguments supporting that position. Unless the competent authorities agree otherwise, the arbitration panel may not take into account any information that was not

available to both competent authorities before both competent authorities received the request for arbitration.

27. It is expected that one or more meetings of the arbitration panel and both competent authorities will be necessary to discuss the case. Paragraph 3 provides that the competent authorities will decide when and where each such meeting will be held within 30 days after the Chair of the arbitration panel has informed them of the need for such a meeting.

~~2820. Paragraph 211 of the sample agreement~~ provides that the person requesting arbitration, either directly or through its representatives, is entitled to present a written submission of its position to the arbitrators *to the same extent that the person can present such a submission during the mutual agreement procedure* and, if *the competent authorities and arbitrators all agree*, to make an oral presentation during a meeting of the arbitrators. *The involvement in the arbitration process of the person who made the request for arbitration is, therefore, conditional on what the competent authorities agree as part of the mutual agreement procedure and during the arbitration process.*

~~2948. The simplest way to establish the evidentiary and other procedural rules that will govern the “independent opinion” arbitration process and that have not already been agreed to between the competent authorities provided in the agreement or the Terms of Reference is to leave it to the arbitrators to develop these rules on an ad hoc basis. In doing so, the arbitrators are free to refer to existing arbitration procedures, such as the International Chamber of Commerce Rules which deal with many of these questions. It should be made clear in the procedural rules that, unless agreed otherwise by the competent authorities, as general matter, the factual material on which the arbitration panel will base its decision will be that developed in the mutual agreement procedure (see the last sentence of paragraph 1 of the Article). Only in special situations would the panel be allowed to investigate factual issues which had not been developed in the earlier stages of the case. Paragraph 10 of the sample agreement 5 of the Article follows that approach. Thus, decisions as regards the dates and format of arbitration meetings will be made by the arbitrators unless otherwise agreed to by the competent authorities the agreement or Terms of Reference provide otherwise. Also, whilst the arbitrators will have access to all information necessary to decide the issues submitted to arbitration, including confidential information, any information that was not available to both competent authorities shall not be taken into account by the arbitrators unless the competent authorities agree otherwise.~~

30. According to paragraph 4 of the Article, the arbitrators will decide the issues which have been submitted to arbitration in accordance with the applicable provisions of the Convention and, subject to those provisions, those of the domestic laws of the Contracting States. In this regard, the arbitration panel would review the application of domestic law only to the extent necessary to determine whether a Contracting State correctly applied the provisions of the Convention.

31. As indicated in paragraph 4, the competent authorities may also, by mutual agreement, identify other sources of law or authority that will be considered by the arbitration panel. An examination of the issues on which competent authorities have had difficulties reaching an agreement shows that these are typically often include matters of treaty interpretation or matters related to the application of the of applying the arm’s length principle underlying Article 9 and paragraph 2 of Article 7. As provided in paragraph 14 of the sample agreement, Competent authorities may therefore wish to provide that matters of treaty interpretation should be decided by the arbitrators in the light of the principles of interpretation incorporated in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, having regard to these Commentaries of the OECD

Model Tax Convention as periodically amended, as explained in paragraphs 28 to 36.1 of the Introduction. **They could also provide that** issues related to the application of the arm's length principle should similarly be decided in the light of the OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*. Since Article 32 of the *Vienna Convention on the Law of Treaties* permits a wide access to supplementary means of interpretation, arbitrators will, in practice, have considerable latitude in determining relevant sources for the interpretation of treaty provisions. Also, there may be cases where the competent authorities agree that the interpretation or application of a provision of a tax treaty depends on a particular document (e.g. a memorandum of understanding or mutual agreement concluded after the entry into force of a treaty) but may disagree about the interpretation of that document. In such a case, the competent authorities may wish to make express reference to that document in the Terms of Reference.

32. Paragraph 6 of the Article provides that unless the competent authorities agree otherwise, the decision of the arbitration panel will be delivered to the competent authorities in writing within 365 days after the date of the appointment of the Chair. The decision will indicate the sources of law relied upon and the reasoning which led to its result. It would also normally include a description of the relevant facts and circumstances of the case, a clear statement of the positions of both competent authorities, and a short summary of the proceedings. The adoption of the arbitration decision will be by a simple majority of the arbitrators. As with the "last best offer" approach, the decision will have no precedential value but paragraph 6.15 of the sample agreement therefore provides for the possibility to publish the decision. Such publication, however, should only be made if both competent authorities and the person who made the arbitration request so agree. Also, in order to maintain the confidentiality of information communicated to the competent authorities, the publication should be made in a form that would not disclose the names of the parties nor any element that would help to identify them. Decisions on individual cases reached under the mutual agreement procedure are generally not made public **but, in** the case of reasoned *arbitration* decisions, ~~however,~~ publishing the decisions would lend additional transparency to the process. Also, whilst the decision would not be in any sense a formal precedent, having the material in the public domain could influence the course of other cases so as to avoid subsequent disputes and lead to a more uniform approach to the same issue.

Communication of information and confidentiality

~~33-37.~~ It is important that arbitrators be allowed full access to the information needed to resolve the issues submitted to arbitration but, at the same time, be subjected to the same strict confidentiality requirements as regards that information as apply to the competent authorities themselves. The proposed approach to ensure that result, which is incorporated in ~~paragraph 8~~ **Article 6** of the sample agreement, is to make the arbitrators authorised representatives of the competent authorities. This, however, will only be for the purposes of the application of the relevant provisions of the Convention (*i.e.* Articles 25, and 26) and of the provisions of the domestic laws of the Contracting States, which would normally include the sanctions applicable in case of a breach of confidentiality. ~~The designation of the arbitrator as authorised representative of a competent authority would typically be confirmed in the letter of appointment but may need to be done differently if domestic law requires otherwise or if the arbitrator is not appointed by a competent authority.~~

Procedural and evidentiary rules

~~18.~~ The simplest way to establish the evidentiary and other procedural rules that will govern the arbitration process and that have not already been provided in the agreement or the Terms of Reference is to leave it to the arbitrators to develop these rules on an ad hoc basis. In doing so, the

arbitrators are free to refer to existing arbitration procedures, such as the International Chamber of Commerce Rules which deal with many of these questions. It should be made clear in the procedural rules that as general matter, the factual material on which the arbitral panel will base its decision will be that developed in the mutual agreement procedure. Only in special situations would the panel be allowed to investigate factual issues which had not been developed in the earlier stages of the case.

19. — Paragraph 10 of the sample agreement follows that approach. Thus, decisions as regards the dates and format of arbitration meetings will be made by the arbitrators unless the agreement or Terms of Reference provide otherwise. Also, whilst the arbitrators will have access to all information necessary to decide the issues submitted to arbitration, including confidential information, any information that was not available to both competent authorities shall not be taken into account by the arbitrators unless the competent authorities agree otherwise.

Taxpayer participation in the supplementary dispute resolution process

20. — [moved to paragraph 28 above]

Practical arrangements

21. — A number of practical arrangements will need to be made in connection with the actual functioning of the arbitral process. They include the location of the meetings, the language of the proceedings and possible translation facilities, the keeping of a record, dealing with practical details such as filing etc.

22. — As regards the location and the logistical arrangements for the arbitral meetings, the easiest solution is to leave the matter to be dealt with by the competent authority to which the case giving rise to the arbitration was initially presented. That competent authority should also provide the administrative personnel necessary for the conduct of the arbitration process. This is the approach put forward in paragraph 12 of the sample agreement. It is expected that, for these purposes, the competent authority will use meeting facilities and personnel that it already has at its disposal. The two competent authorities are, however, entitled to agree otherwise (*e.g.* to take advantage of another meeting in a different location that would be attended by both competent authorities and the arbitrators).

23. — It is provided that the administrative personnel provided for the conduct of the arbitration process will report only to the Chair of the arbitration panel concerning any matter related to that procedure.

24. — The language of the proceedings and whether, and which, translation facilities should be provided is a matter that should normally be dealt with in the Terms of Reference. It may be, however, that a need for translation or recording will only arise after the beginning of the proceedings. In that case, the competent authorities are entitled to reach agreement for that purpose. In the absence of such agreement, the arbitrators could, at the request of one competent authority and pursuant to paragraph 10 of the sample agreement, decide to provide such translation or recording; in that case, however, the costs thereof would have to be borne by the requesting party (see under “Costs” below).

25. — Other practical details (*e.g.* notice and filing of documents) should be similarly dealt with. Thus, any such matter should be decided by agreement between the competent authorities (ideally, included in the Terms of Reference) and, failing such agreement, by decision of the arbitrators.

Suspension of time in the case of failure to provide information in a timely manner

34. As indicated in paragraph 15 above, Article 7 of the sample agreement provides that the two year period referred to in paragraph 1 of Article 2 may be extended where both competent authorities agree that a person directly affected by the case has failed to provide in a timely manner any additional material information requested by either competent authority after the start of that two year period. In that case, the approach taken by the sample agreement is to extend that two year period by an amount of time equal to the period beginning on the date by which the information was requested and ending on the date on which that information was provided. [The following two sentences are currently at the end of paragraph 16 of the Commentary on the sample mutual agreement.] Where, however, the competent authorities are not provided with the information necessary to solve a particular case, there is nothing that prevents them from resolving the case on the basis of the limited information that is at their disposal, thereby preventing any access to arbitration. Also, it would be possible to provide in the agreement that if within an additional period (e.g. one year), the taxpayer still had not provided the ~~additional material necessary~~ information requested by either ~~for the~~ competent authorities to properly evaluate the issue, the issue would no longer be required to be submitted to arbitration.

Costs

3526. Different costs may arise in relation to the arbitration process and it should be clear who should bear these costs. ~~Paragraph 13~~ Article 8 of the sample agreement, which deals with this issue, is based on the principle that where a competent authority or a person involved in the case can control the amount of a particular cost, this cost should be borne by that party and that other costs should be borne ~~equally~~ **in equal shares** by the two competent authorities.

3627. Thus, it seems logical to provide that each competent authority, as well as the person who requested the arbitration, should pay for its own participation in the arbitration proceedings. This would include costs of being represented at the meetings and of preparing and presenting a position and arguments, whether in writing or orally. **This is provided in subparagraph a).**

3728. The fees to be paid to the arbitrators are likely to be one of the major costs of the arbitration process. **As indicated in subparagraph b),** ~~e~~Each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority (or appointed by the **highest ranking official of the Centre for Tax Policy and Administration of the Organisation for Economic Co-operation and Development** ~~Director of the OECD Centre for Tax Policy and Administration~~ because of the failure of that competent authority to appoint that arbitrator), together with that arbitrator's travel, telecommunication and secretariat costs.

3829. **Subparagraph c) provides, however, that** ~~T~~the fees and the travel, telecommunication and secretariat costs of the ~~other arbitrators~~ **Chair of the arbitration panel** will, however, be ~~shared~~ **equally borne in equal shares** by the competent authorities. The competent authorities will normally agree to incur these costs at the time that the arbitrators are appointed and this would typically be confirmed in the letter of appointment. The fees should be large enough to ensure that appropriately qualified experts could be recruited. ~~One possibility would be to use a fee structure similar to that established under the EU Arbitration Convention Code of Conduct.~~

39. **The competent authorities may also wish to include in the agreement a scale for the fees to be paid to the arbitrators. They are free to agree to set such fees in a way that reflects the particular circumstances of the Contracting States, their particular relationship, and the type of arbitration process. Competent authorities have used a variety**

of schedules of fees as resources for this purpose, including the schedule of fees set by the International Centre for Settlement of Investment Disputes and the schedule of fees provided in the Revised Code of Conduct for the EU Arbitration Convention. The agreement may also limit the amount of travel and the number of days for which the arbitrators will be compensated.

~~4030.~~ The costs related to ~~the any~~ meetings of the *arbitration* panel, including those of the administrative personnel necessary for the *preparation and* conduct of *that meeting and costs associated to the use of meeting facilities* ~~the arbitration process, should~~*will* be borne by the competent authority *that will host that meeting* ~~to which the case giving rise to the arbitration was initially presented, as long as that competent authority is required to arrange such meetings and provide the administrative personnel (see paragraph 12 of the sample agreement).~~ In most cases, that competent authority will use meeting facilities and personnel that it already has at its disposal and it would seem inappropriate to try to allocate part of the costs thereof to the other competent authority. Clearly, the reference to “costs related to the meetings” does not include the travel and accommodation costs incurred by the participants; these are dealt with above.

~~4134.~~ The other costs (not including any costs resulting from the taxpayers’ participation in the process) should be borne *equally in equal shares* by the two competent authorities as long as they have agreed to incur the relevant expenses. This would include, *for example*, costs related to translation and recording that both competent authorities have agreed to provide. *It would also include the costs of a meeting of the arbitration panel agreed to by both competent authorities but not hosted by either of them.* In the absence of ~~such an~~ agreement *between the competent authorities*, the party that has requested that particular costs be incurred should pay for these.

~~4232.~~ As indicated *at the beginning of* ~~paragraph 13~~*Article 8* ~~of the sample agreement,~~ the competent authorities may, however, *depart from these rules and* agree to a different allocation of costs *with respect to a specific case or a specific expense.* ~~Such agreement can be included in the Terms of Reference or be made afterwards (e.g. when unforeseen expenses arise).~~

Applicable legal principles

~~33.—[moved to paragraph 30 above]~~

~~34.—~~ In many cases, the application of the provisions of a tax convention depends on issues of domestic law (for example, the definition of immovable property in paragraph 2 of Article 6 depends primarily on the domestic law meaning of that term). As a general rule, it would seem inappropriate to ask arbitrators to make an independent determination of purely domestic legal issues and the description of the issues to be resolved, which will be included in the Terms of Reference, should take this into account. There may be cases, however, where there would be legitimate differences of views on a matter of domestic law and in such cases, the competent authorities may wish to leave that matter to be decided by an arbitrator who is an expert in the relevant area.

~~35.—[moved to paragraph 30 above]~~

Arbitration decision

~~36.—~~ Paragraph 15 of the sample agreement provides that where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators. Unless otherwise provided in the Terms of Reference, the decision is presented in writing and indicates the sources of law relied upon and the reasoning which led to its result. It is important

that the arbitrators support their decision with the reasoning leading to it. Showing the method through which the decision was reached is important in assuring acceptance of the decision by all relevant participants.

~~37.— Pursuant to paragraph 16, the arbitration decision must be communicated to the competent authorities and the person who made the request for arbitration within six months from the date on which the Chair notifies in writing the competent authorities and the person who made the request for arbitration that he has received all of the information necessary to begin consideration of the case. However, at any time within two months from the date on which the last arbitrator was appointed, the Chair, with the consent of one of the competent authorities, may notify in writing the other competent authority and the person who made the request for arbitration that he has not received all the information necessary to begin consideration of the case. In that case, a further two months will be given for the necessary information to be sent to the Chair. If the information is not received by the Chair within that period, it is provided that the decision will be rendered within the next six months without taking that information into account (unless both competent authorities agree otherwise). If, on the other hand, the information is received by the Chair within the two month period, that information will be taken into account and the decision will be communicated within six months from the reception of that information.~~

~~38.—[moved to paragraph 43 below]~~

Publication of the decision

~~39.—[moved to paragraph 32 above]~~

~~40.—[moved to paragraph 32 above]~~

Failure to communicate the decision within the required period

~~4338.~~ In order to deal with the unusual circumstances in which the arbitrators may be unable or unwilling to present an arbitration decision, ~~paragraph 17~~**Article 9** provides that if the decision is not communicated within the ~~relevant period~~ ***provided for in paragraph 5 of Article 4 or paragraph 6 of Article 5, or within any other period agreed to by the competent authorities***, the competent authorities may agree to extend the period for presenting the arbitration decision or, if they fail to reach such agreement within one month, appoint new arbitrators to deal with the case. In ~~such a case~~ the case of the appointment of new arbitrators, ***the date of such an agreement between the competent authorities will, for the purposes of the process described in Articles 4 and 5, be treated as the date of the request for arbitration***—the arbitration process would go back to the point where the original arbitrators were appointed and will continue with the new arbitrators.

Where no arbitration decision will be provided

~~4443.~~ ~~Paragraph 20~~**Article 10** of the sample agreement ***first*** deals with the case where the competent authorities are able to solve the unresolved issues that led to arbitration before the decision is rendered. Since the arbitration process is an exceptional mechanism to deal with issues that cannot be solved under the usual mutual agreement procedure, it is appropriate to put an end to that exceptional mechanism if the competent authorities are able to resolve these issues by themselves. The competent authorities may agree on a resolution of these issues as long as the arbitration decision has not been rendered. ***Article 10 also provides that the arbitration process and the mutual agreement procedure will terminate automatically if, before a decision has been rendered, the person that presented the case withdraws either its request for arbitration or its request for a mutual agreement procedure.***

Final decision

45. *Article 11 deals with the case where the arbitration decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or for any other reason. In such a case, the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place except for the purposes of the provisions of the same agreement dealing with “Communication of information and confidentiality” and “Costs”. In that case, the taxpayer can immediately make a new request for arbitration since the two year period for making such a request will have already passed. The competent authorities may also provide, however, that such a request should not be permitted in certain cases, e.g. where the actions of the taxpayer were the main reason for the invalidation of the arbitration decision.*

46. *Article 11 is not intended to provide independent grounds for the invalidation of an arbitration decision where such grounds do not exist under the domestic laws of the Contracting States. Instead, it is meant to ensure that where a court of one of the Contracting States invalidates an arbitration decision based on such existing rules, the other Contracting States is not bound to implement the decision. This may occur under the domestic laws of some States, for example, where there has been a procedural failure (e.g. a violation of the impartiality or independence requirements applicable to arbitrators) that has materially affected the outcome of the arbitration process. Since the arbitration decision is final, however, it is not expected that a court would invalidate an arbitration decision merely because it disagrees with the outcome of the arbitration process.*

Implementing the decision

4741. Once the arbitration process has provided a binding solution to the issues that the competent authorities have been unable to resolve, the competent authorities will proceed to conclude a mutual agreement that reflects that decision and that will be presented to the persons directly affected by the case. In order to avoid further delays, it is suggested that the mutual agreement that incorporates the solution arrived at should be completed and presented to the taxpayer within ~~six months~~ **180 days after** the date of the communication of the decision. This is provided in ~~paragraph 19~~ **Article 12** of the sample agreement.

4842. Paragraph 2 of Article 25 provides that the competent authorities have the obligation to implement the agreement reached notwithstanding any time limit in their domestic law. Paragraph 5 of the Article also provides that the arbitration decision is binding on both Contracting States. Failure to assess taxpayers in accordance with the agreement or to implement the arbitration decision through the conclusion of a mutual agreement would therefore result in taxation not in accordance with the Convention and, as such, would allow the person whose taxation is affected to seek relief through domestic legal remedies or by making a new request pursuant to paragraph 1 of the Article.

43.—[moved to paragraph 44 above]

Article 29

67. Add the following new Commentary on Article 29

COMMENTARY ON ARTICLE 29 CONCERNING THE ENTITLEMENT TO TREATY BENEFITS

Preliminary remarks

1. *As explained in the footnote to the Article, Article 29 reflects the intention of the Contracting States, incorporated in the preamble of the Convention, to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance, including through treaty-shopping arrangements. This intention and the wording of the Article correspond to the minimum standard that was agreed to as part of the OECD/G20 Base Erosion and Profit Shifting Project and that is described in paragraph 22 of the report Preventing the Granting of Treaty Benefits in Inappropriate Circumstances - Action 6: 2015 Final Report. As indicated in that report, the drafting of the Article will depend on how the Contracting States decide to implement that minimum standard. Depending on their own circumstances, States may wish to adopt only the general anti-abuse rule of paragraph 9 of the Article, may prefer instead to adopt the detailed version of paragraphs 1 to 7 that is described below, which they would supplement by a mechanism that would address conduit arrangements not otherwise dealt with by the provisions of the Convention, or may prefer to include in their treaty the general anti-abuse rule of paragraph 9 together with any variation of paragraphs 1 to 7 described below.*

2. *A State may prefer the last approach described above because it combines the flexibility of a general rule that can prevent a large number of abusive transactions with the certainty of a more “automatic” rule that prevents transactions that are known to cause treaty shopping concerns and that can be easily described by reference to certain features (such as the foreign ownership of an entity). That last approach is reflected in the “simplified version” of paragraphs 1 to 7 reproduced below, which should only be used in combination with the general rule of paragraph 9. Such a combination should not be construed in any way as restricting the scope of the general anti-abuse rule of paragraph 9: a transaction or arrangement should not be considered to be outside the scope of paragraph 9 simply because the specific anti-abuse rules of paragraphs 1 to 7, which only deal with certain cases of treaty shopping that can be easily identified by certain of their features, are not applicable.*

3. *A State may, however, prefer to deal with treaty shopping without the general anti-abuse rule of paragraph 9, relying instead on the specific anti-abuse rules of paragraphs 1 to 7, together with a mechanism that will address conduit arrangements that would escape the application of these paragraphs. This may be the case of a State whose domestic law includes strong anti-abuse rules that are sufficient to deal with other forms of treaty abuses. States that adopt that approach will need to ensure that the version of paragraphs 1 to 7 that they include in their bilateral conventions is sufficiently robust to prevent most forms of treaty shopping. For this reason, the paragraphs below provide different versions of the provisions of paragraphs 1 to 7, the more robust version of these paragraphs mentioned above being referred to as the “detailed version”. States that do not wish to include paragraph 9 for the reasons explained in this paragraph should adopt the detailed version, as opposed to the “simplified” version, subject to any adaptations referred to in the Commentary below.*

4. *This Article contains provisions that prevent various forms of treaty shopping through which persons who are not residents of a Contracting State might establish an entity that would be a resident of that State in order to reduce or eliminate taxation in the other Contracting State through the benefits of the tax treaty concluded between these two States. Allowing persons who are not directly entitled to treaty benefits (such as the reduction or elimination of withholding taxes on dividends, interest or royalties) to obtain these benefits indirectly through treaty shopping would frustrate the bilateral and reciprocal nature of tax treaties. If, for instance, a State knows that its residents can indirectly access the benefits of treaties concluded*

by another State, it may have little interest in granting reciprocal benefits to residents of that other State through the conclusion of a tax treaty. Also, in such a case, the benefits that would be indirectly obtained may not be appropriate given the nature of the tax system of the former State; if, for instance, that State does not levy an income tax on a certain type of income, it would be inappropriate for its residents to benefit from the provisions of a tax treaty concluded between two other States that grant a reduction or elimination of source taxation for that type of income and that were designed on the assumption that the two Contracting States would tax such income.

5. The provisions of paragraphs 1 to 7 seek to deny treaty benefits in the case of structures that typically result in the indirect granting of treaty benefits to persons that are not directly entitled to these benefits whilst recognising that in some cases, persons who are not residents of a Contracting State may establish an entity in that State for legitimate business reasons. Although these provisions apply regardless of whether or not a particular structure was adopted for treaty-shopping purposes, the Article allows the competent authority of a Contracting State to grant treaty benefits where the other provisions of the Article would otherwise deny these benefits but the competent authority determines that the structure did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. The Article restricts the general scope of the other provisions of the Convention, including those of Article 1 according to which the Convention applies to persons who are residents of a Contracting State. Paragraph 1 of the Article provides that a resident of a Contracting State shall not be entitled to the benefits of the Convention unless it constitutes a “qualified person” under paragraph 2 or unless benefits are granted under the provisions of paragraphs 3, 4, 5 or 6. Paragraph 2 determines who constitutes a “qualified person” by reference to the nature or attributes of various categories of persons; any person to which that paragraph applies is entitled to all the benefits of the Convention. Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a “qualified person” under paragraph 2 as long as that item of income emanates from, or is incidental to, the active conduct of a business in that person’s State of residence (subject to certain exceptions). Paragraph 4 is a “derivative benefits” provision that allows certain entities owned by residents of third States to obtain treaty benefits provided that these residents would have been entitled to equivalent benefits if they had invested directly. Paragraph 5 is a “headquarters company” provision under which a company that is not eligible for benefits under paragraph 2 may nevertheless qualify for benefits with respect to particular items of income. Paragraph 6 includes the provisions that allow the competent authority of a Contracting State to grant treaty benefits where the other provisions of the Article would otherwise deny these benefits. Paragraph 7 includes a number of definitions that apply for the purposes of the Article.

Paragraph 1: provision restricting treaty benefits to a resident of a Contracting State who is a “qualified person”

Simplified and detailed versions

1. Except as otherwise provided in this Article, a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25) unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.

Commentary on paragraph 1 of the simplified and detailed versions

7. Paragraph 1 of both the simplified and detailed versions provides that a resident of a Contracting State, as defined under Article 4, will be entitled to the benefits otherwise accorded to residents of a Contracting State under the Convention only if it constitutes a “qualified person” under paragraph 2 or unless benefits are otherwise granted under paragraphs 3, 4, 5 or 6. The benefits otherwise accorded to a resident of a Contracting State under the Convention include all limitations to the Contracting States’ taxing rights under Articles 6 through 22, the elimination of double taxation provided by Article 23 and the protection afforded to residents of a Contracting State under Article 24. The Article does not, however, restrict the availability of treaty benefits under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25 or under the few provisions of the Convention that do not require that a person be a resident of a Contracting State in order to enjoy the benefits of those provisions (e.g. the provisions of paragraph 1 of Article 24, to the extent that they apply to nationals who are not residents of either Contracting State). Whilst the provisions of paragraph 3 of Article 7 share the main features of paragraph 2 of Article 9, the availability of the benefits of paragraph 3 of Article 7 is restricted by paragraph 1 of Article 29 because relief of double taxation under Article 7 depends largely on the provisions of paragraph 2 of that Article (see paragraphs 40 to 57 of the Commentary on Article 7) and it would be inconsistent to be more generous with respect to the relief provided under paragraph 3 of Article 7 than with respect to the relief provided under paragraph 2 of that Article.

8. Paragraph 1 does not extend in any way the scope of the benefits granted by the other provisions of the Convention. Thus, a resident of a Contracting State who constitutes a “qualified person” under paragraph 2 must still meet the conditions of the other provisions of the Convention in order to obtain these benefits (e.g. that resident must be the beneficial owner of dividends in order to benefit from the provisions of paragraph 2 of Article 10) and these benefits may be denied or restricted under applicable anti-abuse rules such as the rules in paragraphs 8 and 9.

9. Paragraph 1 applies at any time when the Convention would otherwise provide a benefit to a resident of a Contracting State. Thus, for example, it applies at the time when income to which Article 6 applies is derived by a resident of a Contracting State, at the time that dividends to which Article 10 applies are paid to a resident of a Contracting State or at any time when profits to which Article 7 applies are made. The paragraph requires that, in order to be entitled to the benefit provided by the relevant provision of the Convention, the resident of the Contracting State must be a “qualified person”, within the meaning of paragraph 2, at the relevant time. In some cases, however, the definition of “qualified person” requires that a resident of a Contracting State must satisfy certain conditions over a period of time in order to constitute a “qualified person” at a given time.

10. Since the definition of “equivalent beneficiary” that would be used for the purpose of paragraph 4 of the detailed version dealing with derivative benefits would exclude persons who, under another convention, are entitled to relief from taxation by the State of source that is not as favourable as the relief provided under the Convention, that definition would have the so-called “cliff” effect of denying all treaty benefits even if the difference in the relief provided by the two conventions is relatively minor. In that case, some States consider that it is appropriate to provide relief from taxation by the State of source that is similar to the relief that would be provided under the other convention. This treatment may be achieved through the alternative provisions included in paragraph 147 below that relate to the taxation of dividends, interest and royalties, which are provisions that alleviate the so-called “cliff effect” when a potential

equivalent beneficiary is, under another convention, entitled to restrictions on taxation by the State of source that are not as favourable as those provided by the Convention. Instead of denying all treaty benefits with respect to such income, these provisions grant limited benefits that broadly correspond to those that would have been available under the other convention. In order to ensure that paragraph 1 does not deny the benefits granted under these alternative provisions, which would be contrary to the purpose of these provisions, these States should adopt a different version of paragraph 1 that would be drafted as follows:

Except as otherwise provided in this Article and in [reference to the paragraphs of Articles 10, 11 and 12 that relate to the so-called “cliff effect”], a resident of a Contracting State shall not be entitled to a benefit that would otherwise be accorded by this Convention (other than a benefit under paragraph 3 of Article 4, paragraph 2 of Article 9 or Article 25), unless such resident is a “qualified person”, as defined in paragraph 2, at the time that the benefit would be accorded.

Paragraph 2: situations where a resident is a qualified person

Simplified and detailed versions

2. A resident of a Contracting State shall be a qualified person at a time when a benefit would otherwise be accorded by the Convention if, at that time, the resident is:

Commentary on the preamble of paragraph 2 of the simplified and detailed versions

11. Each of the subparagraphs of paragraph 2 of the simplified and detailed versions describes a category of residents that are qualified persons at the time when the relevant treaty benefits are claimed.

12. It is intended that the provisions of paragraph 2 will be self-executing. Unlike the provisions of paragraph 5 (simplified version) / 6 (detailed version), discussed below, claiming benefits under paragraph 2 does not require advance competent authority ruling or approval. The tax authorities may, of course, on review, determine that the taxpayer has improperly interpreted the paragraph and is not entitled to the benefits claimed.

Subparagraph a): individuals

Simplified and detailed versions

a) an individual;

Commentary on subparagraph a) of paragraph 2 of the simplified and detailed versions

13. Subparagraph a) of both the simplified and detailed versions provides that any individual who is a resident of a Contracting State will be a qualified person. As explained in paragraph 61 below, under some treaty provisions, a collective investment vehicle must be treated as an individual for the purposes of applying the relevant treaty; where that is the case, such a collective investment vehicle will therefore constitute a qualified person by virtue of subparagraph a).

Subparagraph b): Contracting States, political subdivisions and their agencies and instrumentalities

Simplified and detailed versions

- b) *that Contracting State, or a political subdivision or local authority thereof, or an agency or instrumentality of that State, political subdivision or local authority;*

Commentary on subparagraph b) of paragraph 2 of the simplified and detailed versions

14. *Subparagraph b) of both the simplified and detailed versions provides that the Contracting States and any political subdivision or local authority thereof constitute qualified persons. These words apply to any part of a State, such as a separate fund established by the State that does not constitute, and is not owned by, a separate person. Under the last part of the subparagraph, a separate legal person which is a resident of a Contracting State and is an agency or instrumentality of a Contracting State, or a political subdivision or local authority thereof, will also be a qualified person and, therefore, will be entitled to all the benefits of the Convention whilst it qualifies as such. The concept of “agency or instrumentality” is restricted to entities set up by a State (or a political subdivision or local authority thereof) to perform exclusively functions of a governmental nature; it does not apply, for example, to a company that acts as an agent of the State for certain purposes but that was not set up by the State to perform functions of a governmental nature. The wording of the subparagraph may need to be adapted to reflect the different legal nature that State-owned entities, such as sovereign wealth funds, may have in the Contracting States as well as the different views that these States may have concerning the application of Article 4 to these entities (see paragraphs 50 to 53 of the Commentary on Article 1 and paragraphs 8.5 and 8.11 of the Commentary on Article 4).*

Subparagraph c): publicly-traded companies and entities

Simplified version

- c) *a company or other entity, if the principal class of its shares is regularly traded on one or more recognised stock exchanges;*

Detailed version

- c) *a company or other entity, if, throughout the taxable period that includes that time, the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:*
- (i) its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or*
 - (ii) the company’s or entity’s primary place of management and control is in the Contracting State of which it is a resident;*

Commentary on subparagraph c) of paragraph 2 of the simplified version

15. *Subparagraph c) of the simplified version recognises that because the shares of publicly-traded companies and of some entities are generally widely-held, these companies and entities are unlikely to be established for treaty shopping purposes. The terms “shares”, “principal class of shares” and “recognised stock exchange” are defined in paragraph 7; as indicated in the definition of “shares”, that term covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, publicly-traded units of a trust.*

Commentary on subparagraph c) of paragraph 2 of the detailed version

16. *Subparagraph c) recognises that, as a general rule, because the shares of publicly-traded companies and of some entities are generally widely-held, these companies and entities are unlikely to be established for treaty shopping purposes.*

17. *Subparagraph c) provides that a company or entity resident in a Contracting State constitutes a qualified person at a time when a benefit is provided by the Convention if, throughout the taxable period that includes that time, the principal class of its shares, and any disproportionate class of shares, is regularly traded on one or more recognised stock exchanges, provided that the company or entity also satisfies at least one of the following additional requirements: first, the company's or entity's principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident or, second, the company's or entity's primary place of management and control is in its State of residence. These additional requirements take account of the fact that whilst a publicly-traded company or entity may be technically resident in a given State, it may not have a sufficient relationship with that State to justify allowing such a company or entity to obtain the benefits of treaties concluded by that State. Such a sufficient relationship may be established by the fact that the shares of the publicly-traded company or entity are primarily traded in recognised stock exchanges situated in the State of residence of the company or entity; given the fact that the globalisation of financial markets means that shares of publicly-listed companies that are residents of some States are often traded on foreign stock exchanges, the alternative test provides that this sufficient relationship may also be established by the fact that the company or entity is primarily managed and controlled in its State of residence.*

18. *A company or entity whose principal class of shares is regularly traded on a recognised stock exchange will nevertheless not qualify for benefits under subparagraph c) of paragraph 2 if it has a disproportionate class of shares that is not regularly traded on a recognised stock exchange.*

19. *The terms "recognised stock exchange", "shares", "principal class of shares" and "disproportionate class of shares" are defined in paragraph 7. As indicated in these definitions, the term "shares" covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, publicly-traded units of a trust.*

20. *The regular trading requirement can be met by the trading of issued shares on any recognised exchange or exchanges located in either State. Trading on one or more recognised stock exchanges may be aggregated for purposes of this requirement; a company or entity could therefore satisfy this requirement if its shares are regularly traded, in whole or in part, on a recognised stock exchange located in the other Contracting State.*

21. *Subdivision (i) includes the additional requirement that the shares of the company or entity be primarily traded in one or more recognised stock exchanges located in the State of residence of the company or entity. In general, the principal class of shares of a company or entity is "primarily traded" on one or more recognised stock exchanges located in the State of residence of that company or entity if, during the relevant taxation year, the number of shares in the company's or entity's principal class of shares that are traded on these stock exchanges exceeds the number of shares in the company's or entity's principal class of shares that are traded on established securities markets in any other State. Some States, however, consider that the fact that shares of a company or entity resident in a Contracting State are primarily traded on recognised stock exchanges situated in other States (e.g. in a State that is part of the*

European Economic Area within which rules relating to stock exchanges and securities create a single market for securities trading) constitutes a sufficient safeguard against the use of that company or entity for treaty-shopping purposes; States that share that view may modify subdivision (i) accordingly.

