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# BUSINESS INCOME AND PASSIVE INCOME IN THE UN MODEL DOUBLE TAXATION CONVENTION

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INDEX

**INTRODUCTION: The historical evolution of the UN Model Convention**

**CHAPTER I: The UN Model Convention's subjective and objective scope**

**Introduction**

## CHAPTER II: The determination of active income: current points of difference between the UN and OECD Models

## CHAPTER III: The determination of passive income: differences and similarities between the UN and the OECD Model Conventions

## CHAPTER IV: Transfer Pricing



## CONCLUSIONS

# INTRODUCTION

## The historical evolution of the UN Model Convention

Fiscal policy plays an important role in the channelling and settlement of economic resources, both in international and national areas.

In fact, an efficient budgetary system allows the economic actors to concentrate fiscal resources into areas of high development interest, in the same time taxation can be used as a means to encourage a more effective use of idle resources through the utilisation, for example, of tax incentives to encourage more labour-intensive methods of production, thereby decreasing unemployment or underemployment.

As well as, foreign exchanges could be increased through the adoption of tax policies which favour export transactions.

Recently, the extent of fiscal problems has increased its volume because of the growth of transnational corporations, which continue to expand their activities in the absence of a uniform juridical discipline.

In the taxation of transnational corporations, states face three main problems:

- double taxation;
- tax evasion and avoidance;
- determination of permanent establishment (PE).

The first two issues will be shortly examined in this Chapter, while PE will be dealt in Chapter II.

*Double taxation*

International double taxation arises whenever the same profit is liable to tax in two or more countries at the same time.[1]

The problem derives from the fact that countries' principles above taxation are deeply different. The fundamental distinction among international tax regimes is the one between residency-based (or global) regime and source-based (or territorial) regime.

Graetz and O'Hear said about this topic:

"When income is earned in one country by a citizen or resident of another country, both the country where income is earned (the source country) and the country where the investor or earner resides (the residence country) have legitimate claims to tax the income. The basic task of international tax rules is to resolve the competing claims of residence and source nations in order to avoid the double taxation that results when both fully exercise their taxing power"[2].

In a residency-based tax regime, a country taxes resident people on their worldwide income, while non-residents are taxed only on the incomes deriving from the source country.

Countries based on this tax regime are, for example, the United States, Japan and the United Kingdom.

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[1] T. MODIBO OCRAN, *Double taxation treaties and transnational investment: a comparative study*, in *Westlaw*, 1989, p.2.
[2] MICHAEL J.GRAETZ & MICHAEL M. O'HEAR, *The "Original Intent" of U.S.international Taxation, 46 Duke L.J.1021, 1033* (1997).

The other way round, under the source principle of taxation, people are taxed only on the incomes earned within the source country's territorial jurisdiction. Examples are Germany and the Netherlands. Anyway, the majority of states prefers adopting a mixed type of taxation, which combines some elements from both the systems, for example by granting a deferral or an exemption for active income earned through foreign subsidiaries, in this way some global regimes do not tax certain kinds of foreign source income; in the same way, there are certain types of foreign source passive income taxed also by source regimes.

Finally, we have the nationality principle of taxation, in which taxation is based on the world-wide income of nationals or citizens of the country concerned, wherever they are resident[3]; anyway this system is applied only by few countries.

In addition to these different types of tax regimes, States also differ in the way they try to settle corporation taxes and personal taxes through the taxation of corporate dividends.

There are three main systems:

- the classical one in which a company, as a separate legal entity, is regarded as a taxpayer and pays taxes on its taxable income. Dividends paid by a company to shareholders are taxable to the shareholders as income from property.;
- under the imputation system, profits are subject to tax when they are distributed as dividends, anyway part of the tax paid by the shareholder is used as a credit against his liability to personal income tax on the

[3]ADAMS & J. WHALLEY, *The International Taxation Of Multinational Enterprises In Developed Countries,* (1977).

distribution.

- Finally, under the two-rate system one rate of the corporation tax applies to the undistributed profits, while a lower rate to distributed profits.

Another circumstance which entails international issues is the fact that often countries do not agree on what constitutes “profit”.

*Tax evasion and avoidance*

Tax evasion is the behaviour by which a subject do not pay the properly due tax through wilful and conscious acts.

On the other hand tax avoidance can be described as the behaviour of a tax payer who takes advantage of a loophole in tax laws, or, in case of doubts regarding the interpretation of a law, the behaviour of been favoured by it.

Tax evasion is definitively illegal, while tax avoidance do not properly infringe the law, even if it can be harmful for the host state.

All these issues can be faced unilaterally by the states, or through reciprocal obligations, which can have the form of bilateral or multilateral agreements.

According to Professor Hugh Ault, “From the beginning, treaties have involved the allocation of taxing claims and the international division of revenue.”[4]

In fact, double tax treaties constitute the main source of the Conventional International Tax Law; these agreements become parts of the contracting states’

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[4] Hugh J. Ault, Colloquium on Corporate Integration: *Corporate integration, Tax Treaties and the Division of the International Tax Base: Principles and Practices, 47 Tax L. Rev. 565* (1992).

domestic law, and, by expressing the rules for the resolution of conflicts, they permeate the domestic law systems, thus provoking their adaptation to the international conventional law.

In this context, the OECD and the UN Models Tax Conventions play an important role, providing a model for future agreements between the states. They are enacted by international organisations, but they do not constitute proper sources of international tax law.

They absolve, prima facie, two main functions: of guide in the predisposition of rules in bilateral conventions, and of help in their interpretation.

Therefore the Models do not properly belong to the international conventional law, but they do constitute an important means for the reconstruction of principles and customs in the international tax law.

The Models' dispositions do not have preceptive effects, but they are reproduced in bilateral Conventions which are incorporated in the Contracting States' law systems. Consequently, in addition to the two previous functions, the Models acquire an indirect normative validity towards the two States bound by a convention, if the Models' dispositions are literally reproduced in the ratified and enforceable Convention.

The first versions of the two models were released some decades ago.

In fact, after World War II, the Organisation of Economic Cooperation and Development (OECD) organised a commission for the realising of a Model international tax convention against double taxation; the first draft was published in 1963, and it was revised in 1977.

In 1976 the United States decided to adopt their own Model convention, to use as a starting point for future bilateral agreements.

Both the conventions relied upon the residency-based taxation principle, while source-based taxation of active income was allowed only when the active income was “attributable” to a “permanent establishment”.[5]

Consequently, whether an item was taxable in the source country depended on how high the threshold for permanent establishment was.

Moreover, income and capital flows between developed and lesser developed countries are generally unequal, if not unidirectional. Developing countries felt the need for a more balanced system of taxation.

The reason why developing countries are interested in entering in an agreement with a more developed country is mainly because of the stability the convention creates.

The developing countries' interests are more efficiently represented in the United Nations Model Convention.

The UN's role in tax matters has its roots in the activity of the League of Nations. Although the League of Nation was active in tax matters, the United Nations has historically played a less active role in this field.

In 1946 the UN appointed a fiscal commission that was requested to study and advise the ECOSOC (the UN Economic and Social Council) on public finance, particularly its legal, administrative and technical aspects; anyway this commission ceased functioning in 1954.

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[5]YORAM KEINAN, *The case for residency-based taxation of financial transactions in developing countries,* in *Westlaw,* 2008.

In 1967 the UN started again working on tax matters: it adopted resolution 1273 of 4 August 1967, which requested the Secretary General to appoint a working group, composed by delegates, acting on their personal capacity, but nominated by the governments of developed and developing states, thus representing different regions and tax systems.

The Group's task was of finding a way to facilitate the stipulation of tax agreements between developed and developing countries, identifying principles which could serve as guidelines for future conventions.

The Ad Hoc Group of Experts on Tax Treaties Between Developed and Developing Countries realised the 1979 Manual for Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries (UN Treaty Manual), and also the 1980 Model Double Taxation Convention Between Developed and Developing Countries (UN Model Income Tax Treaty).

In 1980 the Group was reorganised: it was invested with more relevant responsibilities in tax issues and the name was changed in Ad Hoc Group of Experts on International Cooperation in Tax Matters (UN Ad Hoc Group of Tax Experts), it was composed by ten members from developed countries and fifteen from developing ones.

Anyway the weakness of its role was still evidenced by some aspects: the group met only once every two years, it had very limited resources and staff and the delegates acted on their personal capacity.

Consequently, the OECD, provided with a more efficient structure, has played a dominant role, which lately has been challenged by offshore and onshore tax havens; moreover, in 1999 Vito Tanzi, Ernesto Zedillo and Frances Horner, three important tax experts, have pointed out the need for a stronger institutional frame to deal with international taxation issues: they suggested the creation of a structure, the international tax organisation (ITO) in which developing countries could play a more active role.

In particular, Vito Tanzi, then head of the IMF's Fiscal Department, published an article, "Is There a Need for a World Tax Organisation?"[6].

In its article Tanzi highlighted that the phenomenon of globalisation contributes to turn national problems in international ones, and that globalisation has challenged the territoriality principle of taxation, since transnational corporations try to reduce their tax burden through a sort of competition between different tax jurisdictions; this behaviour led to the erosion of tax revenue, also determined by the attempt of individuals to evade taxes by hiding assets and incomes in tax havens.

In December 2000, the Secretary General of the UN, Kofi Annan, recommended an in-depth study of the potential for an international organisation or forum for cooperation in tax matters.[7]

In the UN program of Financing for Development, Kofi Anann appointed a panel headed by Ernesto Zedillo, the former Mexico President.

The UN Report of the High Level Panel on Financing for development of

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[6]V Tanzi, "Is there a Need for a World Tax Organisation?", in A Razin and E Sadka (Eds), *The Economics of Globalisation: Policy Perspectives from Public Economics*, (New York, Cambridge University Press, 1999).
[7]K Annan ( **UN** Secretary General), *Report of the Secretary General to the Preparatory Committee for the High Level International Intergovernmental Event on Financing for Development* (A/AC.257/12), (New York, 2001)

June 2001[8] gave a substantial boost to the call for an ITO.

The Report was resumed by Frances Horner in an article in which the author, who had worked at the OECD, stressed that the concerns of developing countries should be given priority.

According to Horner, the OECD's Global Forum on Taxation, devised for a dialogue with non-OECD counties is not efficient, since participation is by invitation, the agenda is set but the OECD, and generally decisions are a prerogative of OECD countries in closed meetings.

The article shows that OECD's rules are intended to favour the richest countries, and the author illustrates his point by examining the residence principle, income allocation rules and taxation of portfolio income.

In particular, with regard to the residence principle, Professor McIntyre notes that most of the developed countries prefer restricting source jurisdiction, while developing ones favour an utilisation of this kind of jurisdiction.

Horner has prefigured an active role for the United Nations, which "seems to be the best contender for the job of convening an international tax body, and it is clearly positioning itself to become globally what the OECD has become for its interest group."[9]

In 2003, with the release of an important UN report, *Institutional Framework for International Tax Cooperation* by professor McIntyre, the attention shifted to the UN Model; in fact professor Michael McIntyre shared

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[8] High-Level Panel on Financing for Development (Chairman: E Zedillo), *Report of the High-Level Panel on Financing for Development* (A/55/1000), (New York, 2001).
[9] FM Horner, "*Do We Need an International Tax Organisation?*", (2001) Vol 24 *Tax Notes International* 179, p.183.

many of Tanzi, Zedillo and Horner's concerns, but his suggestion was not for the creation of an ITO, but for the strengthening of the UN ad Hoc Group of Tax Experts.

In its article, Professor McIntyre faces many of the tax problems the developing countries have: the administration of an effective tax system, due to the globalisation process outside their control; tax evasion and avoidance; excessive tax competition.

He also stresses that, even if the OECD has recently attempted to sponsor various benefit programmes for developing countries, the latter ones do not have a seat when the OECD takes decisions of international tax issues.

"Some developed countries also undermine the enabling domestic environment necessary for domestic resource mobilisation by facilitating capital flight from developing and transitional countries. For example the United States provides an exemption from its income tax for interest earned by foreign persons on bank deposits. This exemption has the effect of drawing funds out of developing and transitional countries for deposit in United States banks."[10]

In the 2003 Report to the General Assembly, the UN Secretary General, Kofi Annan shared McIntyre's position upon the strengthening of the UN Ad Hoc Group, suggesting its conversion into an intergovernmental body, as a committee of governmental experts or as a new special body of the ECOSOC.

In 2004 the Group was converted into the UN Committee of Experts on

[10] Ad Hoc Group of Experts on International Cooperation in Tax Matters, *Institutional Framework for International Tax Cooperation*, (Geneva, 2003), Section II: *Mobilization of Domestic Resources for Development: The Need to Mitigate International Tax Evasion, Excessive Tax Competition and Capital Flight*, p. 9.

International Cooperation in Tax Matters (UN Committee of Tax experts), an expert body integrated in the UN's Economic and Social Council, thus facing the favour of developing countries, but also opposition from OECD states.

An improvement was that the Committee had to meet yearly, while it continued to be  composed by 25 members chosen by the governments and nominated by the Secretary General.

The ECOSOC decided that each meeting would have last no more than five days and "[t]he Committee shall be serviced by a small technical staff, which shall, inter alia, within existing resources, help collect and disseminate information on tax policies and practises, in collaboration with concerned multilateral bodies and relevant international organisations."[11]

The participant countries can be classified as follows:

- OECD financial centers: Switzerland, UK and US;
- other OECD developed countries: France, Ireland, Italy, Japan, Norway and Spain;
- OECD developing countries: South Korea and Mexico;
- financial center tax haven: Bahamas;
- non-financial center tax haven: Barbados (in its June 2000 Report, the OECD identified Barbados as a tax haven but subsequently determined that it should not be on the haven list);
- developing countries: Brazil, China, Indonesia, Morocco, Peru,

[11] United Nations, *Draft Resolution Submitted by the President of the Council, Ms Marjatta Rasi (Finland), on the Basis of Informal Consultations* (E/2004/L60), (New York, 2004), p 2.

Philippines, Tanzania, Tunisia and Zambia;

- other countries: Qatar, Russia and South Africa.[12]

At the first meeting in 2005, the Moroccan delegated was appointed Chairman, and three vice chairs were nominated, all belonging to developed countries.

Among the topics discussed during the meeting, two of them held a particular relevance for developing countries:

- the proposed modification of article 5 of the UN Model Convention, relating to the Permanent Establishment;
- the proposed amendments to the article 26 of the Convention, relating to the Exchange of Information.

In late 2011, the Committee of Experts released the third version of the UN Model Double Taxation Convention between developed and Developing Countries (the UN Model 2011).

The Secretariat was headed by Michael Lennard, while the subcommittee responsible for the 2011 revision was chaired by Robin Oliver of New Zealand.

The UN Model continues to offer an alternative to the OECD Model, by reflecting the interests of developing countries and allowing greater source-country taxing rights than the OECD Model.

Since the Committee's members serve in their personal capacities and not as representatives from their governments, the UN Model is still not binding for the

[12]DAVID E SPENCER, *the United Nations: A Forum for Global Tax Issues?,* in *Westlaw,* 2006.

participant countries, nor does it constitutes a formal recommendation of the United Nations.

Its relevance relies on its merits, since it is meant to ease the negotiation, interpretation and application of bilateral tax treaties.

The UN Model introduction marks that this latest version is “the beginning of an ongoing process of review”[13], which should lead to more frequent updates of the UN Model's provisions.

[13]Paragraph 16 of the Introduction to the UN Model Double Tax Convention between Developed and Developing Countries.

# CHAPTER I

## THE UN MODEL CONVENTION'S SUBJECTIVE AND OBJECTIVE SCOPE.

### 1 Introduction

The allocation of fiscal withdrawal in the territory of a single State could rise equity problems with reference to single taxpayers, but not jurisdiction conflicts; in federal States, where more than one authority has the power of levying tax, conflicts usually involve coordination problems.