22. Subdivision (ii) provides the alternative requirement applicable to a company or entity whose principal class of shares is regularly traded on recognised stock exchanges but not primarily traded on recognised stock exchanges situated in the State of residence of the company or entity. Such a company or entity may claim treaty benefits if its “primary place of management and control” (as defined in paragraph 7) is in its State of residence.

23. The conditions of subparagraph c) must be satisfied throughout the taxable period of the company or entity. This does not require that the shares of the company or entity be traded on the relevant stock exchanges each day of the relevant period. For shares to be considered as regularly traded on one or more stock exchanges throughout the taxable period, it is necessary that more than a very small percentage of the shares be actively traded during a sufficiently large number of days included in that period. The test would be met, for example, if 10 per cent of the average number of outstanding shares of a given class of shares of a company were traded during 60 days of trading taking place in the taxable period of the company. The phrase “taxable period” in subparagraphs c) and e) refers to the period for which an annual tax return must be filed in the State of residence of the company or entity. If the Contracting States have a concept corresponding to “taxable period” in their domestic law, such as “taxable year”, they are free to replace the reference to taxable period by that other concept.

Subparagraph d) (detailed version): affiliates of publicly-traded companies and entities

Detailed version only

d) a company, if:

- (i) throughout the taxable period that includes that time, at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subparagraph c) of this paragraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner; and*
- (ii) with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company’s gross income, and less than 50 per cent of the tested group’s gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e);*

Commentary on subparagraph d) of paragraph 2 of the detailed version

24. *Subparagraph d) extends the principle underlying subparagraph c) (i.e. that publicly-traded companies and entities are unlikely to be established for treaty shopping purposes) to some companies in which five or fewer publicly-traded companies and entities own a majority interest, subject to additional conditions.*

25. *In order for a company resident of a Contracting State to be entitled to all the benefits of the Convention under subparagraph d) at a given time, that company must satisfy two conditions applicable to the taxable period that includes that time.*

26. *First, under subdivision (i), the company must satisfy an ownership test. Under that test, five or fewer publicly-traded companies or entities described in subparagraph c) must be, throughout that taxable period, the direct or indirect owners of at least 50 per cent of the aggregate vote and value of the company's shares (and at least 50 per cent of any disproportionate class of shares). If the publicly-traded companies or entities are indirect owners, however, each of the intermediate companies or entities must either be a resident of the Contracting State from which a benefit under this Convention is being sought or be a "qualifying intermediate owner". The term "qualifying intermediate owner" is defined in paragraph 7; under that definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company claiming benefits under subparagraph d).*

27. *Thus, for example, a company resident of a Contracting State satisfies the requirements of subdivision (i) if it is wholly owned by a company that is a resident of the same State and that satisfies the requirements of subparagraph c). Furthermore, if a publicly-traded parent company in the other Contracting State indirectly owns the company through a chain of subsidiaries, each such subsidiary in the chain, as an intermediate owner, must be a resident of the Contracting State from which a benefit under this Convention is being sought or a qualifying intermediate owner in order for the company to meet the ownership test in subdivision (i).*

28. *The phrase "50 per cent of the aggregate vote and value of the shares", which is used in subparagraphs d) and f) and in other parts of paragraphs 1 to 7, refers to a participation that represents both at least 50 per cent of all the voting rights in the relevant company or entity and at least 50 per cent of the value of all the shares in that company or entity. That test would therefore not be satisfied in the case of a participation that would satisfy the vote condition without satisfying the value condition (or vice versa).*

29. *Under the second condition, included in subdivision (ii), the company must also satisfy a base erosion test with respect to any treaty benefits that it claims (other than a benefit with respect to dividends under Article 10). That base erosion test is satisfied if*

- less than 50 per cent of the company's gross income (and less than 50 per cent of the tested group's gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and*
- less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.*

30. The term “ineligible persons” used in the previous paragraph refers to any persons other than the residents of each Contracting State who are entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2. Entities that are residents of the Contracting States and that are entitled to the benefits of this Convention under this subparagraph or under subparagraph f) of paragraph 2 are, therefore, ineligible persons; this ensures that these entities are not used in arrangements that could allow third country investors to accumulate indirectly a significant amount of the base eroding payments made by a company seeking benefits under this subparagraph. Paragraph 7 includes the definition of the terms “tested group” and “gross income” which are used in subdivision (ii).

31. For the purpose of the base erosion test, deductible payments do not include arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base, trust distributions are deductible payments. Depreciation and amortisation deductions, which do not represent payments or accruals to other persons, are disregarded for this purpose. Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Finally, payments of interest are not arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property, and would therefore be taken into account if made to an ineligible person.

32. The following examples illustrate the application of the base erosion test of subdivision (ii) of subparagraph d) by a Contracting State (referred to in the examples as the “first-mentioned State”), taking into account the definitions of “tested group” and “gross income” in paragraph 7:

- Example A: Assume that at all relevant times, R3 is a company wholly owned by another company, R2, which in turn is wholly owned by R1, a publicly-traded company that satisfies the requirements of subparagraph c). R3, R2 and R1 are all residents of the other Contracting State under Article 4 and are all members of the same tax consolidation group. The ownership test in subdivision (i) of subparagraph d) is satisfied because R1, a company satisfying the requirements of subparagraph c), indirectly owns at least 50 per cent of the aggregate vote and value of R3 (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares of R3), and R2, which is an intermediate owner, is a resident of the other Contracting State and is therefore a qualifying intermediate owner.

During the taxable period that includes the time when the benefit would otherwise be accorded by the first-mentioned State, R3 derives: first, 200 of dividends from a company resident in a third State that are excluded from gross income of R3 in the other Contracting State; and, second, 100 of interest arising in the first-mentioned State, for which R3 is seeking the benefits of Article 11 of the Convention. R3 makes a base eroding payment of 49 to an ineligible person and pays a dividend of 51 to R2. In addition to the 51 dividend that it receives from R3, R2 receives additional gross receipts of 100 from persons outside the tested group. R2 makes a base eroding payment of 51 to an ineligible person.

In this example, the tested group, as defined in paragraph 7, consists of R3, R2 and R1, because the three companies participate in a tax consolidation regime. In order to be eligible for benefits with respect to the interest arising in the first-mentioned State, R3 and the tested group must each meet the base erosion test of subparagraph (ii).

R3’s gross income, as defined in paragraph 7, is 100 (the interest arising in the first-mentioned State), since the 200 dividend paid to R3 from a third-State company is excluded. Thus, for the taxable period for which R3 seeks benefits, less than 50 of R3’s

gross income is in the form of base eroding payments to ineligible persons. R3 has made only 49 in base eroding payments and would therefore satisfy the part of the base erosion test that applies to it.

The tested group's gross income computed under the tax law of the other Contracting State excludes the 200 dividend paid to R3 from a third-State company as well as intragroup transactions (i.e., the 51 dividend from R3 to R2). The tested group's gross income is, therefore, 200 (the 100 interest arising in the first-mentioned State plus the 100 R2 received from persons outside the tested group). Thus, during the taxable period in question, the tested group must make less than 100 in base eroding payments to ineligible persons in order to satisfy the base erosion test of subdivision (ii).

In this example, R3 does not satisfy the requirements of subparagraph d). Although R3's 49 of base eroding payments to ineligible persons does not exceed the allowable limit of less than 50, the tested group's total base eroding payments to ineligible persons of 100 (49 + 51), exceeds the tested group's allowable limit of base eroding payments to ineligible persons, which was less than 100.

- *Example B: Assume the same facts as in Example A, except that R3 derives 100 of dividends paid by a company resident of the first-mentioned State rather than interest arising in that State, and has no other gross income in the taxable year. Since the only treaty benefit that R3 is seeking is under Article 10 with respect to the dividends, R3 is not required to apply the base erosion test under subdivision (ii). Accordingly, R3 will be a qualified person with respect to the dividend under subparagraph d) because it satisfies the ownership requirement of subdivision (i).*
- *Example C: Assume that at all relevant times, P2 (the relevant company) is a company that is wholly owned by P1, a publicly-traded company that satisfies the requirements of subparagraph c). P2 and P1 are residents of the other Contracting State.*

During the taxable year in question, P2's only items of income are interest of 100 arising in the first-mentioned State for which P2 seeks to claim the benefits of Article 11. P2 makes a deductible interest payment of 100 to P1, a person that satisfies subparagraph c). P1 makes a deductible payment during the same taxable period of 100 to ThirdCo, a company resident in State Y. P2, through P1, has indirectly made a base eroding payment of 100 to an ineligible person. In this example, the base erosion test under subdivision (ii) is not satisfied and P2 will not be a qualified person.

33. *As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons (as defined in paragraph 7) that benefit from regimes that constitute "special tax regimes" (see paragraphs 85 to 106 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). These States may want to modify the base-erosion test of subdivision (ii) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subdivision (ii) as follows:*

- (ii) *with respect to benefits under this Convention other than under Article 10, less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that*

includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)

- A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e);*
- B) to persons that are connected to the person described in this subparagraph and that benefit from a special tax regime, as defined in [reference to the paragraph of the convention that includes the definition of "special tax regime"] of this Convention, with respect to the deductible payment; or*
- C) with respect to a payment of interest, to persons that are connected to the person described in this subparagraph and that benefit from notional deductions described in [reference to the paragraph of Article 11 that relates to notional deductions for equity].*

34. *The following example illustrates the application of the alternative formulation of the base erosion test included in the previous paragraph:*

- Example: Assume the same facts as in Example B in paragraph 32 above, except that R3's only items of income are 100 of royalties arising in the State from which the treaty benefits are sought, for which R3 seeks to claim the benefits of Article 12. R3 makes a deductible royalty payment of 100 to R1. At all relevant times, R1 benefits from a special tax regime (as defined in that Convention) with respect to royalties.*

The ownership condition of subdivision (i) of subparagraph d) is satisfied because R1, a company satisfying the requirements of subparagraph c), indirectly owns at least 50 per cent of the aggregate vote and value of R3 and R2 is a qualifying intermediate owner. However, even though R1 is a person that satisfies subparagraph c), the deductible royalty payment made to R1 by R3 is a base eroding payment because R1 is an ineligible person. R1 is a connected person with respect to R3 and benefits from a special tax regime with respect to the royalty income. In this example, R3 does not satisfy the base erosion test under subdivision (ii) because R3 has made 100 of base eroding payments to a person who benefits from a special tax regime and the amount, 100, exceeds R3's allowable limit of base eroding payments to ineligible persons (that limit being exceeded if the total of these payments is not lower than 50).

35. *Some other States, however, may consider that there is no need to impose the base-erosion condition of subdivision (ii) in the case of companies that are primarily owned by publicly-traded companies or entities. These States may therefore wish to omit subparagraph d) and use the following version of subparagraph c) which would deal both with publicly-traded companies or entities and with companies in which five or fewer publicly-traded companies and entities own a majority interest (States following this approach should also renumber the subsequent subparagraphs of paragraph 2 and replace the references to "subparagraph c)" by references to "subdivision (i) of subparagraph c)" in the wording of the "ownership/base erosion", "derivative benefits" and headquarters company rules in order to avoid the problem described in paragraph 30 above):*

- c) *a company or other entity, if, throughout the taxable period that includes that time*
 - (i) *the principal class of its shares (and any disproportionate class of shares) is regularly traded on one or more recognised stock exchanges, and either:*
 - A) *its principal class of shares is primarily traded on one or more recognised stock exchanges located in the Contracting State of which the company or entity is a resident; or*
 - B) *the company's or entity's primary place of management and control is in the Contracting State of which it is a resident; or*
 - (ii) *at least 50 per cent of the aggregate vote and value of the shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the company or entity is owned directly or indirectly by five or fewer companies or entities entitled to benefits under subdivision (i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of the Contracting State from which a benefit under this Convention is being sought or is a qualifying intermediate owner;*

Subparagraph d) (simplified version) / e) (detailed version): non-profit organisations and recognised pension funds

Simplified version

- d) *a person, other than an individual, that*
 - (i) *is a [agreed description of the relevant non-profit organisations found in each Contracting State],*
 - (ii) *is a recognised pension fund;*

Detailed version

- e) *a person, other than an individual, that*
 - (i) *is a [agreed description of the relevant non-profit organisations found in each Contracting State],*
 - (ii) *is a recognised pension fund to which subdivision (i) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State, or more than [__ per cent] of the beneficial interests in that person are owned by individuals resident of either Contracting State or of any other State with respect to which the following conditions are met*
 - A) *individuals who are residents of that other State are entitled to the benefits of a comprehensive convention for the avoidance of double taxation between that other State and the State from which the benefits of this Convention are claimed, and*
 - B) *with respect to income referred to in Articles 10 and 11 of this Convention, if the person were a resident of that other State entitled to all the benefits of that other convention, the person would be*

entitled, under such convention, to a rate of tax with respect to the particular class of income for which benefits are being claimed under this Convention that is at least as low as the rate applicable under this Convention; or

- (iii) is a recognised pension fund to which subdivision (ii) of the definition of recognised pension fund in paragraph 1 of Article 3 applies, provided that it is established and operated exclusively or almost exclusively to invest funds for the benefit of entities or arrangements referred to in the preceding subdivision;*

Commentary on subparagraph d) of paragraph 2 of the simplified version

36. Subparagraph d) of the simplified version provides rules under which certain non-profit organisations (to the extent that they qualify as residents of a Contracting State as explained in paragraph 8.11 of the Commentary on Article 4) and recognised pension funds will be entitled to all the benefits of the Convention.

37. The entities of each State that would be described in subdivision (i) would generally correspond to those that do not pay tax in their State of residence and that are constituted and operated exclusively to fulfil certain social functions (e.g. charitable, scientific, artistic, cultural, or educational). The description of such entities that would be included in subdivision (i) with respect to each State would typically refer to the provisions of the domestic law of that State that describe these entities or to the domestic law factors that allow the identification of these entities. Depending on the wording used, States may also want to amend subdivision (i) in order to allow their competent authorities to agree subsequently to amend or supplement the description provided.

38. Subdivision (ii) refers to any entity that qualifies as a “recognised pension fund” under the definition of that term in paragraph 1 of Article 3.

Commentary on subparagraph e) of paragraph 2 of the detailed version

39. Subparagraph e) of the detailed version provides rules under which certain non-profit organisations (to the extent that they qualify as residents of a Contracting State, as explained in paragraph 8.11 of the Commentary on Article 4) and certain recognised pension funds will be entitled to all the benefits of the Convention.

40. Entities that would be described in subdivision (i) automatically qualify for treaty benefits without regard to the residence of their beneficiaries or members. These entities would generally correspond to those that do not pay tax in their State of residence and that are constituted and operated exclusively to fulfil certain social functions (e.g. charitable, scientific, artistic, cultural, or educational). The description of such entities that will be included in subdivision (i) with respect to each State will typically refer to the provisions of the domestic law of that State that describe these entities or to the domestic law factors that allow the identification of these entities. Depending on the wording used, States may also want to amend subdivision (i) in order to allow their competent authorities to agree subsequently to amend or supplement the description provided.

41. Under subdivision (ii), a recognised pension fund that falls within subdivision (i) of the definition of that term in paragraph 1 of Article 3 (which is the part of the definition that applies to an entity that administers or provides retirement benefits and ancillary or incidental benefits

to individuals) will qualify for treaty benefits if more than 50 per cent of the beneficial interests in that person are owned by individuals resident of either Contracting State or if more than a certain percentage of these beneficial interests, to be determined during bilateral negotiations, are owned by such residents or by individuals who are residents of third States provided that, in the latter case, two additional conditions are met: first, these individuals are entitled to the benefits of a comprehensive tax convention concluded between that third State and the State of source and, second, that convention provides for a similar or greater reduction of source taxes on interest and dividends derived by pension funds of that third State. For purposes of this provision, the term “beneficial interests in that person” should be understood to refer to the interests held by persons entitled to receive pension benefits from the fund. Some States, however, consider that the risk of treaty shopping by recognised pension funds does not warrant the costs of compliance inherent in requiring funds to identify the treaty residence and entitlement of the individuals entitled to receive pension benefits. States that share that view may modify subdivisions (ii) and (iii) accordingly and may, for instance, simply replace these two subdivisions by one subdivision that would read “is a recognised pension fund”, which, like the provision found in the simplified version, would ensure that any recognised pension fund covered by the definition found in paragraph 1 of Article 3 would automatically constitute a “qualified person”.

42. Subdivision (iii) applies to the so-called “funds of funds” that are referred to in subdivision (ii) of the definition of “recognised pension fund” in paragraph 1 of Article 3. These are funds which do not directly provide retirement benefits to individuals but are constituted and operated to invest funds of recognised pension funds that are themselves covered by subdivision (i) of the definition of “recognised pension fund”. Subdivision (iii) only applies, however, if substantially all the income of such a “fund of funds” is derived from investments made for the benefit of recognised pension funds qualifying for benefits under subdivision (ii).

Subparagraph e) (simplified version) / f) (detailed version): ownership / base erosion

Simplified version

- e) a person other than an individual if, at that time and on at least half the days of a twelve-month period that includes that time, persons who are residents of that Contracting State that are entitled to benefits of this Convention under subparagraphs a) to d) own, directly or indirectly, at least 50 per cent of the shares of the person;*

Detailed version

- f) a person other than an individual, if
 - (i) at that time and on at least half the days of a twelve-month period that includes that time, persons who are residents of that Contracting State and that are entitled to the benefits of this Convention under subparagraph a), b), c) or e) own, directly or indirectly, shares representing at least 50 per cent of the aggregate vote and value (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) of the shares in the person, provided that, in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and*
 - (ii) less than 50 per cent of the person’s gross income, and less than 50 per cent of the tested group’s gross income, for the taxable period that includes that**

time, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions), to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of this paragraph;

Commentary on subparagraph e) of paragraph 2 of the simplified version

43. Subparagraph e) of the simplified version provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. Under that subparagraph, any entity that is a resident of a Contracting State may qualify for treaty benefits if, at the time when the relevant treaty benefit otherwise would be accorded and on at least half the days of a twelve-month period that includes that time, at least 50 per cent of the shares of that entity are owned, directly or indirectly, by persons who are residents of that Contracting State and that are themselves entitled to benefits of this Convention under the previous subparagraphs of paragraph 2 (i.e. subparagraphs a), b), c) or d) of the simplified version).

44. Under the definition of the term "shares" in paragraph 7, that term covers comparable interests in entities, other than companies, to which the subparagraph applies; this includes, for example, units of a trust.

45. Unlike the corresponding provision in subparagraph f) of the detailed version, subparagraph e) of the simplified version does not require that the entity also satisfy a base erosion test. Also, in the case of an indirect ownership, it does not impose any requirement applicable to the intermediate owners.

Commentary on subparagraph f) of paragraph 2 of the detailed version

46. Subparagraph f) of the detailed version provides an additional method to qualify for treaty benefits that applies to any form of legal entity that is a resident of a Contracting State. The test provided in subparagraph f), the so-called ownership and base erosion test, is a two-part test; both parts must be satisfied for the resident to be entitled to treaty benefits under subparagraph f).

47. Under subdivision (i), which is the ownership part of the test, 50 per cent or more of the aggregate vote and value of the outstanding shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) in the person must be owned, directly or indirectly, at the time when the relevant treaty benefit otherwise would be accorded and on at least half the days of a twelve-month period that includes that time, by persons who are residents of the Contracting State of which that person is a resident and that are themselves entitled to treaty benefits under subparagraphs a), b), c) or e). In the case of indirect owners, however, each of the intermediate owners must be a qualifying intermediate owner. The term "qualifying intermediate owner" is defined in paragraph 7; under that definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company claiming benefits under subparagraph f).

48. Whilst subparagraph f) will typically be relevant in the case of private companies, it may also apply to an entity such as a trust that is a resident of a Contracting State and that otherwise satisfies the requirements of the subparagraph. According to the definition of shares in paragraph 7, the reference to “shares”, in the case of entities that are not companies, means interests that are comparable to shares; this would generally be the case of the beneficial interests in a trust. For the purposes of subdivision (i), the beneficial interests in a trust will be considered to be owned by its beneficiaries in proportion to each beneficiary’s actuarial interest in the trust. The interest of a beneficiary entitled to the remaining part of a trust will be equal to 100 per cent less the aggregate percentages held by income beneficiaries. A beneficiary’s interest in a trust will not be considered to be owned by a person entitled to benefits under subparagraphs a), b), c) or e) if it is not possible to determine the beneficiary’s actuarial interest. Consequently, if it is not possible to determine the actuarial interest of the beneficiaries in a trust, the ownership test under subdivision (i) cannot be satisfied, unless all possible beneficiaries are persons entitled to benefits under subparagraphs a), b), c) or e).

49. Subdivision (ii) constitutes the base erosion part of the test, which is broadly similar to the base erosion test in subdivision (ii) of subparagraph d) except for the fact that, unlike that other test, it also applies to a person that is seeking benefits under Article 10. That base erosion test is satisfied if

- less than 50 per cent of the company’s gross income (and less than 50 per cent of the tested group’s gross income if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company’s tax in its State of residence, and
- less than 50 per cent of the tested group’s gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.

50. The term “ineligible persons” used in the previous paragraph refers to any persons other than the residents of each Contracting State who are entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2. Also, paragraph 7 includes the definition of the terms “tested group” and “gross income” which are used in subdivision (ii).

51. The base erosion test of subdivision (ii), unlike that of subparagraph d), applies if a person wishes to obtain the benefits of Article 10. Such a person shall, for the purpose of subdivision (ii), include in its gross income any dividends received even if the dividends are effectively exempt from tax in that person’s State of residence. This is provided for in subdivision (i) of the definition of “gross income” in paragraph 7.

52. As in the case of the base erosion test in subparagraph d), for the purpose of applying the test in subdivision (ii), deductible (i.e. base-eroding) payments do not include arm’s-length amounts paid or accrued in the ordinary course of business for services or tangible property. To the extent they are deductible from the taxable base under the tax law of the person’s State of residence, trust distributions constitute such base-eroding payments. Depreciation and amortisation deductions, which do not represent payments or accruals to other persons, are not taken into account for the purposes of subdivision (ii). Furthermore, in the case of a tested group, deductible payments do not include intra-group payments. Finally, payments of interest

are not arm's-length amounts paid or accrued in the ordinary course of business for services or tangible property, and would therefore be taken into account if made to an ineligible person.

53. *As explained in paragraph 33 above, which is applicable to the base erosion test of subparagraph d), States that want to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute "special tax regimes" and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity, may also want to modify the base erosion test of subdivision (ii) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subdivision (ii) as follows:*

- (ii) less than 50 per cent of the company's gross income, and less than 50 per cent of the tested group's gross income, for the taxable period that includes that time, is paid or accrued, directly or indirectly, in the form of payments that are deductible in that taxable period for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)*
 - A) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e);*
 - B) to persons that are connected to the person described in this subparagraph and that benefit from a special tax regime, as defined in [reference to the paragraph of the convention that includes the definition of "special tax regime"] of this Convention, with respect to the deductible payment; or*
 - C) with respect to a payment of interest, to persons that are that are connected to the person described in this subparagraph and that benefit from notional deductions described in [reference to the paragraph of Article 11 that relates to notional deductions for equity];*

54. *The following examples illustrate the application of the base erosion test of subdivision (ii) of subparagraph f) by a Contracting State (referred to in the examples as the "first-mentioned State"), taking into account the definitions of "tested group" and "gross income" in paragraph 7:*

- Example A: Assume that at all relevant times, R2 (the entity seeking treaty benefits under subparagraph f)) is a wholly owned subsidiary of R1, which in turn is wholly owned by Z, an individual. R1, R2 and Z are all residents of the other Contracting State under Article 4. R2 and R1 are both members of the same tax consolidation group. The ownership test in subdivision (i) of subparagraph f) is satisfied because Z, a qualified person under subparagraph a), owns indirectly at least 50 per cent of the aggregate vote and value of R2, and R1 is a qualifying intermediate owner.*

During the relevant taxable period, R2 has 50 of exempt dividends paid by a company resident of a third State and 50 of interest arising in the first-mentioned State. R2 makes

a deductible interest payment of 24 to an ineligible person and pays a 51 dividend to R1. In addition to the 51 dividend that it receives from R2, R1 receives additional income of 100 from persons outside the tested group. R1 makes a deductible interest payment of 51 to an ineligible person. R2 is seeking to claim the benefits of Article 11 of the Convention, but not of Article 10.

For purposes of applying the tested group base erosion test, the tested group consists of R1 and R2. The tested group's gross income for this purpose is 150 (50 of interest arising in the first-mentioned State plus 100 of additional income from persons outside of the tested group). R2 has made a base eroding payment of 24 and R1 has made a base eroding payment of 51 to ineligible persons. The base eroding payments of the tested group total 75 (24 + 51), which is not less than 50 per cent of the tested group's gross income of 150. Therefore, the base erosion test is not satisfied and R2 is not a qualified person under subparagraph f).

- *Example B: Assume the same facts as Example A above, except that the income with respect to which R2 seeks to be a qualified person is 50 of dividends paid by a company resident of the first-mentioned State instead of 50 of interest arising in that State. For this purpose, R2's gross income is 100 (the 50 of dividends paid by a company resident of a third State and the 50 of dividends paid by a company of the first-mentioned State). The gross income of the tested group is 200 (R2's gross income of 100 plus R1's income of 100 from persons outside the tested group). R2 has made a base eroding payment of 24 and R1 has made a base eroding payment of 51. The base eroding payments of R2 equal 24, which is less than 50 per cent of R2's gross income of 100. In addition, the base eroding payments of the tested group total 75 (24 + 51), which is less than 50 per cent of the tested group's gross income of 200. Therefore, under this example, the base erosion test of subdivision (ii) is satisfied and R2 shall be a qualified person under subparagraph f) for purposes of obtaining a lower rate of taxation on the dividend paid by the company resident of the first-mentioned State.*

Subparagraph g): Collective investment vehicles

Detailed version only

g) [possible provision on collective investment vehicles]¹

Commentary on subparagraph g) of paragraph 2 of the detailed version

55. As indicated in the footnote to subparagraph g), whether a specific rule concerning collective investment vehicles (CIVs) should be included in paragraph 2, and, if so, how that rule should be drafted, will depend on how the Convention applies to CIVs and on the treatment and use of CIVs in each Contracting State.² Whilst no such rule will be needed with respect to an entity that would otherwise constitute a “qualified person” under other parts of paragraph 2,

1 This subparagraph should be drafted (or omitted) based on how collective investment vehicles are treated in the Convention and are used and treated in each Contracting State: see the Commentary on the subparagraph and paragraphs 22 to 48 of the Commentary on Article 1.

2 See also paragraphs 67.1 to 67.7 of the Commentary on Article 10 and the report “Tax Treaty Issues Related to REITs” which deal with the treaty entitlement of Real Estate Investment Trusts (REITs). With respect to the application of the definition of “resident of a Contracting State” to REITs, see paragraphs 8-9 of the report “Tax Treaty Issues Related to REITs”.

a specific rule will frequently be needed since a CIV may not be entitled to treaty benefits under either the other provisions of paragraph 2 or under paragraphs 3, 4 or 5 because, in many cases

- the interests in the CIV are not publicly-traded (even though these interests are widely distributed);*
- these interests are held by residents of third States;*
- the distributions made by the CIV are deductible payments;*
- the CIV is used for investment purposes rather than for the “active conduct of a business” within the meaning of paragraph 3;*
- the CIV does not meet the ownership test of paragraph 4, and*
- the CIV does not qualify as a headquarters company under paragraph 5.*

56. Paragraphs 22 to 48 of the Commentary on Article 1 discuss various factors that should be considered for the purpose of determining the treaty entitlement of CIVs and these paragraphs are therefore relevant when determining whether a provision on CIVs should be included in paragraph 2 and how it should be drafted. These paragraphs include alternative provisions that may be used to deal adequately with the CIVs that are found in each Contracting State. As explained below, the use of these provisions may make it unnecessary to include a specific rule on CIVs in paragraph 2, although it will be important to make sure that, in such a case, the definition of “equivalent beneficiary”, if the term is used for the purposes of one of these alternative provisions, is adapted to reflect the definition included in paragraph 7.

57. If it is included, subparagraph g) will address cases where a Contracting State agrees that CIVs established in the other Contracting State constitute residents of that other State under the analysis in paragraphs 23 to 26 of the Commentary on Article 1 (such agreement may be evidenced by a mutual agreement as envisaged in paragraph 30 of the Commentary on Article 1 or may result from judicial or administrative pronouncements). The provisions of the Article, including subparagraph g), are not relevant with respect to a CIV that does not qualify as a resident of a Contracting State under the analysis in paragraphs 23 to 26 of the Commentary on Article 1. Also, the provisions of subparagraph g) are not relevant where the treaty entitlement of a CIV is dealt with under a treaty provision similar to one of the alternative provisions in paragraphs 31, 35, 40, 41 and 46 of the Commentary on Article 1.

58. As explained in paragraphs 33 and 34 of the Commentary on Article 1, Contracting States wishing to address the issue of CIVs’ entitlement to treaty benefits may want to consider the economic characteristics, including the potential for treaty shopping, of the different types of CIVs that are used in each Contracting State.

59. As a result of that analysis, they may conclude that the tax treatment of CIVs established in the two States does not give rise to treaty-shopping concerns and decide to include in their bilateral treaty the alternative provision in paragraph 31 of the Commentary on Article 1, which would expressly provide for the treaty entitlement of CIVs established in each State and, at the same time, would ensure that they constitute qualified persons under subparagraph a) of paragraph 2 of the Article (because a CIV to which that alternative provision would apply would be treated as an individual). In such a case, subparagraph g) should be omitted. States that share the view that CIVs established in the two States do not give rise to treaty shopping concerns but that do not include in their treaty the alternative provision in paragraph 31 of the Commentary on Article 1 should ensure that any CIV that is a resident of a Contracting State should constitute a qualified person. In that case, subparagraph g) should be drafted as follows:

- g) *a collective investment vehicle [a definition of “collective investment vehicle” would then be included in paragraph 7];*

60. *The Contracting States could, however, conclude that CIVs present the opportunity for residents of third States to receive treaty benefits that would not have been available if these residents had invested directly and, for that reason, might prefer to draft subparagraph g) in a way that will ensure that a CIV that is a resident of a Contracting State will constitute a qualified person but only to the extent that the beneficial interests in the CIV are owned by equivalent beneficiaries. In that case, subparagraph g) should be drafted as follows:*

- g) *a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by [residents of the Contracting State in which the collective investment vehicle is established or by]¹ equivalent beneficiaries.*

61. *That treatment corresponds to the treatment that would result from the inclusion in a tax treaty of a provision similar to the alternative provision in paragraph 35 of the Commentary on Article 1. As explained in paragraphs 32 to 38 of the Commentary on Article 1, the inclusion of such an alternative provision would provide a more comprehensive solution to treaty issues arising in connection with CIVs because it would address treaty-shopping concerns whilst, at the same time, clarifying the tax treaty treatment of CIVs in both Contracting States. If that alternative provision is included in a tax treaty, subparagraph g) would not be necessary as regards the CIVs to which that alternative provision would apply: since that alternative provision provides that a CIV to which it applies shall be treated as an individual (to the extent that the beneficial interests in that CIV are owned by equivalent beneficiaries), that CIV will constitute a qualified person under subparagraph a) of paragraph 2 of the Article.*

62. *The approach described in the preceding two paragraphs, like the approach in paragraphs 35, 40 and 42 of the Commentary on Article 1, makes it necessary for the CIV to make a determination, when a benefit is claimed as regards a specific item of income, regarding the proportion of holders of interests who would have been entitled to benefits had they invested directly. As indicated in paragraph 43 of the Commentary on Article 1, however, the ownership of interests in CIVs changes regularly, and such interests frequently are held through intermediaries. For that reason, the CIV and its managers often do not themselves know the names and treaty status of the beneficial owners of interests. It would therefore be impractical for the CIV to collect such information from the relevant intermediaries each time the CIV receives income. Accordingly, Contracting States should be willing to accept practical and reliable approaches that do not require such daily tracing. As indicated in paragraph 45 of the Commentary on Article 1, the proportion of investors in the CIV is likely to change relatively slowly even though the identity of individual investors will change daily. For that reason, the determination of the extent to which the beneficial interests in a CIV are owned by equivalent beneficiaries should be made at regular intervals, the determination made at a given time being applicable to payments received until the following determination. This corresponds to the approach described in paragraph 45 of the Commentary on Article 1, according to which:*

... it would be a reasonable approach to require the CIV to collect from other intermediaries, on specified dates, information enabling the CIV to determine the

¹ *The words “residents of the Contracting State in which the collective investment vehicle is established” would not be needed if the definition of “equivalent beneficiary” used for the purpose of that provision was identical to the detailed version of the definition of the term “equivalent beneficiary” in paragraph 7; see paragraph 145 below.*

proportion of investors that are treaty-entitled. This information could be required at the end of a calendar or fiscal year or, if market conditions suggest that turnover in ownership is high, it could be required more frequently, although no more often than the end of each calendar quarter. The CIV could then make a claim on the basis of an average of those amounts over an agreed-upon time period. In adopting such procedures, care would have to be taken in choosing the measurement dates to ensure that the CIV would have enough time to update the information that it provides to other payers so that the correct amount is withheld at the beginning of each relevant period.

63. *Another view that Contracting States may adopt regarding CIVs is that expressed in paragraph 40 of the Commentary on Article 1. Contracting States that adopt that view may wish to draft subparagraph g) so that a CIV that is a resident of a Contracting State would only constitute a qualified person to the extent that the beneficial interests in that CIV are owned by residents of the Contracting State in which the CIV is established. In that case, subparagraph g) should be drafted as follows:*

- g) a collective investment vehicle, but only to the extent that, at that time, the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established.*

Since the inclusion of the alternative provision in paragraph 40 of the Commentary on Article 1 would achieve the same result with respect to the CIVs to which it would apply, subparagraph g) would not be necessary, if that alternative provision is included in a treaty, as regards the CIVs to which that provision would apply.

64. *A variation on the preceding approach would be to consider that a CIV that is a resident of a Contracting State should constitute a qualified person if the majority of the beneficial interests in that CIV are owned by individuals who are residents of the Contracting State in which the CIV is established. This result could be achieved by omitting subparagraph g) and simply relying on the application of subparagraph f) (the ownership and base erosion test).*

65. *Another possible view that the Contracting States could adopt would be to conclude that the fact that a substantial proportion of the CIV's investors are treaty-eligible is adequate protection against treaty shopping, and thus that it is appropriate to provide an ownership threshold above which benefits would be provided with respect to all income received by a CIV. An alternative provision that would ensure that result is included in paragraph 41 of the Commentary on Article 1 and subparagraph g) would not be necessary, if the Contracting States include that provision in their bilateral treaty, with respect to the CIVs to which the provision would apply. If that provision is not included in the treaty, the scope of subparagraph g) could be broadened in order to achieve a similar result by referring to "a collective investment vehicle, but only if [percentage to be determined bilaterally] per cent of the beneficial interests in the collective investment vehicle are owned by residents of the Contracting State in which the collective investment vehicle is established and by equivalent beneficiaries".*

66. *Similarly, the Contracting States may use the alternative provision in paragraph 46 of the Commentary on Article 1 where they consider "that a publicly-traded collective investment vehicle cannot be used effectively for treaty shopping because the shareholders or unit holders of such a collective investment vehicle cannot individually exercise control over it". In such case, subparagraph g) would not be necessary with respect to the CIVs to which the alternative provision would apply. States that share that view but that have not included the alternative provision in their treaty could draft subparagraph g) to read:*

- g) a collective investment vehicle if the principal class of shares in the collective investment vehicle is listed and regularly traded on a recognised stock exchange.*

67. Finally, as explained in paragraph 39 of the Commentary on Article 1, States that share the concern described in that paragraph about the potential deferral of taxation that could arise with respect to a CIV that is subject to no or low taxation and that may accumulate its income rather than distributing it on a current basis may wish to negotiate provisions that extend benefits only to those CIVs that are required to distribute earnings currently. Depending on their drafting, such provisions may render subparagraph g) unnecessary.

Paragraph 3: active conduct of a business

Simplified and detailed versions

3. a) *A resident of a Contracting State shall be entitled to benefits under this Convention with respect to an item of income derived from the other Contracting State, regardless of whether the resident is a qualified person, if the resident is engaged in the active conduct of a business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank or [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer respectively), and the income derived from the other State emanates from, or is incidental to, that business. For purposes of this Article, the term "active conduct of a business" shall not include the following activities or any combination thereof:*
- (i) operating as a holding company;*
 - (ii) providing overall supervision or administration of a group of companies;*
 - (iii) providing group financing (including cash pooling); or*
 - (iv) making or managing investments, unless these activities are carried on by a bank [list financial institutions similar to banks that the Contracting States agree to treat as such], insurance enterprise or registered securities dealer in the ordinary course of its business as such.*
- b) *If a resident of a Contracting State derives an item of income from a business activity conducted by that resident in the other Contracting State, or derives an item of income arising in the other State from a connected person, the conditions described in subparagraph a) shall be considered to be satisfied with respect to such item only if the business activity carried on by the resident in the first-mentioned State to which the item is related is substantial in relation to the same or complementary business activity carried on by the resident or such connected person in the other Contracting State. Whether a business activity is substantial for the purposes of this paragraph shall be determined based on all the facts and circumstances.*
- c) *For purposes of applying this paragraph, activities conducted by connected persons with respect to a resident of a Contracting State shall be deemed to be conducted by such resident.*

Commentary on paragraph 3 of the simplified and detailed versions

68. *Paragraph 3 of both the simplified and detailed versions sets forth an alternative test under which a resident of a Contracting State may receive treaty benefits with respect to certain items of income that are connected to an active business conducted in its State of residence. This paragraph recognises that where an entity resident of a Contracting State actively carries on business activities in that State, including activities conducted by connected persons, and derives income from the other Contracting State that emanates from, or is incidental to, such business activities, granting treaty benefits with respect to such income does not give rise to treaty-shopping concerns regardless of the nature and ownership of the entity. The paragraph will provide treaty benefits in a large number of situations where benefits would otherwise be denied under paragraph 1 because the entity is not a “qualified person” under paragraph 2.*

69. *A resident of a Contracting State may qualify for benefits under paragraph 3 regardless of the fact that it is not a qualified person under paragraph 2. Under the active-conduct test of paragraph 3, a person (typically a company) will be eligible for treaty benefits if it satisfies two conditions: first, it is engaged in the active conduct of a business in its State of residence and second, the payment for which benefits are sought is related to the business. In certain cases, an additional requirement that the business be substantial in size relative to the activity in the State of source generating the income must be met.*

70. *Subparagraph a) sets forth the general rule that a resident of a Contracting State engaged in the active conduct of a business in that State may obtain the benefits of the Convention with respect to an item of income derived from the other Contracting State. The item of income, however, must emanate from, or be incidental to, that business.*

71. *The term “business” is not defined (except for the limited purpose of clarifying that it includes the performance of professional services and of other activities of an independent character; see subparagraph h) of paragraph 1 of Article 3) and, under the general rule of paragraph 2 of Article 3, must therefore be given the meaning that it has under domestic law. An entity generally will be considered to be engaged in the active conduct of a business only if persons through whom the entity is acting (such as officers or employees of a company) conduct substantial managerial and operational activities.*

72. *Under subparagraph a), the business of making or managing investments for the resident’s own account is not considered to be a business unless the relevant activities are part of banking, insurance or securities activities conducted by a bank, or a financial institution that the Contracting States would consider to be similar to a bank (such as a credit union or building society), an insurance enterprise or a registered securities dealer respectively. Such activities conducted by a person other than a bank (or financial institution agreed to by the Contracting States), insurance enterprise or registered securities dealer will not be considered to be the active conduct of a business, nor would they be considered to be the active conduct of a business if conducted by a bank (or financial institution agreed to by the Contracting States), insurance enterprise or registered securities dealer but not as part of the enterprise’s banking, insurance or dealer business.*

73. *In addition, subdivisions (i) through (iv) of subparagraph a) identify specific functions that, either on their own or in combination, will be considered, for purposes of paragraph 3, not to constitute the active conduct of a business in a Contracting State, even when all such functions are conducted in the same State. These are: (i) operating as a holding company; (ii) providing overall supervision or administration of a group of companies; (iii) providing*

group financing (including cash pooling); and (iv) making or managing investments, unless these activities are carried on by a regulated bank (or financial institution agreed to by the Contracting States), insurance company or registered securities dealer in the ordinary course of its business as such. This list of activities is intended to clarify that the administrative support functions of multinationals, as well as the activities of operating as a holding company, do not constitute the active conduct of a business and, therefore, income that emanates from, or is incidental to, such activities cannot be entitled to treaty benefits under paragraph 3. Some States consider, however, that some or all of the activities listed in subdivisions (i) through (iv) should be included in what constitutes the active conduct of a business and these States may therefore wish to adopt a different formulation of subparagraph a).

74. Whether an item of income emanates from the company's active conduct of a business in the State of residence must be determined based on facts and circumstances. In general, an item of income emanates from the active conduct of a business in the State of residence if there is a factual connection between the actively conducted business and the item of income for which benefits are sought. For example, if a company conducts research and development in its State of residence and develops a patent for a new process, royalties from licensing the patent would be factually connected to the actively conducted business in the State of residence. In the case of dividends or interest paid to a parent company, the activities of the paying company will be relevant in determining whether the dividend or interest emanates from the parent's actively conducted business in its State of residence.

75. For the purposes of determining whether the activities of the paying company in the State of source have the required factual connection with the actively conducted business in the State of residence, it will be important to compare the lines of business in each State. The line of business in the State of source may be upstream or downstream to the activity conducted in the State of residence. Thus, the line of business in the State of source may provide inputs for a manufacturing process that occurs in the State of residence, or the line of business in the State of source may sell the output of the manufacturing process conducted by a resident. The following examples illustrate these principles:

- Example A: ACO is a company resident of State A and is engaged in the active conduct of a business in that State consisting in manufacturing product X. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO acquires product X from ACO and distributes it to customers in State B. Since the distribution activity by BCO of product X is factually connected to ACO's manufacturing of that product, dividends paid by BCO to ACO will be treated as emanating from ACO's business.*
- Example B: ACO is a company resident of State A that operates a large research and development facility in State A that develops intellectual property that it licenses to affiliates worldwide, including BCO. ACO owns 100 per cent of the shares of BCO, a company resident of State B. BCO manufactures and markets the ACO-designed products in State B. Since the activities conducted by BCO are factually connected to ACO's actively conducted business in State A, royalties paid by BCO to ACO for the use of its intellectual property will be treated as emanating from ACO's business.*
- Example C: ACO is a company resident of State A and is engaged in State A in the active conduct of a manufacturing business that requires the use of commodity X. ACO owns 100 per cent of the shares of BCO, a company resident of State B, which contains a large supply of commodity X. BCO extracts commodity X and sells it to ACO, which uses the commodity to manufacture goods that it sells in the open market. Since the business activity conducted by BCO provides upstream inputs to ACO for use in manufacturing its goods, BCO's business is factually connected to ACO's*

manufacturing activities in State A. Dividends paid by BCO to ACO will be treated as emanating from ACO's business.

76. *An item of income derived from the State of source is "incidental to" the business carried on in the State of residence if production of the item facilitates the conduct of the business in the State of residence. An example of incidental income is income derived from the temporary investment of working capital of a person in the State of residence in securities issued by persons in the State of source.*

77. *Subparagraph b) of paragraph 3 states a further condition to the general rule in subparagraph a) in cases where the business generating the item of income in question is carried on either by the person deriving the income or by a connected person in the State of source. Subparagraph b) states that the business carried on in the State of residence, under these circumstances, must be substantial in relation to the activity in the State of source. The determination of substantiality is based upon all the facts and circumstances, including the comparative sizes of the businesses in each Contracting State, the relative sizes of the economies and markets in the two States, the nature of the activities performed in each State, and the relative contributions made to that business in each State.*

78. *The determination of whether subparagraph b) applies is made separately for each item of income derived from the State of source, with reference to the business in the State of residence from which the item of income in question emanates. It is therefore possible that a person would be entitled to the benefits of the Convention with respect to one item of income but not with respect to another. If a resident of a Contracting State is entitled to treaty benefits with respect to a particular item of income under paragraph 3, the resident is entitled to all the benefits of the Convention insofar as they affect the taxation of that item of income in the State of source.*

79. *The substantiality requirement under subparagraph b) will not apply, however, if the business generating the item of income in question is not carried on in the State of source by the resident seeking benefits or by a connected person in the State of source. For example, if a small research firm in one State develops a process that it licenses to a very large pharmaceutical manufacturer in another State that is not a connected person with respect to the small research firm, the size of the business activity of the research firm in the first State would not have to be tested against the size of the business activity of the manufacturer. Similarly, a small bank of one State that makes a loan to a very large company that is not a connected person and that is operating a business in the other State would not have to pass a substantiality test to be eligible for treaty benefits under paragraph 3.*

80. *Subparagraph c) provides attribution rules in the case of activities conducted by connected persons for purposes of applying the substantive rules of subparagraphs a) and b). Thus, these rules apply for purposes of determining whether a person meets the requirement in subparagraph a) that it be engaged in the active conduct of a business and that the item of income emanates from that active business, and for making the comparison required by the "substantiality" requirement in subparagraph b). The term "connected person" is defined in paragraph 7.*

81. *The following examples illustrate the application of paragraph 3 in relation to activities conducted by connected persons:*

- Example A: PARENTCO is a resident of a third State and is the parent of HOLDCO, which itself is the parent of OPCO1 and OPCO2. OPCO1 and HOLDCO are residents of State A. OPCO2 is a resident of State B. OPCO1 and OPCO2 are engaged in the*

business of manufacturing the same product in their respective States of residence. HOLDCO manages the investments of the group and is considered not to be engaged in the active conduct of a business. HOLDCO receives dividends from OPCO2. Under subparagraph c), HOLDCO is deemed to be engaged in the active conduct of a business because it is deemed to conduct the activities of OPCO 1, which is engaged in the active conduct of a business. Therefore, HOLDCO is treated as engaged in the active conduct of a business in State A. Nevertheless, the fact that HOLDCO's deemed business is the same as the business of OPCO2 is not sufficient to demonstrate that the dividends paid by OPCO 2 are factually connected to HOLDCO's actively conducted business. Accordingly, such dividends will not enjoy by virtue of paragraph 3 the reduced rates of withholding of Article 10 of the convention between States A and B.

- *Example B: ACO is a company resident of State A and is engaged in State A in the active conduct of a manufacturing business that requires the use of commodity X. All the shares of ACO are owned by HOLDCO, also a resident of State A, which also owns 100 per cent of the shares of BCO, a company resident of State B where there is a large supply of commodity X. BCO extracts commodity X and sells it to ACO, which uses the commodity to manufacture goods that it sells in the open market. HOLDCO is considered to be engaged in the active conduct of a business because it is deemed under subparagraph c) to conduct the activities of ACO. Since the business activity conducted by BCO provides upstream inputs for use in HOLDCO's deemed active conduct of a business, BCO's business is considered to be factually connected to HOLDCO's deemed manufacturing business, Dividends paid by BCO to HOLDCO will therefore emanate from HOLDCO's deemed active conduct of a business.*

Paragraph 4: derivative benefits

Simplified version

4. *A resident of a Contracting State that is not a qualified person shall nevertheless be entitled to a benefit that would otherwise be accorded by this Convention with respect to an item of income if, at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, persons that are equivalent beneficiaries own, directly or indirectly, at least 75 per cent of the shares of the resident.*

Detailed version

[The question of how the derivative benefits paragraph should be drafted in a convention that follows the detailed version is discussed in the Commentary below]

Commentary on paragraph 4 of the simplified version

82. *Paragraph 4 of the simplified version sets forth a derivative benefits test that is potentially applicable to all treaty benefits, although the test must be applied to each individual item of income. This derivative benefits test entitles companies and entities that are residents of a Contracting State but that are not qualifying persons under paragraph 2 to be entitled to treaty benefits with respect to an item of income if, at the time that the benefit would otherwise be granted with respect to that item of income and on at least half of the days of any twelve-month period that includes that time, at least 75 per cent of the shares (as defined in paragraph 7) of that company or entity are owned, directly or indirectly, by persons that satisfy the definition of*

“equivalent beneficiary” found in paragraph 7. The definition of “equivalent beneficiary”, which is crucial for the application of paragraph 4, basically refers to persons who would have been entitled to equivalent or more favourable benefits from the State of source if they had received the same income directly (subject to the conditions included in that definition).

Commentary on paragraph 4 of the detailed version

83. The drafting of the derivative benefits paragraph in a convention that follows the detailed version depends on the views of the Contracting States concerning treaty-shopping opportunities that might arise from such a paragraph with respect to residents of States whose tax system includes certain preferential features.

84. As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income that is paid to connected persons (as defined in paragraph 7) that benefit from regimes that constitute “special tax regimes” (see paragraphs 85 to 106 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). These States may want to ensure that any derivative benefits provisions included in their conventions do not allow base eroding payments to be made to such connected persons even if they qualify as equivalent beneficiaries. States that share these views are likely to want to adopt a derivative benefits paragraph drafted as follows:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if:

- a) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, at least 95 per cent of the aggregate vote and value of its shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and*
- b) less than 50 per cent of the person’s gross income, and less than 50 per cent of the tested group’s gross income for the taxable period that includes that time, as determined in the person’s Contracting State of residence, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person’s Contracting State of residence (but not including arm’s length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)*
 - (i) to persons that are not equivalent beneficiaries;*
 - (ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation;*
 - (iii) to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from a special tax regime, as defined in [reference to the paragraph of the convention that includes the definition of “special tax regime”] of this*

Convention, with respect to the deductible payment, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of a special tax regime analogous to the definition of that term included in this Convention, the principles of that definition shall apply, but without regard to the requirement in subdivision (v) of that definition; or

- (iv) with respect to a payment of interest, to persons that are equivalent beneficiaries that are connected persons with respect to the company described in this paragraph and that benefit from notional deductions of the type described in [reference to the paragraph of Article 11 that relates to notional deductions for equity].*

85. States that do not consider that provisions on special tax regimes and notional deductions with respect to equity should be included in their tax treaties, however, may prefer to use the following version of the derivative benefits paragraph:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded by this Convention if:

- a) at the time when the benefit otherwise would be accorded and on at least half of the days of any twelve-month period that includes that time, at least 95 per cent of the aggregate vote and value of its shares (and at least 50 per cent of the aggregate vote and value of any disproportionate class of shares) is owned, directly or indirectly, by seven or fewer persons that are equivalent beneficiaries, provided that in the case of indirect ownership, each intermediate owner is a qualifying intermediate owner, and*
- b) less than 50 per cent of the person's gross income, and less than 50 per cent of the tested group's gross income for the taxable period that includes that time, as determined in the person's Contracting State of residence, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property, and in the case of a tested group, not including intra-group transactions)*
 - (i) to persons that are not equivalent beneficiaries; or*
 - (ii) to persons that are equivalent beneficiaries only by reason of paragraph 5 of this Article or of a substantially similar provision in the relevant comprehensive convention for the avoidance of double taxation;*

86. Some States, however, may consider that the provisions of a derivative benefits paragraph drafted along the lines of the provision included in the previous paragraph create unacceptable risks of treaty shopping with respect to payments that are deductible in the State of source. Instead of not providing any derivative benefits, these States might prefer to restrict the scope of that provision to dividends, which are typically not deductible. States that share that view are free to amend the first part of the alternative provision so that it reads as follows:

4. A company that is a resident of a Contracting State shall also be entitled to a benefit that would otherwise be accorded under Article 10 if:

87. Whether drafted as suggested in paragraph 84 or in paragraph 85 above, paragraph 4 on derivative benefits sets forth an alternative test under which a resident of a Contracting State

that is not a qualified person under paragraph 2 may receive treaty benefits with respect to certain items of income. In general, this derivative benefits test entitles a company that is a resident of a Contracting State to treaty benefits if 95 per cent of the vote and value of its shares are owned, directly or indirectly, by seven or fewer equivalent beneficiaries and the company satisfies a base erosion test. The requirement that at least 95 per cent of the vote and value of the company seeking treaty benefits under paragraph 4 be owned, directly or indirectly, by seven or fewer equivalent beneficiaries is intended to avoid the administrative burden of having to determine whether a large number of shareholders are equivalent beneficiaries; it is also consistent with the objective of the derivative benefits test to provide benefits for holding companies of a multinational group in the situations contemplated by the provision.

88. Subparagraph a) sets forth the ownership test. Under this test, seven or fewer equivalent beneficiaries must own, directly or indirectly, shares representing at least 95 per cent of the aggregate vote and value of the company and at least 50 per cent of any disproportionate class of shares on at least half of the days of any twelve-month period that includes the date when benefits would otherwise be accorded. In the case of indirect ownership, each intermediate owner must be a qualifying intermediate owner. The term “qualifying intermediate owner” is defined in paragraph 7 (see paragraphs 151 to 154 below); the following example illustrates the application of that definition in the context of paragraph 4:

- Example: HOLDCO, a company resident of State A, is a wholly owned direct subsidiary of ZCO, a company resident of State Z, which itself is a wholly owned direct subsidiary of XCO, a resident of State X. XCO’s principal class of shares is primarily and regularly traded on the stock exchange in State X. HOLDCO is not entitled to benefits under paragraph 2 of the treaty between States A and B because it is a subsidiary of a company resident and publicly traded in a third state. HOLDCO is not engaged in the conduct of an active business in State A, and therefore it is not entitled to any benefits under paragraph 3. HOLDCO derives and beneficially owns interest arising in State B that would otherwise be entitled to the benefits of Article 11 of the treaty between States A and B. Assume that by virtue of the provisions of the income tax convention between State B and State X, XCO qualifies as an equivalent beneficiary under the definition of that term included in the treaty between States A and B.*

Although XCO indirectly owns all the shares of HOLDCO, ZCO, as an intermediate owner, must satisfy the definition of “qualifying intermediate owner” in paragraph 7 of the treaty between States A and B in order for HOLDCO to be eligible for the benefits of Article 11 of the treaty between States A and B with respect to the interest that it received from State B. If State Z does not have in effect a comprehensive convention for the avoidance of double taxation (or, if the definition of qualifying intermediate owner is drafted as suggested in paragraph 153 below, such a convention is in effect but ZCO benefits from either a “special tax regime” or notional interest deductions), ZCO will not be a qualifying intermediate owner and the requirements of subparagraph a) will not be satisfied with the result that HOLDCO will not be eligible, under paragraph 4, for the benefits of the convention.

89. Subparagraph b) sets forth the base erosion test applicable for purposes of paragraph 4. That test is broadly similar to the base erosion test in subdivision (ii) of subparagraph f) of paragraph 2 except that the list of ineligible persons is different (see below). The base erosion test of subparagraph b) is satisfied if

- less than 50 per cent of the company’s gross income (and less than 50 per cent of the tested group’s gross income if there is a tested group), for the taxable period that*

includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the company's tax in its State of residence, and

- less than 50 per cent of the tested group's gross income (if there is a tested group), for the taxable period that includes the time when the benefits are claimed, is paid or accrued, directly or indirectly, in the form of payments to ineligible persons that are deductible, for tax purposes, in computing the tax of any member of the tested group in the State of residence of the company claiming the treaty benefits.*

90. *Paragraph 7 includes the definition of the terms "tested group" and "gross income" which are used in subparagraph b). Also, the term "ineligible persons" used in the previous paragraph refers to:*

- if paragraph 4 is drafted as indicated in paragraph 84 above, persons who are not equivalent beneficiaries under the definition of that term in paragraph 7 as well as persons who are equivalent beneficiaries under that definition but fall within one of the three following categories:
 - 1. they are equivalent beneficiaries solely by reason of being a headquarters company under paragraph 5 of this Convention or of the relevant convention;*
 - 2. they are connected persons (as defined in paragraph 7) with the company seeking treaty benefits under paragraph 4 and benefit from a special tax regime with respect to the payment, or*
 - 3. with respect to a payment of interest, they are connected persons (as defined in paragraph 7) with the company seeking treaty benefits under paragraph 4 and benefit from notional deductions for equity.**
- if paragraph 4 is drafted as indicated in paragraph 85 above, persons who are not equivalent beneficiaries under the definition of that term in paragraph 7 as well as persons who are equivalent beneficiaries under that definition solely by reason of being a headquarters company under paragraph 5 of this Convention or of the relevant convention.*

91. *The following illustrates the base erosion test of paragraph 4:*

- Example: Company X, a resident of State X, owns Company Y, a resident of State Y. Company Y owns Company B, a resident of State B that seeks benefits of the treaty between States A and B under paragraph 4. Company X is an equivalent beneficiary and Company Y is a qualifying intermediate owner under the definitions of these terms in paragraph 7 of the treaty between States A and B. Accordingly, Company B would satisfy the ownership requirement of subparagraph a) because, first, Company X, an equivalent beneficiary, indirectly owns shares representing at least 95 per cent of the aggregate vote and value of Company B and at least 50 per cent of any disproportionate class of shares (as defined in paragraph 7), and, second, each intermediate owner (i.e. Company Y) is a qualifying intermediate owner.*

Company B's gross income for the taxable period in question consists of 100 of interest arising in State A and 200 of dividends from a third State which is exempt from tax under the law of State B. Company B seeks treaty benefits with respect to the 100 of interest. Under the law of State B, Company B, Company Y and Company X are not allowed to participate in a common tax consolidation or other regime that would allow

the three companies to share profits or losses nor is there any loss sharing regime available. Accordingly, in this example, there is no tested group. Company B's gross income is 100 (the interest arising in State A). Company B will fail the base erosion test of subparagraph b) if Company B makes base eroding payments of at least 50 to ineligible persons described in the previous paragraph.

Paragraph 5 (detailed version): headquarters company

Detailed version only

5. A company that is a resident of a Contracting State that functions as a headquarters company for a multinational corporate group consisting of such company and its direct and indirect subsidiaries shall be entitled to benefits under this Convention with respect to dividends and interest paid by members of its multinational corporate group, regardless of whether the resident is a qualified person. A company shall be considered a headquarters company for this purpose only if:

- a) such company's primary place of management and control is in the Contracting State of which it is a resident;
- b) the multinational corporate group consists of companies resident of, and engaged in the active conduct of a business in, at least four States, and the businesses carried on in each of the four States (or four groupings of States) generate at least 10 per cent of the gross income of the group;
- c) the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company generate less than 50 per cent of the gross income of the group;
- d) no more than 25 per cent of such company's gross income is derived from the other Contracting State;
- e) such company is subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3 of this Article; and
- f) less than 50 per cent of such company's gross income, and less than 50 per cent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2.

If the requirements of subparagraph b), c) or d) of this paragraph are not fulfilled for the relevant taxable period, they shall be deemed to be fulfilled if the required ratios are met when averaging the gross income of the preceding four taxable periods.

Commentary on paragraph 5 of the detailed version

92. Paragraph 5 sets forth an alternative test under which a resident of a Contracting State that is a headquarters company and that is not a qualified person under paragraph 2 may receive treaty benefits with respect to dividends and interest paid by members of the company's

multinational corporate group. A headquarters company's multinational corporate group means the company and its direct and indirect subsidiaries (and does not include upper-tier companies).

93. *A company seeking to qualify for benefits as a headquarters company must satisfy six conditions. First, under subparagraph a), the headquarters company's primary place of management and control, as defined in paragraph 7, must be in the Contracting State of which it is a resident. The same test is applied for publicly-traded companies. Subdivision (ii) of the definition of "primary place of management and control" allows the possibility that, in certain limited cases, the management of a subgroup (such as a subgroup responsible for a regional area) may be exercised more by a company that is not the top-tier company for the entire group of connected companies, and in certain narrow cases a lower-tier company may satisfy the headquarters company test.*

94. *Second, under subparagraph b), the multinational corporate group must consist of companies resident of, and engaged in the active conduct of a business (as defined in paragraph 3) in, at least four States (including either Contracting State), and the businesses carried on in each of the four States (or four groupings of States) must generate at least 10 per cent of the gross income of the group. The application of this requirement is illustrated by the following example:*

- *Example: Company X is resident of State X and is a member of a multinational corporate group consisting of itself and its direct and indirect subsidiaries resident in States X, A, B, C, D, E and F. The gross income generated by each of these companies for year 01 and year 02 is as follows:*

<i>State</i>	<i>Year 01</i>	<i>Year 02</i>
<i>X</i>	<i>45</i>	<i>60</i>
<i>A</i>	<i>25</i>	<i>12</i>
<i>B</i>	<i>10</i>	<i>20</i>
<i>C</i>	<i>10</i>	<i>12</i>
<i>D</i>	<i>7</i>	<i>10</i>
<i>E</i>	<i>10</i>	<i>9</i>
<i>F</i>	<i>5</i>	<i>7</i>
<i>Total</i>	<i>112</i>	<i>130</i>

For year 01, 10 per cent of the gross income of this group is equal to 11,20. Only the companies in States X and A satisfy the requirement of subparagraph b) for that year. The other States may be aggregated into groupings to meet this requirement. Since States B and C have a total gross income of 20, and States D, E and F have a total gross income of 22, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph b).

For year 02, 10 per cent of the gross income is 13. Only the companies in States X and B satisfy this requirement. Since States A and C have a total gross income of 24, and States D, E and F have a total gross income of 26, these two groupings of countries may be treated as the third and fourth members of the group for purposes of subparagraph b). The fact that State A replaced State B in a group is not relevant for this purpose. The composition of the grouping may change annually.

95. *Third, under subparagraph c), the businesses of the multinational corporate group that are carried on in any one State other than the Contracting State of residence of such company*

must generate less than 50 per cent of the gross income (as defined in paragraph 7) of the group. A company whose multinational corporate group generates 50 per cent or more of the group's gross income in the Contracting State of source does not meet this condition.

96. Fourth, under subparagraph d), no more than 25 per cent of the company's gross income can be derived from the other Contracting State. Unlike the third condition described in the previous paragraph, this condition looks only at the gross income earned by the company seeking status as a headquarters company rather than the gross income earned by members of its multinational corporate group.