When, on the other hand, the income is generated in an international environment and more States claim the existence of a link with the income, the problem also regards equity issues between States, namely subjects with powers of taxation.

The "inter-country equity" or "inter-nation equity" problem in substance regards the allocation of tax return between capital exporter States and capital importer States.[14]

States usually justify their claim to tax by reference to the person's personal attachment to their territory, or by reference to its economic attachment to the State.

The first justification reflects the conception of State as a provider of social services, so that taxes could be represented as a fee for being part of State's society; while the second justification, that the income must be taxed when it has

[14] C. GARBARINO, *La tassazione del reddito transnazionale*, Padova, 1990, p. 80.

an economic attachment to the State, could be described as the fee for the use of State's infrastructure and resources. An economic attachment can be found when the income is generated within the State's territory.

Thus, there are two main principles under which countries tax income: source and residency.[15]

Nowadays, the majority of States has adopted a mixed taxation system, in which they apply the worldwide principle of imposition over their fiscal residents, namely their local residents and their nationals, and the territorial principal of imposition above the income produced by other subjects.[16]

The personal and economic attachment of a taxpayer are usually located in the same State; for example in the case of a company which invests in the place in which it was incorporated. But, with the growth of international companies and the worldwide spread of interests, linked to globalisation process, cases arise more frequently when personal and economic attachment are located in different countries.

In the hypothesis of State A of residence which exports capital in State B of source, in absence of imposition, the income arising from the investment flows into State A of investors' residence and it constitutes a national gain for State A.[17]

While, whether State B of source levies tax on the income there produced, State's A national gain shall be reduced corresponding to State's B withdrawal.

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[15] OECD, *The impact of the Communications revoultion on the Application of "Place of Effective Management" as a Tie Breaker Rule,* 2001.
[16] N. MELOT, *Territorialité et mondialité de l'impôt*, 2004, p. 48.
[17] C. GARBARINO, *La tassazione del reddito transnazionale,* cit., p.86.

If both States affirm their right to tax the income, a phenomenon of double taxation arises.

The following cases are typical situations in which both State of residence and State of source affirm their right to tax:

- *First case:* both States consider the taxpayer who generates the income as a resident;
- *Second case:* both States consider the income to have its source in their territory;
- *Third case:* State A (residence State) considers the person as a resident, while State B (source State) considers the income to have its source within its territory.[18]

Usually, conflict number 3 takes place between a capital exporter State and a capital importer State, the latter one tending to deem as much taxable income as possible to have its source within its territory, while the former tries to levy taxes also on incomes generated abroad.

Conflicts number 1 and 2, instead, are usually determined by a non-coordination between the juridical systems of the investing States.

In particular, conflict number 1 leads to a situation of dual residence, which has been the subject of discussion in two notable cases during the last decade.

The first situation occurred when a US company which had its central management and control in the UK was, for tax consolidation purposes, declared

[18] C. GARBARINO, *La tassazione del reddito transnazionale*, cit., p.88.

to be a part of a group of companies in each of the two countries.[19] The company was in a continuous loss-position, with respect to which a treaty to avoid double taxation has no bearing.

As a consequence of its dual residence, the loss could be deducted twice: once from the group profits in the US and once from the group profits in the UK. The company's continuing losses were due to the interests payments on a large loan which the dually resident company acquired in connection with financing the purchase price of a UK subsidiary company. [20]

New legislation has been introduced in both countries to face this kind of issues.

The second notable situation regards dividend withholding taxes: Netherlands often serves as a base for holding companies of various multinational groups of companies.

Sometimes these companies have been incorporates under Netherlands law, but they are also resident in another country due to the place of effective management.

Question arises both in receiving and distributing dividends.[21]

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[19] MURBY, *Dual residence compagnie, Uses and Abuses,* in *Bulletin for International Fiscal Documentation*, 1985, p.373.
[20] EDGAR A. BROOD, *Dual residence of companies,* in *Intertax*, 1990, p. 23.
[21] EDGAR A. BROOD, *Dual residence of companies,* cit., p. 22.

In order to solve these situations, States enter into bilateral agreements which can be seen as fiscal compromises: in fact, by becoming parts of a bilateral convention, States allow the rearrangement of their imposition rules, trying above all to avoid double imposition, thus facilitating capital movements.[22]

The United Model Double Taxation Convention Between Developed and Developing Countries and the OECD Model Tax Convention on Income and on Capital try to offer relief from double taxation.

The Models do not create taxation rights, they offer the States guidelines they can follow in the negotiation of bilateral treaties, as to allocate the existing taxation rights between themselves.

The UN Model and the OECD Model share many common provisions, the first four Articles are almost alike, but for a small difference in Art 4, while the most important differences start with the following Articles; anyway, in general, it can be said that the UN Model grants more taxation rights to the source State or capital-importing countries than the OECD Model, thus being quickly embraced by mostly developing nations.[23]

The Conventions' first two articles, which are identical in substance and form, define the Models' subjective and objective scope, and they are of primary importance, since they identify the subjects and the types of taxes covered by the Conventions.

[22] N. MELOT, *Territorialité et mondialité de l'impôt*, cit., p.50.
[23] BART KOSTERS, *The United Nations Model Tax Convention and Its recent Developments*, in *Asia-Pacific Tax Bulletin*, 2004.

**2 The UN Model subjective scope.**

The UN Model's first article, entitled "Persons Covered", states that:

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

It reproduces Article 1 of the OECD Model; like the latter one, the UN Model applies to persons who are residents of one or both of the Contracting States, even though there are some exemptions to this rule, for example in Article 24, paragraph 1 and in Article 25, paragraph 1, in which the nationality criterion is adopted.

According to Article 3, which contains general definitions in order to clarify the meaning of the words used in the Convention, unless the context otherwise requires, under the purpose of the Convention, "the term "person" includes an individual, a company and any other body of persons"[24]; while "the term "company" means any body corporate or any entity that is treated as a body corporate for tax purposes"[25].

According to paragraph 2 of article 3 any term not defined in the Convention shall have the meaning that it has under the domestic law of the Contracting State, any meaning given in tax laws having priority over different meanings given in other internal laws.

When a conflict arises between the law in force when the Convention was signed and the one in force when the Convention is applied, the latter law

[24] United Model Double Taxation Convention Between Developed and Developing Countries, art. 3 sub par. A.
[25] United Model Double Taxation Convention Between Developed and Developing Countries, art. 3 sub par. B.

prevails, but the posterior law cannot give to the Contracting State greater rights than those it had at the moment the Convention was signed.

However, correctives can be introduced in order to deal with particular situations: for example, the UK-Hong Kong double taxation agreement needed to tackle the problem that Hong Kong's taxation system is based upon source in the jurisdiction and does not use the connecting factor of residence.[26]

Hence the double taxation agreement had to include innovative provisions to define residence.

In particular, the UK-Hong Kong treaty defines a resident of the latter country as a company incorporated in Hong Kong or centrally managed and controlled there, and any other person constituted under the laws of Hong Kong or (if constituted outside the Hong Kong SAR) centrally managed and controlled in Hong Kong.[27] This rather precise definition was necessitated by the absence of a definition of residence in Hong Kong domestic tax law. More generally, this wording would function as a workable definition of individual and corporate residence for any double taxation agreement with a jurisdiction that did not utilise that concept in its domestic law.

Anyway, in general, a company can be allowed to enjoy treaty benefits only if it can be qualified as a person and a resident of the Contracting State, once the "person" requirement in respect of an entity has been met, the subsequent issue is the residence requirement.[28]

[26] PHILIP BAKER, *A note on recent UK Treaties Developments*, in *Westlaw,* 2011.
[27] UK/Hong Kong Double Taxation Agreement and Protocol (UK-Hong Kong DTA).
[28] RACHEL GALEA, *OECD-The Meaning of "Liable to Tax" and the OECD Reports: Their Interaction and Ambiguous Interpretation,* in *Bulletin for International Taxation,* 2012.

## 2.1 Partnerships' treatment

A problem the UN Model leaves unsolved is the one regarding the treatment of partnerships, which are those subjects thus defined by States' civil or commercial laws.

The Commentary specifies that the Convention does not contain special provisions upon partnerships, so that states are free in determining their fiscal treatment during the negotiations of a treaty, it recalls, instead the report "The application of the OECD Model Tax Convention to partnerships", published by the OECD Committee on Fiscal Affairs published in 1999.

The report deals with the application of the OECD Model to partnerships, but it also specifies that the same discipline can be used with other non-corporate entities.

The main core of the matter is whether a partnership should benefit from the Convention's provisions.

Problems with them derive from the fact that the States' domestic laws are deeply different: some countries consider partnerships as independent subjects, with the consequence that the partnership is an independent taxable unit; while other countries tax only the partners on their share of partnership's income[29], considering partnerships as transparent subjects.

But this qualification difference could be of minor importance, if transparent companies were considered, as well as opaque ones, residents. This is, for

[29] Paragraph 4 of the Commentary to Article 1 of the UN Model.

example, France's position. Anyway this is not the most classic approach, for example the United States do not consider partnership as residents.[30]

Consequently, the qualification of an entity as opaque entails conventional problems.

Hence, problems with hybrid entities derive from a different fiscal treatment between opaque and transparent companies and from a different qualification of the same subject, operated by the State of residence and the State of source.

In fact States, and especially source State, qualify *lege fori* and not *lege causae.*[31]

In order to avoid conflicts of qualification, and consequently different treatments of identical subjects, the OECD report suggests that the State of source should apply the qualification adopted by the residence State.

Assuming that the source State regards the partnership as a taxable unit, but the residence State does not, the income is allocated to the partners, as the partnership is not a resident for the purposes of the residence State.[32]

For example, in the French case of SA Diebold Courtage, the French Conseil d'Etat, after establishing the entitlement of the partners to treaty benefits, deliberated on whether or not the partners were "real beneficiaries" who should be claiming the benefits of the tax treaty to avoid the use of abusive structures and treaty shopping.

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[30] N. MELOT, *Territorialité et mondialité de l'impôt*, cit., p.55.
[31] N. MELOT, *Territorialité et mondialité de l'impôt*, cit., p.55.
[32] RACHEL GALEA, *OECD-The meaning of "Liable to tax" and the OECD Reports: Their Interaction and Ambiguous Interpretation,* in*Bulletin for International Taxation*, 2012.

According to the Partnership Report, such an approach ensures that "the benefits of the Convention accrue to the persons who are liable to tax on the income"[33] and, therefore, that the treaty benefits are granted to the beneficial owner of the income.

The UK-Australia double taxation agreement made an attempt of dealing with partnerships: the term "person" does not include a partnership except that a partnership deriving its status from Australian law as a limited partnership which is treated as a taxable unit under the law of Australia shall be treated as a person for the purposes of the Convention.[34]

Thus, a UK resident partner in an Australian limited partnership, which is entitled to relief from UK tax under the treaty on income or gains arising in the UK, may still be taxed in the UK on his share of that income or gains.

Moreover, in triangular cases, issues can derive from differences of attribution rules between two States, being the partnership in a country and the partners in another, while the income is produced in a third State.

The OECD wants to ensure that those who are rightfully entitled obtain treaty benefits, but it also wants to avoid abuses due to persons claiming dual entitlement. Thus, in situations of this kind, where the same income benefits under two treaties, the State of source may not impose taxation which is inconsistent with the terms of either applicable Convention, therefore, when different rates are provided for in the two Conventions, the lower will be applied.[35]

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[33] OECD, *The Application of the OECD Model Tax Convention to Partnerships*, 1999.
[34] J.D.B. OLIVER, *The new Australia-UK tax treaty,* in *Westlaw,* 2004.
[35] RACHEL GAELA, , *OECD-The meaning of "Liable to tax" and the OECD Reports: Their Interaction and Ambiguous Interpretation,* cit., 1999.

The UK-Germany double tax agreement contains a specific provision which aims to deal with triangular cases in general, not only with reference to partnership: it applies where an enterprise of Germany derives dividends, interest or royalties from the UK, but that income is attributable to a permanent establishment which the German enterprise has in a third state.

In theory, the payment would be made from a source in the UK to a resident of Germany.[36] However, Germany might exempt the profits of the permanent establishment in the third state, and an unintended reduction in overall taxation would result. For that reason, the protocol provides that, if the combined taxation in Germany and the third jurisdiction is less than 60 per cent of the tax that would have been payable in Germany, then the UK should apply a rate not exceeding 15 per cent to the dividends, interest or royalties.[37]

This ensures, therefore, a minimum level of source taxation in the UK if the income is not subject to significant taxation in Germany and the third state.

## 3 The concept of "residence"

A concept which often generates problems of treaty abuse is the one of "resident of a Contracting State".

According to the OECD Model Convention, this concept has various functions and is of importance in three cases:

- in determining a convention's personal scope of application;

[36] PHILIP BAKER, *A Note on recent tax treaty developments in the UK*, cit.
[37] UK/Federal Republic of Germany Double Taxation Convention (UK-Germany DTA).

- in solving cases where double taxation arises in consequence of double residence;
- in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs.

Article 4 of the UN Model Convention reproduces Article 4 of the OECD Model, with an adjustment, represented by the inclusion in paragraph 1 of the "place of incorporation" among the useful criteria for the identification of residency.

Both the articles define the expression "resident of a Contracting State", and they establish rules for the resolution of conflicts deriving from dual residence. Actually, conventions for the avoidance of double imposition do not usually bind States with the conditions for determining residency, but in those cases of conflicts between two countries, when no solution can be found by reference to the concept of residence adopted in the States, special provisions must be applied.

In particular, the first paragraph of art. 4 contains the definition of resident, while the second and third paragraphs deal with dual residence, respectively, of individuals and companies, or "any other body of persons, irrespective of whether they are legal persons"[38].

The first part of Article 4 paragraph 1 states that:

"For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management

[38] Commentary of article 4 of the United Nations ModelDouble Taxation Convention Between Developed and Developing Countries, para. 3, sub para. 8.

or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof."

This is the positive definition of "resident of a Contracting State"; with this expression the Convention indicates any person (individual, company or body of persons) liable to tax under the laws of that State, thus expressing the subject's full liability to tax; in other words a taxation on the taxpayer's worldwide income is provided.

The person is deemed to be a resident when a personal attachment to the State will be found, in the cases of domicile or residence; or when an economic attachment shall be found, as in the case of the place of incorporation or place of management.

The OECD wording of Article 4 is almost identical, but for the exclusion of the "place of incorporation" from the residence criteria. Unlike the UN Model, the OECD Model discourages the use of this criterion; moreover, paragraph 21 of the Commentary to Article 4, while dealing with dual residence situations, affirms that:

"It may be rare in practise for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course, possible 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 to the preference must be established

It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed.”.[39]

As for the other criteria of a similar nature, they can be divided in two categories:

- Formal criteria, like nationality for individuals, or the place of registration for companies;
- Physical criteria, like the presence of the subject in the territory of the state for at least 183 days; or, for companies, the statutory seat, the location of the main office or of the main business.

Also the Contracting States and its political subdivisions or local authorities can be regarded as residents for the purposes of the Convention.

The second part of article 4 contains a negative definition of “resident”: “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.” This sentence was not included in the original version of the UN Convention, it was inserted in 1999 in article 4 to deal with the particular situation of diplomats or members of the consular staff, who, according to the domestic laws of the State in which they are serving, could be considered as residents, but, because of their status, they can be taxed only on the income derived from sources in that State.