97. Fifth, under subparagraph e), such company must be subject to the same income taxation rules in its Contracting State of residence as persons described in paragraph 3. Therefore, such company must be subject to the general corporate taxation rules for companies that are engaged in the active conduct of a business in the Contracting State of residence, and not to a regime for headquarters companies.

98. Sixth, under subparagraph f), such company must satisfy a base erosion test that is broadly similar to the base erosion test in subdivision (ii) of subparagraph f) of paragraph 2 except that base eroding payments do not include payments in respect of financial obligations to a bank that is not a connected person with respect to the company. For example, unlike the base erosion test in subparagraph f) of paragraph 2, interest payments made by a company to a bank that is not a connected person to the company will not be treated as a base eroding payment for purposes of applying the base erosion test under paragraph 5. Paragraph 7 includes the definition of the terms "tested group" and "gross income" which are used for the purposes of this base erosion test.

99. As explained in paragraph 33 above which is applicable to the base erosion test of subparagraph d) of paragraph 2, States that want to deny the application of specific treaty provisions with respect to income that is paid to connected persons that benefit from regimes that constitute "special tax regimes" and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity, may also want to modify the base erosion test of subparagraph f) in order to include in the category of "ineligible persons" persons who, although they are residents of one of the Contracting States, benefit from such special tax regimes or notional deductions with respect to deductible payments made or accruing to them. This could be done by amending subparagraph f) as follows:

- f) less than 50 per cent of such company's gross income, and less than 50 per cent of the tested group's gross income, is paid or accrued, directly or indirectly, in the form of payments that are deductible for purposes of the taxes covered by this Convention in the company's Contracting State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property or payments in respect of financial obligations to a bank that is not a connected person with respect to such company, and in the case of a tested group, not including intra-group transactions):*
 - (i) to persons that are not residents of either Contracting State entitled to the benefits of this Convention under subparagraph a), b), c) or e) of paragraph 2;*
 - (ii) to persons that are connected persons with respect to such company and that benefit from a special tax regime as defined in [reference to the*

paragraph of the convention that includes the definition of “special tax regime”] with respect to the deductible payment; or

- (iii) with respect to a payment of interest, to persons that are connected persons with respect to the company referred to in this paragraph and that benefit from notional deductions of the type described in [reference to the paragraph of Article 11 that relates to notional deductions for equity].*

100. The six conditions of paragraph 5 must be tested with respect to the taxable year in which the company received the dividends or interest for which it is seeking benefits under the Convention. A company that does not satisfy the second, third or fourth conditions described above for the relevant taxable year may still be treated as a headquarters company if it satisfies such conditions by averaging the required ratios for the preceding four taxable periods (which does not include the taxable period that includes the payment for which a treaty benefit is being sought).

Paragraph 5 (simplified version) / 6 (detailed version): discretionary relief

Simplified and detailed versions

5/6. If a resident of a Contracting State is neither a qualified person pursuant to the provisions of paragraph 2 of this Article, nor entitled to benefits under paragraph 3[or 4 (simplified version)] [, 4 or 5 (detailed version)], the competent authority of the Contracting State in which benefits are denied under the previous provisions of this Article may, nevertheless, grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if such resident demonstrates to the satisfaction of such competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. The competent authority of the Contracting State to which a request has been made, under this paragraph, by a resident of the other State, shall consult with the competent authority of that other State before either granting or denying the request.

Commentary on paragraph 5 (simplified version) / 6 (detailed version)

101. Paragraph 5 of the simplified version and paragraph 6 of the detailed version provide that where, under the previous paragraphs of the Article, a resident of a Contracting State is not entitled to benefits of the Convention, that resident may request that the competent authority of the State in which benefits are denied under these paragraphs grant these benefits. The only difference between the simplified and the detailed versions relates to the cross-reference to the paragraphs of the Article under which benefits of the Convention are otherwise granted.

102. Where a request is made under paragraph 5 (simplified version) or paragraph 6 (detailed version), the competent authority to which that request is made may grant the benefits of this Convention, or benefits with respect to a specific item of income or capital, taking into account the object and purpose of this Convention, but only if the person who made the request demonstrates to the satisfaction of the competent authority that neither its establishment, acquisition or maintenance, nor the conduct of its operations, had as one of its principal purposes the obtaining of benefits under this Convention. Thus, persons that establish operations in one of the Contracting States with a principal purpose of obtaining the benefits of the Convention will not be granted benefits of the Convention under the paragraph.

103. In order to be granted benefits under the paragraph, a person must establish, to the satisfaction of the competent authority of the State from which benefits are being sought, that, first, there were clear non-tax business reasons for its formation, acquisition, or maintenance and for the conduct of its operations and, second, that the allowance of benefits would not otherwise be contrary to the object and purpose of the Convention. For the purposes of determining that neither the establishment, acquisition or maintenance, nor the conduct of the operations, of a resident of a Contracting State had as one of its principal purposes the obtaining of benefits under the Convention, one of the factors that the competent authority will typically take into account is whether or not the resident has a substantial non-tax nexus to its State of residence. For example, in the case of a resident subsidiary company with a parent in a third State, the fact that the relevant withholding rate provided in the Convention is at least as low as the corresponding withholding rate in the income tax convention between the State of source and the third State is not by itself evidence of a nexus or relationship to the other Contracting State. Similarly, a relationship or nexus to the treaty State cannot be established by a desire to take advantage of favourable domestic laws of the treaty State, including the existence of a network of tax treaties.

104. Also, discretionary benefits typically will not be granted if the benefit requested would result in no or minimal tax imposed on the item of income in both the State of residence of the applicant and the State of source, taking into account the domestic law of both Contracting States as well as the provisions and the object and purpose of the Convention. For example, double non-taxation may occur through the use of a hybrid instrument that generates a deduction in the State of source where the income from that instrument is treated as exempt in the State of residence. On the other hand, the fact that there is no or minimal tax in both States may not be inconsistent with the object and purpose of the Convention in the case of dividends paid by a company resident of one State to a company resident of the other State that owns a substantial part of the shares of the paying company where the provisions of the Convention reveal that the Contracting States intended these dividends to be subject to low or no taxation in both States.

105. Whilst it is impossible to provide a detailed list of all the facts and circumstances that would be relevant to the application of the paragraph, examples of such facts and circumstances include the history, structure, ownership and operations of the resident that makes the request, whether that resident is a long-standing entity that was recently acquired by non-residents for non-tax reasons, whether the resident carries on substantial business activities, whether the resident's income for which the benefits are requested is subject to double taxation and whether the establishment or use of the resident gives rise to non-taxation or reduced taxation of the income.

106. The reference to "one of its principal purposes" in the paragraph means that obtaining benefits under a tax treaty needs not be the sole or dominant purpose for the establishment, acquisition or maintenance of the person and the conduct of its operations. It is sufficient that at least one of the principal purposes was to obtain treaty benefits. Where the competent authority determines, having regard to all relevant facts and circumstances, that obtaining benefits under the Convention was not a principal consideration and would not have justified the establishment, acquisition or maintenance of the person and the conduct of its operations, it may grant that person these benefits, or benefits with respect to a specific item of income or capital. Where, however, the establishment, acquisition or maintenance of the person and the conduct of its operations is carried on for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will

prevent the obtaining of benefits under one treaty from being considered a principal purpose for these operations.

107. Although a request under the paragraph will usually be made by a resident of a Contracting State to the competent authority of the other Contracting State, there may be cases in which a resident of a Contracting State may request the competent authority of its own State of residence to grant relief under the paragraph. This would be the case if the treaty benefits that are requested are provided by the State of residence, such as the benefits of the provisions of Articles 23 A and 23 B concerning the elimination of double taxation.

108. The paragraph grants broad discretion to the competent authority and, as long as the competent authority has exercised that discretion in accordance with the requirements of the paragraph, it cannot be considered that the decision of the competent authority is an action that results in taxation not in accordance with the provisions of the Convention (see paragraph 1 of Article 25). The paragraph does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before granting or denying a request to grant benefits made by a resident of that other State. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request has been presented obtain the agreement of the competent authority that is consulted.

109. The competent authority to which a request is made under the paragraph may grant benefits but it may then grant all of the benefits of the Convention to the taxpayer making the request, or it may grant only certain benefits. For instance, it may grant benefits only with respect to a particular item of income in a manner similar to paragraph 3. Further, the competent authority may establish conditions, such as setting time limits on the duration of any relief granted.

110. The request for a determination under the paragraph may be presented before (e.g. through a ruling request) or after the establishment, acquisition or maintenance of the person for whom the request is made. The request must be presented, however, before benefits may be claimed. If the competent authority determines that benefits are to be allowed, it is expected that benefits will be allowed retroactively to the later of the time of entry into force of the relevant treaty provision or to the time of the establishment or acquisition of the person for whom the request is made, assuming that all relevant facts and circumstances justify granting the retroactive application of benefits.

111. The competent authority that receives a request for relief under the paragraph should process that request expeditiously.

112. To reduce the resource implications of having to consider requests for discretionary relief, and to discourage vexatious requests, a Contracting State may find it useful to publish guidelines on the types of cases that it considers will and will not qualify for discretionary relief. However, any administrative conditions that a Contracting State imposes on applicants should not deter persons from making requests where they consider that they have a reasonable prospect of satisfying a competent authority that benefits should be granted.

Paragraph 6 (simplified version) / 7 (detailed version): Definitions

Definitions (preamble)

Simplified and detailed versions

6/7. *For the purposes of this and the previous paragraphs of this Article:*

113. Paragraph 6 of the simplified version and paragraph 7 of the detailed version include a number of definitions that apply for the purposes of these paragraphs themselves as well as the previous paragraphs of the Article. These definitions supplement the definitions included in Articles 3, 4 and 5 of the Convention, which apply throughout the Convention.

The term “recognised stock exchange”

Simplified version

- a) *the term “recognised stock exchange” means:*
- (i) *any stock exchange established and regulated as such under the laws of either Contracting State; and*
 - (ii) *any other stock exchange agreed upon by the competent authorities of the Contracting States;*

Detailed version

- a) *the term “recognised stock exchange” means:*
- (i) *[list of stock exchanges agreed to at the time of signature]; and*
 - (ii) *any other stock exchange agreed upon by the competent authorities of the Contracting States;*

Commentary on the definition of “recognised stock exchange” in the simplified version

114. Subdivision (i) of the definition of “recognised stock exchange” in the simplified version applies to all stock exchanges established and regulated as such under the laws of either Contracting State. This general reference does not require a list of the stock exchanges established in each of these States.

115. Subdivision (ii) of the definition allows the competent authorities to agree to treat any other stock exchange as a “recognised stock exchange” for the purposes of paragraphs 1 to 6 of the Article. The possibility to treat stock exchanges established in third States as “recognised stock exchanges” takes account of the fact that the globalisation of financial markets and the prominence of some large financial centres have resulted in the shares of many public companies being actively traded on more than one stock exchange and on stock exchanges established outside the Contracting States. The agreement referred to in subdivision (ii) may be reached during the negotiation of the Convention or at any time afterwards. Paragraphs 117 and 119 below provide additional explanations with respect to the application of the definition of “recognised stock exchange” to stock exchanges established outside the Contracting States.

Commentary on the definition of “recognised stock exchange” in the detailed version

116. The definition of “recognised stock exchange” in the detailed version includes, in subdivision (i), stock exchanges that both Contracting States agree to identify at the time of the signature of the Convention. Although this would typically include stock exchanges established in the Contracting States on which shares of publicly listed companies and entities that are residents of these States are actively traded, the stock exchanges to be identified in the definition need not be established in one of the Contracting States. This recognises that the globalisation of financial markets and the prominence of some large financial centres have resulted in the shares of many public companies being actively traded on more than one stock exchange and on stock exchanges situated outside the State of residence of these companies.

117. The list to be included in subdivision (i) may include the names of specific stock exchanges. It may also include a generic description of a number of stock exchanges that would each constitute a “recognised stock exchange”. For example, in the case of the United States, such a generic description could read “any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934”. If the Contracting States wish to cover European Union stock exchanges that are officially recognised as such, such a generic description could read “any stock exchange established in States that are members of the European Union or are party to the Agreement on the European Economic Area and that are regulated by the European Union Markets in Financial Instruments Directive (Directive 2004/39/EC as amended) or by any successor Directive”.

118. Subdivision (ii) of the definition allows the competent authorities of the Contracting States to supplement, through a subsequent agreement, the list of stock exchanges identified in the definition at the time of signature of the Convention.

119. The stock exchanges to be included in the definition should impose listing requirements that ensure that shares of entities listed on that stock exchange are genuinely publicly traded. The following factors should be considered when determining whether a stock exchange should be listed in the definition or subsequently added to that list through the competent authority agreement referred to in the preceding paragraph:

- What are the requirements/standards with respect to listing a company on the stock exchange?*
- What are the requirements/standards in order to continue to be listed on the stock exchange, including minimum financial standards?*
- What are the annual/interim disclosure and/or filing requirements for companies whose shares are traded on the stock exchange?*
- What is the volume of shares traded on the stock exchange in a calendar year?*
- Do the rules governing the stock exchange ensure active trading of listed stocks? If so, how?*
- Are the companies listed on the stock exchange required to disclose on an ongoing basis financial information and information on events that may have a material impact on their financial situations?*
- Is information on the trading volume and overall shareholding of the companies listed on the stock exchange publicly available?*

- *Does the stock exchange impose any minimum size requirements, such as minimum capitalisation or number of employees, for companies whose shares are traded on the exchange?*
- *Does the stock exchange impose a required minimum percentage of public ownership? If so, what is the minimum amount?*
- *For a company to be listed on the stock exchange, are the shares of companies required to be freely negotiable and fully paid for?*
- *Is the stock exchange required to disclose the share prices of its listed companies within a certain timeframe?*
- *Is the stock exchange regulated or supervised by a government authority of the State in which it is located?*
- *[In the case of a new stock exchange to be added to an existing list:] Why would a company prefer to list on the new exchange rather than on another exchange, including those exchanges that are already “recognised stock exchanges” in the tax treaty? For example, are there lesser corporate governance and financial disclosure requirements?*
- *[In the case of a new stock exchange to be added to an existing list:] Does the new stock exchange provide a more efficient vehicle for raising capital and, if so, why?*

The term “shares”

Simplified and detailed versions

- b) *with respect to entities that are not companies, the term “shares” means interests that are comparable to shares;*

Commentary on the definition of “shares” in the simplified and detailed versions

120. Neither the simplified nor the detailed version contains an exhaustive definition of the term “shares”, which, under paragraph 2 of Article 3, should generally have the meaning which it has under the domestic law of the State that applies the Article. Subparagraph b), however, provides that the term “shares”, when used with respect to entities that do not issue shares (e.g. trusts), refers to interests that are comparable to shares. These will typically be beneficial interests that entitle their holders to a share of the income or assets of the entity.

The term “principal class of shares”

Simplified version

- c) *the term “principal class of shares” means the class or classes of shares of a company or entity which represents the majority of the aggregate vote and value of the company or entity;*

Detailed version

- c) *the term “principal class of shares” means the ordinary or common shares of the company or entity, provided that such class of shares represents the majority of the aggregate vote and value of the company or entity. If no single class of ordinary or common shares represents the majority of the aggregate vote and value of the*

company or entity, the “principal class of shares” are those classes that in the aggregate represent a majority of the aggregate vote and value;

Commentary on the definition of “principal class of shares” in the simplified version

121. The simplified version’s definition of the term “principal class of shares” generally corresponds to the definition included in the detailed version but, instead of dealing expressly with the case where no single class of ordinary or common shares represents the majority of the aggregate vote and value of the company or entity, deals with that issue through the phrase “class or classes of shares”.

Commentary on the definition of “principal class of shares” in the detailed version

122. The detailed version’s definition of the term “principal class of shares” refers to the ordinary or common shares of a company or entity but only if these shares represent the majority of the voting rights as well as of the value of the company or entity. If a company or entity has only one class of shares, that class of shares will naturally constitute its “principal class of shares”. If a company or entity has more than one class of shares, it is necessary to determine which class or classes constitute the “principal class of shares”, which will be the class of shares, or any combination of classes of shares, that represent, in the aggregate, a majority of the aggregate vote and value of the company or entity. If a company or entity does not have a class of ordinary or common shares representing the majority of its aggregate vote and value, then the “principal class of shares” shall be any combination of classes of shares that represent, in the aggregate, a majority of the vote and value of the company or entity. Although in a particular case involving a company with several classes of shares it is conceivable that more than one group of classes could be identified that would represent the majority of the aggregate vote and value of the company, it is only necessary to identify one such group that meets the conditions of subparagraph c) of paragraph 2 in order for the company to be entitled to treaty benefits under that provision (benefits will not be denied to the company or entity even if a second group of shares representing the majority of the aggregate vote and value of the company or entity, but not satisfying the conditions of subparagraph c) of paragraph 2, could be identified).

123. In a few States, certain publicly-listed traded companies are governed by a dual listed company arrangement and these States may wish to address expressly the situation of these companies in order to ensure that they are not inadvertently denied the benefits of conventions because of the definition of “principal class of shares”. The term “dual listed company arrangement” refers to an arrangement, adopted by certain publicly-listed companies, that reflects a commonality of management, operations, shareholders’ rights, purpose and mission through a series of agreements between two parent companies, each with its own stock exchange listing, together with special provisions in their respective articles of association including in some cases, for example, the creation of special voting shares. Under these structures, the position of the parent company’s shareholders is, as far as possible, the same as if they held shares in a single company, with the same dividend entitlement and same rights to participate in the assets of the dual listed companies in the event of a winding up. States wishing to address the situation of such companies may therefore wish to add the following sentence to the definition of “principal class of shares”:

In the case of a company participating in a dual listed company arrangement, the principal class of shares will be determined after excluding the special voting shares which were issued as a means of establishing that dual listed company arrangement.

124. This additional sentence would be supplemented by the addition of the following definition of “dual listed company arrangement”:

the term “dual listed company arrangement” means an arrangement pursuant to which two publicly listed companies, while maintaining their separate legal entity status, shareholdings and listings, align their strategic directions and the economic interests of their respective shareholders through:

- (i) the appointment of common (or almost identical) boards of directors, except where relevant regulatory requirements prevent this;*
- (ii) management of the operations of the two companies on a unified basis;*
- (iii) equalised distributions to shareholders in accordance with an equalisation ratio applying between the two companies, including in the event of a winding up of one or both of the companies;*
- (iv) the shareholders of both companies voting in effect as a single decision-making body on substantial issues affecting their combined interests; and*
- (v) cross-guarantees as to, or similar financial support for, each other’s material obligations or operations except where the effect of the relevant regulatory requirements prevents such guarantees or financial support.*

125. Other States, however, may prefer not to include any specific reference to dual listed company arrangements in the Article because of possible concerns about the use of similar arrangements for avoidance purposes and may therefore prefer to address legitimate dual listed arrangements on a case-by-case basis through the other provisions of the Article, including the discretionary relief provision of paragraph 6.

The term “connected person”

Simplified and detailed versions

- d) two persons shall be “connected persons” if one owns, directly or indirectly, at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares) or another person owns, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company’s shares) in each person. In any case, a person shall be connected to another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.*

Commentary on the definition of “connected person” in the simplified and detailed versions

126. The term “connected person” is used in paragraph 3 of the simplified version and in various parts of the detailed version. Although the definition is somewhat similar to the definition of “closely related” in Article 5, a main difference is that a direct or indirect ownership of exactly 50 per cent of the beneficial interests could result in a person being “connected” to another person whilst the definition of “closely related” requires a direct or indirect ownership of more than 50 per cent of the beneficial interests.

127. As indicated in paragraph 33 above, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with

respect to income that is paid to connected persons that benefit from regimes that constitute “special tax regimes” (see paragraphs 85 to 100 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). If such provisions are included in the Convention, the Contracting States may consider it more appropriate to include the definition of “connected person” in Article 3, which includes definitions that apply throughout the Convention.

The term “equivalent beneficiary”

Simplified version

- e) *the term “equivalent beneficiary” means any person who would be entitled to benefits with respect to an item of income accorded by a Contracting State under the domestic law of that Contracting State, this Convention or any other international agreement which are equivalent to, or more favourable than, benefits to be accorded to that item of income under this Convention. For the purposes of determining whether a person is an equivalent beneficiary with respect to dividends received by a company, the person shall be deemed to be a company and to hold the same capital of the company paying the dividends as such capital the company claiming the benefit with respect to the dividends holds.*

Detailed version

- e) *the term “equivalent beneficiary” means:*
 - (i) *a resident of any State, provided that:*
 - A) *the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident’s multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, such convention shall be applied as if the provisions of subparagraphs a), b), c) and e) of paragraph 2 (including the definitions relevant to the application of the tests in such subparagraphs) were contained in such convention; and*
 - B) *1) with respect to income referred to in Article 10, 11 or 12, if the resident had received such income directly, the resident would be entitled under such convention, a provision of domestic law or any international agreement, to a rate of tax with respect to such income for which benefits are being sought under this Convention that is less than or equal to the rate applicable under this Convention. Regarding a company seeking, under paragraph 4, the benefits of Article 10 with respect to dividends, for purposes of this subclause:*

- I) if the resident is an individual, and the company is engaged in the active conduct of a business in its Contracting State of residence that is substantial in relation, and similar or complementary, to the business that generated the earnings from which the dividend is paid, such individual shall be treated as if he or she were a company. Activities conducted by a person that is a connected person with respect to the company seeking benefits shall be deemed to be conducted by such company. Whether a business activity is substantial shall be determined based on all the facts and circumstances; and*
- II) if the resident is a company (including an individual treated as a company), to determine whether the resident is entitled to a rate of tax that is less than or equal to the rate applicable under this Convention, the resident's indirect holding of the capital of the company paying the dividends shall be treated as a direct holding; or*
- 2) with respect to an item of income referred to in Article 7, 13 or 21 of this Convention, the resident is entitled to benefits under such convention that are at least as favourable as the benefits that are being sought under this Convention; and*
- C) notwithstanding that a resident may satisfy the requirements of clauses A) and B) of this subdivision, where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking benefits, if the item of income would not be treated as the income of the resident under a provision analogous to paragraph 2 of Article 1 had the resident, and not the company seeking benefits under paragraph 4 of this Article, itself owned the entity through which the income was derived by the company, such resident shall not be considered an equivalent beneficiary with respect to the item of income;*
- (ii) a resident of the same Contracting State as the company seeking benefits under paragraph 4 of this Article that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident's multinational corporate group, the resident is entitled to benefits under paragraph 5, provided that, in the case of a resident described in paragraph 5, if the resident had received such interest or dividends directly, the resident would be entitled to a rate of tax with respect to such income that is less than or equal to the rate applicable under this Convention to the company seeking benefits under paragraph 4; or*
- (iii) a resident of the Contracting State from which the benefits of this Convention are sought that is entitled to all the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2, provided that all such residents' ownership of the aggregate vote and value of the shares (and any disproportionate class of shares) of the company seeking benefits under paragraph 4 does not exceed 25 per cent of the total vote and value of the shares (and any disproportionate class of shares) of the company;*

Commentary on the definition of “equivalent beneficiary” in the simplified version

128. *The definition of “equivalent beneficiary” in the simplified version is only relevant for the purposes of paragraph 4 on derivative benefits. That paragraph allows an entity that is a resident of a Contracting State and that is not a qualified person to access treaty benefits with respect to an item of income if persons that meet the definition of “equivalent beneficiary” own, directly or indirectly, more than 75 per cent of the beneficial interests in that entity.*

129. *According to the definition, an equivalent beneficiary is any person who, if it had received the relevant item of income directly, would have been entitled, in a Contracting State, to benefits that are either equivalent or more favourable than the benefits provided to that item of income by that Contracting State under the Convention. These equivalent or more favourable benefits may result from either the domestic law of that State, the Convention itself or any other international agreement to which that State is a party.*

130. *The last sentence of the definition applies for the purposes of determining the percentage of the capital of a company paying a dividend that a potential equivalent beneficiary will be deemed to hold in that company. This is relevant for the purposes of comparing the benefits accorded to dividends under the Convention with the benefits to which that potential equivalent beneficiary would have been entitled if it had received the dividend directly (e.g. either 5 per cent under subparagraph a) of paragraph 2 of Article 10 or 15 per cent under subparagraph b) of paragraph 2 of Article 10). According to the last sentence, the potential equivalent beneficiary will be deemed to be a company holding the same capital in the company paying the dividends that the company that seeks the benefits of paragraph 4 is holding (whilst paragraph 4 may apply to entities that are not companies, the rate differential of Article 10 only matters with respect to dividends paid to a company).*

Commentary on the definition of “equivalent beneficiary” in the detailed version

131. *The definition of “equivalent beneficiary” in the detailed version is relevant for the purposes of the derivative benefits test in paragraph 4 but may also be relevant for the purposes of subparagraph g) of paragraph 2 dealing with collective investment vehicles, depending on how that subparagraph is drafted (see paragraph 56 above).*

132. *The definition recognises three different categories of persons who qualify as “equivalent beneficiary”.*

133. *The first category (subdivision (i) of the definition) covers residents of third States that would be entitled to all of the benefits of a comprehensive income tax convention between that person’s State of residence and the State from which benefits are sought (referred to below as the “tested convention”) under provisions that are substantially similar to the rules in subparagraph a), b), c) or e) of paragraph 2. A company may also be an equivalent beneficiary under subdivision (i) if it is entitled to benefits under a convention pursuant to a headquarters company test under the tested convention that is substantially similar to paragraph 5, but only if the benefits being sought by the company are with respect to interest or dividends paid by a member of the equivalent beneficiary’s multinational corporate group. If the tested convention does not have a comprehensive limitation-on-benefits article, the requirements of clause A) of subdivision (i) are also met if the resident of the third state applies the tested convention as if such convention included the provisions of subparagraphs a), b), c) and e) of paragraph 2 (including the relevant definitions for purposes of applying the provisions of such*

subparagraphs), and would have satisfied one of the limitation-on-benefits provision by reason of one of the incorporated subparagraphs.

134. *The following examples illustrate the application of subdivision (i) of the definition:*

- *Example A: HOLDCO, a resident of State R, is a wholly owned direct subsidiary of XCO, a resident of State X. XCO’s principal class of shares is primarily and regularly traded on the X Stock Exchange, a stock exchange located in State X. HOLDCO is not entitled to benefits under paragraph 2 of the convention between States S and R because it is a subsidiary of a company resident of, and publicly traded in, a third state. HOLDCO is not engaged in the conduct of an active business in State R, and therefore it is not entitled to any benefits under paragraph 3. HOLDCO derives and beneficially owns interest arising in State S that would otherwise be subject to the 10 per cent rate of Article 11 of the convention between States S and R. In order to determine if HOLDCO is entitled to benefits under the derivative benefits test of paragraph 4 of that convention, it is necessary to determine whether XCO satisfies the definition of equivalent beneficiary in paragraph 7. The income tax convention between States S and X contains a comprehensive limitation-on-benefits provision, including a rule for companies whose principal class of shares is primarily and regularly traded on the X Stock Exchange that is substantially similar to subparagraph c) of paragraph 2. Therefore, XCO satisfies the requirement of clause A) of subdivision (i) of the definition of equivalent beneficiary. The convention between States S and X would also subject interest arising in either State to the 10 per cent rate of Article 11, so XCO satisfies the requirement of clause B) of subdivision (i) of the definition of equivalent beneficiary. Accordingly, XCO is an equivalent beneficiary.*
- *Example B: Assume the same facts as in Example A, except that the income tax convention between States S and X does not include a comprehensive limitation-on-benefits provision. Accordingly, for the purpose of determining whether XCO is an equivalent beneficiary, that convention shall be applied as if it contained the provisions of subparagraphs a), b), c) and e) of paragraph 2 (including the relevant definitions for purposes of applying these subparagraphs) of this Convention. If this Convention defines a recognised stock exchange to include the X Stock Exchange, the principal class of XCO’s shares would be primarily traded on a recognised stock exchange located in XCO’s State of residence. Therefore XCO would satisfy subparagraph c) of paragraph 2 and would be an equivalent beneficiary. If however, the X Stock Exchange is not included in this Convention as a recognised stock exchange, XCO would not be an equivalent beneficiary.*

135. *A third-State resident cannot be an equivalent beneficiary if the person only satisfies:*

- *a test for affiliates of publicly traded companies substantially similar to subparagraph d) of paragraph 2;*
- *an ownership / base erosion test substantially similar to subparagraph f) of paragraph 2;*
- *a test for collective investment vehicles substantially similar to what may be included in subparagraph g) of paragraph 2;*
- *an active business test substantially similar to paragraph 3;*
- *a derivative benefits test substantially similar to paragraph 4;*
- *a discretionary relief provision substantially similar to paragraph 6, or*

- *any other limitation-on-benefits provision of the tested convention that is not a test under this Convention,*

because such resident would not be a qualified person under provisions substantially similar to subparagraph a), b), c) or e) of paragraph 2 of this Article.

136. Some States may wish to restrict and in some cases deny treaty benefits to individuals who are liable to tax on a remittance basis or taxed on a fixed-fee / forfait basis. If the Convention between the Contracting States does so, these States may also wish to prevent such individuals resident of third States from qualifying as an “equivalent beneficiary”. This could be done by amending clause A) of subdivision (i) as follows:

A) the resident is entitled to all the benefits of a comprehensive convention for the avoidance of double taxation between that State and the Contracting State from which the benefits of this Convention are sought, under provisions substantially similar to subparagraph a), b), c) or e) of paragraph 2 or, when the benefit being sought is with respect to interest or dividends paid by a member of the resident’s multinational corporate group, the resident is entitled to benefits under provisions substantially similar to paragraph 5 of this Article in such convention, provided that, if such convention does not contain a detailed limitation on benefits article, the resident would be entitled to the benefits of this Convention by reason of subparagraph a), b), c) or e) of paragraph 2 if such resident were a resident of one of the Contracting States under Article 4. Notwithstanding the preceding sentence, an individual

1) who is liable to tax in that individual’s State of residence with respect to foreign source income or gains only on a remittance or similar basis, or

2) whose tax is determined in that State, in whole or in part, on a fixed-fee, “forfait” or similar basis,

shall not be considered an equivalent beneficiary; and

137. Subclause B) 1) of subdivision (i) requires an equivalent beneficiary to be entitled to a rate of tax on the type of income derived by the company seeking benefits under paragraph 4 under either the tested convention, domestic law or any international agreement that is less than or equal to the rate of tax applicable under this Convention to the company seeking benefits under paragraph 4. Thus, the rates to be compared are: first, the rate of tax that the State of source could impose under the Convention on income paid to that company if it qualified for the benefits; and, second, the rate of tax that the State of source could have imposed if the potential equivalent beneficiary had derived the income directly from the State of source.

138. As described above, subclause B) 1) provides that any reduced rates of taxation that are available under domestic law or any international agreement will be taken into account. This rule recognises that withholding taxes on many inter-company dividends, interest and royalties may be eliminated, for example, pursuant to provisions such as those of the Parent-Subsidiary

and Interest and Royalties Directives¹ of the European Union, rather than by an income tax convention. This is illustrated by the following example:

- Example: EUCO1, a company resident of State EU1, wholly owns ACO, a resident of State A. ACO wholly owns EUCO2, a resident of State EU2, and derives interest arising in State EU2. The income tax convention between States A and EU2 contains the detailed version’s definition of equivalent beneficiary and exempts interest from source taxation. EU1 and EU2 are both members of the European Union. Under the Interest and Royalties Directive, interest paid by EUCO2 to EUCO1 may not be taxed by EU2. Therefore, EUCO1 satisfies subclause B) 1) of subdivision (i) of the definition of equivalent beneficiary in the income tax convention between States A and EU2 even if the income tax convention between States EU1 and EU2 allows the source taxation of interest.*

139. Subclause B) 1) (I) of subdivision (i) provides a rule, applicable with respect to dividends, that allows an individual to be treated as a company for purposes of the rate comparison test of subclause B) 1). Since dividends beneficially owned by individuals are not entitled to the lower rate provided for by subparagraph a) of paragraph 2 of Article 10, whereas a company may be entitled to that lower rate if certain conditions are met, absent this provision, individual shareholders of a company seeking derivative benefits under paragraph 4 generally would not qualify as equivalent beneficiaries in the case of dividends derived from substantial participations in other companies. By treating individuals as companies for purposes of the rate comparison test, this rule allows a company seeking derivative benefits under paragraph 4 to take into account the shares owned, directly or indirectly, by the individual as if such shares were owned by a company described in subparagraph c) of paragraph 2 for purposes of determining whether the company seeking derivative benefits under paragraph 4 is 95 percent owned by equivalent beneficiaries.

140. To be eligible to apply the rule in subclause B) 1) I), the company seeking derivative benefits under paragraph 4 must be engaged in the active conduct of a business in its State of residence. The rule treats an individual shareholder who otherwise meets the requirements of subclause A) of subparagraph (i) as if it were a company described in subparagraph c) of paragraph 2 but only if the company seeking derivative benefits under paragraph 4 is engaged in the active conduct of a business in its State of residence that is both substantial in relation to, and similar or complementary, to the business that generated the earnings from which the dividend is paid. The test in subclause B) 1) I) is similar to the active conduct of a business test under paragraph 3, but is not exactly the same because it does not require that the income from the State of source “emanate” from the business actively conducted by the company seeking derivative benefits under paragraph 4. The phrase “active conduct of a business” has the same meaning as in subparagraph a) of paragraph 3, and therefore does not include the activities described in subdivisions (i) through (iv) of that subparagraph. For purposes of determining if the company seeking derivative benefits under paragraph 4 is engaged in the active conduct of a business in a Contracting State, activities conducted by a person connected to that company shall be deemed to be conducted by the company. The phrase “substantial in relation to” has the same meaning as in subparagraph c) of paragraph 3. That substantiality requirement, however, must be applied regardless of whether the dividend is derived from a connected person. On the other hand, the dividend derived from the other Contracting State does not have to emanate

¹ Council Directive 2011/96/EU of 30 November 2011 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, as amended; Council Directive 2003/49/EC of 3 June 2003 on a common system of taxation applicable to interest and royalty payments made between associated companies of different Member States.

from the active business of the company seeking derivative benefits under paragraph 4, as is required under subparagraph a) of paragraph 3, in order to obtain benefits, because the active business conducted in the Contracting State of residence for purposes of subclause B) 1) I) needs only be “similar or complementary” to the active business conducted in the State of source, and not “the same or complementary” to that active business conducted in the State of source.

141. *The following example illustrates the application of subclause B) 1) I):*

- *Example: RCO is a company resident of State R. RCO is engaged in the active conduct of a business in State R that is similar to the business of SCO, a company resident of State S. RCO has been a resident of State R for 13 months and has also held 25 per cent of the capital of SCO for 13 months. Individual Y is the sole shareholder of RCO and is a resident of State Y. Paragraph 2 of Article 10 of the income tax conventions between States S and Y and between States S and R is identical to the corresponding provision of the OECD Model Tax Convention. RCO, therefore, satisfies the requirements set forth in subparagraph a) of paragraph 2 of Article 10 for purposes of the lower rate applicable to dividends. Absent subclause B) 1) I), however, RCO would not be entitled to that lower rate because individual Y would only have been entitled to the 15 per cent rate (under subparagraph b) of paragraph 2 of Article 10) if he had received the dividends directly from SCO. By virtue of subclause B) 1) I), however, Y shall be treated as a company within the meaning of paragraph c) of paragraph 2 of the income tax convention between States S and R for the purposes of the rate comparison test, which means that RCO will satisfy the rate comparison requirement. Therefore, assuming all other requirements (such as the base erosion test and the beneficial ownership requirement of Article 10) are satisfied, RCO will be entitled to the lower rate in Article 10 of the income tax convention between States S and R with respect to the dividends paid by SCO.*

142. *Subclause B) 1) II) provides the rule for determining the percentage of the capital of a company paying a dividend that a potential equivalent beneficiary will be deemed to hold for purposes of the rate comparison test, which, like subclause B) 1) I), will affect the entitlement to the lower rate of tax, under subparagraph a) of paragraph 2 of Article 10, of the equivalent beneficiary, had it derived the dividend directly. For these purposes, when applying the rate comparison test described in subclause B) 1), the potential equivalent beneficiary’s indirect holding of the capital of the company paying the dividends shall be treated as a direct holding. The following example illustrates the application of subclause B) 1) II):*

- *Example: XCO and YCO each own directly 50 per cent of RCO, a company resident of State R. For 13 months, RCO has held 25 per cent of the capital of SCO and has been a resident of State R. State S has income tax conventions with States R, X and Y; paragraph 2 of Article 10 of these income tax conventions is identical to the corresponding provision of the OECD Model Tax Convention. XCO is a resident of State X and would have qualified person status under subparagraph c) of paragraph 2 of the income tax convention between States S and R. YCO is a resident of State Y and would also have qualified person status under subparagraph c) of paragraph 2 of the income tax convention between States S and R. Both XCO and YCO, therefore, would satisfy subclause A) of the definition of equivalent beneficiary. For purposes of determining the rate of tax on dividends paid by SCO that XCO and YCO would have been entitled to under their respective tax treaties with State S, however, XCO and YCO are each treated, under subclause B) 1) II), as holding directly 12.5 per cent of the capital of SCO (50 per cent of the 25 per cent shareholding in SCO is equal to 12.5 per*

cent, the amount of XCO's and YCO's respective indirect holdings in the capital of SCO that is treated as a direct holding). XCO and YCO, therefore, would not be entitled to the lower rate of tax of subparagraph a) of paragraph 2 of Article 10 and would not, therefore, be considered equivalent beneficiaries because they fail to meet the rate comparison test under subclause B) 1) (see, however, paragraph 147 below concerning alternative provisions that would allow RCO to benefit from the 15 per cent rate of subparagraph b) of paragraph 2 of Article 10 of the income tax convention between States S and R).

143. Subclause B) 2) of subdivision (i) provides derivative benefits rules for items of income that fall within Articles 7, 13 or 21. The potential equivalent beneficiary must be entitled to a benefit under the tested convention that is at least as favourable as that which would apply under the Convention to such business profits, gains or other income. Thus, the benefits to be compared are: first, the benefits that the State of source would grant to the company seeking derivative benefits under paragraph 4 if it qualified for benefits with respect to the relevant item of income and, second, the benefits that the State of source would grant to the potential equivalent beneficiary if it derived the income directly. The following example illustrates the application of subclause B) 2):

- Example: RCO is a company resident in State R, which is wholly owned by XCO, a publicly traded company resident in State X. RCO has a contract to construct a major office complex in State S. Under the terms of the income tax convention between States S and R, a construction site constitutes a permanent establishment only if it lasts for more than twelve months. Under the terms of the income tax convention between States S and X, however, a construction site constitutes a permanent establishment only if it lasts more than six months. If the construction site lasts more than six months but less than 12 months, XCO would not be an equivalent beneficiary because it would not be entitled to the same protection, under Article 7 of the income tax convention between States S and X, that a qualifying person would be entitled to under Article 7 of the income tax convention between States S and R.*

144. Subclause C) of subdivision (i) provides an additional limitation where the item of income has been derived through an entity that is treated as fiscally transparent under the laws of the Contracting State of residence of the company seeking derivative benefits under paragraph 4. In such case, notwithstanding that the resident may satisfy the requirements of subclauses A) or B) based on a comparison of the terms of the tested convention with the terms of the convention under which the company is seeking derivative benefits, the resident will not meet the requirements of this subclause if the relevant item of income would not be treated as the income of that resident under a provision analogous to paragraph 2 of Article 1 had it, rather than the company seeking derivative benefits under paragraph 4, been paid the item of income for which that company is claiming benefits. The following example illustrates the application of subclause C):

- Example: RCO, a publicly traded company resident of State R, owns shares of SCO, a company resident of State S, through P, a partnership organised in State S. P is fiscally transparent under the domestic tax law of State S and is treated as a company under the domestic tax law of State R. Accordingly, under the provisions of paragraph 2 of Article 1, dividends paid by SCO through P would not be considered derived by RCO, and thus would not be eligible for a reduction from source taxation in State S under Article 10. RCO interposes XCO, a resident of State X, between itself and P. Under the domestic tax law of State X, P is fiscally transparent, and therefore, XCO is considered to derive dividends paid by SCO to P.*

The income tax convention between States S and X contains the detailed version of paragraphs 1 to 7 of Article 29. In order to enjoy the dividend withholding tax reductions provided in that convention, XCO must satisfy the derivative benefits test. Although the dividend rates under paragraph 2 of Article 10 of the convention between States S and X are the same as those under Article 10 of the convention between States S and R, and subclause A) of subdivision (i) would be satisfied, dividends would not be considered derived by RCO if RCO, and not XCO, had owned SCO through the partnership P. Accordingly, by virtue of subclause C), RCO is not an equivalent beneficiary, and for that reason, XCO is not entitled to derivative benefits under paragraph 4 with respect to the dividends paid by SCO through P.

145. The second category of persons who qualify as “equivalent beneficiary” (subdivision (ii) of the definition) applies to persons who are residents of the same Contracting State as the company seeking derivative benefits under paragraph 4. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph a), b), c) or e) of paragraph 2, or under paragraph 5 as a headquarters company. A headquarters company, however, will solely be an equivalent beneficiary of the company seeking derivative benefits under paragraph 4 if it receives interest or dividends from a member of the headquarters company’s multinational corporate group. A rate comparison test applies, however, for any resident satisfying the headquarters company test in paragraph 5 that derives dividends or interest from the other Contracting State. That requirement is intended to ensure that the headquarters company is entitled to at least the same treaty benefits with respect to dividends or interest as the company seeking derivative benefits under paragraph 4 so that if, for instance, Article 11 of the Convention generally exempts interest from source taxation but does not do so with respect to interest paid to a headquarters company by a member of that company’s multinational group, the headquarters company will not be an equivalent beneficiary of a company that would otherwise be entitled to the treaty exemption from source taxation applicable to a similar interest payment.

146. The third category of persons who qualify as “equivalent beneficiary” (subdivision (iii) of the definition), applies to persons who are residents of the Contracting State of source. Such persons will be equivalent beneficiaries if they are eligible for benefits by reason of subparagraph a), b), c) or e) of paragraph 2, provided that such residents’ ownership of the aggregate vote and value of the shares (and any disproportionate class of shares as defined in paragraph 7) of the company that requests the derivative benefits does not exceed 25 per cent. Under the ownership requirement in subparagraph a) of paragraph 4, ownership may be direct or indirect, but in the case of indirect ownership, each intermediate owner must be a “qualifying intermediate owner” under the definition of that term in paragraph 7 (see below).

147. As explained in paragraph 10 above, where paragraph 4 on derivative benefits applies, the definition of equivalent beneficiary will exclude persons who, under another convention, are entitled to relief from taxation by the State of source that is not as favourable as the relief provided under the Convention. Some States may want to address the resulting so-called “cliff” effect of denying all treaty benefits even if the difference in the relief provided by the two conventions is relatively minor by providing relief from taxation by the State of source that is similar to the relief that would have been provided under the other convention. This treatment could be achieved through the alternative provisions below that relate to the taxation of dividends, interest and royalties and that grant limited benefits that broadly correspond to those that would have been available under the other convention:

Provision on dividends to be added to Article 10

Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 4 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 of this Convention regarding a dividend, if such company fails to satisfy the criteria of that paragraph solely by reason of:

- a) the requirement in clause B) of subdivision (i) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29; or***
- b) the requirement, in subdivision (ii) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29, that a person entitled to benefits under paragraph 5 of Article 29 would be entitled to a rate of tax with respect to the dividend that is less than or equal to the rate applicable under paragraph 2 of this Article;***

such company may be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that Contracting State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 (notwithstanding the requirements referred to in subparagraphs a) and b) of this paragraph) would have been entitled if such persons had received the dividend directly. For purposes of this paragraph:

- c) such persons’ indirect ownership of the voting stock of the company paying the dividends shall be treated as direct ownership, and***
- d) a person described in subdivision (iii) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the dividends.***

Provision on interest to be added to Article 11

Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 4 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 regarding a payment of interest, if such company fails to satisfy the criteria of that paragraph solely by reason of:

- a) the requirement in clause B) of subdivision (i) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29; or***
- b) the requirement in subdivision (ii) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 that a person entitled to benefits under paragraph 5 of Article 29 would be entitled to a rate of tax with respect to the interest that is less than or equal to the rate applicable under paragraph 2 of this Article;***

such company may be taxed by the Contracting State in which the interest arises according to the laws of that State. In these cases, however, the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 (notwithstanding the requirements referred to in subparagraphs a) and b) of this paragraph) would have been entitled if such persons had received the interest directly. For purposes of this paragraph, a person described in subdivision (iii) of the

definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the interest.

Provision on royalties to be added to Article 12

Notwithstanding the provisions of paragraph 1 but subject to the provisions of paragraph 3 of this Article, in the case of a company seeking to satisfy the requirements of paragraph 4 of Article 29 regarding royalties, if such company fails to satisfy the criteria of that paragraph solely by reason of the requirement in clause B) of subdivision (i) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29, such company may be taxed in the Contracting State of which the royalty arises and according to the laws of that State, except that the tax so charged shall not exceed the highest rate among the rates of tax to which persons described in the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 (notwithstanding the requirement of clause B) of subdivision (i) of that definition) would have been entitled if such persons had received the royalty directly. For purposes of this paragraph, a person described in subdivision (iii) of the definition of the term “equivalent beneficiary” in subparagraph e) of paragraph 7 of Article 29 shall be treated as entitled to the limitation of tax to which such person would be entitled if such person were a resident of the same Contracting State as the company receiving the royalties.

The term “disproportionate class of shares”

Detailed version only

- f) *the term “disproportionate class of shares” means any class of shares of a company or entity resident in one of the Contracting States that entitles the shareholder to disproportionately higher participation, through dividends, redemption payments or otherwise, in the earnings generated in the other Contracting State by particular assets or activities of the company;*

Commentary on the definition of “disproportionate class of shares” in the detailed version

148. Under the definition of the term “disproportionate class of shares”, which is used in the ownership test in various parts of the Article, a company or entity has a disproportionate class of shares if it has outstanding shares that are subject to terms or other arrangements that entitle the holder of these shares to a larger portion of the company’s or entity’s income derived from the other Contracting State than that to which the holder would be entitled in the absence of such terms or arrangements. Thus, for example, a company resident in one Contracting State has a “disproportionate class of shares” if some of the outstanding shares of that company are “tracking shares” that pay dividends based upon a formula that approximates the company’s return on its assets employed in the other Contracting State. This is illustrated by the following example:

- *Example: ACO is a company resident of State A. ACO has issued common shares and preferred shares. The common shares are listed and regularly traded on the principal stock exchange of State A. The preferred shares have no voting rights and only entitle their holders to receive dividends equal in amount to interest payments that ACO receives from unrelated borrowers in State B. The preferred shares are owned entirely by a single shareholder who is a resident of a third State with which State B does not*

have a tax treaty. The common shares account for more than 50 per cent of the value of ACO and for 100 per cent of the votes. Since the owner of the preferred shares is entitled to receive payments corresponding to ACO's interest income arising in State B, the preferred shares constitute a "disproportionate class of shares" and because these shares are not regularly traded on a recognised stock exchange, ACO will not qualify for benefits under subparagraph c) of paragraph 2.

The term "primary place of management and control"

Detailed version only

- g) *a company's or entity's "primary place of management and control" is in the Contracting State of which it is a resident only if:*
 - (i) *the executive officers and senior management employees of the company or entity exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, in that Contracting State than in any other State; and*
 - (ii) *such executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company or entity and its direct and indirect subsidiaries, and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions, than the officers or employees of any other company or entity;*

Commentary on the definition of "primary place of management and control" in the detailed version

149. *The term "primary place of management and control" is relevant for the purposes of subparagraph c) of paragraph 2 and of paragraph 5 of the detailed version. This term must be distinguished from the concept of "place of effective management", which was used before 2017 in paragraph 3 of Article 4 and in various provisions, including Article 8, applicable to the operation of ships and aircraft. The concept of "place of effective management" was interpreted by some States as being ordinarily the place where the most senior person or group of persons (for example a board of directors) made the key management and commercial decisions necessary for the conduct of the company's business. The concept of the primary place of management and control, by contrast, refers to the place where the day-to-day responsibility for the management of the company or entity (and its direct and indirect subsidiaries) is exercised.*

150. *A company's or entity's primary place of management and control will be situated in the State of residence of that company or entity only if the following two conditions are satisfied:*

- *First, under subdivision (i), the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company or entity and for its direct and indirect subsidiaries, and the staff that support such management in preparing for and making those decisions conduct more of their necessary day-to-day activities, in that State than in the other State or any third State. Thus, the test looks to the overall activities of the relevant persons to see where those activities are conducted. In most cases, it will be a*

necessary, but not a sufficient, condition that the chief executive officer and other top executives normally are in the Contracting State of which the company is a resident.

- *Second, the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision-making for the company and its direct and indirect subsidiaries, and the staff that support such management in making those decisions conduct more of their necessary day-to-day activities, than the officers or employees of any other company or entity.*

The term “qualifying intermediate owner”

Detailed version only

- h) *the term “qualifying intermediate owner” means an intermediate owner that is either:*
 - (i) *a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation; or*
 - (ii) *a resident of the same Contracting State as the company applying the test under subparagraph d) or f) of paragraph 2 or paragraph 4 to determine whether it is eligible for benefits under the Convention;*

Commentary on the definition of “qualifying intermediate owner” of the detailed version

151. *The definition of “qualifying intermediate owner” in the detailed version is relevant for the purposes of the ownership tests found in subparagraphs d) and f) of paragraph 2 as well as the derivative benefits rule of paragraph 4.*

152. *Under subdivision (i) of that definition, a qualifying intermediate owner is an entity resident of a third State that has in effect a comprehensive income tax convention with the Contracting State from which a treaty benefit is sought.*

153. *As indicated in the Commentary on Article 1, some States consider that provisions should be included in their tax treaties in order to deny the application of specific treaty provisions with respect to income benefiting from regimes that constitute “special tax regimes” (see paragraphs 85 to 100 of the Commentary on Article 1) and to deny the application of Article 11 to interest that is paid to connected persons that benefit from domestic law provisions that provide for a notional deduction with respect to equity (see paragraph 107 of the Commentary on Article 1). These States may want to restrict the scope of subdivision (i) so that it would only apply to residents of third States with which the State from which treaty benefits are sought has concluded comprehensive income tax conventions, and that do not benefit from a special tax regime or from notional interest deductions. This could be done by amending subdivision (i) as follows:*

- (i) *a resident of a State that has in effect with the Contracting State from which a benefit under this Convention is being sought a comprehensive convention for the avoidance of double taxation and that does not benefit from either*
 - A) *a special tax regime, provided that if the relevant comprehensive convention for the avoidance of double taxation does not contain a definition of special tax regime analogous to the provisions included*

in [reference to the paragraph of the convention that includes the definition of “special tax regime”], the principles of the definition provided in this Convention shall apply, but without regard to the requirement in clause (v) of that definition; or

- B) notional interest deductions of the type described in [reference to the paragraph of Article 11 that relates to notional deductions for equity]; or*

154. *Under subdivision (ii) of the definition, a qualifying intermediate owner also includes a resident of the same Contracting State as the company to which the relevant ownership test is applied under subparagraphs d) or f) of paragraph 2 or under the derivative benefits rule of paragraph 4.*

The term “tested group”

Detailed version only

- i) *the term “tested group” means the resident of a Contracting State that is applying the test under subparagraph d) or f) of paragraph 2 or under paragraph 4 or 5 to determine whether it is eligible for benefits under the Convention (the “tested resident”), and any company or permanent establishment that:*
- (i) participates as a member with the tested resident in a tax consolidation, fiscal unity or similar regime that requires members of the group to share profits or losses; or*
 - (ii) shares losses with the tested resident pursuant to a group relief or other loss sharing regime in the relevant taxable period;*

Commentary on the definition of “tested group” in the detailed version

155. *This subparagraph defines the term “tested group” for purposes of the base erosion rules in subdivision (ii) of subparagraphs d) and f) of paragraph 2 and in paragraphs 4 and 5. The tested group shall consist of the tested company to which the relevant base erosion rule is applied (which is referred to as the “tested resident”) and any company that either participates as a member with that tested resident in a tax consolidation regime, fiscal unity or similar regime that allows members of the group to share profits or losses, or any company that, during the relevant taxable period, shares losses with the tested resident pursuant to a group relief or other loss sharing regime. If there is no tested group, then the relevant base erosion test applicable to a tested group does not apply.*

The term “gross income”

Detailed version only

- j) *the term “gross income” means gross receipts as determined in the person’s Contracting State of residence for the taxable period that includes the time when the benefit would be accorded, except that where a person is engaged in a business that includes the manufacture, production or sale of goods, “gross income” means such gross receipts reduced by the cost of goods sold, and where a person is engaged in a business of providing non-financial services, “gross income” means such gross receipts reduced by the direct costs of generating such receipts, provided that:*

- (i) *except when relevant for determining benefits under Article 10 of this Convention, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise; and*
- (ii) *except with respect to the portion of any dividend that is taxable, a tested group's gross income shall not take into account transactions between companies within the tested group;*

Commentary on the definition of “gross income” in the detailed version

156. This subparagraph defines the term “gross income” for purposes of the base erosion rules in subdivision (ii) of subparagraphs d) and f) of paragraph 2 and in paragraphs 4 and 5. The starting point for calculating gross income is gross receipts as determined in the relevant entity's Contracting State of residence for the taxable period that includes the time when the benefit would be accorded. If the entity is engaged in a business that includes the manufacture, production or sale of goods, “gross income” means gross receipts reduced by the cost of goods sold. If the tested subsidiary is engaged in a business of providing non-financial services, “gross income” means such gross receipts reduced by the direct costs of generating such receipts.

157. Subdivision (i) of the definition further provides that except for determining benefits with respect to dividends under Article 10, gross income shall not include the portion of any dividends that are effectively exempt from tax in the person's Contracting State of residence, whether through deductions or otherwise, regardless of the State of residence of the company paying these dividends. Subdivision (ii) provides that, except with respect to the portion of any dividend that is taxable, a tested group's gross income will not take into account any transactions between companies within the tested group.

The term “collective investment vehicle”

Detailed version only

- k) *[possible definition of “collective investment vehicle”].¹*

Commentary on the definition of “collective investment vehicle” in the detailed version

158. As indicated in the footnote to the subparagraph, a definition of “collective investment vehicle” should be included if a provision dealing with collective investment vehicles is included in subparagraph g) of paragraph 2. That definition should identify the collective investment vehicles of each Contracting State to which that provision is applicable and could be drafted as follows:

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

159. As explained in paragraph 36 of the Commentary on Article 1, it is intended that the open parts of that definition would include cross-references to relevant tax or securities law

¹ A definition of the term “collective investment vehicle” should be added if a provision on collective investment vehicles is included in paragraph 2 (see subparagraph g) of paragraph 2).

provisions of each State that would identify the CIVs to which subparagraph g) of paragraph 2 should apply.

Paragraph 7 (simplified version): mode of application to be determined by the competent authorities

Simplified version only

7. *The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.*

Commentary on paragraph 7 of the simplified version

160. Paragraph 7 of the simplified version allows the competent authorities of the Contracting States to determine, by mutual agreement, how the provisions of the previous paragraphs of the Article should be applied. They may, for instance, agree on the procedural aspects of making a request for treaty benefits under the discretionary relief provisions of paragraph 5.

Paragraph 8

161. As mentioned in paragraph 32 of the Commentary on Article 10, paragraph 25 of the Commentary on Article 11 and paragraph 21 of the Commentary on Article 12, potential abuses may result from the transfer of shares, debt-claims, rights or property to permanent establishments set up solely for that purpose in countries that do not tax, or offer preferential tax treatment to, the income from such assets. Where the State of residence exempts the profits attributable to such permanent establishments situated in third jurisdictions, the State of source should not be expected to grant treaty benefits with respect to such income. The paragraph, which applies where a Contracting State exempts the income of enterprises of that State that are attributable to permanent establishments situated in third jurisdictions, provides that treaty benefits will not be granted in such cases. That rule, however, does not apply if

- the income bears a significant level of tax in the State in which the permanent establishment is situated, or*
- the income emanates from, or is incidental to, the active conduct of a business through the permanent establishment, excluding an investment business that is not carried on by a bank, insurance enterprise or registered securities dealer.*

162. Under subparagraph c), in any case where benefits are denied under this paragraph, the resident of a Contracting State who derives the relevant income may request that the competent authority of the other Contracting State grant these benefits. The competent authority who receives such a request may, at its discretion, grant these benefits if it determines that doing so would be justified; it shall, however, consult with the competent authority of the other Contracting State before granting or denying the request.

163. The following example illustrates the type of situation in which the paragraph is intended to apply. An enterprise of a Contracting State sets up a permanent establishment in a third jurisdiction that imposes no or low tax on the profits of the permanent establishment. The profits attributable to the permanent establishment are exempt from tax by the first-mentioned State either pursuant to a provision similar to Article 23 A included in a tax convention between that State and the jurisdiction where the permanent establishment is located or pursuant to the first-mentioned State's domestic law. The enterprise derives interest arising from the other

Contracting State which is included in the profits attributable to the permanent establishment. Assuming that the conditions for the application of Article 11 are met, the State in which the interest arises would, in the absence of paragraph 8, be obliged to grant the benefits of the limitation of tax provided for in paragraph 2 of Article 11 despite the fact that the interest is exempt from tax in the first-mentioned State and is subject to little or no tax in the third jurisdiction in which the permanent establishment is situated. In that situation, the benefits of the Convention will be denied with respect to that income unless the exception of subparagraph b) applicable to income that emanates from, or incidental to, the active conduct of a business applies to the relevant income or unless these benefits are granted, under the discretionary relief provision of subparagraph c), by the competent authority of the State in which the interest arises.

164. The reference to the word “income” in subdivision (i) means that the provision applies regardless of whether the relevant income constitutes business profits. The rule therefore applies where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned State treats the right or property in respect of which the income is paid as effectively connected with a permanent establishment situated in a third jurisdiction (including under a provision such as paragraph 2 of Article 21 in a treaty between the first-mentioned State and the third jurisdiction).

165. Where the conditions of subdivisions (i) and (ii) are met, subparagraph a) denies the benefits that otherwise would apply under the other provisions of the Convention if the relevant item of income is treated as being part of the profits of the permanent establishment situated in the third jurisdiction and the amount of tax levied on that item of income in that third jurisdiction is less than the lower of the following two amounts: a) the amount of that item of income multiplied by the minimum rate that the Contracting States have determined bilaterally for the purposes of the paragraph, and b) 60 per cent of the amount of tax that would be imposed on that item of income in the State of the enterprise if that permanent establishment were situated in that State.

166. The phrase “the amount of that item of income” refers to the amount of the relevant income after the deduction of all expenses relevant to that item of income that are deductible under the law of the relevant jurisdiction. Thus, for the purposes of determining the tax in the third jurisdiction that relates to that item of income, the overall tax applicable to the profits of the permanent establishment situated in that jurisdiction will first be computed after deducting all expenses that are deductible, in accordance with the law of that jurisdiction, in determining the taxable profits attributable to the permanent establishment. The tax that applies to the relevant amount of item of income would then be determined by multiplying that overall tax applicable to the profits of the permanent establishment by the ratio of the net amount of the item of income (i.e. the gross amount of the item of income less the deduction of the expenses deducted in computing the taxable profits of the permanent establishment that relate specifically or proportionally to that item of income) to the taxable profits of the permanent establishment. A similar computation will be made for the purposes of determining the tax that would be imposed on that item of income in the Contracting State of the enterprise if the permanent establishment were situated in that State; in that case, the expenses that will be deducted are those that are deductible in accordance with the law of that State.

167. For the purposes of the exception included in subparagraph b), the reference to income that “emanates from, or is incidental to, the active conduct of a business” should be interpreted as indicated in paragraphs 74 to 76 above.

168. *Instead of adopting the wording of paragraph 8, some States may prefer a more comprehensive solution that would not be restricted to situations where an enterprise of a Contracting State is exempt from tax, in that State, on the profits attributable to a permanent establishment situated in a third jurisdiction, that would not include the exception applicable to income that emanates from or is incidental to the active conduct of a business and that would not require an evaluation of the tax that would have been paid in the State of the enterprise if the permanent establishment had been situated in that State. In such a case, the rule would be applicable in any case where income derived from one Contracting State that is attributable to a permanent establishment situated in a third jurisdiction is subject to combined taxation, in the State of the enterprise and the jurisdiction of the permanent establishment, at an effective rate that is less than the lower of a rate to be determined bilaterally and 60 per cent of the general rate of corporate tax in the State of the enterprise. The following is an example of a rule that could be used for that purpose:*

Where an enterprise of a Contracting State derives income from the other Contracting State and the first-mentioned Contracting State treats that income as profits attributable to a permanent establishment situated in a third jurisdiction, the benefits of this Convention shall not apply to that income if that income is subject to a combined aggregate effective rate of tax in the first-mentioned Contracting State and the jurisdiction in which the permanent establishment is situated that is less than the lesser of [rate to be determined bilaterally] or 60 per cent of the general statutory rate of company tax applicable in the first-mentioned Contracting State. If benefits under this Convention are denied pursuant to the preceding sentence with respect to an item of income derived by a resident of a Contracting State, the competent authority of the other Contracting State may, nevertheless, grant these benefits with respect to that item of income if, in response to a request by such resident, such competent authority determines that granting such benefits is justified in light of the reasons such resident did not satisfy the requirements of this paragraph (such as the existence of losses). The competent authority of the Contracting State to which a request has been made under the preceding sentence shall consult with the competent authority of the other Contracting State before either granting or denying the request.

Paragraph 9

169. *Paragraph 9 mirrors the guidance in paragraphs 61 and 76 to 80 of the Commentary on Article 1. According to that guidance, the benefits of a tax convention should not be available where one of the principal purposes of certain transactions or arrangements is to secure a benefit under a tax treaty and obtaining that benefit in these circumstances would be contrary to the object and purpose of the relevant provisions of the tax convention. Paragraph 9 incorporates the principles underlying these paragraphs into the Convention itself in order to allow States to address cases of improper use of the Convention even if their domestic law does not allow them to do so in accordance with paragraphs 76 to 80 of the Commentary on Article 1; it also confirms the application of these principles for States whose domestic law already allows them to address such cases.*

170. *The provisions of paragraph 9 have the effect of denying a benefit under a tax convention where one of the principal purposes of an arrangement or transaction that has been entered into is to obtain a benefit under the convention. Where this is the case, however, the last part of the paragraph allows the person to whom the benefit would otherwise be denied the possibility of establishing that obtaining the benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention.*

171. Paragraph 9 supplements and does not restrict in any way the scope or application of the provisions of paragraphs 1 to 7 (the limitation-on-benefits rule) and of paragraph 8 (the rule applicable to a permanent establishment situated in a third jurisdiction: a benefit that is denied in accordance with these paragraphs is not a “benefit under the Convention” that paragraph 9 would also deny. Moreover, the guidance provided in the Commentary on paragraph 9 should not be used to interpret paragraphs 1 to 8 and vice-versa.

172. Conversely, the fact that a person is entitled to benefits under paragraphs 1 to 7 does not mean that these benefits cannot be denied under paragraph 9. Paragraphs 1 to 7 are rules that focus primarily on the legal nature, ownership in, and general activities of, residents of a Contracting State. As illustrated by the example in the next paragraph, these rules do not imply that a transaction or arrangement entered into by such a resident cannot constitute an improper use of a treaty provision.

173. Paragraph 9 must be read in the context of paragraphs 1 to 7 and of the rest of the Convention, including its preamble. This is particularly important for the purposes of determining the object and purpose of the relevant provisions of the Convention. Assume, for instance, that a public company whose shares are regularly traded on a recognised stock exchange in the Contracting State of which the company is a resident derives income from the other Contracting State. As long as that company is a “qualified person” as defined in paragraph 2, it is clear that the benefits of the Convention should not be denied solely on the basis of the ownership structure of that company, e.g. because a majority of the shareholders in that company are not residents of the same State. The object and purpose of subparagraph c) of paragraph 2 is to establish a threshold for the treaty entitlement of public companies whose shares are held by residents of different States. The fact that such a company is a qualified person does not mean, however, that benefits could not be denied under paragraph 9 for reasons that are unrelated to the ownership of the shares of that company. Assume, for instance, that such a public company is a bank that enters into a conduit financing arrangement intended to provide indirectly to a resident of a third State the benefit of lower source taxation under a tax treaty. In that case, paragraph 9 would apply to deny that benefit because subparagraph c) of paragraph 2, when read in the context of the rest of the Convention and, in particular, its preamble, cannot be considered as having the purpose, shared by the two Contracting States, of authorising treaty-shopping transactions entered into by public companies.