[39] Commentary of article 4 of the OECD Model Tax Convention on Income and Capital, para. 21

### 3.1 Individuals' dual residence

Paragraph 2 of article 4 contains tie-breaker rules for peculiar situations in which an individual could be deemed to be a resident of both the States; these rules are listed in decreasing order of relevance: first, the individual shall be deemed to be a resident of the State in which he has a permanent home available to him; if this criterion does not work because, for example, the person has a home in both the States or in neither of them, he shall be considered to be a resident of the State in which he has his centre of vital interest, meaning with that, the State to which his personal and economic attachment are closer.

If his centre of vital interest cannot be found he shall be judged to be resident of the State in which his habitual abode is located; if he has an habitual abode in both the States or in neither of them, he shall be deemed to a be a resident of the State of which he is a national.

If the subject is a national of both the countries the Contracting States shall determine his residence with the mutual agreement procedure.

### 3.2 Companies' dual residence

The problem of the identification of companies' fiscal residence in dual residence cases is more complex than the one regarding individuals.

In fact, there are a number of criteria the legislator could use for fiscal residency's determination.

He could take into account, among the personal attachment criteria, the fiscal residence, citizenship, or nationality of the shareholders, or the fiscal residence, citizenship, or nationality of the administrators. But the legislator could also consider the company’s place of management, the place of incorporation or registration.[40]

When all this attributes are located in the same country, the company is clearly a resident of that State, but, if they are divided into more States, each one shall determine whether the company is a resident or not.

The most formal criterion is the one focused on the place of incorporation, anyway formal criteria are usually mixed with more factual ones, for example the company’s place of management.

Of course, it is possible for a company to be regarded as a resident by two or more States, for example in the case of a company which is incorporated in State A, but managed and controlled in State B.

Central Management and Control is one of the residence test adopted in a number of different countries for non-individuals, for example Australia, Ireland and United Kingdom.

Under Section 6 of Australia’s Income Tax Assessment Act 1936, a company is resident of Australia if:

- it is incorporated in Australia;
- it carries on business in Australia and is centrally managed and controlled in Australia;
- it carries on business in Australia and its voting power is controlled by shareholders resident in Australia.[41]

[40] C. GARBARINO, *La tassazione del reddito transnazionale*, cit., p. 183.

In Australia the expression “centrally managed and controlled” is not defined by the internal law, but a number of court cases can be useful.

Accordingly to court decisions, the place of central management and control coincides with the place where the directors of the company exercise their power and authority, which will generally be where they meet.[42]

An important case expressing this principle is “De Beers Consolidated Gold Mines (1906) AC 455.[43] In this case the company was registered in South Africa, had its workers and main activity in South Africa, while the directors’ meetings were held both in South Africa and in the United Kingdom.

The reunions held in the latter country were recognised to be the ones in which the real control of the company was exercised. Thus, the company was found to be a UK resident.

This decision was the base for some Canadian cases in which the courts have found that the place of control and management was where the company “really keeps house and does business”.[44]

Some of the factors having relevance in this determination were:

- place of incorporation;
- place of residence of shareholders and directors;
- where the business operations take place;
- where financial dealings of the company occurred;

[41] OECD, *The Impact of the Communications Revolution on the Application of “Pleace of Effective Management” as a Tie Breaker Rule*, cit, p.5.
[42] Waterloo Pastoral Co Ltd v FCT (1946).
[43] OECD, *The Impact of the Communications Revolution on the Application of “Pleace of Effective Management” as a Tie Breaker Rule*, cit, p.5.
[44] Birmount Holdings Ltd v R (1978) CTC 358, Tara Exploration & Development Co Ltd v MNR (1970) CTC 557.

- where the seal and minute books of the company were kept;[45]

In exceptional circumstances the place where the controlling shareholder makes the relevant decisions can be decisive in determining where the place of control and management is: for example in "Unit Construction Co Ltd v Bullock (Inspector of Taxes)", three companies incorporated in Kenya were wholly controlled by the company resident in the United Kingdom. Even though the Kenyan companies' directors held meetings only in Kenya, the management powers were exercised by the British ones, which resulted in the court finding that the subsidiaries were UK residents.

### 3.3 Place of Effective Management

According to paragraph 3 article 4 of the Convention "Where by reason of the provisions of paragraph 1 a person, rather 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."

While there is wide agreement among States upon the tie-breaker rules settled for individuals, no unanimity could be reached upon the third paragraph, since there is not a uniform interpretation  of the place of effective management concept.

In order to identify the "place of effective management", paragraph 3 of the UN Commentary states that the circumstances which may be taken into account are:

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[45] OECD, *The Impact of the Communications Revolution on the Application of "Pleace of Effective Management" as a Tie Breaker Rule,* cit, p.5.

- the place where a company is effectively controlled or managed;
- the place where key-decisions, necessary for the conduct of the entity, are taken;
- the place that plays a fundamental part for the management of the company, from an economic and functional point of view;
- the place where the most important accounting books are kept.

Switzerland's domestic law uses the concept of "place of effective management", introducing a distinction between the place of effective management and merely administrative management or decision-making by executive bodies.

Professor Vogel states that what is decisive is not the place where the management directives take effect, but rather the place where they are given; namely, the centre of top level management.[46]

Anyway, in some European countries, public companies such as Dutch NVs and German AGs have two levels of board; the Supervisory Board and the Management Board; the Supervisory Board has the ultimate authority vested in it by the shareholders, whilst the management board meets more frequently and implements the company strategy.[47]

If these two boards were to meet in separate locations the question arises would this be a case of a separation of central management and control, and effective management.

[46] K. VOGEL, *Double Taxation Conventions*, in *Kluwer Law International*, p.262.
[47] PHILIP OWEN, *Can effective* management *be distinguished from central management and control?*, in *British Tax Review*, 2003

However, provided that the supervisory board have and exercise their power to set strategy and ratify or reject recommendations made to them by the management board, the central management and control of the company and, as is being argued, also the effective management of the company rests with them.

The UK-Australia treaty offers a peculiar solution for dual listed companies; the treaty is unique in addressing for the first time in UK and Australian treaty practice, and probably in any treaty, the issue of dual listed structures which are effectively contractual mergers between two companies.[48]

At least three structures of this kind have been introduced between the UK and Australia--Rio Tinto, BHP/Billiton, and Brambles.

The feature of all three structures was the need to ensure that both companies followed similar commercial policies and strategies, which were integrated with each other, in other words the companies acted as one.

This gave rise to an issue: where, in such a case, could the central management and control, in Australian and UK terms, or the place of effective management, in treaty terms, be said to be located. If there were a common board of directors for each company, tax authorities and judicial doctrine wondered whether it was sufficient for them to meet with one hat in the UK as the board of the UK company and with another hat in Australia as the board of the Australian company.

The treaty provision applies to participants in a "dual listed company

[48] RICHARD J VANN, *The new Australia-Uk Tax Treaty,* in *Westlaw,* 2004.

arrangement”[49] which is defined as an arrangement pursuant to which two publicly listed companies, while maintaining their separate legal entity status, shareholding and listings, align their strategic directions and the economic interests of their respective shareholders through:

- common or almost identical boards of directors;
- management of the operations on a unified basis;
- equalised distributions to shareholders;
- shareholders of both companies voting in effect as a single decision-making body;
- cross-guarantees of each other's obligations.[50]

Where such a participant is a resident of both Contracting States, it shall be deemed to be a resident only of the Contracting State in which it was incorporated, provided that it has its primary stock exchange listing in that State.[51]

Anyway, some countries consider the companies’ dual residence so rare, that they find a factual approach to be the most suitable solution. In these countries local authorities shall be competent to solve the issue.

Paragraph 24 of the OECD Model, recalled by the UN Commentary, gives element which shall be taken into account: the place where the board directors meet; the place where the person’s headquarters are located; which country’s law governs the legal status of the person.

[49] Australia-UK Double Taxation Agreement.
[50] Australian Treasurer's Press Release No.32/2003, Review of International Tax Arrangements, p.3
[51] RICHARD J VANN, *The new Australia-Uk Tax Treaty,* cit., 2004.

However no definite rule can be given, all facts and circumstances must be taken into account, keeping in mind that a company can have more than one place of management, but only one place of effective management.

Nowadays the situation has become more complex especially because of communication revolution: places of management have not to be physically located in one place, since the board directors can meet on a rotational basis, as well as they can use e-mail or video conferences in order to communicate.

In general, directors are independent of the location of the company, since a great deal of freedom is left to directors for the administration of subsidiaries.

German case law suggests that the residence of a company may be determined by the residence of the top manager, in cases where the place of management cannot be determined. However, it is likely that situations will arise where managers are not all residents of the same country.[52]

**4 POEM and treaty abuses**

Thus provided, it is easy to understand that residency is not always easy to determine, especially because there are some cases in which taxpayers shift their residence with the only aim of enjoying treaty benefits that otherwise they could not take advantage of.

Paragraph 41 of the Commentary on the first article of the UN Model offers some examples:

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[52] OECD, *The Impact of the Communications Revolution on the Application of "Pleace of Effective Management" as a Tie Breaker Rule,* cit

- Company X, a resident of State A, is contemplating the sale of shares of companies that are also residents of State A. Such a sale would trigger a capital gain that would be taxable under the domestic law of State A. Prior to the sale, company X arranges for meetings of its board directors to take place in State B, a country that does not tax capital gains on shares of companies and in which the place where a company's directors meet is usually determinative of that company's residence for tax purposes. Company X claims that is has become a resident of State B for the purposes of the tax treaty between States A and B pursuant to paragraph 3 of Article 4 of that treaty, which is identical to the United nations Model Convention. It then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (paragraph 5 of that Article would not apply as company X does not own substantial participations in the relevant companies).
- Ms. X, a resident of State A, owns all the shares of a company that is also a resident of State A. The value of these shares has increased significantly over the years. Both States A and B tax capital gains on shares; however the domestic law of State B provides that residents who are not domiciled in that State are only taxed on the income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. In contemplation of the sale of these shares, Ms. X moves to State B for two years and becomes resident, but not domiciled in that State. She then sells the shares and

> claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (the relevant treaty does not include a provision similar to paragraph 5 of the United Nations Model Convention). [53]

When the residence transfer has its only goal in obtaining tax advantages it could be argued that a treaty abuse is taking place. But in cases similar to the previous ones, it could be difficult for local authorities to prove that the change of residence is primarily intended to access treaty benefits.

Neither the UN Model does not give a proper definition of "treaty abuse", it recalls the OECD Model's general guidance, defined as "guiding principle":

"a guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."[54]

Thus given, in order to identify an abuse of the treaty two elements must be present: the conclusion of an arrangement or a transaction with the main purpose of securing a more favourable tax position, and the fact that the more favourable treatment is contrary to the object and purpose of the treaty.

In these cases States can apply their domestic anti-abuse rules, but "it is important that this guiding principle be applied on the basis of objective finding of

[53] Paragraph 41 of the Commentary on Article 1 of the UN Model Convention.
[54] Paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention.

facts, not solely the alleged intention of the parties".[55] Hence, local authorities should wonder if a reasonable taxpayer should have entered into the transaction or arrangement also without the tax advantages.

A correct interpretation of paragraph 3 of Article 4 could be useful to deal with these situations, since the concept of "place of effective management" requires a strong relationship between the company and the State: the mere fact, for example, that the board directors' meetings take place in a country, not being enough to consider the company a resident of that State.

An example of concrete application of the place of effective management rule as a way to oppose treaty abuses, is offered by a decision of the 2008 given by a Special Commission in the United Kingdom. The claimants were the trustees and settler of the Trevor Smallwood Trust ("the trust"), which had been created by Mr Smalwood for the benefit of himself and his family in 1989. In 2000, a tax-planning scheme was entered into for the purpose of avoiding liability to United Kingdom capital gains tax on sale of shares subject to the trust.

The scheme involved appointing a trust company registered in Mauritius as sole trustee of the trust and selling the shares while the Mauritius trust company retired and Mr and Mrs Smallwood were appointed trustees.

All this took place during the taxable year 2000-2001. It was agreed that Mr and Mrs Smallwood were at all times resident in the United Kingdom for the purposes of the treaty. The claimants argued that, at the time of the sale, the shares were the property of a resident of Mauritius and claimed the benefit of Art. 13(5) of the UK-Mauritius treaty, by virtue of which the capital gain on the sale of

[55] Paragraph 27 of the Commentary on Article 1 of the UN Model Convention.

shares was taxable only in Mauritius. The tax authority argued that the place of effective management of the trust was at all times in the United Kingdom.[56]

The Special Commissioners concluded that the place of effective management was in the UK, rending a decision in favour of British tax authorities.

When assessing whether the “centre of top-level management” of the trust was in the United Kingdom or Mauritius, the taxpayers submitted that the court should adopt the approach of the Court of Appeal in *Wood v Holden.*

That case established that, in relation to a company, there is no material distinction between the POEM test and the “central management and control” test, which is used to determine whether a company incorporated outside the United Kingdom has become UK resident for corporation tax purposes. Unless the functions of the company's “constitutional organs” (typically, its directors) have been usurped by an “outsider” (where such a person is exercising management and control independently of, or without regard to, the “constitutional organs”), the place of “central management and control” is where the “constitutional organs” carry out their functions.

An “outsider” is not regarded as usurping the functions of the “constitutional organs” merely by counselling them and influencing the decisions taken by them, provided that the “outsider” does not dictate the decisions that are taken.[57]

[56] Special Commissioners (Dr A N Bryce and Dr John F Avery Jones CBE), 19 February 2008.
[57] DOMINIC LAWRENCE, *Smallwood: Part 2: poetic justice?*, in *Westlaw*, 2011.

Moreover, many States tend to insert, among the treaty provisions, special rules that enables them to tax certain kinds of income received by a taxpayer that was previously a resident of that State.

Some countries have also adopted the so called “departure tax” or “exit charge” provision, under which the change of residence provokes the realization of certain types of income, for example capital gains on shares.

In these situations there are basically two ways to avoid a contrast with treaty provisions: pretending that the realization of the income took place before the change of residence, or inserting specific provisions in the body of the treaty.

However, some States prefer recurring to a mutual agreement procedure for situations of residency uncertainty.

The provision upon POEM in the UK-Hong Kong treaty is slightly unusual, since it states that:

“In cases of doubt, the competent authorities of the Contracting Parties shall endeavour to determine by mutual agreement the Party in which that person's place of effective management is exercised, and in doing so, shall take into account all relevant factors. In the absence of such agreement, that person shall not be entitled to claim any benefits provided by this Agreement, except those provided by article 21, 22 and 23.”[58]

This is an interesting variant on the alternative form of tiebreaker now in general use, which is based upon determination by the competent authorities.

[58] UK/Hong Kong Double Taxation Agreement and Protocol (UK-Hong Kong DTA).

The wording in the Hong Kong DTA adopts the test of POEM, but also contemplates a role for the competent authorities in determining doubtful cases, and limits the application of the double taxation agreement where it has not been possible to apply the tiebreaker and determine a single country of residence.[59]

## 5 Treaty shopping

A behaviour often resulting in an improper use of treaties' provisions is the so-called treaty shopping, through a which a person, not entitled to the benefits of the Convention, use another person in order to indirectly access them.

For example a person who is not a resident of a Contracting State could transfer its profits to a company which is instead entitled to the Convention's benefits, using it as a conduit company. Entities more often used for these purposes are usually companies, but they can also be partnerships or trust.

The Commentary on article 1 of the UN Model gives further clarifications: it distinguishes between direct conduit and stepping stone conduit.

- Company X, a resident of State A, receives dividends, interests or royalties from Company Y, a resident of State B. Company X claims that, under the tax treaty between State A and B, it is entitled to full or partial exemption from the domestic withholding taxes provided for under the tax legislation of State B. Company X is wholly-owned by a resident of third State C who is not entitled to the benefits of the treaty between States A and B. Company X was created with the purpose of

[59] PHILIP BAKER, *A note on recent UK tax treaty developments*, cit.