174. The provisions of paragraph 9 establish that a Contracting State may deny the benefits of a tax convention where it is reasonable to conclude, having considered all the relevant facts and circumstances, that one of the principal purposes of an arrangement or transaction was for a benefit under a tax treaty to be obtained. The provision is intended to ensure that tax conventions apply in accordance with the purpose for which they were entered into, i.e. to provide benefits in respect of bona fide exchanges of goods and services, and movements of capital and persons as opposed to arrangements whose principal objective is to secure a more favourable tax treatment.

175. The term “benefit” includes all limitations (e.g. a tax reduction, exemption, deferral or refund) on taxation imposed on the State of source under Articles 6 through 22 of the Convention, the relief from double taxation provided by Article 23, and the protection afforded to residents and nationals of a Contracting State under Article 24 or any other similar limitations. This includes, for example, limitations on the taxing rights of a Contracting State in respect of dividends, interest or royalties arising in that State, and paid to a resident of the other State (who is the beneficial owner) under Article 10, 11 or 12. It also includes limitations on the taxing rights of a Contracting State over a capital gain derived from the alienation of movable

property located in that State by a resident of the other State under Article 13. When a tax convention includes other limitations (such as a tax sparing provision), the provisions of this Article also apply to that benefit.

176. The phrase “that resulted directly or indirectly in that benefit” is deliberately broad and is intended to include situations where the person who claims the application of the benefits under a tax treaty may do so with respect to a transaction that is not the one that was undertaken for one of the principal purposes of obtaining that treaty benefit. This is illustrated by the following example:

TCO, a company resident of State T, has acquired all the shares and debts of SCO, a company resident of State S, that were previously held by SCO’s parent company. These include a loan made to SCO at 4 per cent interest payable on demand. State T does not have a tax convention with State S and, therefore, any interest paid by SCO to TCO is subject to a withholding tax on interest at a rate of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on interest paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State; also, that treaty does not include provisions similar to paragraphs 1 to 7. TCO decides to transfer the loan to RCO, a subsidiary resident of State R, in exchange for three promissory notes payable on demand on which interest is payable at 3.9 per cent.

In this example, whilst RCO is claiming the benefits of the State R-State S treaty with respect to a loan that was entered into for valid commercial reasons, if the facts of the case show that one of the principal purposes of TCO in transferring its loan to RCO was for RCO to obtain the benefit of the State R-State S treaty, then the provision would apply to deny that benefit as that benefit would result indirectly from the transfer of the loan.

177. The terms “arrangement or transaction” should be interpreted broadly and include any agreement, understanding, scheme, transaction or series of transactions, whether or not they are legally enforceable. In particular they include the creation, assignment, acquisition or transfer of the income itself, or of the property or right in respect of which the income accrues. These terms also encompass arrangements concerning the establishment, acquisition or maintenance of a person who derives the income, including the qualification of that person as a resident of one of the Contracting States, and include steps that persons may take themselves in order to establish residence. An example of an “arrangement” would be where steps are taken to ensure that meetings of the board of directors of a company are held in a different country in order to claim that the company has changed its residence. One transaction alone may result in a benefit, or it may operate in conjunction with a more elaborate series of transactions that together result in the benefit. In both cases the provisions of paragraph 9 may apply.

178. To determine whether or not one of the principal purposes of an arrangement or transaction is to obtain benefits under the Convention, it is important to undertake an objective analysis of the aims and objects of all persons involved in putting that arrangement or transaction in place or being a party to it. What are the purposes of an arrangement or transaction is a question of fact which can only be answered by considering all circumstances surrounding the arrangement or event on a case by case basis. It is not necessary to find conclusive proof of the intent of a person concerned with an arrangement or transaction, but it must be reasonable to conclude, after an objective analysis of the relevant facts and circumstances, that one of the principal purposes of the arrangement or transaction was to obtain the benefits of the tax convention. It should not be lightly assumed, however, that obtaining a benefit under a tax treaty was one of the principal purposes of an arrangement or

transaction and merely reviewing the effects of an arrangement will not usually enable a conclusion to be drawn about its purposes. Where, however, an arrangement can only be reasonably explained by a benefit that arises under a treaty, it may be concluded that one of the principal purposes of that arrangement was to obtain the benefit.

179. A person cannot avoid the application of this paragraph by merely asserting that the arrangement or transaction was not undertaken or arranged to obtain the benefits of the Convention. All of the evidence must be weighed to determine whether it is reasonable to conclude that an arrangement or transaction was undertaken or arranged for such purpose. The determination requires reasonableness, suggesting that the possibility of different interpretations of the events must be objectively considered.

180. The reference to “one of the principal purposes” in paragraph 9 means that obtaining the benefit under a tax convention need not be the sole or dominant purpose of a particular arrangement or transaction. It is sufficient that at least one of the principal purposes was to obtain the benefit. For example, a person may sell a property for various reasons, but if before the sale, that person becomes a resident of one of the Contracting States and one of the principal purposes for doing so is to obtain a benefit under a tax convention, paragraph 9 could apply notwithstanding the fact that there may also be other principal purposes for changing the residence, such as facilitating the sale of the property or the re-investment of the proceeds of the alienation.

181. A purpose will not be a principal purpose when it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining the benefit was not a principal consideration and would not have justified entering into any arrangement or transaction that has, alone or together with other transactions, resulted in the benefit. In particular, where an arrangement is inextricably linked to a core commercial activity, and its form has not been driven by considerations of obtaining a benefit, it is unlikely that its principal purpose will be considered to be to obtain that benefit. Where, however, an arrangement is entered into for the purpose of obtaining similar benefits under a number of treaties, it should not be considered that obtaining benefits under other treaties will prevent obtaining one benefit under one treaty from being considered a principal purpose for that arrangement. Assume, for example, that a taxpayer resident of State A enters into a conduit arrangement with a financial institution resident of State B in order for that financial institution to invest, for the ultimate benefit of that taxpayer, in bonds issued in a large number of States with which State B, but not State A, has tax treaties. If the facts and circumstances reveal that the arrangement has been entered into for the principal purpose of obtaining the benefits of these tax treaties, it should not be considered that obtaining a benefit under one specific treaty was not one of the principal purposes for that arrangement. Similarly, purposes related to the avoidance of domestic law should not be used to argue that obtaining a treaty benefit was merely accessory to such purposes.

182. The following examples illustrate the application of the paragraph (the examples included in paragraph 187 below should also be considered when determining whether and when the paragraph would apply in the case of conduit arrangements). When reading these examples, it is important to remember that the application of paragraph 9 must be determined on the basis of the facts and circumstances of each case. The examples below are therefore purely illustrative and should not be interpreted as providing conditions or requirements that similar transactions must meet in order to avoid the application of the provisions of paragraph 9:

- Example A: TCO, a company resident of State T, owns shares of SCO, a company listed on the stock exchange of State S. State T does not have a tax convention with State S and, therefore, any dividend paid by SCO to TCO is subject to a withholding tax on*

dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, there is no withholding tax on dividends paid by a company resident of a Contracting State and beneficially owned by a company resident of the other State. TCO enters into an agreement with RCO, an independent financial institution resident of State R, pursuant to which TCO assigns to RCO the right to the payment of dividends that have been declared but have not yet been paid by SCO.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which TCO assigned the right to the payment of dividends to RCO was for RCO to obtain the benefit of the exemption from source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that exemption under this treaty-shopping arrangement.

- *Example B: SCO, a company resident of State S, is the subsidiary of TCO, a company resident of State T. State T does not have a tax convention with State S and, therefore, any dividend paid by SCO to TCO is subject to a withholding tax on dividends of 25 per cent in accordance with the domestic law of State S. Under the State R-State S tax convention, however, the applicable rate of withholding tax on dividends paid by a company of State S to a resident of State R is 5 per cent. TCO therefore enters into an agreement with RCO, a financial institution resident of State R and a qualified person under subparagraph c) of paragraph 2 of this Article, pursuant to which RCO acquires the usufruct of newly issued non-voting preferred shares of SCO for a period of three years. TCO is the bare owner of these shares. The usufruct gives RCO the right to receive the dividends attached to these preferred shares. The amount paid by RCO to acquire the usufruct corresponds to the present value of the dividends to be paid on the preferred shares over the period of three years (discounted at the rate at which TCO could borrow from RCO).*

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the arrangement under which RCO acquired the usufruct of the preferred shares issued by SCO was to obtain the benefit of the 5 per cent limitation applicable to the source taxation of dividends provided for by the State R-State S tax convention and it would be contrary to the object and purpose of the tax convention to grant the benefit of that limitation under this treaty-shopping arrangement.

- *Example C: RCO, a company resident of State R, is in the business of producing electronic devices and its business is expanding rapidly. It is now considering establishing a manufacturing plant in a developing country in order to benefit from lower manufacturing costs. After a preliminary review, possible locations in three different countries are identified. All three countries provide similar economic and political environments. After considering the fact that State S is the only one of these countries with which State R has a tax convention, the decision is made to build the plant in that State.*

In this example, whilst the decision to invest in State S is taken in the light of the benefits provided by the State R-State S tax convention, it is clear that the principal purposes for making that investment and building the plant are related to the expansion of RCO's business and the lower manufacturing costs of that country. In this example, it cannot reasonably be considered that one of the principal purposes for building the

plant is to obtain treaty benefits. In addition, given that a general objective of tax conventions is to encourage cross-border investment, obtaining the benefits of the State R-State S convention for the investment in the plant built in State S is in accordance with the object and purpose of the provisions of that convention.

- *Example D: RCO, a collective investment vehicle resident of State R, manages a diversified portfolio of investments in the international financial market. RCO currently holds 15 per cent of its portfolio in shares of companies resident of State S, in respect of which it receives annual dividends. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 10 per cent.*

RCO's investment decisions take into account the existence of tax benefits provided under State R's extensive tax convention network. A majority of investors in RCO are residents of State R, but a number of investors (the minority investors) are residents of States with which State S does not have a tax convention. Investors' decisions to invest in RCO are not driven by any particular investment made by RCO, and RCO's investment strategy is not driven by the tax position of its investors. RCO annually distributes almost all of its income to its investors and pays taxes in State R on income not distributed during the year.

In making its decision to invest in shares of companies resident of State S, RCO considered the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, unless RCO's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax treaty to RCO.

- *Example E: RCO is a company resident of State R and, for the last 5 years, has held 24 per cent of the shares of company SCO, a resident of State S. Following the entry-into-force of a tax treaty between States R and S (Article 10 of which is identical to Article 10 of this Model), RCO decides to increase to 25 per cent its ownership of the shares of SCO. The facts and circumstances reveal that the decision to acquire these additional shares has been made primarily in order to obtain the benefit of the lower rate of tax provided by Article 10(2) a) of the treaty.*

In that case, although one of the principal purposes for the transaction through which the additional shares are acquired is clearly to obtain the benefit of Article 10(2) a), paragraph 9 would not apply because it may be established that granting that benefit in these circumstances would be in accordance with the object and purpose of Article 10(2) a). That subparagraph uses an arbitrary threshold of 25 per cent for the purposes of determining which shareholders are entitled to the benefit of the lower rate of tax on dividends and it is consistent with this approach to grant the benefits of the subparagraph to a taxpayer who genuinely increases its participation in a company in order to satisfy this requirement.

- *Example F: TCO is a publicly-traded company resident of State T. TCO's information technology business, which was developed in State T, has grown considerably over the last few years as a result of an aggressive merger and acquisition policy pursued by TCO's management. RCO, a company resident of State R (a State that has concluded many tax*

treaties providing for no or low source taxation of dividends and royalties), is the family-owned holding company of a group that is also active in the information technology sector. Almost all the shares of RCO are owned by residents of State R who are relatives of the entrepreneur who launched and developed the business of the RCO group. RCO's main assets are shares of subsidiaries located in neighbouring countries, including SCO, a company resident of State S, as well as patents developed in State R and licensed to these subsidiaries. TCO, which has long been interested in acquiring the business of the RCO group and its portfolio of patents, has made an offer to acquire all the shares of RCO.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that the principal purposes for the acquisition of RCO are related to the expansion of the business of the TCO group and do not include the obtaining of benefits under the treaty between States R and S. The fact that RCO acts primarily as a holding company does not change that result. It might well be that, after the acquisition of the shares of RCO, TCO's management will consider the benefits of the tax treaty concluded between State R and State S before deciding to keep in RCO the shares of SCO and the patents licensed to SCO. This, however, would not be a purpose related to the relevant transaction, which is the acquisition of the shares of RCO.

- *Example G: TCO, a company resident of State T, is a publicly-traded company resident of State T. It owns directly or indirectly a number of subsidiaries in different countries. Most of these companies carry on the business activities of the TCO group in local markets. In one region, TCO owns the shares of five such companies, each located in different neighbouring States. TCO is considering establishing a regional company for the purpose of providing group services to these companies, including management services such as accounting, legal advice and human resources; financing and treasury services such as managing currency risks and arranging hedging transactions, as well as some other non-financing related services. After a review of possible locations, TCO decides to establish the regional company, RCO, in State R. This decision is mainly driven by the skilled labour force, reliable legal system, business friendly environment, political stability, membership of a regional grouping, sophisticated banking industry and the comprehensive double taxation treaty network of State R, including its tax treaties with the five States in which TCO owns subsidiaries, which all provide low withholding tax rates.*

In this example, merely reviewing the effects of the treaties on future payments by the subsidiaries to the regional company would not enable a conclusion to be drawn about the purposes for the establishment of RCO by TCO. Assuming that the intra-group services to be provided by RCO, including the making of decisions necessary for the conduct of its business, constitute a real business through which RCO exercises substantive economic functions, using real assets and assuming real risks, and that business is carried on by RCO through its own personnel located in State R, it would not be reasonable to deny the benefits of the treaties concluded between State R and the five States where the subsidiaries operate unless other facts would indicate that RCO has been established for other tax purposes or unless RCO enters into specific transactions to which paragraph 9 would otherwise apply (see also example F in paragraph 187 below with respect to the interest and other remuneration that RCO might derive from its group financing activities).

- *Example H: TCO is a company resident of State T that is listed on the stock exchange of State T. It is the parent company of a multinational enterprise that conducts a variety of business activities globally (wholesaling, retailing, manufacturing, investment, finance, etc.).*

Issues related to transportation, time differences, limited availability of personnel fluent in foreign languages and the foreign location of business partners make it difficult for TCO to manage its foreign activities from State T. TCO therefore establishes RCO, a subsidiary resident of State R (a country where there are developed international trade and financial markets as well as an abundance of highly-qualified human resources), as a base for developing its foreign business activities. RCO carries on diverse business activities such as wholesaling, retailing, manufacturing, financing and domestic and international investment. RCO possesses the human and financial resources (in various areas such as legal, financial, accounting, taxation, risk management, auditing and internal control) that are necessary to perform these activities. It is clear that RCO's activities constitute the active conduct of a business in State R.

As part of its activities, RCO also undertakes the development of new manufacturing facilities in State S. For that purpose, it contributes equity capital and makes loans to SCO, a subsidiary resident of State S that RCO established for the purposes of owning these facilities. RCO will receive dividends and interest from SCO.

In this example, RCO has been established for business efficiency reasons and its financing of SCO through equity and loans is part of RCO's active conduct of a business in State R. Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for the establishment of RCO or the financing of SCO was the obtaining of the benefits of the treaty between States R and S, paragraph 9 would not apply to these transactions.

- *Example I: RCO, a company resident of State R, is one of a number of collective management organisations that grant licenses on behalf of neighbouring right and copyright holders for playing music in public or for broadcasting that music on radio, television or the internet. SCO, a company resident of State S, carries on similar activities in State S. Performers and copyright holders from various countries appoint RCO or SCO as their agent to grant licenses and to receive royalties with respect to the copyrights and neighbouring rights that they hold; RCO and SCO distribute to each right holder the amount of royalties that they receive on behalf of that holder minus a commission (in most cases, the amount distributed to each holder is relatively small). RCO has an agreement with SCO through which SCO grants licenses to users in State S and distributes royalties to RCO with respect to the rights that RCO manages; RCO does the same in State R with respect to the rights that SCO manages. SCO has agreed with the tax administration of State S that it will process the royalty withholding tax on the payments that it makes to RCO based on the applicable treaties between State S and the State of residence of each right holder represented by RCO based on information provided by RCO since these right holders are the beneficial owners of the royalties paid by SCO to RCO.*

In this example, it is clear that the arrangements between the right holders and RCO and SCO, and between SCO and RCO, have been put in place for the efficient management of the granting of licenses and collection of royalties with respect to a large number of small transactions. Whilst one of the purposes for entering into these arrangements may well be to ensure that withholding tax is collected at the correct treaty rate without the need for each individual right holder to apply for a refund on small payments, which would be cumbersome and expensive, it is clear that such purpose, which serves to promote the correct and efficient application of tax treaties, would be in accordance with the object and purpose of the relevant provisions of the applicable treaties.

- *Example J: RCO is a company resident of State R. It has successfully submitted a bid for the construction of a power plant for SCO, an independent company resident of State S. That construction project is expected to last 22 months. During the negotiation of the*

contract, the project is divided into two different contracts, each lasting 11 months. The first contract is concluded with RCO and the second contract is concluded with SUBCO, a recently incorporated wholly-owned subsidiary of RCO resident of State R. At the request of SCO, which wanted to ensure that RCO would be contractually liable for the performance of the two contracts, the contractual arrangements are such that RCO is jointly and severally liable with SUBCO for the performance of SUBCO's contractual obligations under the SUBCO-SCO contract.

In this example, in the absence of other facts and circumstances showing otherwise, it would be reasonable to conclude that one of the principal purposes for the conclusion of the separate contract under which SUBCO agreed to perform part of the construction project was for RCO and SUBCO to each obtain the benefit of the rule in paragraph 3 of Article 5 of the State R-State S tax convention. Granting the benefit of that rule in these circumstances would be contrary to the object and purpose of that paragraph as the time limitation of that paragraph would otherwise be meaningless.

- *Example K: RCO, a company resident of State R, is a wholly-owned subsidiary of Fund, an institutional investor that is a resident of State T and that was established and is subject to regulation in State T. RCO operates exclusively to generate an investment return as the regional investment platform for Fund through the acquisition and management of a diversified portfolio of private market investments located in countries in a regional grouping that includes State R. The decision to establish the regional investment platform in State R was mainly driven by the availability of directors with knowledge of regional business practices and regulations, the existence of a skilled multilingual workforce, State R's membership of a regional grouping and the extensive tax convention network of State R, including its tax convention with State S, which provides for low withholding tax rates. RCO employs an experienced local management team to review investment recommendations from Fund and performs various other functions which, depending on the case, may include approving and monitoring investments, carrying on treasury functions, maintaining RCO's books and records, and ensuring compliance with regulatory requirements in States where it invests. The board of directors of RCO is appointed by Fund and is composed of a majority of State R resident directors with expertise in investment management, as well as members of Fund's global management team. RCO pays tax and files tax returns in State R.*

RCO is now contemplating an investment in SCO, a company resident of State S. The investment in SCO would constitute only part of RCO's overall investment portfolio, which includes investments in a number of countries in addition to State S which are also members of the same regional grouping. Under the tax convention between State R and State S, the withholding tax rate on dividends is reduced from 30 per cent to 5 per cent. Under the tax convention between State S and State T, the withholding tax rate on dividends is 10 per cent.

In making its decision whether or not to invest in SCO, RCO considers the existence of a benefit under the State R-State S tax convention with respect to dividends, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made, including the reasons for establishing RCO in State R and the investment functions and other activities carried out in State R. In this example, in the absence of other facts or circumstances showing that RCO's investment is part of an arrangement or relates to another transaction

undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

- *Example L: RCO, a securitisation company resident of State R, was established by a bank which sold to RCO a portfolio of loans and other receivables owed by debtors located in a number of jurisdictions. RCO is fully debt-funded. RCO has issued a single share which is held on trust and has no economic value. RCO's debt finance was raised through the issuance of notes that are widely-held by third-party investors. The notes are listed on a recognised stock exchange, which allows for their trading on the secondary market, and are held through a clearing system. To comply with regulatory requirements, the bank has also retained a small percentage of the listed, widely-held debt securities issued by RCO. RCO currently holds 60 per cent of its portfolio in receivables of small and medium sized enterprises resident in State S, in respect of which RCO receives regular interest payments. The bank is a resident of State T which has a tax treaty with State S that provides benefits equivalent to those provided under the State R-State S tax treaty. Under the tax treaty between State R and State S, the withholding tax rate on interest is limited to 10 per cent (the domestic law of State S provides for a withholding tax of 30 per cent).*

In establishing RCO, the bank took into account a large number of issues, including State R's robust securitisation framework, its securitisation and other relevant legislation, the availability of skilled and experienced personnel and support services in State R and the existence of tax benefits provided under State R's extensive tax convention network. Investors' decisions to invest in RCO are not driven by any particular investment made by RCO and RCO's investment strategy is not driven by the tax position of the investors. RCO is taxed in State R on income earned and is entitled to a full deduction for interest payments made to investors.

In making its decision to sell receivables owed by enterprises resident in State S, the bank and RCO considered the existence of a benefit under the State R-State S tax convention with respect to interest, but this alone would not be sufficient to trigger the application of paragraph 9. The intent of tax treaties is to provide benefits to encourage cross-border investment and, therefore, to determine whether or not paragraph 9 applies to an investment, it is necessary to consider the context in which the investment was made. In this example, in the absence of other facts or circumstances showing that RCO's investment is part of an arrangement or relates to another transaction undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the State R-State S tax convention to RCO.

- *Example M: Real Estate Fund, a State C partnership treated as fiscally transparent under the domestic tax law of State C, is established to invest in a portfolio of real estate investments in a specific geographic area. Real Estate Fund is managed by a regulated fund manager and is marketed to institutional investors, such as pension schemes and sovereign wealth funds, on the basis of the fund's investment mandate. A range of investors resident in different jurisdictions commit funds to Real Estate Fund. The investment strategy of Real Estate Fund, which is set out in the marketing materials for the fund, is not driven by the tax positions of the investors, but is based on investing in certain real estate assets, maximising their value and realising appreciation through the disposal of the investments. Real Estate Fund's investments are made through a holding company, RCO, established in State R. RCO manages all of Real Estate Fund's immovable property assets and holds these assets indirectly through wholly-owned companies resident of the States where the immovable property assets are situated; it also provides debt and/or equity financing to these local companies, which directly own the*

underlying investments. RCO is established for a number of commercial and legal reasons, such as to protect Real Estate Fund from the liabilities of and potential claims against the fund's immovable property assets, and to facilitate debt financing (including from third-party lenders) and the making, management and disposal of investments. It is also established for the purposes of administering the claims for relief of withholding tax under any applicable tax treaty. This is an important function of RCO as it is administratively simpler for one company to get treaty relief rather than have each institutional investor process its own claim for relief, especially if the treaty relief to which each investor would be entitled as regards a specific item of income is a small amount. After a review of possible locations, Real Estate Fund decided to establish RCO in State R. This decision was mainly driven by the political stability of State R, its regulatory and legal systems, lender and investor familiarity, access to appropriately qualified personnel and the extensive tax convention network of State R, including its treaties with other States within the specific geographic area targeted for investment. RCO, however, does not obtain treaty benefits that are better than the benefits to which its investors would have been entitled if they had made the same investments directly in these States and had obtained treaty benefits under the treaties concluded by their States of residence.

In this example, whilst the decision to locate RCO in State R is taken in light of the existence of benefits under the tax conventions between State R and the States within the specific geographic area targeted for investment, it is clear that RCO's immovable property investments are made for commercial purposes consistent with the investment mandate of the fund. Also, RCO does not derive any treaty benefits that are better than those to which its investors would be entitled and each State where RCO's immovable property investments are made is allowed to tax the income derived directly from such investments. In the absence of other facts or circumstances showing that RCO's investments are part of an arrangement, or relate to another transaction, undertaken for a principal purpose of obtaining the benefit of the Convention, it would not be reasonable to deny the benefit of the tax treaties between RCO and the States in which RCO's immovable property investments are located.

183. In a number of States, the application of the general anti-abuse rule found in domestic law is subject to some form of approval process. In some cases, the process provides for an internal acceleration of disputes on such provisions to senior officials in the administration. In other cases, the process allows for advisory panels to provide their views to the administration on the application of the rule. These types of approval processes reflect the serious nature of disputes in this area and promote overall consistency in the application of the rule. States may wish to establish a similar form of administrative process that would ensure that paragraph 9 is only applied after approval at a senior level within the administration.

184. Also, some States consider that where a person is denied a treaty benefit in accordance with paragraph 9, the competent authority of the Contracting State that would otherwise have granted this benefit should have the possibility of treating that person as being entitled to this benefit, or to different benefits with respect to the relevant item of income or capital, if such benefits would have been granted to that person in the absence of the transaction or arrangement that triggered the application of paragraph 9. In order to allow that possibility, such States are free to include the following additional paragraph in their bilateral treaties:

10. Where a benefit under this Convention is denied to a person under paragraph 9, the competent authority of the Contracting State that would otherwise have granted this benefit shall nevertheless treat that person as being entitled to this benefit, or to different benefits with respect to a specific item of income or capital, if such competent authority, upon request from that person and after consideration of the relevant facts and

circumstances, determines that such benefits would have been granted to that person in the absence of the transaction or arrangement referred to in paragraph 9. The competent authority of the Contracting State to which the request has been made will consult with the competent authority of the other State before rejecting a request made under this paragraph by a resident of that other State.

185. For the purpose of this alternative provision, the determination that benefits would have been granted in the absence of the transaction or arrangement referred to in paragraph 9 and the determination of the benefits that should be granted are left to the discretion of the competent authority to which the request is made. The alternative provision grants broad discretion to the competent authority for the purposes of these determinations. The provision does require, however, that the competent authority must consider the relevant facts and circumstances before reaching a decision and must consult the competent authority of the other Contracting State before rejecting a request to grant benefits if that request was made by a resident of that other State. The first requirement seeks to ensure that the competent authority will consider each request on its own merits whilst the requirement that the competent authority of the other Contracting State be consulted if the request is made by a resident of that other State should ensure that Contracting States treat similar cases in a consistent manner and can justify their decision on the basis of the facts and circumstances of the particular case. This consultation process does not, however, require that the competent authority to which the request was presented obtain the agreement of the competent authority that is consulted.

186. The following example illustrates the application of this alternative provision. Assume that an individual who is a resident of State R and who owns shares in a company resident of State S assigns the right to receive dividends declared by that company to another company resident of State R which owns more than 10 per cent of the capital of the paying company for the principal purpose of obtaining the reduced rate of source taxation provided for in subparagraph a) of paragraph 2 of Article 10. In such a case, if it is determined that the benefit of that subparagraph should be denied pursuant to paragraph 9, the alternative provision would allow the competent authority of State S to grant the benefit of the reduced rate provided for in subparagraph b) of paragraph 2 of Article 10 if that competent authority determined that such benefit would have been granted in the absence of the assignment to another company of the right to receive dividends.

187. For various reasons, some States may be unable to accept the rule included in paragraph 9. In order to effectively address all forms of treaty-shopping, however, these States will need to supplement the limitation-on-benefits rule of paragraphs 1 to 7 by rules that will address treaty-shopping strategies commonly referred to as “conduit arrangements” that would not be caught by these paragraphs. These rules would deal with such conduit arrangements by denying the benefits of the provisions of the Convention, or of some of them (e.g. those of Articles 7, 10, 11, 12 and 21), in respect of any income obtained under, or as part of, a conduit arrangement. They could also take the form of domestic anti-abuse rules or judicial doctrines that would achieve a similar result. The following are examples of conduit arrangements that would need to be addressed by such rules as well as examples of transactions that should not be considered to be conduit arrangements for that purpose:

- Example A: RCO a publicly-traded company resident of State R, owns all of the shares of SCO, a company resident of State S. TCO, a company resident of State T, which does not have a tax treaty with State S, would like to purchase a minority interest in SCO but believes that the domestic withholding tax on dividends levied by State S would make the investment uneconomic. RCO proposes that SCO instead issue to RCO preferred shares paying a fixed return of 4 per cent plus a contingent return of 20 per cent of SCO’s net*

profits. The preferred shares mature in 20 years. TCO will enter into a separate contract with RCO pursuant to which it will pay to RCO an amount equal to the issue price of the preferred shares and will receive from RCO after 20 years the redemption price of the shares. During the 20 years, RCO will pay to TCO an amount equal to 3.75 per cent of the issue price plus 20 per cent of SCO's net profits.

This arrangement constitutes a conduit arrangement that should be addressed by the rules referred to above because one of the principal purposes for RCO participating in the transaction was to achieve a reduction of the withholding tax for TCO.

- *Example B: SCO, a company resident of State S, has issued only one class of shares that is 100 per cent owned by RCO, a company resident of State R. RCO also has only one class of shares outstanding, all of which is owned by TCO, a company resident of State T, which does not have a tax treaty with State S. RCO is engaged in the manufacture of electronics products, and SCO serves as RCO's exclusive distributor in State S. Under paragraph 3 of the limitation-of-benefits rule, RCO will be entitled to benefits with respect to dividends received from SCO, even though the shares of RCO are owned by a resident of a third country.*

This example refers to a normal commercial structure where RCO and SCO carry on real economic activities in States R and S. The payment of dividends by subsidiaries such as SCO is a normal business transaction. In the absence of evidence showing that one of the principal purposes for setting up that structure was to flow-through dividends from SCO to TCO, this structure would not constitute a conduit arrangement.

- *Example C: TCO, a company resident of State T, which does not have a tax treaty with State S, loans 1 000 000 to SCO, a company resident of State S that is a wholly-owned subsidiary of TCO, in exchange for a note issued by SCO. TCO later realises that it can avoid the withholding tax on interest levied by State S by assigning the note to its wholly-owned subsidiary RCO, a resident of State R (the treaty between States R and S does not allow source taxation of interest in certain circumstances). TCO therefore assigns the note to RCO in exchange for a note issued by RCO to TCO. The note issued by SCO pays interest at 7 per cent and the note issued by RCO pays interest at 6 per cent.*

The transaction through which RCO acquired the note issued by SCO constitutes a conduit arrangement because it was structured to eliminate the withholding tax that TCO would otherwise have paid to State S.

- *Example D: TCO, a company resident of State T, which does not have a tax treaty with State S, owns all of the shares of SCO, a company resident of State S. TCO has for a long time done all of its banking with RCO, a bank resident of State R which is unrelated to TCO and SCO, because the banking system in State T is relatively unsophisticated. As a result, TCO tends to maintain a large deposit with RCO. When SCO needs a loan to fund an acquisition, TCO suggests that SCO deal with RCO, which is already familiar with the business conducted by TCO and SCO. SCO discusses the loan with several different banks, all on terms similar to those offered by RCO, but eventually enters into the loan with RCO, in part because interest paid to RCO would not be subject to withholding tax in State S pursuant to the treaty between States S and R, whilst interest paid to banks resident of State T would be subject to tax in State S.*

The fact that benefits of the treaty between States R and S are available if SCO borrows from RCO, and that similar benefits might not be available if it borrowed elsewhere, is clearly a factor in SCO's decision (which may be influenced by advice given to it by TCO, its 100 per cent shareholder). It may even be a decisive factor, in the sense that, all

else being equal, the availability of treaty benefits may swing the balance in favour of borrowing from RCO rather than from another lender. However, whether the obtaining of treaty benefits was one of the principal purposes of the transaction would have to be determined by reference to the particular facts and circumstances. In the facts presented above, RCO is unrelated to TCO and SCO and there is no indication that the interest paid by SCO flows through to TCO one way or another. The fact that TCO has historically maintained large deposits with RCO is also a factor that indicates that the loan to SCO is not matched by a specific deposit from TCO. On the specific facts as presented, the transaction would therefore likely not constitute a conduit arrangement.

If, however, RCO's decision to lend to SCO was dependent on TCO providing a matching collateral deposit to secure the loan so that RCO would not have entered into the transaction on substantially the same terms in the absence of that deposit, the facts would indicate that TCO was indirectly lending to SCO by routing the loan through a bank of State R and, in that case, the transaction would constitute a conduit arrangement.

- *Example E: RCO, a publicly-traded company resident of State R, is the holding company for a manufacturing group in a highly competitive technological field. The manufacturing group conducts research in subsidiaries located around the world. Any patents developed in a subsidiary are licensed by the subsidiary to RCO, which then licenses the technology to its subsidiaries that need it. RCO keeps only a small spread with respect to the royalties it receives, so that most of the profit goes to the subsidiary that incurred the risk with respect to developing the technology. TCO, a company located in a State with which State S does not have a tax treaty, has developed a process that will substantially increase the profitability of all of RCO's subsidiaries, including SCO, a company resident of State S. According to its usual practice, RCO licenses the technology from TCO and sub-licenses the technology to its subsidiaries. SCO pays a royalty to RCO, substantially all of which is paid to TCO.*

In this example, there is no indication that RCO established its licensing business in order to reduce the withholding tax payable in State S. Because RCO is conforming to the standard commercial organisation and behaviour of the group in the way that it structures its licensing and sub-licensing activities and assuming the same structure is employed with respect to other subsidiaries carrying out similar activities in countries which have treaties which offer similar or more favourable benefits, the arrangement between SCO, RCO and TCO does not constitute a conduit arrangement.

- *Example F: TCO is a publicly-traded company resident of State T, which does not have a tax treaty with State S. TCO is the parent of a worldwide group of companies, including RCO, a company resident of State R, and SCO, a company resident of State S. SCO is engaged in the active conduct of a business in State S. RCO is responsible for coordinating the financing of all of the subsidiaries of TCO. RCO maintains a centralised cash management accounting system for TCO and its subsidiaries in which it records all intercompany payables and receivables. RCO is responsible for disbursing or receiving any cash payments required by transactions between its affiliates and unrelated parties. RCO enters into interest rate and foreign exchange contracts as necessary to manage the risks arising from mismatches in incoming and outgoing cash flows. The activities of RCO are intended (and reasonably can be expected) to reduce transaction costs and overhead and other fixed costs. RCO has 50 employees, including clerical and other back office personnel, located in State R; this number of employees reflects the size of the business activities of RCO. TCO lends to RCO 15 million in*

currency A (worth 10 million in currency B) in exchange for a 10-year note that pays 5 per cent interest annually. On the same day, RCO lends 10 million in currency B to SCO in exchange for a 10-year note that pays 5 per cent interest annually. RCO does not enter into a long-term hedging transaction with respect to these financing transactions, but manages the interest rate and currency risk arising from the transactions on a daily, weekly or quarterly basis by entering into forward currency contracts.

In this example, RCO appears to be carrying on a real business performing substantive economic functions, using real assets and assuming real risks; it is also performing significant activities with respect to the transactions with TCO and SCO, which appear to be typical of RCO's normal treasury business. RCO also appears to be bearing the interest rate and currency risk. Based on these facts and in the absence of other facts that would indicate that one of the principal purposes for these loans was the avoidance of withholding tax in State S, the loan from TCO to RCO and the loan from RCO to SCO do not constitute a conduit arrangement.

PART 2 - CONSEQUENTIAL CHANGES TO THE OECD MODEL TAX CONVENTION

[All the changes to the existing text of the Model Tax Convention put forward in Part 2 appear in *bold italics* for additions and ~~strikethrough~~ for deletions]

A. CHANGES TO THE INTRODUCTION

1. Add the following new paragraph 11.2 to the Introduction:

11.2 Since the publication of the first ambulatory version in 1992, the Model Convention was updated 10 times (in 1994, 1995, 1997, 2000, 2002, 2005, 2008, 2010, 2014 and 2017). The last such update, which was adopted in 2017, included a large number of changes resulting from the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, from the final reports on Actions 2, 6, 7 and 14¹ produced as part of that project.

2. Replace paragraphs 21, 22, 23, 26, 35 and 39 to 41 of the Introduction by the following:

21. The following are the classes of income and capital that may be taxed without any limitation in the State of source or situs:

- income from immovable property situated in that State (including income from agriculture or forestry), gains from the alienation of such property, and capital representing it (Article 6 and paragraph 1 of Articles 13 and 22) as well as gains from the alienation of shares deriving more than 50 per cent of their value from such property (paragraph 4 of Article 13);
- profits of a permanent establishment situated in that State, gains from the alienation of such a permanent establishment, and capital representing movable property forming part of the business property of such a permanent establishment (Article 7 and paragraph 2 of Articles 13 and 22); an exception is made, however, if the permanent establishment is maintained for the purposes of international shipping, ~~inland waterways transport,~~ and international air transport (see paragraph 23 below);
- income from the activities of artistes and sportsmen exercised in that State, irrespective of whether such income accrues to the artiste or sportsman himself or to another person (Article 17);
- directors' fees paid by a company that is a resident of that State (Article 16);
- remuneration in respect of an employment in the private sector, exercised in that State, unless the employee is present therein for a period not exceeding 183 days in any twelve month period commencing or ending in the fiscal year concerned and certain conditions are met; ~~and remuneration in respect of an employment exercised aboard a ship or aircraft operated internationally or aboard a boat, if the place of effective management of the enterprise is situated in that State (Article 15);~~

¹ Neutralising the Effects of Hybrid Mismatch Arrangements, Action 2 - 2015 Final Report, *OECD Publishing, Paris*, DOI: <http://dx.doi.org/10.1787/9789264241138-en>; OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, *OECD Publishing, Paris*, DOI: <http://dx.doi.org/10.1787/9789264241695-en>; OECD (2015), Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report, *OECD Publishing, Paris*, DOI: <http://dx.doi.org/10.1787/9789264241220-en>; OECD (2015), Making Dispute Resolution Mechanisms More Effective, Action 14 - 2015 Final Report, *OECD Publishing, Paris*, DOI: <http://dx.doi.org/10.1787/9789264241633-en>.

- subject to certain conditions, remuneration and pensions paid in respect of government service (Article 19).
22. The following are the classes of income that may be subjected to limited taxation in the State of source:
- dividends: provided the holding in respect of which the dividends are paid is not effectively connected with a permanent establishment in the State of source, that State must limit its tax to 5 per cent of the gross amount of the dividends, where the beneficial owner is a company that holds directly, **during a 365 day period**, at least 25 per cent of the capital of the company paying the dividends, and to 15 per cent of their gross amount in other cases (Article 10);
 - interest: subject to the same proviso as in the case of dividends, the State of source must limit its tax to 10 per cent of the gross amount of the interest, except for any interest in excess of a normal amount (Article 11).
23. Other items of income or capital may not be taxed in the State of source or situs; as a rule they are taxable only in the State of residence of the taxpayer. This applies, for example, to royalties (Article 12), gains from the alienation of shares or securities (paragraph 5 of Article 13, subject to the exception of paragraph 4 of Article 13), **remuneration in respect of an employment exercised aboard a ship or aircraft operated in international traffic (paragraph 3 of Article 15)**, private sector pensions (Article 18), payments received by a student for the purposes of his education or training (Article 20), and capital represented by shares or securities (paragraph 4 of Article 22). ~~Similarly, profits from the operation of ships or aircraft in international traffic or of boats engaged in inland waterways transport, gains from the alienation of such ships, boats, or aircraft, and capital represented by them, are taxable only in the State in which the place of effective management of the enterprise is situated~~ **of residence** (Article 8 and paragraph 3 of Articles 13 and 22). Business profits that are not attributable to a permanent establishment in the State of source are **also** taxable only in the State of residence (paragraph 1 of Article 7).
26. There are a number of special provisions in the Convention. These provisions concern:
- the elimination of tax discrimination in various circumstances (Article 24);
 - the establishment of a mutual agreement procedure for eliminating double taxation and resolving conflicts of interpretation of the Convention (Article 25);
 - the exchange of information between the tax authorities of the Contracting States (Article 26);
 - the assistance by Contracting States in the collection of each other's taxes (Article 27);
 - the tax treatment of members of diplomatic missions and consular posts in accordance with international law (Article 28);
 - **the entitlement to the benefits of the Convention (Article 29);**
 - the territorial extension of the Convention (Article ~~29~~**30**).
35. Needless to say, amendments to the Articles of the Model Convention and changes to the Commentaries that are a direct result of these amendments are not relevant to the interpretation or application of previously concluded conventions where the provisions of those conventions are different in substance from the amended Articles (*see, for instance, paragraph 4 of the Commentary on Article 5*). However, other changes or additions to the Commentaries are

normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD member countries as to the proper interpretation of existing provisions and their application to specific situations.

39. Also relevant is the Convention on Mutual Administrative Assistance in Tax Matters, which was drawn up within the Council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs. This Convention entered into force on 1 April 1995. ***Another relevant multilateral convention is the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS, which was drafted in order to facilitate the implementation of the treaty-related measures resulting from the OECD/G20 Base Erosion and Profit Shifting Project and which was opened for signature on 31 December 2016.***

40. Despite these ~~two~~ ***multilateral*** conventions, there are no reasons to believe that the conclusion of a multilateral tax convention involving ~~all member~~ ***a large number of*** countries ***that could replace the network of current bilateral tax conventions*** could now be considered practicable. The Committee therefore considers that bilateral conventions are still a more appropriate way to ensure the elimination of double taxation at the international level.

Tax avoidance and evasion; improper use of conventions

41. ~~The Committee on Fiscal Affairs continues to examine both the improper use of tax conventions and international tax evasion. The problem is referred to in the Commentaries on several Articles. In particular, Article 26, as clarified in the Commentary, enables States to exchange information to combat these abuses.~~ ***Issues related to the improper use of tax conventions and international tax avoidance and evasion have been a constant preoccupation of the Committee on Fiscal Affairs since the publication of the 1963 Draft Convention. Over the years, a number of provisions (such as Article 29, which was added in 2017) have been added to the Model Convention, or have been modified, in order to address various forms of tax avoidance and evasion. The Committee on Fiscal Affairs will continue to monitor the application of tax treaties in order to ensure that, as stated in the preamble of the Convention, the provisions of the Convention are not used for the purposes of tax avoidance or evasion.***

B. CHANGES TO THE TABLE OF CONTENTS

3. Replace the table of contents for Chapter VI and VII by the following:

Chapter VI

SPECIAL PROVISIONS

Article 24	Non-discrimination
Article 25	Mutual agreement procedure
Article 26	Exchange of information
Article 27	Assistance in the collection of taxes
Article 28	Members of diplomatic missions and consular posts
Article 29	<i>Entitlement to benefits</i>
Article 29 30	Territorial extension

Chapter VII

FINAL PROVISIONS

Article 30 31	Entry into force
Article 31 32	Termination

C. CHANGES TO THE CONVENTION

4. Replace Article 29 by the following:

ARTICLE ~~29~~30
TERRITORIAL EXTENSION¹

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article ~~30~~32 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.

5. Replace the titles of Articles 30 and 31 by the following:

ARTICLE ~~30~~31
ENTRY INTO FORCE

ARTICLE ~~31~~32
TERMINATION

D. CHANGES TO THE COMMENTARY

Article 3

6. Replace paragraph 3 of the Commentary on Article 3 by the following:

3. The term “company” means in the first place any body corporate. In addition, the term covers any other taxable unit that is treated as a body corporate for the purposes of the tax law of the Contracting State of which it is a resident. The definition is drafted with special regard to the Article on dividends. The term “company” has a bearing only on that Article, paragraphs 7 **and** 8 of Article 5, and Articles 16 **and** 29.

Article 4

7. Replace paragraphs 8.5 and 8.8 of the Commentary on Article 4 by the following:

8.5 This raises the issue of the application of paragraph 1 to sovereign wealth funds, which are special purpose investment funds or arrangements created by a State or a political subdivision for macroeconomic purposes. These funds hold, manage or administer assets to achieve financial objectives, and employ a set of investment strategies which include investing in foreign financial assets. They are commonly established out of balance of payments surpluses, official foreign currency operations, the proceeds of privatisations, fiscal surpluses or receipts resulting from commodity exports.¹ Whether a sovereign wealth fund qualifies as a “resident of a Contracting State” depends on the facts and circumstances of each case. For example, when a sovereign wealth fund is an integral part of the State, it will likely fall within the scope of the expression “[the] State and any political subdivision or local authority thereof” in Article 4. In other cases, paragraphs ~~8.5 and 8.6~~ **8.11 and 8.12** below will be relevant. States may want to address the issue in the course of bilateral negotiations, particularly in relation to whether a sovereign wealth fund qualifies as a “person” and is “liable to tax” for purposes of the relevant tax treaty (see also paragraphs ~~6.35 to 6.39~~ **50 to 53** of the Commentary on Article 1).

~~8.8~~ **8.13** Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. ***In that case, however, paragraph 2 of Article 1 clarifies that the Convention will apply to the partnership’s income to the extent that the income is treated, for purposes of taxation by that State, as the income of a partner who is a resident of that State. The same treatment will apply to income of other entities or arrangements that are treated as fiscally transparent under the tax law of a Contracting State (see paragraphs 2 to 16 of the Commentary on Article 1).*** ~~In such a case, since the income of the partnership “flows through” to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.~~

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

Article 6

8. Replace paragraph 2 of the Commentary on Article 6 by the following:

2. Defining the concept of immovable property by reference to the law of the State in which the property is situated, as is provided in paragraph 2, will help to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not. The paragraph, however, specifically mentions the assets and rights which must always be regarded as immovable property. In fact such assets and rights are already treated as immovable property according to the laws or the taxation rules of most OECD member countries. Conversely, the paragraph stipulates that ships, ~~boats~~ and aircraft shall never be considered as immovable property. No special provision has been included as regards income from indebtedness secured by immovable property, as this question is settled by Article 11.

Article 7

9. Replace paragraphs 14 and 43 of the Commentary on Article 7 by the following:

14. The purpose of paragraph 1 is to limit the right of one Contracting State to tax the business profits of enterprises of the other Contracting State. **As confirmed by paragraph 3 of Article 1,** ~~The~~ paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph ~~23-31~~ **81** of the Commentary on Article 1 ~~and paragraphs 37 to 39 of the Commentary on Article 10~~).

43. A final provision that was deleted from the Article at the same time provided that “[n]o profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.” Subparagraph 4 *d*) of Article 5, **as it read at that time,** recognised that where an enterprise of a Contracting State maintained in the other State a fixed place of business exclusively for the purpose of purchasing goods for itself, its activity at that location should not be considered to have reached a level that justified taxation in that other State (**changes made to Article 5 in 2017 have restricted the scope of that exception**). Where, however, subparagraph 4 *d*) ~~is~~**was** not applicable because other activities ~~are~~**were** carried on by the enterprise through that place of business, which therefore constituted a permanent establishment, it ~~is~~**was** appropriate to attribute profits to all the functions performed at that location. Indeed, if the purchasing activities ~~were~~**had been** performed by an independent enterprise, the purchaser would **have been** remunerated on an arm's length basis for its services. Also, since a tax exemption restricted to purchasing activities undertaken for the enterprise ~~would~~**required** that expenses incurred for the purposes of performing these activities be excluded in determining the profits of the permanent establishment, such an exemption ~~would~~ raise administrative problems. The Committee therefore considered that a provision according to which no profits should be attributed to a permanent establishment by reason of the mere purchase of goods or merchandise for the enterprise was not consistent with the arm's length principle and should not be included in the Article.

Article 8

10. Replace the title of the Commentary on Article 8 by the following:

**COMMENTARY ON ARTICLE 8
CONCERNING THE TAXATION OF PROFITS FROM SHIPPING, INLAND
WATERWAYS TRANSPORT AND AIR TRANSPORT**

Article 10

11. Replace paragraphs 2, 9, 10, 12.4, 12.5, 12.7, 13.2, 16, 17, 19, 20, 22, 32, 37, 59, 67.4 and 67.6 of the Commentary on Article 10 by the following:

2. *Many States consider that* ~~the~~ profits of a business carried on by a partnership are the partners' profits derived from their own exertions; for them they are business profits. So *these States treat the partnership as fiscally transparent and* the partners ~~are~~ ordinarily taxed personally on ~~his~~ *their* share of the partnership capital and partnership profits.

9. Paragraph 2 reserves a right to tax to the State of source of the dividends, i.e. to the State of which the company paying the dividends is a resident; this right to tax, however, is limited considerably. *Under subparagraph b),* ~~the~~ rate of tax is limited to 15 per cent, which appears to be a reasonable maximum figure. A higher rate could hardly be justified since the State of source can already tax the company's profits.

10. On the other hand, a lower rate (5 per cent) is expressly provided *by subparagraph a)* in respect of dividends paid by a subsidiary company to its parent company. If a company of one of the States owns directly, *throughout a 365 day period that includes the day of the payment of a dividend,* a holding of at least 25 per cent in a company of the other State, it is reasonable that *the* payments of *that dividend* ~~profits~~ by the subsidiary to the foreign parent company should be taxed less heavily to avoid recurrent taxation and to facilitate international investment. The realisation of this intention depends on the fiscal treatment of the dividends in the State of which the parent company is a resident (see paragraphs 49 to 54 of the Commentary on Articles 23 A and 23 B).

12.4 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the dividend is not the "beneficial owner" because that recipient's right to use and enjoy the dividend is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs ~~6.8 to 6.3422 to~~ **48** of the Commentary on Article 1. Where the recipient of a dividend does have the right to use and enjoy the dividend unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of that dividend. It should also be noted that Article 10 refers to the beneficial owner of a dividend as opposed to the owner of the shares, which may be different in some cases.

12.5 The fact that the recipient of a dividend is considered to be the beneficial owner of that dividend does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision (see also paragraphs 17 and 22 below). ***The provisions of Article 29 and the principles put forward***. As explained in the section on “Improper use of the Convention” in the Commentary on Article 1, there are many ways of addressing conduit company and, more generally, ***will apply to prevent abuses, including treaty shopping situations where the recipient is the beneficial owner of the dividends***. These include specific anti-abuse provisions in treaties, general anti-abuse rules and substance over form or economic substance approaches. Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the dividend to someone else), it does not deal with other cases of ***abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles*** and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

12.7 Subject to other conditions imposed by the Article ***and the other provisions of the Convention***, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 and in 2014 to clarify this point, which has been the consistent position of all member countries).

13.2 Similarly, some States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.38 and 6.39-52 and 53 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:

Notwithstanding the provisions of paragraph 2, dividends referred to in paragraph 1 ***paid by a company which is a resident of a Contracting State*** shall be taxable only in the ***other*** Contracting State of which the recipient is a resident if the beneficial owner of the dividends is that State or a political subdivision or local authority thereof.

~~16. — Subparagraph a) of paragraph 2 does not require that the company receiving the dividends must have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, i.e. in most cases the situation existing at the time when the dividends become legally available to the shareholders. The primary reason for this resides in the desire to have a provision which is applicable as broadly as possible. To require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received. In view of this, Contracting States may include a similar condition in their conventions.~~

17. ***Before 2017, paragraph 17 of the Commentary on the Article provided that*** ¶ “[t]he reduction envisaged in subparagraph a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly

before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction.”: *Such abuses were addressed by the final report on Action 6¹ of the OECD/G20 Base Erosion and Profit Shifting (BEPS) Project. As a result of that report, subparagraph a) was modified in order to restrict its application to situations where the company that receives the dividend holds directly at least 25 per cent of the capital of the company paying the dividends throughout a 365 day period that includes the day of the payment of the dividend. The subparagraph also provides, however, that in computing that period, changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, should not be taken into account. Also, the addition of Article 29 will address other abusive arrangements aimed at obtaining the benefits of subparagraph a).*

19. The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a refund (see, however, paragraph 26.2-109 of the Commentary on Article 1). *Potential abuses arising from situations where dividends paid by a company resident of a Contracting State are attributable to a permanent establishment which an enterprise of the other State has in a third State are dealt with in paragraph 8 of Article 29. Other* Specific questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

20. *Also, the paragraph* ~~It~~ does not specify whether or not the relief in the State of source should be conditional upon the dividends being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

22. *The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, the final report on Action 6² produced as part of that project, have addressed a number of abuses related to cases such as the following one:* Attention is drawn generally to the following case: the beneficial owner of the dividends arising in a Contracting State is a company resident of the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). *Apart from the fact that Article 29, which was included in the Convention as a result of the final report on Action 6, addresses the treaty shopping aspects of that case, States wishing to deny the benefits of Article 10 to dividends that enjoy a preferential tax treatment in the State of residence may consider including in their conventions provisions such as those described in paragraphs 82 to 100 of the Commentary on Article 1.* ~~The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the dividends the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.~~

32. It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that *the provisions of Article 29 (and, in particular, paragraph 8 of that Article) and the principles put forward in the section on*

1 OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264241695-en>.

2 OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264241695-en>.

“Improper use of the Convention” in the Commentary on Article 1 will typically prevent such abusive transactions ~~might trigger the application of domestic anti-abuse rules~~, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, as explained below, that the requirement that a shareholding be “effectively connected” to such a location requires more than merely recording the shareholding in the books of the permanent establishment for accounting purposes.

37. **As confirmed by paragraph 3 of Article 1, It might be argued that paragraph 5 cannot be interpreted as preventing the State of residence of where the a taxpayer’s country of residence from taxing that taxpayer**, pursuant to its controlled foreign companies legislation or other rules with similar effect, ~~seeks to tax on~~ profits which have not been distributed **by a foreign company**; ~~it is acting contrary to the provisions of paragraph 5. However~~**Moreover**, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

59. Comments above relating to dividends paid to individuals are generally applicable to dividends paid to companies which hold less than 25 per cent of the capital of the company paying the dividends. The treatment of dividends paid to collective investment vehicles raises particular issues which are addressed in paragraphs ~~6.8 to 6.34~~**22 to 48** of the Commentary on Article 1.

67.4 States that wish to achieve that result may agree bilaterally to replace paragraph 2 of the Article by the following:

2. However, ~~such~~ dividends **paid by a company which is a resident of a Contracting State** may also be taxed in ~~the Contracting that State of which the company paying the dividends is a resident and~~ according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), the tax so charged shall not exceed:

- a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company ~~(other than a partnership)~~ which holds directly at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT) **throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend)**;
- b) 15 per cent of the gross amount of the dividends in all other cases.

According to this provision, a large investor in a REIT is an investor holding, directly or indirectly, capital that represents at least 10 per cent of the value of all the REIT’s capital. States may, however, agree bilaterally to use a different threshold. Also, the provision applies to all distributions by a REIT; in the case of distributions of capital gains, however, the domestic law of some countries provides for a different threshold to differentiate between a large investor and a small investor entitled to taxation at the rate applicable to portfolio dividends and these countries may wish to amend the provision to preserve that distinction in their treaties. Finally, because it would be inappropriate to restrict the source taxation of a REIT distribution to a large investor, the drafting of subparagraph a) excludes dividends paid by a REIT from its application; thus, the subparagraph can never apply to such dividends, even if a company that did not hold capital

representing 10 per cent or more of the value of the capital of a REIT held at least 25 per cent of its capital as computed in accordance with paragraph 15 above. The State of source will therefore be able to tax such distributions to large investors regardless of the restrictions in subparagraphs a) and b).

67.6 For example, if the REIT is a company that does not qualify as a resident of the State, paragraphs 1 and 2 of the Article will need to be amended as follows to achieve that result:

1. Dividends paid by a company which is a resident, or a REIT organised under the laws, of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, ~~such~~ dividends may also be taxed in, and according to the laws of, the Contracting State of which the company paying the dividends is a resident or, in the case of a REIT, under the laws of which it has been organised, but if the beneficial owner of the dividends is a resident of the other Contracting State (other than a beneficial owner of dividends paid by a company which is a REIT in which such person holds, directly or indirectly, capital that represents at least 10 per cent of the value of all the capital in that company), the tax so charged shall not exceed:
 - a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (~~other than a partnership~~) which holds directly at least 25 per cent of the capital of the company paying the dividends (other than a paying company that is a REIT) ***throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend)***;
 - b) 15 per cent of the gross amount of the dividends in all other cases.

Article 11

12. Replace paragraphs 7.4, 7.11, 8, 10.2, 10.3, 11, 12, 25 and 29 of the Commentary on Article 11 by the following:

7.4 Some States refrain from levying tax on income derived by other States and some of their wholly-owned entities (*e.g.* a central bank established as a separate entity), at least to the extent that such income is derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs ~~6.38 and 6.39~~ ***52 and 53*** of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. In their bilateral conventions, many States wish to confirm or clarify the scope of these exemptions with respect to interest or to grant such an exemption in cases where it would not otherwise be available. States wishing to do so may therefore agree to include the following category of interest in a paragraph providing for exemption of certain interest from taxation in the State of source:

- a) is that State or the central bank, a political subdivision or local authority thereof;

7.11 If the Contracting States do not wish to exempt completely any or all of the above categories of interest from taxation in the State of source, they may wish to apply to them a lower rate of tax than that provided for in paragraph 2 (that solution would not, however, seem very practical in the case of interest paid by a State or its political subdivision or statutory body). In that case, paragraph 2 might be drafted along the following lines:

2. However, ~~such~~ interest *arising in a Contracting State* may also be taxed in ~~the Contracting that State in which it arises and~~ according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed:

- a) [*lower rate of tax*] per cent of the gross amount of the interest in the case of interest paid [*description of the relevant category of interest*] ...
- b) 10 per cent of the gross amount of the interest in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

If the Contracting States agree to exempt some of the above categories of interest, this alternative provision would be followed by a paragraph 3 as suggested in paragraph 7.2 above.

8. *The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, the final report on Action 6¹ produced as part of that project, have addressed a number of abuses related to cases such as the following one:* Attention is drawn generally to the following case: the beneficial owner of interest arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (~~private investment company, base company~~). *Whilst Article 29, which was included in the Convention as a result of the final report on Action 6, addresses the treaty shopping aspects of that case, States wishing to deny the benefits of Article 11 to interest that enjoy a preferential tax treatment in the State of residence may consider including in their conventions provisions such as those described in paragraphs 82 to 100 of the Commentary on Article 1.* ~~The question may arise whether, in the case of such a company, it is justifiable to allow in the State of source of the interest the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.~~

10.2 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the interest is not the “beneficial owner” because that recipient’s right to use and enjoy the interest is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs ~~6.8 to 6.34~~ **22 to 48** of the Commentary on Article 1. Where the recipient of interest does have the right to use and enjoy the interest unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the “beneficial owner” of that interest. It should also be noted that Article 11 refers to the beneficial owner of interest as opposed to the owner of the debt-claim with respect to which the interest is paid, which may be different in some cases.

¹ OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264241695-en>.

10.3 The fact that the recipient of an interest payment is considered to be the beneficial owner of that interest does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse (see also paragraph 8 above). ***The provisions of Article 29 and the principles put forward*** ~~As explained in the section on “Improper use of the Convention” in the Commentary on Article 1, there are many ways of addressing conduit company and, more generally, will apply to prevent abuses, including treaty shopping situations where the recipient is the beneficial owner of interest. These include specific anti-abuse provisions in treaties, general anti-abuse rules and substance over form or economic substance approaches.~~ Whilst the concept of “beneficial owner” deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the interest to someone else), it does not deal with other cases of ***abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles*** and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

11. Subject to other conditions imposed by the Article ***and the other provisions of the Convention***, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 and in 2014 to clarify this point, which has been the consistent position of all member countries).

12. The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law (see, however, paragraph ~~26.2109~~ of the Commentary on Article 1). ***Potential abuses arising from situations where interest arising in a Contracting State is attributable to a permanent establishment which an enterprise of the other State has in a third State are dealt with in paragraph 8 of Article 29.*** ~~Other~~ ***Specific*** questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

25. It has been suggested that the paragraph could give rise to abuses through the transfer of loans to permanent establishments set up solely for that purpose in countries that offer preferential treatment to interest income. Apart from the fact that ***the provisions of Article 29 (and, in particular, paragraph 8 of that Article) and the principles put forward in the section on “Improper use of the Convention” in the Commentary on Article 1 will typically prevent*** such abusive transactions ~~might trigger the application of domestic anti-abuse rules~~, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, as explained below, that the requirement that a debt-claim be “effectively connected” to such a location requires more than merely recording the debt-claim in the books of the permanent establishment for accounting purposes.

29. It has been decided not to deal with that case in the Convention. The Contracting State of the payer’s residence does not, therefore, have to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. If this were not the case and the third State did not subject the interest borne by the permanent establishment to source taxation, there could be attempts to avoid source taxation in the Contracting State through the use of a permanent establishment situated in such a third State. States for which this is not a concern and that wish to address the issue described in the paragraph above may do so by agreeing to use, in their bilateral convention, the alternative formulation of paragraph 5 suggested in paragraph 30 below. The risk

of double taxation just referred to could also be avoided through a multilateral convention. Also, if in the case described in paragraph 28, the State of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence, from concerting measures to avoid the double taxation that would result from such claims using, where necessary, the mutual agreement procedure (as envisaged in paragraph 3 of Article 25; *see paragraphs 38.1 and 55 to 55.2 of the Commentary on Article 25*).

Article 12

13. Replace paragraphs 4.3, 4.4, 4.6, 5, 7, 9.2 and 21 of the Commentary on Article 12 by the following:

4.3 In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the royalties is not the "beneficial owner" because that recipient's right to use and enjoy the royalties is constrained by a contractual or legal obligation to pass on the payment received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the royalties unconstrained by a contractual or legal obligation to pass on the payment received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the payment by the direct recipient such as an obligation that is not dependent on the receipt of the payment and which the direct recipient has as a debtor or as a party to financial transactions, or typical distribution obligations of pension schemes and of collective investment vehicles entitled to treaty benefits under the principles of paragraphs ~~6.8 to 6.3422 to~~ **48** of the Commentary on Article 1. Where the recipient of royalties does have the right to use and enjoy the royalties unconstrained by a contractual or legal obligation to pass on the payment received to another person, the recipient is the "beneficial owner" of these royalties. It should also be noted that Article 12 refers to the beneficial owner of royalties as opposed to the owner of the right or property in respect of which the royalties are paid, which may be different in some cases.

4.4 The fact that the recipient of royalties is considered to be the beneficial owner of these royalties does not mean, however, that the provisions of paragraph 1 must automatically be applied. The benefit of these provisions should not be granted in cases of abuse (see also paragraph 7 below). ***The provisions of Article 29 and the principles put forward*** ~~As explained in the section on "Improper use of the Convention" in the Commentary on Article 1, there are many ways of addressing conduit company and, more generally,~~ ***will apply to prevent abuses, including treaty shopping situations where the recipient is the beneficial owner of royalties*** ~~situations. These include specific anti-abuse provisions in treaties, general anti-abuse rules and substance-over-form or economic substance approaches.~~ Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (*i.e.* those involving the interposition of a recipient who is obliged to pass on the royalties to someone else), it does not deal with other cases of ***abuses, such as certain forms of treaty shopping, that are addressed by these provisions and principles*** and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

4.6 Subject to other conditions imposed by the Article ***and the other provisions of the Convention***, the exemption from taxation in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer, in those cases where the beneficial owner is a

resident of the other Contracting State (the text of the Model was amended in 1997 to clarify this point, which has been the consistent position of all member countries).

5. The Article deals only with royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State. It does not, therefore, apply to royalties arising in a third State as well as to royalties arising in a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases see paragraphs 4 to 6 of the Commentary on Article 21). *Potential abuses arising from situations where royalties arising in a Contracting State are attributable to a permanent establishment which an enterprise of the other State has in a third State are dealt with in paragraph 8 of Article 29.* Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law. ~~Specific~~*Other* questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

7. *The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project and, in particular, the final reports on Actions 5, 6 and 8-10¹ produced as part of that project, have addressed a number of abuses related to* ~~Attention is drawn generally to the following cases such as the following one:~~ the beneficial owner of royalties arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment ~~(private investment company, base company)~~. *Whilst Article 29, which was included in the Convention as a result of the final report on Action 6, addresses the treaty shopping aspects of that case, States wishing to deny the benefits of Article 12 to royalties that enjoy a preferential tax treatment in the State of residence may consider including in their conventions provisions such as those described in paragraphs 82 to 100 of the Commentary on Article 1.* ~~(private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the royalties the tax exemption which is provided in paragraph 1. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.~~

9.2 Also, payments made by a telecommunications network operator to another network operator under a typical “roaming” agreement (see paragraph ~~9.1–38~~ of the Commentary on Article 5) will not constitute royalties under the definition of paragraph 2 since these payments are not made in consideration for the use of, or right to use, property, or for information, referred to in the definition (they cannot be viewed, for instance, as payments for the use of, or right to use, a secret process since no secret technology is used or transferred to the operator). This conclusion holds true even in the case of treaties that include the leasing of industrial, commercial or scientific (ICS) equipment in the definition of royalties since the operator that pays a charge under a roaming agreement is not paying for the use, or the right to use, the visited network, to which it does not have physical access, but rather for the telecommunications services provided by the foreign network operator.