> obtaining the benefits of the treaty between States A and B and it is for that purpose that the assets and rights giving rise to the dividends, interests or royalties have been transferred to it. The income is exempt from tax in State A, e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic law of State A or under the treaty between States A and B. In that case, Company X constitutes a direct conduit of its shareholder who is a resident of State C.[60]

During the past five years the Chinese tax authority has embraced an unorthodox approach to international tax avoidance arrangements that utilise conduit companies  and undermine China's tax base as a country of source of income for foreign investors. Since China's new Enterprise Income Tax Law took effect on January 1, 2008, China has contended that general anti-avoidance rule contained therein can be applied to strike down international corporate structures founded on treaty shopping.[61]

Chapter VI of the Special Adjustments to the Enterprise Income Tax Law contains article 47, which declares:

"if an enterprise carries out any other business arrangements without reasonable business purposes, resulting in reduction of its taxable revenue or income, the tax authority shall be empowered to make adjustments using reasonable methods."

[60] Paragraph 49 of the Commentary to Article 1 of the UN Model Convention.
[61] KEVIN HOLMES, *the politics of the improper use of double tax treaties: China waves red flags,* in *British Tax Review,* 2011.

On December 2008 the State Administration of Taxation (SAT) issued a circular in response to a request from its Xinjiang office for direction in deciding whether the Barbados-China double taxation agreement had been abused in a share sale transaction.[62]

In March 2003, two Chinese resident companies, ChinaCo1 and ChinaCo2, jointly established another Chinese resident company, TargetCo, to undertake certain manufacturing and sale activities. China Co1 and ChinaCo2 contributed 97.5 per cent and 2.5 per cent, respectively, of the registered share capital of TargetCo. In july 2006 ChinaCo1 and ChinaCo2 entered into a joint venture agreement with BarbadosCo, ostensibly a resident of Barbados. BarbadosCo was established in Barbados in May 2006 and was wholly owned by a company that was a resident of the US. Pursuant to the joint venture agreement, BarbadosCo purchased 33,32 per cent of TargetCo's share capital from ChinaCo1 for $33.8 million, making payments through a Cayman Islands bank account. As a consequence, the shareholdings in TargetCo became: ChinaCo1 64,18 per cent; BarbadosCo 33,32 per cent; ChinaCo2 2,5 per cent. Twenty-seven days after the share purchase by BarbadosCo, ChinaCo1 to acquire additional capital in TargetCo. As a consequence, TargetCo's registered capital became allocated as follows: ChinaCo1 73,13 per cent, BarbadosCo 24,99 per cent; and ChinaCo2 1,88 per cent. Approximately one year later, BarbadosCo sold all of its shares in TargetCo to ChinaCo1, realising a capital gain of $12.17 million.[63]

[62] GUO SHUI HAN, *Notice on Correctly Dealing with Treaty Abuse Case,* in *Westlaw,* 2008.
[63] KEVIN HOLMES, *the politics of the improper use of double tax treaties: China waves red flags,* in *British Tax Review,* cit, 2011.

The gain came to the notice of the Xinjiang tax authorities because ChinaCo1 needed a tax clearance certificate before it could acquire the foreign exchange to pay for BarbadoCo’s shares in TargetCo.

Under the relevant domestic law of China, which was applicable at the time that the gain was made by BarbadosCo, the gain was taxable in China since it was sourced in China[64]

Anyway, the domestic law, which imposed 10 per cent withholding tax on the amount of the gain, would be rendered surrogate to Art 13 of the Barbados-China double taxation agreement if BarbadosCo met the relevant requirements specified in the treaty.

Art 13 of the Barbados-China double taxation agreement states that:

“Gains from the alienation of any property other than that referred to in paragraphs 1 (immovable property), 2 (moveable property forming part of a permanent establishment that he company of a Contracting State has in the other Contracting State) and 3( international operating ships and aircraft and related moveable property), shall be taxable only in the Contracting State of which the alienator is a resident.”[65]

Thus, in order to avoid the Chinese withholding tax, BarbadosCo needed to be a Barbados resident.

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[64] Art 1 of The Income Tax Law of the People's Republic of China on Enterprises with Foreign Investment and Foreign Enterprises of October 27, 2007

[65]Paragraph 4 of Art 13 of the Agreement between the Government of Barbados and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, May 15, 2000.

Using the exchange of information powers in Article 26 of the Barbados-China double taxation agreement, the Xinjiang tax authority established that, even though BarbadosCo was registered  and had a registration address in Barbados, the three members of its board of directors were all citizens of the US. Furthermore, BarbadosCo had no personnel, operations or assets in Barbados.

The SAT concluded that BarbadosCo was not truly a resident of Barbados and, consequently, it was not entitled to enjoy the benefits provided for in the China-Barbados treaty.

Anyway, being, in this case, the location of the directors determinative of the place of residence of BarbadosCo, then the activities in the US of its US-resident directors renders BarbadosCo a resident of the US; consequently, the provisions of the China-US double taxation agreement would be triggered.[66]

Article 12 of the China-US double taxation agreement provides that:

"gains from the alienation of shares [...] representing a participation of 25 per cent in a company which is a resident a Contracting State, may be taxed in that Contracting State."[67]

At the time that it sold its shares, BarbadosCo had not breached the 25 per cent threshold, instead its participation was of 24,99 per cent. However, in addition to the question of the residence of BarbadosCo, the SAT advanced other reasoning in order to support the Chinese right to tax: the gain arose from a predetermined arrangement; BarbadosCo was established only a short time before

[66] YANG HOULU, *New Developments in the General Anti-Abuse Rules and the Impact on International Tax Planning,* in *Asia-Pacific Tax Bulletin,* p.180, 2009.

[67] Art 12 Agreement between the Government of the United States of America and the Government of the People's Republic of China for the Avoidance of Double Taxation and the Prevention of Tax Evasion with respect to Taxes on Income, April 30, 1984, (China-US DTA).

it acquired the shares in TargetCo from ChinaCo1; the share repurchase by ChinaCo1 appeared opportunistic, given the short period between between the sale and the repurchase.[68]

All these reasons had the hallmarks of a treaty abuse.

Thus, if BarbadosCo was truly a resident of the US, a rational basis upon which the SAT could deny the application of Art 12 of the China-US treaty, was to allege treaty abuse, whereby the parties predetermined BarbadosCo's shareholding in TargetCo at 24,99 per cent.

The structure of a stepping stone conduit is similar: in that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interests, commissions, service fees or similar deductible expenses to a second related conduit company, company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State. The shareholder who is a resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.[69]

In order to avoid these situations States have adopted different approaches.

For example, the United States discipline with reference to financing arrangements provides that a financing arrangement is the acquisition of a product through debt.

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[68] KEVIN HOLMES, *the politics of the improper use of double tax treaties: China waves red flags*, in *British Tax Review*, cit, 2011.
[69] Paragraph 50 of the Commentary to Article 1 of the UN Model Convention.

When one or more intermediaries intervene in the process they shall be considered conduit companies and their existence for tax purposes shall be disregarded, if the total tax burden is reduced because of the intermediary's presence, a tax avoidance plan is detected and the intermediary's relation with the financing entity is found to be the only reason of its participation in the arrangement.

In *Aiken industries Inc. v Commissioner of Internal Revenue* a company, which was a resident of the Bahamas, Ecuadorian Corp. Ltd (ECL), owned 99,997 per cent of the share capital of Mechanical Products inc. (aiken Industries), a US resident corporation. ECL also held all the shares of Compania de Cervezas Nacionales (CCN), a company resident in Ecuador, which, in turn, wholly owned Industris Hondurenas SA de CV (Industrias), a Honduran resident company.[70]

ECL made a loan to Aiken Industries in return for a promissory note. Since there was no treaty between the US and the Bahamas, Aiken Industries would have had to deduct US domestic withholding tax at the rate of 30 per cent on interest payments that it made directly to ECL. Rather, ECL transferred Aiken Industries' note to Industrias in consideration for a second promissory note issued by Industrias to ECL. Aiken Industries then made its interests payments to Industrias rather than to ECL.

This arrangement was designed to take advantage of the exemption from US withholding tax under Art 9 of the Honduras-US double taxation agreement, which establishes that:

[70] KEVIN HOLMES, *the politics of the improper use of double tax treaties: China waves red flags*, in *British Tax Review*, cit, 2011.

"Interest on [...] notes [...] from sources within a Contracting State received by a resident, corporation or other entity of the other Contracting State, not having a permanent establishment in the State of Source [...] shall be exempt from tax therein."[71]

The US Commissioner of Internal Revenue alleged that Industrias should be disregarded for tax purposes because ECL was the true owner and recipient of the interest and ECL, not being a resident of Honduras, was not exempt from the US 30 per cent withholding tax under the Honduras-US treaty.

The Court went on affirming that the interest payments made by Aiken Industries to Industrias were not exempt from the US withholding tax because Industrias was merely a conduit for the passage of the interest from Aiken Industries to ECL and that Aiken Industries "failed to demonstrate that a substantive indebtedness existed between a United States corporation and a Honduran corporation. [...] Its only purpose was to obtain the benefits of the exemption established by the treaty,"[72]

Other States, for example Switzerland, deal with the problem through the interpretation of their treaties. According to a 1962 decree of the Swiss Federal Council, which is applicable to Swiss treaties with countries that, under the relevant treaties, grant relief from withholding tax that would otherwise be collected by these countries, a claim for such relief is considered abusive if,

[71] Convention between the United States of America and the Republic of Honduras for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, June 25, 1956 (Honduras-US DTA)
[72] United States Tax Court, *Aiken Industries Inc. v Commissioner of Internal Revenue* ,56 T.C. 925 (1971)

through such claim, a substantial part of the tax relief would benefit persons not entitled to the relevant treaty.[73]

Moreover, some countries have addressed this problem through their domestic laws or their judicial doctrines.

Another way to deal with treaty shopping problem is the insertion of specific rules in the treaties, for example the UN Model contains the “beneficial owner” concept. The OECD Commentary includes various examples of such rules.

Three approaches are spotted to deal with conduit companies problem: the look-through approach, the subject-to-tax approach and the channel approach.

The first one aims to grant treaty benefits only to those companies which are found to be directly or indirectly owned by residents of a Contracting State. When a solution of this kind is adopted, States can insert, among the treaty’s provisions, relevant criteria in order to determine when a company is hold by a resident of the Contracting State.

The subject-to-tax approach grants tax exemptions in the State of source only when the income is taxed in the State of residence. Anyway this strategy is not adequate for advanced evasion strategies, as in cases of stepping stone conduit.

The most satisfactory solution to deal with the matter has been identified as the channel approach. The OECD Model suggests the following wording:

[73] Paragraph 53 of the Commentary to Article 1 of the UN Model Convention.

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

- 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
- 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 interests, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)."[74]

The channel approach is the only effective way to face stepping stone strategies.

The OECD Commentary suggests for these solutions to be accompanied and mitigated with bona fide provisions.

In *A Holding ApS v Federal Tax Administration* a group of companies was controlled by E, an individual resident in Bermuda. E was the director of D Ltd, a Bermuda Corporation, which held all of the share capital of C Ltd, which was a company resident in Guernsey, the Channel Islands. C Ltd, in turn, wholly owned A Holding ApS ( A Holding), a company resident in Denmark. A Holding did not

[74] Pragraph 17 of the Commentary to Article 1 of the OECD Model Convention.

have its own offices or staff in Denmark and had no assets, or leasing or personnel expenditure recorded in its accounts. In 1999, A Holding acquired the entire issued share capital of F AG, a company resident in Switzerland. F AG distributed dividends to A Holding, which were subjects to a 35 per cent withholding tax under Swiss domestic tax law.[75]

A Holding applied for a refund of the withholding tax under Article 26 of the Denmark-Switzerland double taxation agreement[76], but the Swiss Tax Administration rejected its request.

By reference to Art 26 of the Vienna Convention, the Federal Court noted that:

"good faith, the aim and purpose of a convention are to be taken into account when an international convention is applied. Every contracting state can expect that the other contracting state acts in accordance with these principles. […] This includes the tackling of abuses because the prohibition of abuses is part of the principle of good faith. […] It prohibits the use of an institute of law against its purpose to realise interests which are not protected by it. [...] Accordingly, the prohibition of an abuse of rights as regards conventions is […] recognised […] without being necessary to adopt an explicit provision in the respective convention. [ ... ]  It may be regarded as an internationally accepted principle that

[75] KEVIN HOLMES, *the politics of the improper use of double tax treaties: China waves red flags*, in *British Tax Review*, cit, 2011.
[76] The Convention between the Swiss Federation and the Kingdom of Denmark for the Avoidance of Double Taxation with respect to Taxes on Income and on Capital, November 23, 1973 (Denmark-Switzerland DTA)

states do not have to grant advantages of double tax conventions if arrangements chosen by the taxpayer constitute an abuse of a convention. "[77]

Initially, the Higher Tax Administration found that A Holding was the beneficial owner of the dividends, which it received. However, the Federal Court observed that:

"although the Higher Tax Administration has regarded A Holding as the beneficial owner of the dividends in accordance with art 10 of the Denmark-Switzerland double tax treaty one can assume an abuse. The assumptions of the court of lower instance were based on the fact that the distributed dividends are in principle attributable to A Holding for taxation in Denmark […]; this does not answer the question whether the convention was invoked abusively […][78]."

The Court used the look-through approach, noting that the corporate structure chosen by E allowed it to control not only D Ltd, but also A Holding. Thus, granting a refund to E would have meant granting a refund to E, who was not  a person entitled to enjoy the benefits of the Denmark-Switzerland treaty.

These are some of the approaches which aim to deal with a particular aspect of treaty shopping: conduit companies or stepping stone strategies, but States may prefer to face the treaty shopping problem in a more comprehensive way; the UN Model Commentary refers to the OECD Commentary, which suggests, for example, for treaty benefits to be granted only to those residents who can be defined as "qualified persons"; States are then free to determine in their

[77] *A Holding ApS v. Federal Tax Administration*, 8 ITLR 536 (Swiss Federal Court).
[78] *A Holding ApS v. Federal Tax Administration, cit.*

negotiations which characteristics an entity should possess to be addressed as a qualified person.

Other approaches can be tempted by the States in order to avoid the treaty shopping phenomenon.

One possible method consists in denying treaty benefits to specific types of companies, which are often used as conduit companies. States shall, in first instance, determine the characteristics these companies usually possess, then exclude them from the treaty scope.

A less radical solution could be excluding from the scope of the treaty only some kinds of income received or paid by such companies. In this way the companies concerned would still be subject to the provisions of Article 24 (non-discrimination), Article 25 (mutual agreement procedure) and Article 26 (exchange of information) of the UN Model.

When it is not possible to identify this kind of companies through their legal characteristics a more general formulation should be adopted. The OECD Commentary suggests the following wording:

“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 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 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."[79]

Paragraph 21.3 of the Commentary to the OECD Model also suggests to deny the treaty benefits to those income which are subject to preferential tax regimes or to no taxation at all; in particular the OECD Commentary addresses to those income which could be taxed in a Contracting States and do not require physical presence in the territory of that State, like banking or financing activities, or activities which trigger passive income where, under the laws of that Contracting State those income are preferentially taxed or confidential treatment is provided.

Subparagraph 2 of paragraph 21.3 then specifies when an income is preferentially taxed: when

- is exempt from tax; or
- 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
- 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.[80]

[79] Paragraph 21.2 of the Commentary to Article 1 of the OECD Model.
[80] Paragraph 21.3 subpar. 2 of the Commentary to Article 1 of the OECD Model.

## 6 Objective scope

While the first Article focuses on the personal scope of the Convention, the second one deals with its objective scope, it is entitled “taxes covered” and it reproduces Article 2 of the OECD Model Convention.

This Article is designed to clarify the terminology and nomenclature concerning the taxes to be covered by the Convention.[81]

The UN Commentary upon the Article underlines that, on the same income or capital, different taxes can be levied in the Contracting State, taxes with different nature, or taxes of the same nature levied by different authorities, for example local divisions of the Contacting State. Hence, double imposition cannot be totally avoided, unless the methods of taxation applied by the States take into account all the taxes imposed on the income or capital.

Paragraph 1 of Article 2 states that:

“This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.”

Thus, the first article affirms that the Convention shall apply to taxes on income and on capital, no matter which authority levied them, if the central government or local authorities.

The way taxes are imposed is irrelevant too, no matter whether they are levied by direct assessment or whether they are withheld at the source.

[81] Pragraph 2 of the Commentary on Article 2 of the UN Model Convention.

Paragraph 2:

“There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by the enterprises, as well as taxes on capital appreciation.”

This paragraph gives the definition of taxes on income and on capital, as taxes which can be imposed on the total amount of the income or capital, or on some parts of them; they can also be imposed on gains deriving from the selling of movable or immovable property, or on wages and salaries paid by the enterprise to its workers, as well as taxes on capital appreciation.

Paragraph 3 allows the Contracting State to indicate to which taxes the Convention shall apply.

Finally, paragraph 4 states that:

“The Convention shall apply to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law.”

The UN Commentary refers to the OECD Commentary for the explanation of this paragraph, according to which the Convention shall apply to new taxes, identical or substantially similar to previous taxes, adopted after the signature of the Convention.

Each Contracting State shall notify to the other any significant change made to its tax legislation. The OECD Commentary encourages States to communicate other significant development as well, for example in the application procedure or in judicial doctrine.

Contracting States are also free to notify significant changes in other fields of their legislations, which have a substantial impact on tax law.

# CHAPTER II

## The determination of active income: current points of difference between the UN and the OECD Models.

### 1. Introduction

While the first Articles of the UN and OECD Model Conventions tend to correspond, both in terms of wording and of scope, differences start to appear with the following Articles, which deal with the allocation of fiscal withdrawal between source State and residence State, with reference to the so-called active income earned by the enterprise.

In fact, whilst the similarities between the two leading international Models reflect the importance of achieving consistency where possible in international taxation matters, the UN Model has a special focus on developing countries[82], which means that, inevitably, important differences exist between the two Models.

The principles ruling the taxation of active income are provided by Article 7 of the Conventions, which states that incomes derived by an enterprise, which is a resident of a Contracting State, shall be taxable only in that State, unless that enterprise carries on its activities through a "permanent establishment" (PE) in the source State[83].

[82] A. LARA YAFFAR and M. LENNARD, *An Introduction to the Updated UN Model (2011)*, in *Bulletin for International Taxation*, 2012, p. 590.
[83] C. GARBARINO, *La Tassazione del Reddito Transnazionale*, cit., p. 190.

One significant feature of the UN Model Convention, as compared with the OECD Model, is a limited “force of attraction rule” in Article 7(1), which allows the taxation of certain profits not actually attributable to the PE, thus enhancing source States' taxation rights.

Moreover, the degree of economic activity required to form a PE in a country is, in many respects, lower under the UN Model (2011) than under the OECD Model (2010).

In general, the UN Model Convention preserves greater source country taxation rights in Article 5, which addresses the economic nexus required before source country taxing rights may be exercised under the tax treaty.

**2. Permanent Establishment.**

Both the OECD and UN Models define a PE as a “fixed place of business” and provide an enumeration of common types of fixed PEs. They both also provide for deemed PEs where a business has an enduring presence though not literally a fixed place of business.[84]

In particular, Article 5, paragraph 1 of both the UN and OECD Models states that:

“[...] the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.”[85]

[84]T. HWONG, P. MELLOR, R. KREVER, *Tax Treaty Trends in Central Asian Former Soviet Nations,* in *Bulletin for International Taxation,* 2012, Vol 66, No.10.
[85]Article 5 of the UN Model Convention between developed and developing Countries.

Thus, in order for a PE to exist, a fixed place of business is necessary, namely a facility such as premises or, to some extents, machinery or equipment. Moreover the place of business must be fixed, hence it must be separated from the main structure of the firm, being established in a distinct place with a certain degree of permanency. Finally the economic or commercial activity of the enterprise must be carried on through this fixed place of business.

The term place of business covers any premises, facilities or installation used for carrying on the business of the enterprise[86]; it is immaterial whether the premises, installation or facilities are rented by the entrepreneur or whether they belong to him or are otherwise at his disposal.

Moreover, no formal legal right to use the place is required, a PE being able to exist even when, for instance, the place of business is illegally occupied by the enterprise.

Anyway something more than the mere presence of the enterprise in a particular location is required in order to determine the existence of a permanent establishment, in fact the location must be at the disposal of the enterprise.

The OECD Commentary, quoted by the UN Commentary, specifies that the place of business must be a fixed one, thus a certain degree of permanency and a link between the place of business and a specific geographical point are required; for instance, according to paragraph 5.2 of the OECD Commentary, 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

[86]Commentary on Article 5 of the UN Model Double Tax Convention between Developed and Developing Countries.

single geographical and commercial unit. 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.[87]

Article 5(2) of the UN Model Convention lists examples of places which are likely to constitute permanent establishment: a place of management, a branch, an office, a factory, a workshop, a mine, an oil gas well, a quarry or any other place of extraction of natural resources.

This paragraph reproduces the corresponding paragraph 2 of the OECD Model, and both the commentaries specify that the provision is not self-standing, in fact even though an enterprise carries on its activities through one of the places listed in paragraph 2, the requirements provided by paragraph 1 must be met.

### 2.1 Delivery

Many developing countries consider that, among the relevant places, the inclusion of a "warehouse" would be appropriate, since it could allow a broaden of the scope of the term "permanent establishment", consequently enhancing their capacity to tax activities conducted within their territory.

The UN Model has not included the term "warehouse" among the activities listed in paragraph 2, but it has, indeed, achieved the same goal by deleting the term "delivery" from paragraph 4, which lists a number of activities, whose

[87]Paragraph 5.2 of the OECD Commentary on Article 5 of the OECD Model Tax Convention on Income and on Capital.

common feature consists in their being, in general, preparatory and auxiliary activities, not able to trigger a PE under both the UN and the OECD Conventions.

That is the case for (a) the use of facilities for the sole purpose of storage or display; (b) the maintenance of a stock of good only for storage or display or for the purpose of processing by another enterprise; (c) the maintenance of a fixed place of business for the sole purpose of collecting information or for carrying on other activities of preparatory or auxiliary character.

Thus, delivery alone is an activity that can constitute sufficient economic nexus to the host country as will allow for source country taxation under the UN Model Convention, but not the OECD Model Convention88; this implies that a "warehouse" used for that purpose should, if the requirement of paragraph 1 are met, be a permanent establishment[89], thus reflecting the point of view of the majority of the developing countries.

This difference reflects a view that the presence of a stock of goods for prompt delivery facilitates sales of the product and earning of profit in the host country and represents a continuous connection with the source country, and as such may constitute a PE and be subject to source country taxation.

### 2.2 Treatment of building and supervisory activities

Both the UN and the OECD Models deem a building site or construction or installation project to be a PE, enabling the source country in which the site or

[88]M.LENNARD, *The UN Modl Convention as Compared with the OECD Model Tax Convention- Current Points of Difference and Recent Developments*, in *Asia-Pacific Tax Bulletin*, 2009, Vol 49, No.08.

[89]Paragraph 16 of the UN Commentary on Article 5 paragraph 4 of the UN Model Convention.

project is located to tax the profits of a non-resident business responsible for work at the site or project.

Both the commentaries specify that a building site must be regarded a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically.[90]

This specification has been inserted in order to fight convention abuses deriving from the division of the enterprises' contracts up into several parts, each covering a period shorter than six months and attributed to a different company, which was, however, part of the same group of companies.

The key difference between the Models is the length of time required for work at the location or project to constitute a PE: the OECD Model requires presence at the site or project greater than 12 months, while, under the UN Model, the non-resident must only be at the location for more than six months to be deemed to have a PE. The difference can be significant for a country using foreign expertise to help develop private sector and public infrastructure.[91]

Moreover, the UN Model Convention covers a broader range of activities than the corresponding paragraph of the OECD Model, since the former one extends the building site or construction or installation project deemed PE found in the OECD Model to also include an "assembly" project and "supervisory" activities, providing the same six-month time threshold required for building site or construction or installation projects.

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[90]Paragraph 18 of the Commentary on Article 5 of the OECD Model Convention.

[91]T. HWONG, P. MELLOR, R. KREVER, *Tax Treaty Trends in Central Asian Former Soviet Nations*,cit.

### 2.3 Treatment of services

The first striking difference between the OECD and UN Models is the inclusion in the first one's definition of a PE, of an additional paragraph which addresses the so-called “service permanent establishments” in a way that forms a clear line of demarcation between the UN and OECD approaches.

In fact, Article 5(3) states that:

“The term “permanent establishment” also encompasses:

(b) the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.”[92]

The OECD Model Convention has no special provisions for services, thus the provision of services is treated in the same way as provision of goods. In other words, the same sort of economic presence in the territory is required to justify source country taxation, namely, the criteria established in Article 5(1) must be met.

Hence, the furnishing of services does not, by itself, create a PE under the OECD Model, but many developing countries believe that the inclusion of

[92]Article 5, paragraph 3 of the UN Model Convention between Developed and Developing Countries.

management and consultancy services provided within their territory by industrialized countries could generate large profit, consequently, they tend to insert subparagraph (b) of the UN Model within their tax convention, thus being allowed to tax profits deriving from the performance of these activities.

Subparagraph (b) specifies that the services must be furnished for “the same or a connected project”, these words are included because it has been considered not appropriate to add together unrelated projects, even though some countries tend to delete this provision, considering the project limitation too easy to manipulate, for example in case of an enterprise which carries on a number of unrelated projects, each during less than 183 days.

This difference between the OECD and the UN Model is of the greatest importance, since under the UN provision, a PE is more likely to be found, thus enhancing host countries' rights to tax.

### 2.3.1 Indian experience: Morgan Stanley's case

The following Indian judicial case will show how the inclusion of Article 5(3)(b) within double tax treaties can allow the host country to tax profits which would not be liable to taxation under the OECD Model.

In fact, on July 2007 Indian tax authorities rendered a decision on a case involving significant issues on the principles followed in the taxation of foreign entities that outsource activities to their captive Indian subsidiaries.

The case involved two companies of the Morgan Stanley Group: Morgan Stanley and Company (MSCo), an investment bank in the United States, and

Morgan Stanley Advantage Services Pvt. Ltd. (MSAS), a private limited company established in Mumbay by the Morgan Stanley Group to provide support services to the group members in their global operations.[93]

The two companies entered into an agreement through which through which MSCo outsourced some of its activities to MSAS, and they included, in particular, supporting the main office in equity and fixed income research, account reconciliation and providing information technology enabled services to MSCo. It was also contemplated that this latter company would send some of its employees to India to undertake stewardship activities and would also transfer some in the employment of MSAS.

The payment to MSAS for these support services was made on an arm's length basis, using the transactional net margin method (TNMM).

According to Indian tax law, non-resident entities which have outsourced certain services to a resident entity shall be taxable on their profits only to the extent that a PE is found, otherwise, the non-resident entity will not be liable to tax under the Income Tax Act (ITA).

In particular, when the existence of a PE is determined, global profits attributable to it shall be taxable at the rate of 42.43%.[94]

Indian tax treaties are usually based on the UN Model and a non-resident company is treated as having a PE in India when the conditions of Article 5 of Indian treaties are fulfilled.

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[93] M. SETH and S. GORADIA, *Supreme Court Rules on Permanent Establishment Issues and Attribution of Profits in Outsourcing Industry,* in *Derivatives & Financial Instruments,* p.169, 2007.

[94] J. TANIKELLA and B. AJINKIA, *Morgan Stanley: Indian Supreme Court's Landmanrk Ruling on PE, Transfer Pricing, and Attribution of Profits,* in *Worldwide Tax Daily,* p.1, 2007.

In particular, the concept of a services PE exists in the UN Model Treaty and it is also incorporated in many Indian treaties. No such concept exists in the US Model Treaty, although it is incorporated in the India-United States treaty.[95]

Article 5, paragraph 2 of the India-US treaty provides as follows: “The term permanent establishment includes especially:

[…]

(l) the furnishing of services, other than included services as defined in Art. 12 (Royalties and Fees for Included Services), within a Contracting State by an enterprise through employees or other personnel, but only if:

i. activities of that nature continue within that State for a period or periods aggregating more than 90 days within any twelve-month period; or

ii. the services are performed within that State for a related enterprise [within the meaning of paragraph 1 of Art. 9 (Associated Enterprises)][96]”.

MSCo filed an application with the Authority for Advance Ruling (AAR) to clarify its tax liability. The issue was the following: whether MSCo had a PE in India under Article 5 of the India-US treaty, due to MSAS being regarded as (i) a fixed place of business or (ii) a dependent agent, or (iii) constituting a services PE due to presence of its employees as engaged in stewardship activities and as seconded employees in India.

According to the AAR, MSCo did not have a fixed place of business under the meaning of paragraph 1 because the activity that was performed in India was

[95]M. SETH and S. GORADIA, *Supreme Court Rules on Permanent Establishment Issues and Attribution of Profits in Outsourcing Industry*, cit., p.170.
[96]Article 5 of the India US Double Taxation Avoidance Treaty.

the activity of MSAS and not that of MSCo.

The AAR also rejected the possibility of an agency PE, since MSAS did not have an authority to conclude contracts.

However, as some employees were undertaking stewardship activities and some were being seconded to India, it was concluded that, under Article 5.2 (l), a PE was triggered.

The AAR also held that no portion of the global profits of MSCo. would be taxable in India if the Indian company (PE) was compensated at arm's length. The AAR relied on Indian tax authorities' Circular 23 of 1969 and Circular 5 of 2004 in that regard and held that an arm's-length payment extinguishes any further profits that may be sought to be attributed to the non-resident.[97]

Against this ruling, both MSCo and the Income Tax Department (ITD) filed an appeal to the Supreme Court, in particular, the ITD challenged that (i) MSAS had to be regarded as a fixed place of business of MSCo; (ii) MSAS should be considered as a dependent agent due to its legal and financial dependence on MSCo.

MSCo, on the other hand, argued that the presence of seconded employees or personnel engaged in stewardship activities should not trigger the existence of a services PE in India.

The Supreme Court held that there was not PE under Article 5.1 or 5.4, namely neither a fixed place of business nor an agency PE; however, on account of the seconded employees, a service PE was created in India.

[97]. TANIKELLA and B. AJINKIA, *Morgan Stanley: Indian Supreme Court's Landmanrk Ruling on PE, Transfer Pricing, and Attribution of Profits*, cit.

In fact, Article 5.2 (l), which reproduces the content of Article 5.3 (b) of the UN Model, allows the furnishing of services to be treated as PE.

The two service performed by MSAS were the stewardship activities and the activities carried out by the seconded employees. Those involved in stewardship services were not engaged in day-to-day services undertaken by MSAS.

Thus, the Supreme Court concluded that stewardship could not fall into the provision of Article 5.2 (l). The Court held that a service PE is triggered where the transferring organization was responsible for the work of the seconded employees and retained control over the employment of such persons. In this case, the Court noted that MSCo transferred employees experienced in banking and finance and continued to retain control over the employment of the seconded persons, and that on completion of the term, these persons returned to their jobs with the parent, MSCo.[98]

Hence, the seconded employees lent experience to MSAS in India, but as MSCo's employees, and thus MSCo was rendering services through its employees to MSAS.