1 *OECD (2015), Countering Harmful Tax Practices More Effectively, Taking into Account Transparency and Substance, Action 5 - 2015 Final Report, OECD Publishing, Paris. DOI: <http://dx.doi.org/10.1787/9789264241190-en>; OECD (2015), Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 - 2015 Final Report, OECD Publishing, Paris, DOI: <http://dx.doi.org/10.1787/9789264241695-en> and OECD (2015), Aligning Transfer Pricing Outcomes with Value Creation, Actions 8-10 - 2015 Final Reports, OECD Publishing, Paris. DOI: <http://dx.doi.org/10.1787/9789264241244-en>.*

21. It has been suggested that the paragraph could give rise to abuses through the transfer of rights or property to permanent establishments set up solely for that purpose in countries that offer preferential treatment to royalty income. Apart from the fact that *the provisions of Article 29 (and, in particular, paragraph 8 of that Article) and the principles put forward in the section on “Improper use of the Convention” in the Commentary on Article 1 will typically prevent* such abusive transactions ~~might trigger the application of domestic anti-abuse rules~~, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, as explained below, that the requirement that a right or property be “effectively connected” to such a location requires more than merely recording the right or property in the books of the permanent establishment for accounting purposes.

Article 13

14. Replace paragraphs 20, 23, 26, 28, 28.1, 28.2 of the Commentary on Article 13 by the following:

20. *Paragraphs 1 to 4 of t*~~The Article deals first with the gains from the alienation of specific categories of property which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph 5 gives the right to tax to the State of which the alienator is a resident.~~

23. The rules of paragraph 1 are supplemented by those of paragraph 4, which applies to gains from the alienation of ~~all or part of the shares~~ *or comparable interests that derive more than 50 per cent of their value from* ~~in a company holding immovable property (see paragraphs 28.3 to 28.812 below).~~

26. On the other hand, paragraph 2 may not always be applicable to capital gains from the alienation of a participation in an enterprise. *Where the enterprise performs its activities in the form of an entity or arrangement that is treated as fiscally transparent under the tax law of a Contracting State, that State will, under paragraph 2 of Article 13, be allowed to tax in the hands of the non-resident partners or members of the entity or arrangement the gains derived from the alienation of the movable property forming part of the business property of a permanent establishment of the enterprise that is situated in that State even where the gains arise from the alienation of the enterprise as a whole (see also paragraph 2 of Article 1 and paragraphs 2 to 16 of the Commentary on Article 1). Where, however, an enterprise performs its activities in the form of an entity or arrangement that a State treats as a separate taxpayer resident of one of the Contracting States, that State should treat the alienation of a participation in such an entity or arrangement* ~~The provision applies only to property which was owned by the alienator, either wholly or jointly with another person. Under the laws of some countries, capital assets of a partnership are considered to be owned by the partners. Under some other laws, however, partnerships and other associations are treated as body corporate for tax purposes, distinct from their partners (members), which means that participations in such entities are dealt with in the same way as shares in a company to which paragraphs 4 or 5 of the Article apply. Paragraphs 32.4 to 32.7 of the Commentary on Articles 23 A and 23 B address situations where the domestic laws of the two Contracting States differ in this regard. Capital gains from the alienation of such participations, like capital gains from the alienation of shares, are therefore taxable only in the State of residence of the alienator. Contracting States may agree bilaterally on special rules governing the taxation of capital gains from the alienation of a participation in a partnership.~~

28. An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic ~~and for boats engaged in inland waterways transport and movable property~~

pertaining to the operation of such ships *and*, aircraft ~~and boats~~. Normally, gains from the alienation of such assets are taxable only in the State ~~in which the place of effective management of the enterprise operating such ships *and*, aircraft ~~and boats~~ is situated~~. This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 22. ~~It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of such enterprise is aboard a ship or a boat.~~ Contracting States which would prefer to confer the exclusive taxing right on the State of residence ~~in which the place of effective management of the enterprise is situated~~ or to use a combination of the residence criterion and the place of effective management criterion are free, in bilateral conventions, to substitute for paragraph 3 a provision corresponding to ~~that~~ *these* proposed in paragraphs 2 ~~and 3~~ of the Commentary on Article 8.

28.1 Paragraph 3 applies where the enterprise that alienates the property operates itself the ~~boats~~, ships or aircraft referred to in the paragraph, whether for its own transportation activities or when leasing the boats, ships or aircraft on charter fully equipped, manned and supplied. It does not apply, however, where the enterprise owning the ~~boats~~, ships or aircraft does not operate them (for example, where the enterprise leases the property to another person, other than in the case of an occasional bare boat lease as referred to in paragraph 5 of the Commentary on Article 8). In such a case, the gains accruing to the true owner of the property, or connected moveable property, will be covered by paragraph 2 or 5.

28.2 ~~In their bilateral conventions, member countries are free to clarify further the application of Article 13 in this situation. They might adopt the following alternative version of paragraph 3 of the Article (see also paragraphs 4.1 and 4.2 of the Commentary on Article 22):~~

~~3. Gains from the alienation of property forming part of the business property of an enterprise and consisting of ships or aircraft operated by that enterprise in international traffic or movable property pertaining to the operation of such ships or aircraft, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~

28.3 By providing that gains from the alienation of shares *or comparable interests which, at any time during the 365 days preceding the alienation*, derived ~~ing~~ more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State may be taxed in that State, paragraph 4 provides that gains from the alienation of such shares *or comparable interests* and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in that State.

28.4 Paragraph 4 allows the taxation of the entire gain attributable to the shares *or comparable interests* to which it applies even where part of the value of these shares *or comparable interests* is derived from property other than immovable property located in the source State. The determination of whether shares ~~of a company~~ *or comparable interests* derive, *at any time during the 365 days preceding the alienation*, more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State will normally be done by comparing the value of such immovable property to the value of all the property owned by the company, *entity or arrangement* without taking into account debts or other liabilities ~~of the company~~ (whether or not secured by mortgages on the relevant immovable property).

28.5 *Before 2017, paragraph 4 applied only in the case of the alienation of shares but the Commentary provided that States could extend its scope to cover* ~~In their bilateral conventions, many States either broaden or narrow the scope of the paragraph. For instance, some States consider that the provision should not only cover gains from shares but also gains from the alienation of interests in other entities, such as partnerships or trusts, that ~~do~~ *did* not issue shares, as~~

long as the value of these interests ~~is~~^{was} similarly derived principally from immovable property. *In 2017, the reference to “comparable interests” was added for that purpose. At the same time, the paragraph was amended in order to cover situations where the shares or comparable interests derive their value primarily from immovable property at any time during the 365 days preceding the alienation as opposed to at the time of the alienation only. This change was made in order to address situations where assets are contributed to an entity shortly before the sale of the shares or other comparable interests in that entity in order to dilute the proportion of the value of these shares or interests that is derived from immovable property situated in a Contracting State.* States wishing to extend the scope of the paragraph to cover such interests are free to amend the paragraph as follows:

~~4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that other State.~~

28.6 *In their bilateral conventions, many States either broaden or narrow the scope of the paragraph. For instance, it is also possible for States to increase or reduce the percentage of the value of the shares or comparable interests that must be derived directly or indirectly from immovable property for the provision to apply. This would simply be done by replacing “50 per cent” by the percentage that these States would agree to. Another change that some States may agree to make is to restrict the application of the provision to cases where the alienator holds a certain level of participation in the entity.*

28.7 Also, some States consider that the paragraph should not apply to gains derived from the alienation of shares of companies, *or interests in entities or arrangements*, that are listed on an approved stock exchange of one of the States, to gains derived from the alienation of shares *or comparable interests* in the course of a corporate reorganisation or where the immovable property from which the shares *or comparable interests* derive their value is immovable property (such as a mine or a hotel) in which a business is carried on. States wishing to provide for one or more of these exceptions are free to do so.

28.8 Another possible exception relates to shares *or comparable interests* held by pension funds and similar entities. Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income derived by such an entity resident of the other State, which would include capital gains on shares *or comparable interests* referred to in paragraph 4, shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

28.9 *[this new paragraph is part of the 2017 Update] Since the paragraph applies in any case where, at any time during the 365 days preceding the alienation of shares or comparable interests, these shares or comparable interests derive more than 50 per cent of their value directly or indirectly from immovable property, the paragraph would apply when shares are alienated within a period of 365 days after the day when immovable property, the value of which is taken into account for the purposes of that paragraph, has itself been alienated by the company or other entity. Some States consider that in such a case, since the alienation of the immovable property is taxable under paragraph 1 in the State where it is situated, it would be inappropriate to take account of the value of that property when determining whether paragraph 4 should apply to the gain on the subsequent alienation of the shares or comparable interests. Assume, for example, that individual X, a resident of State R, owns all the shares of XCO, a company resident of State R. The main asset of XCO is an immovable property situated*

in State S. In January 00, the property is sold by XCO and State S taxes the gain in accordance with paragraph 1. At the end of 00, X dies, which, under the domestic law of State S, triggers an alienation of the shares of XCO for tax purposes. In that case, some States consider that the value of the immovable property that has been alienated should not be taken into account when applying paragraph 4 to the shares that are alienated as a result of the death of X. These States may agree bilaterally to replace paragraph 4 by a provision drafted along the following lines:

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State (except immovable property, or part thereof, that was alienated between that time and the time of the alienation of the shares or comparable interests, as long as no part of the value of these shares or comparable interests is derived directly or indirectly from that immovable property, or the part thereof that was alienated, at the time of that subsequent alienation).

States that are concerned that the exception provided in that suggested provision could be abused by arranging sales between related parties may consider restricting its scope to alienations taking place between unrelated parties. Also, States whose domestic tax law does not recognise capital gains upon certain types of alienations are free to exclude such alienations from the scope of the exception included in the suggested provision.

28.910 Finally, a further possible exception relates to shares and ~~similar~~ **comparable** interests in a Real Estate Investment Trust (see paragraphs 67.1 to 67.7 of the Commentary on Article 10 for background information on REITs). Whilst it would not seem appropriate to make an exception to paragraph 4 in the case of the alienation of a large investor's interests in a REIT, which could be considered to be the alienation of a substitute for a direct investment in immovable property, an exception to paragraph 4 for the alienation of a small investor's interest in a REIT may be considered to be appropriate.

28.110 As discussed in paragraph 67.3 of the Commentary on Article 10, it may be appropriate to consider a small investor's interest in a REIT as a security rather than as an indirect holding in immovable property. In this regard, in practice it would be very difficult to administer the application of source taxation of gains on small interests in a widely held REIT. Moreover, since REITs, unlike other entities deriving their value primarily from immovable property, are required to distribute most of their profits, it is unlikely that there would be significant residual profits to which the capital gain tax would apply (as compared to other ~~companies~~ **entities**). States that share this view may agree bilaterally to add, before the phrase "may be taxed in that other State", words such as "except shares **or comparable interests** held by a person who holds, directly or indirectly, **shares or** interests representing less than 10 per cent of all the **shares or** interests in **an entity** ~~company~~—if that ~~company~~ **entity** is a REIT". (If paragraph 4 is amended along the lines of paragraph 28.5 above to cover interests similar to shares, these words should be amended accordingly.)

28.124 Some States, however, consider that paragraph 4 was intended to apply to any gain on the alienation of shares **or similar interests** in a ~~company~~ **an entity** that derives its value primarily from immovable property and that there would be no reason to distinguish between a REIT and a publicly held ~~company~~ **entity** with respect to the application of that paragraph, especially since a REIT is not taxed on its income. These States consider that as long as there is no exception for the

alienation of shares *or similar interests* in companies ~~quoted~~ *entities listed* on a stock exchange (see paragraph 28.7 above), there should not be a special exception for interests in a REIT.

28.132 Since the domestic laws of some States do not allow them to tax the gains covered by paragraph 4, States that adopt the exemption method should be careful to ensure that the inclusion of the paragraph does not result in a double exemption of these gains. These States may wish to exclude these gains from exemption and apply the credit method, as suggested by paragraph 35 of the Commentary on Articles 23 A and 23 B.

Article 15

15. Replace paragraphs 2, 6.1, 6.2, 8.8 and 8.9 of the Commentary on Article 15 by the following:

2. The general rule is subject to exception only in the case of *the remuneration of crews of ships or aircraft operated in international traffic (paragraph 3 of Article 15)*, pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Non-employment remuneration of members of boards of directors of companies is the subject of Article 16.

6.1 The application of the second condition in the case of fiscally transparent partnerships presents difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (see paragraph 8.28 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an “employer” (especially under the domestic law definitions of the term in some countries, *e.g.* where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.

6.2 The object and purpose of subparagraphs *b)* and *c)* of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as ~~he~~*it* neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of subparagraph *b)* that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent *entities or arrangements such as* partnerships, that subparagraph applies at the level of the partners *or members*. Thus, the concepts of “employer” and “resident”, as found in subparagraph *b)*, are applied at the level of the partners *or members* rather than at the level of a fiscally transparent partnership *entity or arrangement*. This approach is consistent with *the approach under paragraph 2 of Article 1* that under which *the benefit of* other provisions of tax conventions must be applied ~~at~~*granted with respect to income that is taxed at* the partners’ *or members’ level* rather than at the partnership’s level *or an entity or arrangement that is treated as fiscally transparent*. While this interpretation could create difficulties where the partners *or members* reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners *or members* who own the majority of the interests in the *entity or arrangement* partnership reside (*i.e.* the State in which the greatest part of the deduction will be claimed).

8.8 As mentioned in paragraph 8.2, even where the domestic law of the State that applies the Convention does not offer the possibility of questioning a formal contractual relationship and

therefore does not allow the State to consider that services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise, ~~it is possible for that State to~~ **may** deny the application of the exception of paragraph 2 in abusive cases, **as recognised by paragraph 9 of Article 29 (see also paragraphs 54 to 80 of the Commentary on Article 1).**

~~8.9—The various approaches that are available to States that want to deal with such abusive cases are discussed in the section “Improper use of the Convention” in the Commentary on Article 1. As explained in paragraph 9.1 of that Commentary, it is agreed that States do not have to grant the benefits of a tax convention where arrangements that constitute an abuse of the Convention have been entered into. As noted in paragraph 9.5 of that Commentary, however, it should not be lightly assumed that this is the case (see also paragraph 22.2 of that Commentary).~~

Article 17

16. Replace paragraph 11.3 of the Commentary on Article 17 by the following:

11.3 As a general rule it should be noted, however, that, regardless of Article 7, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsperson or the star-company in abusive cases, as is recognised in paragraphs ~~22 and 22.1~~ **76 to 79** of the Commentary on Article 1. **Also, paragraph 9 of Article 29 will prevent the benefits of provisions such as those of Articles 7 and 15 from being granted in these abusive cases.**

Article 18

17. Replace paragraphs 3, 49, 64 and 69 of the Commentary on Article 18 by the following:

3. The types of payment that are covered by the Article include not only pensions directly paid to former employees but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees) and other similar payments, such as annuities, paid in respect of past employment. The Article also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19. The Article only applies, however, to payments that are in consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. The Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a “pension or other similar remuneration” (the tax mismatch that could arise in such a situation is discussed below). **Similarly, the Article applies regardless of whether or not the relevant payments are made from a “recognised pension fund” as defined in subparagraph i) of paragraph 1 of Article 3.**

49. In looking at the characteristics of the contributions, paragraph 1 provides a number of tests. It makes it clear that the provision applies only to contributions made by or on behalf of an individual to a pension scheme established in and recognised for tax purposes in the home State. The phrase “recognised for tax purposes” is further defined in subparagraph 2 b) of the suggested provision; **that phrase is unrelated to the definition of the term “recognised pension fund” in subparagraph i) of paragraph 1 of Article 3 and therefore applies whether or not the pension scheme constitutes a “recognised pension fund”.** The phrase “made by or on behalf of” is intended to apply to contributions that are made directly by the individual as well as to those that

are made for that individual's benefit by an employer or another party (e.g. a spouse). Whilst paragraph 4 of Article 24 ensures that the employer's contributions to a pension fund resident of the other Contracting State (*whether or not because it constitutes a "recognised pension fund"*) are deductible under the same conditions as contributions to a resident pension fund, that provision may not be sufficient to ensure the similar treatment of employer's contributions to domestic and foreign pension funds. This will be the case, for example, where the employer's contributions to the foreign fund are treated as a taxable benefit in the hands of the employee or where the deduction of the employer's contributions is not dependent on the fund being a resident but, rather, on other conditions (e.g. registration with tax authorities or the presence of offices) which have the effect of generally excluding foreign pension funds. For these reasons, employer's contributions are covered by the suggested provision even though paragraph 4 of Article 24 may already ensure a similar relief in some cases.

64. Subparagraph 2 b) further defines the phrase "recognised for tax purposes". As the aim of the provision is, so far as possible, to ensure that contributions are neither more nor less favourably treated for tax purposes than they would be if the individual were resident in his home State, it is right to limit the scope of the provision to contributions which would have qualified for relief if the individual had remained in the home State. The provision seeks to achieve this aim by limiting its scope to contributions made to a scheme only if contributions to this scheme would qualify for tax relief in that State. *As already explained in paragraph 49 above, whether or not a pension scheme is recognised for tax purposes is unrelated to the question of whether the pension scheme constitutes a "recognised pension fund" under the definition of that term in subparagraph i) of paragraph 1 of Article 3.*

69. Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory, these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:

Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall be exempt from tax in that State.

As explained in paragraphs 10.7 and 10.8 of the Commentary on Article 3, States may prefer to simply refer to the income of a "recognised pension fund" when drafting such a provision.

Article 21

18. Replace paragraph 6 of the Commentary on Article 21 by the following:

6. Some States which apply the exemption method (Article 23 A) may have reason to suspect that the treatment accorded in paragraph 2 may provide an inducement to an enterprise of a Contracting State to attach assets such as shares, bonds or patents, to a permanent establishment situated in the other Contracting State in order to obtain more favourable tax treatment there. ~~To counteract such arrangements which they consider would represent abuse, some States might take the view that the transaction is artificial and, for this reason, would regard the assets as not effectively connected with the permanent establishment. Some other States may strengthen their position by adding in paragraph 2 a condition providing that the paragraph shall not apply to cases~~

where the arrangements were primarily made for the purpose of taking advantage of this provision. *Apart from the fact that paragraph 9 of Article 29 would deny the benefits of Article 23 A in the case of arrangements undertaken for that purpose, Also, it is important to note that* the requirement that a right or property *such assets* be “effectively connected” with such a *permanent establishment* location requires more than merely recording these *assets right or property* in the books of the permanent establishment for accounting purposes (*see paragraphs 5.1 and 5.2 above*).

Article 22

19. Replace paragraphs 4 to 4.2 of the Commentary on Article 22 by the following:

4. Normally, ships and aircraft operated in international traffic ~~and boats engaged in inland waterways transport~~ and movable property pertaining to the operation of such ships, ~~boats~~ or aircraft shall be taxable only in the State ~~in which the place of effective management of the enterprise is situated~~ *of residence* (paragraph 3). This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 13. ~~It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat.~~ Contracting States which would prefer to confer the exclusive taxing right on the State *of residence in which the place of effective management of the enterprise is situated* or to use a combination of the residence criterion and the place of effective management criterion are free in bilateral conventions to substitute for paragraph 3 a provision corresponding to ~~that~~ *those* proposed in paragraphs 2 and 3 of the Commentary on Article 8. Immovable property pertaining to the operation of ships, ~~boats~~ or aircraft may be taxed in the State in which they are situated in accordance with the rule laid down in paragraph 1.

4.1 Paragraph 3 applies where the enterprise that owns the property operates itself the ~~boats,~~ ships or aircraft referred to in the paragraph, whether for its own transportation activities or when leasing the boats, ships or aircraft on charter fully equipped, manned and supplied. It does not apply, however, where the enterprise owning the ~~boats,~~ ships or aircraft does not operate them (for example, where the enterprise leases the property to another person, other than in the case of an occasional bare boat lease as referred to in paragraph 5 of the Commentary on Article 8). In such a case, the capital will be covered by paragraph 2 or 4.

4.2 ~~In their bilateral conventions, member countries are free to clarify further the application of Article 22 in this situation. They might adopt the following alternative version of paragraph 3 of the Article (see also paragraphs 28.1 and 28.2 of the Commentary on Article 13):~~

~~3. Capital represented by property forming part of the business property of an enterprise the place of effective management of which is situated in a Contracting State, and consisting of ships and aircraft operated by such enterprise in international traffic and of movable property pertaining to the operation of such ships and aircraft shall be taxable only in that State.~~

Articles 23 A and 23 B

20. Replace paragraphs 4, 4.3, 6, 10, 31.1 and 32.2 of the Commentary on Articles 23 A and 23 B by the following:

4. The conflict in case *a*) is reduced to that of case *b*) by virtue of Article 4. This is because that Article defines the term “resident of a Contracting State” by reference to the liability to tax of a person under domestic law by reason of his domicile, residence, place of management or any other criterion of a similar nature (paragraph 1 of Article 4) and by ~~listing special criteria~~ *providing*

special rules for the case of double residence to determine which of the two States is the State of residence (R) within the meaning of the Convention (paragraphs 2 and 3 of Article 4).

4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation *and, as confirmed by the phrase “except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State” found in paragraph 1 of Articles 23 A and 23 B, any resulting double taxation will be outside the scope of these Articles.* The mutual agreement procedure *provided for in paragraph 3 of Article 25* could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States.

6. For some items of income or capital, an exclusive right to tax is given to one of the Contracting States, and the relevant Article states that the income or capital in question “shall be taxable only” in a Contracting State.¹ The words “shall be taxable only” in a Contracting State preclude the other Contracting State from taxing, thus double taxation is avoided. The State to which the exclusive right to tax is given is normally the State of which the taxpayer is a resident within the meaning of Article 4, that is State R, but in ~~four~~ *Articles 19*² the exclusive right may be given to the other Contracting State (S) of which the taxpayer is not a resident within the meaning of Article 4.

10. Where a resident of State R derives income from a third State through a permanent establishment which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment (*paragraph 1 of Article 7 and paragraph 2 of Article 21*). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 3 of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R (see paragraphs 67 to 72 of the Commentary on Article 24).

31.1 One example where paragraph 2 could be so amended is where a State that generally adopts the exemption method considers that that method should not apply to items of income that benefit

1 See first sentence of paragraph 1 of Article 7, paragraphs 1 ~~and 2~~ of Article 8, paragraph 1 of Article 12, paragraphs 3 and 5 of Article 13, first sentence of paragraph 1 ~~and as well as~~ paragraphs 2 *and 3* of Article 15, Article 18, paragraphs 1 and 2 of Article 19, paragraph 1 of Article 21 and paragraphs 3 and 4 of Article 22.

2 See ~~paragraphs 1 and 2 of Article 8, paragraph 3 of Article 13, subparagraph a) of paragraphs 1 and 2 of Article 19 and paragraph 3 of Article 22.~~

from a preferential tax treatment in the other State by reason of a tax measure that has been introduced in that State after the date of signature of the Convention. In order to include these items of income, paragraph 2 could be amended as follows:

2. Where a resident of a Contracting State derives an item of income which
 - a) *may be taxed in the other Contracting State* in accordance with the provisions of Articles 10 and 11, ~~may be taxed in the other Contracting State (except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State), or~~
 - b) *may be taxed in the other Contracting State* in accordance with the provisions of this Convention (*except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State*), ~~may be taxed in the other Contracting State~~ but which benefits from a preferential tax treatment in that other State by reason of a tax measure
 - (i) that has been introduced in the other Contracting State after the date of signature of the Convention, and
 - (ii) in respect of which that State has notified the competent authorities of the other Contracting State, before the item of income is so derived and after consultation with that other State, that this paragraph shall apply,

the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such item of income derived from that other State.

32.2 The interpretation of the phrase “*may be taxed in the other Contracting State* in accordance with the provisions of this Convention, ~~may be taxed~~”, which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.

21. Add the following new paragraph 36 to the Commentary on Articles 23 A and 23 B:

36. *It should also be noted that, as explained in paragraphs 11.1 and 11.2 above, Article 23 A does not oblige a Contracting State to exempt income or capital where the only reason why the other Contracting State may tax that income or capital in accordance with the provisions of the Convention is because that other State attributes that income or capital to a resident of that other State.*

22. Replace paragraphs 59, 61, 69.1, 69.2 and 69.3 of the Commentary on Articles 23 A and 23 B by the following:

59. The obligation imposed by Article 23 B on a State R to give credit for the tax levied in the other State E (or S) on an item of income or capital depends on whether this item may be taxed by the State E (or S) in accordance with the Convention. Paragraphs 32.1 to 32.7 above discuss how this condition should be interpreted. Items of income ~~or capital~~ which according to ~~Article 8, to paragraph 3 of Article 13, to subparagraph a) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22,~~ “shall be taxable only” in the other State, are from the outset exempt from tax in State R (see paragraph 6 above), and the Commentary on Article 23 A applies to such

exempted income ~~and capital~~. As regards progression, reference is made to paragraph 2 of the Article (and paragraph 79 below).

61. The amount of foreign tax for which a credit has to be allowed is the tax effectively paid in accordance with the Convention in the other Contracting State (*excluding the amount of tax paid in that other State solely because the income or capital is also income derived by a resident of that State or capital owned by a resident of that State*). Problems may arise, e.g. where such tax is not calculated on the income of the year for which it is levied but on the income of a preceding year or on the average income of two or more preceding years. Other problems may arise in connection with different methods of determining the income or in connection with changes in the currency rates (devaluation or revaluation). However, such problems could hardly be solved by an express provision in the Convention.

69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State *where a partnership is established* ~~of source~~ treats *that* partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of *the partnership* ~~source~~ may, subject to the applicable provisions of the Convention, tax the partnership on its income when that income is realised and, subject to the limitations of paragraph 2 of Article 10, may also tax the distribution of profits by the partnership to its non-resident partners. The State of residence *of the partner*, however, will only tax the partner on his share of the partnership's income when that income is realised by the partnership.

69.2 The first issue that arises in this case is whether the State of residence *of the partner*, which taxes the partner on his share in the partnership's income, is obliged, under the Convention, to give credit for the tax that is levied *on the partnership* in the State of ~~source~~ ~~on~~ the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative *to the extent that the income may be taxed by the State of the partnership in accordance with the provisions of the Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable (see also paragraphs 11.1 and 11.2 above)*. To the extent that the State of residence *of the partner* flows through the income of the partnership to the partner for the purpose of taxing ~~him~~ *that partner*, it must adopt a coherent approach and flow through to the partner the tax paid by the partnership (*but only to the extent that such tax is paid in accordance with the provisions of the Convention that allow source taxation*) for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.

69.3 A second issue that arises in this case is the extent to which the State of residence *of the partner* must provide credit for the tax levied by the State of *the partnership* ~~source~~ ~~on~~ the distribution, which is not taxed in the State of residence. The answer to that question lies in that last fact. Since the distribution is not taxed in the State of residence *of the partner*, there is simply no tax in ~~that~~ ~~State of residence~~ against which to credit the tax levied by the State of *the partnership* ~~source~~ upon the distribution. A clear distinction must be made between the generation of profits and the distribution of those profits and the State of residence *of the partner* should not be expected to credit the tax levied by the State of ~~source~~ ~~the partnership~~ upon the distribution against its own tax levied upon generation (see the first sentence of paragraph 64 above).

Article 24

23. Replace paragraphs 20 and 72 of the Commentary on Article 24 by the following:

20. Example 1: Under the domestic income tax law of State A, companies incorporated in that State or having their place of effective management in that State are residents thereof. ***Under the domestic income tax law of State B, only companies that have their place of effective management in that State are residents thereof.*** The State A - State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Since a company incorporated in State B that would have its place of effective management in State A would be a resident of State A for purposes of the State A - State B Convention, the fact that dividends paid to such a company by a company incorporated in State A would not be eligible for this exemption, even though the recipient company is in the same circumstances as a company incorporated in State A with respect to its residence, would constitute a breach of paragraph 1 absent other relevant different circumstances.

72. In addition to the typical triangular case considered here, other triangular cases arise, particularly that in which the State of the enterprise is also the State from which the income attributed to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21 ***and paragraphs 9 and 9.1 of the Commentary on Articles 23 A and 23 B***). States can settle these matters in bilateral negotiations.

Article 25

24. Replace paragraphs 15, 39 and 43 of the Commentary on Article 25 by the following:

15. Since the first steps in a mutual agreement procedure may be set in motion at a very early stage based upon the mere probability of taxation not in accordance with the Convention, the initiation of the procedure in this manner would not be considered the ~~presentation of the case to the competent authority~~ ***starting date*** for the purposes of determining the ~~start~~ ***beginning*** of the two year period referred to in paragraph 5 of the Article. Paragraph ~~8-75 below of the Annex to the Commentary on Article 25 describes the circumstances in which~~ ***explains when*** that two year period commences.

39. The purpose of the last sentence of paragraph 2 is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits. This provision does not prevent, however, such States as are not, on constitutional or other legal grounds, able to overrule the time limits in the domestic law from inserting in the mutual agreement itself such time limits as are adapted to their internal statute of limitation (***see also paragraph 62 of the Commentary on Article 7 and paragraph 10 of the Commentary on Article 9 which offer an alternative approach which addresses this issue in the Convention***). In certain extreme cases, a Contracting State may prefer not to enter into a mutual agreement, the implementation of which would require that the internal statute of limitation had to be disregarded (***subject to the possible application of paragraph 5 where such a course of action would prevent a mutual agreement case from being resolved***). Apart from time limits there may exist other obstacles such as “final court decisions” to giving effect to an agreement. Contracting States are free to agree on firm provisions for the removal of such obstacles. As regards the practical implementation of the procedure, it is generally recommended that every effort should be made by tax administrations to ensure that as far as possible the mutual agreement procedure is not in any case frustrated by operational delays or, where time limits would be in point, by the combined effects of time limits and operational delays.

43. The situation is also different if there is a suit ongoing on an issue, but the suit has been taken by another taxpayer than the one who is seeking to initiate the mutual agreement procedure.

In principle, if the case of the taxpayer seeking the mutual agreement procedure supports action by one or both competent authorities to prevent taxation not in accordance with the Convention, that should not be unduly delayed pending a general clarification of the law at the instance of another taxpayer, although the taxpayer seeking mutual agreement might agree to this if the clarification is likely to favour that taxpayer's case. In other cases, delaying competent authority discussions as part of a mutual agreement procedure may be justified in all the circumstances, but the competent authorities *should be mindful of the time constraints imposed by paragraph 5 and* should as far as possible seek to prevent disadvantage to the taxpayer seeking mutual agreement in such a case. This could be done, where domestic law allows, by deferring payment of the amount outstanding during the course of the delay, or at least during that part of the delay which is beyond the taxpayer's control.

Article 29

25. Replace the title of the Commentary on Article 29 by the following:

**COMMENTARY ON ARTICLE ~~29~~³⁰
CONCERNING THE TERRITORIAL EXTENSION OF THE CONVENTION**

Articles 30 and 31

26. Replace the title of the Commentary on Articles 30 and 31 by the following:

**COMMENTARY ON ARTICLES ~~30~~³¹ AND ~~31~~³²
CONCERNING THE ENTRY INTO FORCE AND THE
TERMINATION OF THE CONVENTION**

27. Replace paragraph 2 of the Commentary on Articles 30 and 31 by the following:

2. Some Contracting States may need an additional provision in the first paragraph of Article ~~30~~³¹ indicating the authorities which have to give their consent to the ratification. Other Contracting States may agree that the Article should indicate that the entry into force takes place after an exchange of notes confirming that each State has completed the procedures required for such entry into force.