This judgment is of particular relevance, the Indian Court's conclusion on the existence of a PE being based on the inclusion of services among the activities capable of triggering a permanent establishment.

In fact, Article 5.2 (l) of the India-US treaty reproduces, with minor draft modifications, Article 5.3 (b) of the UN Model; had the bilateral convention been

[98]M. SETH and S. GORADIA, *Supreme Court Rules on Permanent Establishment Issues and Attribution of Profits in Outsourcing Industry,* cit., p.173.

based upon the OECD Model Convention, no PE would have been detected, since, under the OECD Model, the provision of services, by itself, does not generate a permanent establishment, thus, a fixed place of business, along with the other conditions provided by Article 5(1) of the OECD Model, would have been necessary, but MSCo was found not to have a fixed place of business in India.

Hence, many developing countries are willing to include a provision corresponding to Article 5.3 (b) within their double taxation agreements, this is for example China's position, in fact most of the tax treaties concluded by China incorporate Article 5.3 (b) of the UN Model Convention, a service PE thus being one of the key issues of taxation in China.[99]

## 2.4 Agency Permanent Establishment

Paragraph 5 of both the UN and the OECD Models deals the identification of a PE with reference to activities performed by a dependent agent.

It states that:

"[…]where a person –other than an agent of independent status to whom paragraph 7 applies- is acting in a Contracting State on behalf on an enterprise of the other Contracting State, the enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

[99] H. YANG, *Taxation of Income from the Provision of Services – More Requirements, Less Certainty,* in *Asia-Pasicif Tax Bulletin,* p.247, 2010.

a) has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 […]; or

b) has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise."

Subparagraph a) reproduces the content of the corresponding OECD provision, with slight differences in the wording adopted by the two Models.

The UN Model Commentary quotes the OECD Model Commentary, specifying that the authority of concluding contracts must be exercised repeatedly and not only in isolated cases; in particular, paragraph 33 of the OECD Model Commentary provides that: "the authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. […] Moreover, the authority has to be habitually exercised in the other State. A person who is authorized to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise the 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 conclude contracts in the name of the enterprise."[100]

[100] Paragraph 33 of the Commentary on Article 5(5) of the OECD Model Tax Convention on Income and on Capital.

However, the UN Model version of Article 5 has a broader scope than the corresponding Article in the OECD version, in fact, under Article 5(5)(b) of the UN Model there can be, in contrast to the OECD Model, a dependent agent situation if the agent maintains stock, even though that agent does not conclude contracts in the name of the principal.

Similarly as for the delivery exception, this is founded upon a view that the presence of stock, and the delivery of it by the agent, constitutes a sufficient economic nexus to the host country so as to justify taxation by the host country.[101]

## 2.5 Insurance

Paragraph 6 of the UN Model Convention represents an innovation with reference to the OECD Model, since the latter does not contain any equivalent provision, even though the OECD Committee contemplates the possibility of introducing a provision of this kind in bilateral tax agreements.

It deals with some special characteristics of the insurance industry that were of concern to some countries when the UN Model Convention was developed: if an insurance agent was independent, it was considered that the profits would not be taxable to the enterprise in accordance with the provisions suggested in Article 5(7), while if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions suggested in subparagraph 5(a).

Thus, insurance enterprises shall be deemed to have a PE when they collect

[101] M.LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention-Current Points of Difference and Recent Developments,* cit.

premiums within the territory of a Contracting State, or when they maintain a dependent agent therein. Anyway, if the enterprise carries on its activities through an independent agent, the source State will not be able to tax the profits produced within its territory, since the disposal of paragraph 7 would be fulfilled.

### 2.6 Independent agents

Paragraph 7 deals with the determination of PE with reference to an independent agent, stating that:

“an enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State trough 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.”[102]

This paragraph sentence reproduces the content of Article 5(6) of the OECD Model.

Moreover, the UN Model Commentary quotes the corresponding OECD Model Commentary’s provisions, which state that the agent will fall into the scope of the paragraph when (*a)* he is independent of the enterprise both legally and economically and (*b*) he acts in the ordinary course of his business.

The determination of the first requirement will rely on a factual approach, all the facts and circumstances must be taken into account; for example, a decisive factor could be the agent's subjection to detailed instructions from the enterprise

[102]Article 7 of the UN Model Double Tax Convention between Developed and Developing Countries.

as well as the identity of the subject who shall bear the economic risk of the activity.

With reference to the second requirement, a person shall not be deemed to act in the ordinary course of his business when this he carries on activities which, for their nature, belong to the sphere of operations performed by the enterprise rather than by the agent.

Unlike the OECD Model, the UN Model moreover provides that:

"when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status [...]"[103]

### 2.6.1 French experience: Zimmer's case

In order to better understand what consequences could derive from the specification inserted in the UN Model, a French judicial decision will be helpful; in fact, French double taxation agreements are based on the OECD Model and the decision rendered by the Court in following case would probably have been in case of application of the UN Model.

On 31 March 2010, the French Conseil d' état held that a French commissionaire does not constitute a PE for its foreign parent under the France-

[103]Paragraph 7 of Article 5 of the UN Model Double Tax Convention between Developed and Developing Countries.

UK tax treaty.[104]

In particular, Article 5.6 of the treaty exactly reproduces the corresponding provision of the OECD Model:

"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."[105]

The facts of the case were that the taxpayer, Zimmer Limited, a UK resident company, commercialized its orthopedic products in France until 1995 through a French distributor, Zimmer SAS. However, from 27 March 1995, Zimmer SAS commercialized the taxpayer's products in a commissionaire capacity under a commissionaire agreement. The French tax administration assessed the taxpayer to French corporate income tax (plus 10% surcharge) for the years 1995 and 1996 on the ground that it had a permanent establishment in France.[106]

Both the Court of first instance and the Administrative Court of Appeal agreed with French tax administration because, under the commissionaire agreement, Zimmer SAS could accept orders, present estimates and documents within the framework of tender offers and conclude sales contracts for the account of the taxpayer without prior approval.

However, Zimmer SAS acted on its own name as a result of the commissionaire agreement and thereby could not conclude contracts in the name

[104] B. GOUTHIERE, *Zimmer: 'Commissionaire? Agent Is Not a Permanent Establishment*, in *Eurepean Taxation 8*, p. 350 et. Seq., 2010.
[105] Article 5, paragraph 6 of the UK France Double Taxation Convention, 2008.
[106] Conseil d'état, 31 March 2010, n. 304715 and 308525, in *International Bureau of Fiscal Documentation*, 2010.

of the enterprise, but the Court held that this fact did not have any impact on its capacity to engage the taxpayer in commercial relationships related to the taxpayer's activities.

In addition, the Administrative Court of Appeal observed that Zimmer SAS was subject to guidelines from the taxpayer or was under its control with respect to modalities of sales or advertisements. The risks linked to the sales contracts were borne by the taxpayer and Zimmer SAS acted exclusively for the account of the taxpayer. In conclusion, the Administrative Court of Appeal determined that Zimmer SAS could not be regarded as an independent agent within the meaning of Article 4.5 of the treaty.[107]

Hence, the taxpayer appealed the judgment to the Supreme Administrative Court (Conseil d'état).

The Supreme Administrative Court disagreed with the Administrative Court of Appeal. The findings of the Supreme Administrative Court were based on the examination of French commercial law.[108] In particular, the Supreme Administrative Court observed that a commissionaire does not fall within the scope of Article 4.4, since the latter requires that contracts being concluded "in the name of" the foreign enterprise, whilst a commissionaire acts on his own name and does not create a direct contractual relationship between the principal and the third-party customers.

Having been the UN Model applied, the decision would probably have been different, since the Supreme Administrative Court also noted that (i) Zimmer SAS

[107] Conseil d'état, 31 March 2010, n. 304715 and 308525, cit.
[108] L.E.SCHOUER and O.C.GUNTHER, *The Subsidiary as a Permanent Establishment,* in *Bulletin for International Taxation,* 2001, p. 70

sold products exclusively for the taxpayer, which was also the only activity of Zimmer SAS and (ii) the taxpayer largely determined the sales conditions, thus falling within the provision of the second part of Article 5.7 of the UN Model Convention, which actually allows tax and judicial authorities to adopt an approach less formalistic than the one provided by the OECD Model.

### 2.6.2 Indian experience: Rolls Royce's case

This conclusion is supported by an important Indian judicial case: Rolls Royce Plc v. Deputy Director of Income tax. In fact, even though many similarities existed between the Rolls Royce's and the Zimmer's cases, the two Courts invested with the decision, reached totally opposite conclusions.

Rolls Royce plc (RR) was incorporated and, therefore, liable to tax in the United Kingdom without limit. RR wholly owned a UK-incorporated subsidiary, Rolls Royce India Limited (RRIL), which had offices in India.

With reference to subsidiaries PE, both the UN and the OECD Model Conventions provide that:

"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."[109]

Moreover, both the Commentaries affirm that the mere fact that the

[109]Article 5(8) and 5(7) of the UN and OECD Model Conventions.

subsidiary carries on its activities in the source State does not generate a permanent establishment, even when these activities are managed or controlled by the parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary constitutes an independent legal entity.[110]

Accordingly, both companies are subjected to unlimited tax liability in the state in which they are resident or where their place of management is located.[111]

However, by using the word “not of itself”, the provision clarifies that a parent company can have a PE in its subsidiary's state of residence if the general requirement provided by paragraphs 1 and followings are met.

Accordingly, situations of PE could be triggered in case of existence of spaces or premises, belonging to the subsidiary, which are at the disposal of the parent company, that constitute a fixed place of business and through which the latter carries on its own economic activities.

In addition, under the OECD Model, a subsidiary constitutes an agency PE of its parent if the subsidiary has an habitually exercises an authority to conclude contracts in the name of its parent, while, under the UN Model, an agency PE is deemed to exist also in the case in which the subsidiary does not have this power, but its activities fall within the scope of paragraph 5(b).

The facts of the Rolls Royce's case were the following: RRIL entered into an agreement with RR to provide certain support services to RR on a cost-plus basis. The Indian tax authorities were of the opinion that RR had a PE in India due

[110]Paragraph 40 of te Commentary on Article 5 of the OECD Model.
[111]L.E. SCHOUERI and O.C. GUNTHER, *The Subsidiary as a Permanent Establishment*, in *Bulletin for International Taxation*, 2011, p.69.

to the offices of its UK subsidiary.[112]

The Delhi Income Tax Appellate Tribunal (ITAT) took this position because RRIL was totally dependent on RR, operated wholly and exclusively for RR and habitually secured orders exclusively for RR.[113]

The India UK relevant provision on agency PE states that:

*"5.* An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, where such persons are acting in the ordinary course of their business. However, if the activities of such an agent are carried out wholly or almost wholly for the enterprise (or for the enterprise and other enterprises which are controlled by it or have a controlling interest in it or are subject to same common control) he shall not be considered to be an agent of an independent status for the purposes of this paragraph."[114]

Thus, the ITAT stated that the UK subsidiary had created by way of its offices in India an agency PE for its UK parent, as RRIL habitually secured orders wholly exclusively for RR.[115]

However, RRIL did not have the legal authority to negotiate and enter into contracts "in the name of" RR, neither Zimmer SAS had such an authority, but the

[112]Delhi Income Tax Appellate Tribunal, 26 October 2007, *Rolls Royce Plc v. Deputy Director of Income Tax,* ITAT Nos. 1496 to 1501/DEL of 2007.

[113]L.E. SCHOUERI and O.C. GUNTHER, *The Subsidiary as a Permanent Establishment,* cit., p.71.

[114]Convention between the government of the Republic of India and the government of the United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and capital gains.

[115]S.KAPOOR, *Rolls Royce Decision: Income Attribution to Permanent Establishments,* in *International Transfer Pricing Journal 3,* p.141, 2008

differences in the formulation of the respective double taxation agreements lead to opposite solutions.

## 3 Business Profits

Once an enterprise has established a permanent establishment in the territory of a Contracting State, profits attributable to that PE can be taxed in that State.

Fiscal jurisdictions usually resolve the problem of profits' attribution to PEs in a twofold way: by adopting the "limited force of attraction principle", or the "global force of attraction principle". Under the global force of attraction principle, the mere presence of a permanent establishment within the territory of the source State, provokes the attribution to the PE of all the profits generated within the source State's territory, and their subjection to the fiscal treatment provided for resident entities.[116]

Under the limited force of attraction principle, States distinguish between those incomes which derive directly from the performance of the activities which produce income and which, consequently, are not individually considered for the purposes of their localization and treatment, and those incomes which do not have these features.

This is the distinction between business income and investment or passive income, which implies a different fiscal treatment of the income produced by an enterprise.

[116] C. GARBARINO, *La tassazione del reddito transnazionale*, cit., p.191.

### 3.1 The UN Model Convention's limited force of attraction rule

The UN Model Convention has adopted a limited force of attraction, since the rule is limited to Art. 7 business profits – it is not extended to income from capital (dividends, interest and royalties) which is covered by other treaty provisions.[117]

The UN Model rules differ from those established in Art. 7 of the OECD Model Convention in that they allow taxation of certain profits not actually attributable under normal rules to the PE, but which relate to sales of similar goods or merchandise in the source country, as well as other business activities of the same or similar kind carried on by the enterprise in the source country.[118]

As above-mentioned, the principal and most relevant difference between the two Models is that, under the OECD Model, only profits attributable to the Permanent Establishment are taxable in the source State, while this approach is not shared by the UN Model, which allows the taxation of certain profits even though they are not realized through the Permanent Establishment.

Hence, source Countries are granted a greater possibility to tax profits arising within their jurisdiction, thus reflecting the UN Model attention towards developing countries' necessities.

In particular, Article 7, paragraph 1 of the UN Model Convention affirms that the profits of an enterprise which is a resident of a Contracting State shall be

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[117] M. LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current points of Difference and Recent Developments,* in *Asia-Pacific Tax Bulletin,* cit.
[118] M. LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current points of Difference and Recent Developments,* in *Asia-Pacific Tax Bulletin,* 2009, Vol. 49, No. 08.

taxable only in that State, unless a permanent establishment is situated within the territory of another Contracting State. In this hypothesis, the latter State will be able to tax the profits, but only to the extent which is attributable to (*a*) the PE; (*b*) sales or merchandise activities of the same or similar kind as those carried out by the PE; (*c*) other business activities of the same or similar kind as those of the PE.

However, many developed countries consider the UN's approach unsatisfactory, because it could imply the levying of taxation on income deriving from activities totally unrelated with the permanent establishment, and not self-standing enough to constitute an autonomous PE. On the other hand, developing countries find this method useful with reference to the avoidance of administrative problems, which arise from the determination of whether a particular activity has to be regarded as related to the permanent establishment or not.

Moreover, the significantly different tax consequences for a non-resident enterprise deriving income from business activities conducted directly by the enterprise (exempt from source country taxation) and enterprises deriving similar profits through a PE (exposed to full source country taxation) could tempt a non-resident enterprise into using a PE to gain a foothold in the local market and then conducting similar activities directly to bypass the PE.

The UN Model, but not the OECD Model, specifically addresses this risk by way of a "force of attraction" rule that extends full source country taxing rights to income derived by a non-resident enterprise from sales made directly by the enterprise in the source country, provided that the non-resident has a PE in the source country[119], thus contrasting with the view adopted in the OECD Model, whose Commentary on Article 7 explicitly states that " […] the right of the State where the permanent establishment is situated does not extend to profits that the enterprise may derive from that State but that are not attributable to the permanent establishment."[120]

### 3.2 Attribution of profits to the Permanent Establishment

Whilst paragraph 1 clarifies which profits may be taxed in the source country, paragraph 2 contains the rules to be followed in the attribution of profits to the PE.

In particular, paragraph 2 states that, "[...] where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment."[121]

Since this paragraph only contemplates relationships between the PE and the head office, the UN Commentary gives an alternative provision for those countries willing to include also relationships between permanent establishment

[119] T. HWONG, P.MELLOR, R.KREVER, *Tax Treaty Trends in Central Asian Former Soviet Nations,* in *Bulletin for International Taxation,* Vol.66, No.10, 2012.
[120] Paragraph 12 of the Commentary on Article 7 of the OECD Model Convention on Income and on Capital.
[121]Article 7, paragraph 2 of the UN Model Double Tax Convention between Developed and Developing Countries.

and other permanent establishments of the same enterprise:

"there shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions."[122]

### 3.2.1 Arm's length principle

The rule to be followed in the attribution of profits to the PE is the arm's length principle, whose definition is given in the 2008 version of the OECD Commentary on Article 7:

"[...] the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market."[123]

As to method to be applied in the allocation of profits between enterprise and PE, the UN Commentary refers to the 2008 OECD Commentary, which establishes that tax authorities must rely, in first instance, on the enterprise's book accounts. In fact, paragraph 2 does not allow hypothetical reconstructions of permanent establishment's profits, since " it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit

[122] Paragraph 12 of the Commentary on Article 7, paragraph 2 of the UN Model Double Tax Convention between Developed and Developing Countries.

[123] Paragraph 14 of the Commentary on Article 7, paragraph 2 of the OECD Model Tax Convention on Income and on Capital, 2008.

figures which those facts produce."[124]

With reference to the problem of the reliability of the enterprise's book accounts when they are based on agreements between the enterprise and the PE, the 2008 OECD Commentary clarifies that, to the extent that the book accounts are realized symmetrically and that the agreements are consistent with the economic functions of the various parts of the enterprise, tax authorities can rely upon them; while, in case of abusive arrangements, tax authorities can ignore the agreements concluded between the different parts of enterprise and correct the accounts.

Adjustments could be necessary in order to fulfill the arm's length principle, also in case a permanent establishment is able to produce accounts able to show profits arising from its activities, for example in case of goods, invoiced from the head office to the PE at prices lower than the ordinary market prices, or in case of profits diverted from the head office to the PE or vice versa; in this situations, tax authorities should substitute the abnormal prices with the ones usually adopted under normal market conditions, taking into account that, sometimes, there could be commercial motivations for the use of prices less than those prevailing in the ordinary market, for example in case of an enterprise starting its commercial activity within a new market and which tries to enhance its competitiveness by applying low prices at its own goods and services.

Difficulties may arise in case of enterprises selling goods for which no comparable market prices are available; when, in situations of this kind, tax

[124]Paragraph 12 of the Commentary on Article 7, paragraph 2 of the OECD Model Tax Convention on Income and on Capital, 2008.

authorities believe that a correction has to be applied, other methods should be used for determining the profits of the PE, depending on domestic laws.

Anyway, the general rule is that the profits of the PE must be determined according to the enterprise's book accounts, to the extent that they faithfully and completely represent the enterprise's economic situation.

The UN Commentary upon Article 7 then deals with the transfer of assets from the head office to the PE or vice versa. Issues on this matter usually arise because of the difference in regulation among States as to when a taxable profit is deemed to be realized: in fact, some countries levy tax on profits triggered by internal transfers, as soon as they are made, even when profits are not effectively realized until a subsequent commercial year.

In these situations, inevitably a time lag occurs between the moment in which the tax is paid abroad and the moment in which it can be taken into account in the State where the enterprise's head office is located. Thus, it is up to the head office to seek bilateral solutions every time an issue of this kind occurs.

Another frequent problem deriving from the transfer of assets, is the one regarding bad loans, with reference to international banking.

Debts can be transferred from the head office to a branch and vice versa, but the UN Commentary clarifies that they must be ignored when there is not a valid commercial reason which justifies the transfer, for example when debts are transferred only with the aim of maximizing the tax relief at the bank's disposal. In fact, in situations of this kind, a breach of paragraph's 2 disposal occurs, since such transfers would not have occurred between separated enterprises, dealing at an arm's length approach.

In any case, any internal transfer should be treated as taking place between unrelated enterprises, at normal market conditions, and at the market value of the debt at the date it was transferred.

In particular, with reference to loans which have gone bad, paragraph 15.4 of the UN Commentary underlines the need of an agreement between the two States involved, in order to grant relief to the enterprise on a consistent basis.

In case the transfer value was due to a mistaken judgement on the debtor's solvency, the UN Commentary suggests to limit relief to the actual loss suffered by the bank as a whole in the State of the transferring branch, and not to tax the subsequent apparent gain in the receiving country.

While, in case the transfer value reflected a correct judgement of the debtor's solvency, and, after a certain time, the loan improve in value, the transferring branch should be given relief on the basis of the actual value at the time of the transfer.

Thus, paragraph 2 clarifies that the profits to be attributed to the permanent establishment must correspond to the profits that a separate and independent enterprise would have made under the same market conditions, while the third paragraph of Article 7 specifies the rules to be followed in the calculation of the PE's profits.

### 3.3 Treatment of deductions in determining Permanent Establishment's profits

Paragraph 3 states that "in the determination of the profits of a permanent establishment, there shall be allowed as deductions, expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere."[125]

Thus, this paragraph allows the deductions of all the expenses incurred by the enterprise with reference to its business activities, except for capital expenditures which are not deductible or expenses of a personal nature, which cannot be attributed to the business activity.

The UN Model Commentary specifies that the expenses must be "relevant, referable and necessary for carrying out the business operations. There has to be a nexus between the expenditure an the business activity"[126]

Hence, an enterprise can obtain a deduction for the expenses incurred for the purposes of the PE.

Sometimes, however, the allocation of expenditure may be complicated, for example in case of general expenses, incurred at the level of the head office.

In this cases, the UN Commentary adopts the approach of the 2008 version of the OECD Model, which suggested to consider a proportionate part based on the ratio that the PE's turnover bears to that of the enterprise as a whole.

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[125]Article 7, paragraph 3 of the UN Model Double Tax Convention Between Developed and Developing Countries.

[126]Paragraph 17 of the Commentary on Article 7, paragraph 3 of the UN Model Double Tax Convention Between Developed and Developing Countries.

In particular, “it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred.

The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.”[127]

Thus, Article 7 of both the UN and the OECD Models start on the basis that deductions are allowed in the determination of the profits of a permanent establishment. However, in contrast to the OECD Model, the UN Model limits the types of expenses for which deductions are allowed:

“However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment.

Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees, or other similar payments in return for the use of patents or other rights, by way of

[127]Paragraph 27 of the Commentary on Article 7, paragraph 3 of the OECD Model Tax Convention on Income and on Capital, 2008.

commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices."[128]

The Commentary to the UN Model explains that the additions to Article 7.3 stemmed from a proposal by United Nations member countries to assist developing countries that were not represented in the group.[129] Several members were of the view that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral DTT in order to ensure that taxpayers were fully informed about their fiscal obligations. The discussions between members of the United Nations also clarified that Article 7.3 did not prevent the permanent establishment from deducting interest, royalties, and other expenses that were incurred by the head office on behalf of the establishment.

In all other respects the UN Commentary is similar, and in some parts even identical to the 2008 version of the OECD Commentary.

Generally, Article 7.3 of both the UN Model and the OECD Model pursue the same objective: to ensure that an appropriate apportionment of actual total profits is made between the permanent establishment and the head office. However, in generally disallowing the deduction of the above-mentioned payments, the UN Model goes further than the OECD Model and in specific individual situations the usage of the respective models leads to a different

[128] Article 7 paragraph 3 of the UN Model Double Taxation Convention between Developed and Developing Countries.

[129] J.KHOO, *China's Evolution as a Capital Exporter: A Shift in Tax Treaty Policy?,* in *Hong Kong Law Journal,* 2007.

result.[130]

The additions to the UN Model make it more favourable for developing countries to use Article 7.3 of the UN Model as opposed to that of the OECD Model. Given that it is more likely for a business enterprise from a developed country to set up a permanent establishment in the developing country than for a business enterprise from a developing country to set up a permanent establishment in the developed country, the UN Model would ensure that permanent establishments are not able to make deductions for the above-mentioned transactions between the head office and the permanent establishment, thus securing the revenue base of the developing country.[131]

Thus, Article 7.3 of the UN Model explicitly restricts the operation of Article 7.2. All other expenses not covered by the limitation in Article 7.3, including expenses arising from transactions between the head office and the permanent establishment, will be deductible as long as such expenses could be expected to be incurred by a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions.

As to which expenses must be considered as incurred for the purposes of the PE, a factual approach must be taken.

In case of transfer of goods or services between the head office and the PE, the expenditure must be considered referable to the PE's purposes when the

[130]K. Vogel, *Klaus Vogel on Double Taxation Conventions: A Commentary to the OECD-, UN-, and US Model Conventions for the Avoidance of Double Taxation on Income and Capital, with Particular Reference to German Treaty Practice,* in *Kluwer Law International,* 3rd edn, 1997, p. 451.

[131]J.KHOO, *China's Evolution as a Capital Exporter: A Shift in Tax Treaty Policy?,* in *Hong Kong Law Journal,* 2007.

internal transfer is of the same kind as those which would have occurred between independent enterprises, at normal market conditions, namely at an arm's length price.

This would be the situation for expenditures incurred in order to allow or facilitate the performance of the PE's activities, while a different should be adopted for expenses incurred for other purposes, such as rationalise the overall costs of the enterprise or increase in general its sales.

The situation becomes more complex with reference to intangible rights; the UN Model Commentary refers to the 2008 version of the OECD Model Commentary, which clarifies that the rules concerning relations among enterprises of the same group cannot be applied with reference to operations conduced among parts of the same enterprise.

In fact, it is not possible to attribute the legal ownership of an intangible right exclusively to a single part of the enterprise, as well as the costs related to the creation of the intangible good.

Thus, it is more appropriate to consider the various parts of the enterprise as a whole and to allocate the cost of the creation or acquisition of the intangible right among them.

In case the main activity of a PE is that of providing services to the enterprise and in case these services represent an elevate cost for the enterprise, the host country may require for a profit margin to be included in the amount of the cost.

Anyway, the most frequent situation is the one in which the provision of services is a function performed in the context of the enterprise as a whole and does not pertain exclusively to a single part of it.

Thus, it is more appropriate to treat the expense as belonging to the whole enterprise, considering it as a component of general administrative expenses, and to subsequently allocate it to the various parts of the enterprise, to the extent that the cost is incurred for the purposes of a specific part of it.

With reference to the treatment of interests, particular problems arise in this context. In fact, the existence of an obligation upon the PE to correspond interests to the enterprise to which it belongs, usually finds its premise in an internal loan between the head office and the PE and the UN Model Commentary excludes the possibility for these loans to be recognised, but it distinguishes the issue of the deduction of debts actually contracted by the enterprise, for purposes relating to its activity; in this latter hypothesis, debts incurred by the enterprise will serve both the head office and the PE and the matter is that of determining the interests to be deducted in computing the profits attributable to the PE.

The Committee of Experts suggests a practical approach, which must take into account the capital structure of the enterprise and the functions performed by its various parts.

## CHAPTER III

## The determination of passive income: differences and similarities between the UN and the OECD Model Conventions.

### 1. Dividends

Article 10 of the UN Convention, which deals with dividends' taxation, reproduces Article 10 of the OECD Model Convention, so that they are largely identical.[132]

The source country is defined as the residence country of the company that pays the dividends. As long as the beneficial owner of the dividends is a resident of the other Contracting State, the treaty rates of withholding tax apply.

In particular, Article 10(1) of both the Conventions states that:

"Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State."[133]

According to the Commentary on Article 10, paragraph 1, of the OECD Model Convention, quoted by the UN Commentary,

7. […]The term "paid" has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the

[132] J. LI, *China (People's Rep.)- The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base*, in *Bulletin for International Taxation*, Vol. 66 No.9, 2012.

[133] Article 10, paragraph 1 of the UN Model Tax Convention between Developed and Developing Countries.

disposal of the shareholder in the manner required by contract or by custom.

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 does not, therefore, apply to dividends paid by a company which is a resident of a third State or to 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 Sate […].[134]

Both the Models do not provide for an exclusive right to tax in favour of the residence country. They leave open the possibility of taxation by the source State, i.e. the state where the company is resident, which is where the dividend originates.

If the dividend is taxed by both the residence State of the recipient and the source State, according to their respective domestic laws, relief could be agreed upon in terms of Articles 23 of the Conventions to avoid double taxation.

In particular, when the UN Model was first considered, many members of the former Group of Experts from developing countries wished to introduce the principle of the taxation at source of dividends. However, the former Group of Experts reached a consensus that dividends should be taxed in the State of residence, double taxation being eliminated through a combination of exemption or tax credit in the residence country and reduced withholding rates in the source

[134] Commentary on Article 10, paragraph 1 of the OECD Model Tax Convention on Income and on Capital.

country. In fact, the usual withholding rules with respect to dividends tend to be high and such tendency, when juxtaposed with the effective rate of corporate taxation on the subsidiary, and also when seen in the context of the residence State's right to tax the entire amount of the dividends at the normal rates, may have the effect of discouraging foreign investment.[135] Tax treaties, therefore, attempt to remove the deterrents, and in their stead, to provide for lower rates of withholding tax and measures for relief from double taxation.

### 1.1 Taxation of direct and portfolio investments.

However, different needs and perspective continue to exist between developed and developing countries, and they are reflected in the formulation of the second paragraph of the UN Model, which does not fully reproduce Article 10(2) of the OECD Convention.

In fact, the OECD Model Treaty places a ceiling on withholding tax at 5% of the gross amount of the dividends, if the recipient is a company which holds at least 25% of the capital of the company paying the dividends; 15% for other shareholdings.

The UN Model specifies no maximum withholding tax rate, leaving countries with the option of negotiating rates above the OECD's rates.[136]

Moreover, the minimum participation required for direct investment is lower under the UN Convention, being established at 10 per cent of the company's

[135] I. HAQ, *Pakistan- Taxation of Dividends under Treaties,* in *Asia-pacific Tax Bulletin,* 1999, p.307.

[136] T. HWONG, P. MELLOR, R. KREVER, *Tax treaty trends in Central Asian Former Soviet Nations,* in *Bulletin for International Taxation,* Vol. 66 No. 10, 2012.

capital, the reason being that in some developing countries, non-residents are limited to a 50 per cent share ownership, and 10 per cent is a significant portion of such permitted ownership.[137]

The term capital, as used in subparagraph a) of paragraph 2, defines the minimum ownership required for direct investments. The UN Model Commentary gives the following clarifications:

- the term “capital” must be understood as it is understood in company law, other elements, such as reserves are not to be taken into account;
- it must be indicated in terms of par value of all shares;
- no account should be taken of differences due to different classes of shares issued;
- when a loan or other contributions of that kind are not treated as “capital” under corporate law, but the income deriving from them is considered “dividend” on the basis of international law or practise (for example in case of thin capitalization), the value of such loans is to be taken as capital under the meaning of subparagraph (a).

Subparagraph (a) does not provide for a minimum amount of time during which the subject must have owned the capital, thus, all that counts regarding the holding is the situation prevailing at the time relevant for the come into existence of the liability to tax to which paragraph 2 applies.

However, the reduction therein provided, shall not be applied in cases of abusive arrangements, for example in the case of a company with a holding of less

[137]Paragraph 2.6 of the Commentary on Article 10, paragraph 2 of the UN Model Convention

than 10 per cent has, shortly before the dividends become payable, increased its holding percentage in order to obtain the treaty's benefits.

To counteract these behaviours, the UN Commentary suggests for the following provision to be inserted in the text of the subparagraph:

“provided that this holding was acquired primarily for the purpose of taking advantage of this provision.”[138]

The former Group of Experts did not manage to reach a consensus upon the maximum rate to be applied upon dividends, developing countries considering the OECD's tax rate too low, moreover they accepted the principle of the combination of the dividends' taxation both in the residence and in the source country, but they believed that a reduction in the withholding tax applied in the source country should benefit the foreign investor rather than the residence country's treasury, as it may happen with the traditional tax-credit method if the reduction lowers the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

Thus, the UN Model does not specify the tax rate to be applied in bilateral tax treaties, but the Commentary furnishes guidelines which could be helpful during the negotiations of a double taxation agreement.

If a tax credit system is used in the residence country, which often happens to be the developed country, treaties' negotiations should seek to obtain that the withholding tax applied in the source country, combined with the corporate tax rate provided therein, does not exceed the tax rate in the residence country.

[138]Paragraph 17 of the Commentary on Article 10, paragraph 2 of the UN Model Double Taxation Convention between Developed and Developing Countries.

If the developed country uses an exemption method to deal with double taxation issues, it could seek a limitation of source country's withholding tax rates by arguing that *a)* the exemption itself stresses the concept of not taxing inter-corporate dividends, and a limitation of withholding rate at source would be in keeping with that concept, and *b)* the exemption and resulting departure from tac neutrality with domestic investment are of benefit to the international investor, and a limitation of the withholding rate at source, which would also benefit the investor, would be in keeping with this aspect of the exemption.[139]

Traditionally, agreements between developing and developed countries provide for withholding tax rates higher than those provided for in developed countries double taxation treaties; in particular, while the OECD direct and portfolio investment rates are 5 per cent and 15 per cent, developing/developed country treaty rates have traditionally ranged between 5 per cent and 15 per cent for direct investment dividends, and 15 per cent and 25 per cent for portfolio dividends.

Moreover, special features in developing/developed country treaties are often present:

- the tax rates may not be the same for both countries, with higher rates applied in the source country;
- tax rates may be not limited at all;
- reduced tax rates may be applied only with reference to new investments;

[139] Paragraph 8 of the Commentary on Article 10, paragraph 2 of the UN Model Double Tax Convention between Developed and Developing Countries.

- dividends may be subject to reduced tax rates only if the have been held for a certain amount of time.

Thus, the UN Commentary on Article 10(2) gives the following technical criteria to be considered with reference to withholding tax rates' determination:

(a) the corporate tax system of the country of source and the total burden of tax on distributed corporate profits resulting from the system;

(b) the extent to which the country of residence can credit the tax on the dividends and the underlying profits against its own tax and the total tax burden imposed on the tax payer, after relief in both countries;

(c) the extent to which matching credit is given in the country of residence for tax spared in the country of source;

(d) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investor.[140]

Article 10(2)(a) of both the Conventions refers to the concept of "beneficial ownership". The OECD Commentary specifies that it is not meant to be used in a narrow technical sense, but it should be interpreted in light of the scope of the Convention, including preventing fiscal evasion and avoidance.

In fact, when the income is received by an agent or nominee, even though residents of a Contracting State, it would be inconsistent with the purposes of the Convention for the State of source to grant relief or exemption merely because the immediate recipient of the income is a resident of the other Contracting State,

[140]Paragraph 12 of the Commentary on article 10, paragraph 2 of the UN Model Double Taxation Convention between Developed and Developing Countries.

since no potential double taxation arises. And it would be equally inconsistent for the State of source to grant relief or exemption where a resident of the other Contracting State merely acts as a conduit for someone else, not entitled to enjoy the double taxation agreement's benefits.

Thus, the limitation of tax in the State of source remains available when the agent or nominee, located in a Contracting State, or in a third country, act on behalf of a person which is a resident of the other Contracting State.

**1.3 Dividends: the definition.**

With reference to meaning of the term “dividend”, Article 3 of the UN Model, which reproduces Article 3 of the OECD Convention states that:

“the term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders' shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.”[141]

The list contained in the Article is purely illustrative, since, because of the great differences existing among countries' legislations, it was impossible to provide a fully exhaustive definition.

It is important to mention that the Article does not apply exclusively to dividends as such, but also to interests on loans in so far as the lender effectively

[141] Article 10, paragraph 3 of the UN Model Double Taxation Convention between Developed and Developing Countries.

shares the risk run by the company; hence Articles 10 and 11 do not prevent the treatment of this type of interests as dividends under the national rules on thin capitalization applies in the borrower's country.[142]

**1.4 Exceptions.**

Paragraph 4 of the UN Model contains several differences compared to the corresponding OECD's paragraph.

It renders paragraph 1 and 2 inapplicable to dividends on shares connected with a permanent establishment of the recipient in the source country. The UN Convention's version of the paragraph moreover renders the first two paragraphs inapplicable to dividends on shares effectively connected to a company performing independent personal services from a fixed base.

In the hypothesis of shares connected to a PE, Article 7 of the Models shall be applied.

In case of shares connected to a fixed base, Article 14 of the UN Model shall be applied. In fact, the OECD decided to delete Article 14 in the OECD Model (2000) to reflect the OECD's position that income from independent personal services should be taxed in the source country on the basis of the PE, as there was no difference between the concept of PE and "fixed base" as used in Article 14[143], whilst the UN Group of Experts decided to maintain it, principally because the provision is considered to be useful for developing countries and

[142]Paragraph 25 of the Commentary on Article 10, paragraph 3 of the OECD Convention on Income and on Capital.

[143]J. LI, *China (People's Rep.)- The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base*, cit.

some believe that deleting it could reduce source taxation rights under the UN Model.[144]

**2 Interests.**

Article 11 of the United Nations model Convention reproduces the provisions of Article 11 of the OECD Model Convention with the exception of paragraphs 2 and 4, in which substantive changes have been made and with respect to paragraphs 4 and 5 which refer to independent personal services from a fixed base.

In fact, whilst paragraph 1 lays down the principle that interests arising in a Contracting State and paid to a resident of the other Contracting State can be taxed in the latter, paragraph 2 provides the amount of maximum withholding tax rate that can be applied on the interest thus paid.

Under paragraph 5, the source country is determined by the payer's residence or under the base-erosion rule; under the base-erosion rule, where a non-resident has a PE in a Contracting State and pays interests to a beneficial owner resident in the other Contracting State, if the interest is borne by the PE, the interest is deemed to arise in the country where the PE is located.

Article 11(6) clarifies that the treaty reduced rate is not available to the amount of interest that exceeds the arm's length amount due to a special relationship between the payer and the beneficial owner or between both of them and some other person.

[144] A. LARA YAFFAR, M. LENNARD, *An Introduction to the Updated UN Model (2011),* in *Bulletin for International Taxation*, 2012, p.595.

Article 11 of the UN Model does not provide particular withholding tax rates to be applied on interests' payments, for the same reasons as for dividends[145], leaving the percentage to be established through bilateral negotiations.

According to the UN Commentary, the decision not to recommend a maximum withholding rate can be justified under current treaty practise; the withholding rates adopted in developed/developing country tax treaties range more widely than those for dividends-between complete exemption and 25 per cent. However, some developing countries have reduced the interests withholding rate to attract foreign investment; several of them have adopted rates at or below the OECD rate of 10 per cent.[146]

For example China's tax treaties, which for other components of the so-called passive income follow the UN Model provisions, with reference to interests treatment follow the OECD Model. Thus, Chinese domestic law imposes a 20% withholding tax on interests received by a non-resident.[147]

This rate is reduced to 10% by Chinese tax treaties.[148]

Paragraph 4 of the UN Model Convention, which provides that paragraphs 1 and 2 do not apply to some interests if the recipient has a PE or fixed base in the source country, reproduces paragraph 4 of the OECD Convention, with two modifications: first, the UN Model refers to a fixed base as well as a PE. Secondly, the OECD version only applies if the obligation on which the interest is

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[145] M. LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments,* cit., Vol.49 No. 08, 2009.

[146] Paragraph 10 of the Commentary on Article 11, paragraph 2 of the UN Model Double Taxation Convention between Developed and Developing Countries.

[147] Article 3 EIT Law.

[148] J.LI, *The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base,* cit., Vol.66 No.9, 2012.

paid is effectively connected with the PE. Since the UN Convention, unlike the OECD Convention, adopts a limited force of attraction rule in Article 7, defining the income that may be taxed as business profits, a conforming change is made in Article 11, paragraph 4. This modification makes paragraphs 1 and 2 of Article 11 inapplicable if the debt claim is effectively connected with the PE or fixed base, or with business activities in the source country of the same or similar kind as those effected through the PE.[149]

**3 Royalties: preliminary remarks.**

Article 12 of the UN Convention deals with the taxation of royalties. It follows the OECD's provisions upon the subject, but important differences exist between the two Models.

In fact, cross-border transactions of intellectual property rights (IPR) represent a significant part of international trade and capital flow in the world economy. The proceeds from IPR often flow from developing to developed countries as a result of technology transfers.[150]

The flow of IPR  transactions implies that developed countries are often IPR exporters, whereas developing countries are typically IPR importers.

IPR cross-border transactions may take place between multinational enterprises and their subsidiaries around the world or between multinationals and

[149]Paragraph 20 of the Commentary on Article 11, paragraph 4 of the UN Double Taxation Convention between Developed and Developing Countries.

[150]B. HOEKMAN, K. MASKUS and K. SAGGI, *Transfer of Technology to Developing Countries: Unilateral and Multilateral Policy Options,* Inst. Of Behavioural Sci. Working No. PEC 2004-3, p.6.

third parties. Multinational enterprises carry out business in a number of specific industries, such as information technology, communication, biotechnology and pharmaceutical industries.[151]

The OECD Commentary on Article 12 includes the following preliminary remark, which is applicable also to the royalties' discipline provided by the UN Convention:

“in principle, royalties in respect of licenses to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an enterprise or quite independently of any activity of the grantor.”[152]

When the user of a patent or similar instrument is a resident of a Contracting State and pays an amount of money to the owner of the instrument who is a resident of the other Contracting State, usually the first State applies a withholding tax on the amount paid for the patent's use.

This tax, imposed by the source country, is generally levied on the gross amount paid to the recipient, thus not taking into account the expenses which have been necessary in order to develop the object of the “letting”.

With reference to royalties' treatment, the OECD Model reflects the interests of developed countries, as most OECD member countries are developed countries and are, therefore, often technology exporters. On the other hand, the UN Model serves the interests of developing countries as technology importers.

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[151] M.M.ABDELLATIF, *Withholding Tax and Cross-Border Intellectual Property Transactions in Developing Countries: the Example of Egypt and India,* in *Bulletin for International Taxation,* Vol. 65 No.8, 2011.

[152] Paragraph 1 of the Commentary on Article 12 of the OECD Model Tax Convention on Income and on Capital.

Identifying the taxing rights in relation to IPR international licensing transactions is important for a number of reasons, including:

- a licensor is concerned with profit maximization of the cross-border IPR transaction. Taxing IPR either in the source or residence State (or both) affects after-tax profits;
- a high withholding tax rate imposed on non-resident income in a source State (especially in the absence of tax treaty between source and residence States) may make a licensor either reluctant to licence the IPR subject matter in that source State or more likely to transfer the tax burden to the licensee by charging higher royalty payments to keep the after-tax profits fixed;
- the exemption of foreign-source income in the residence State encourages the IPR holder to license the IPR overseas, in particular, in those countries that impose low tax rates on non-resident income.[153]

Thus, one of the starkest distinctions between the OECD and UN Models is to be found in the treatment of royalties.[154]

### 3.1 Royalties' taxation at source.

In fact, Article 12(1) of the OECD Model Convention provides for sole

[153] M.M.ABDELLATIF, *Withholding Tax and Cross-Border Intellectual Property Transactions in Developing Countries: the Example of Egypt and India*, cit., Vol. 65 No.8, 2011.

[154] T. HWONG, P. MELLOR, R. KREVER, *Tax treaty trends in Central Asian Former Soviet Nations,* cit., Vol. 66 No. 10, 2012.

residence country taxation of royalties, by affirming that:

"Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State."[155]

In contrast, the UN Model allows the source State to tax royalty income derived by a non-resident:

"Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State."[156]

Moreover, it must be mentioned that several OECD members have recorded reservations to the exclusive residence State taxation of royalties provided by Article 12 of the OECD Model Convention, allowing the source State to tax royalty income, regardless of whether the source State is developed or developing.

For instance, under Article 12(1) of the Australia-Germany Income and Capital (1972), Australia-Japan Income (2008), Australia-United Kingdom Income (2003) and Australia-United States Income (1982) Tax Treaties, the source State has the right to tax royalty income.[157]

There is a similar provision in Australia's tax treaties with many developing countries, such as China and Malaysia.

This discussion reveals that developed and developing countries, to some extent, agree to share the taxing rights in respect of royalty income between source and residence states.

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[155] Article 12, paragraph 1 of the OECD Model Tax Convention on Income and on Capital.

[156] Article 12, paragraph 1 of the UN Model Double Taxation Convention between Developed and Developing Countries.

[157] M.M.ABDELLATIF, *Withholding Tax and Cross-Border Intellectual Property Transactions in Developing Countries: the Example of Egypt and India,* cit., Vol. 65 No.8, 2011.

Nevertheless, there are many tax treaties in which the taxing right is granted to the residence State in conformity with Article 12(1) of the OECD Model.

In fact, the source State often gives up its taxing right to the residence State when both States are developed countries, as it is expected that outflow and inflow royalty payments will be equivalent, which ultimately makes neither bear any losses.

In contrast, developing countries are often technology importers, which means that royalties flow from developing to developed countries; accordingly, a source State would bear significant revenue losses if it gave up its taxing right to a developed country.

This is the reason why, during discussion by the former Group of Experts in 1999, members from developing countries argued that the primary taxing right should be given to the country in which the income arose: the residence country of the subject paying for the use of patents or licences, namely the source country.

In fact, those member noted that patents or processes might be licensed to developing countries after their exploitation elsewhere and after the expenses incurred in their production had been fully repaid.

Members from developed countries responded that it would be unrealistic to believe that patents and processes addressed to developing countries would be the oldest ones, since, normally, multinational enterprises would licence their patents to foreign subsidiaries and therefore select the most up-to-date inventions, in order to penetrate the new market.

### 3.2 Determination of the withholding tax rate.

Article 12(2) of the UN Convention allows a source State to tax royalty income by imposing a withholding tax on non-residents. The tax is imposed on the gross royalty payment without any deductions.

The withholding tax rate is negotiated between the Contracting States.

A number of considerations may be taken into account during the negotiation process, which is guided by the Commentary on Article 12 of the UN Model. These are:

- the source state must take into account the direct and indirect expenses associated with the development and licensing of the intellectual property right, the the holder and/or the owner has incurred. If the source State and the residence state agree on the withholding tax rate applicable by the source State, the residence State must provide tax relief for its resident's foreign-source income derived from licensing. Tax relief takes a number of forms, including tax credits and exemptions.[158]
- the level of economic development is a significant factor in determining the withholding tax rate. In this respect, developing countries are often technology importers, which means more capital flow in the form of royalties from developing to developed countries. Accordingly, developed countries could assist developing countries in their economic development process by allowing them to tax royalty income at a higher rate and providing a generous foreign tax credit to the foreign-source

[158] S.SURREY, *United Nations Group of Experts and the Guidelines for Tax Treaties between Developed and Developing Countries,* in *Harvard Intl. L.J.,* p.32, 1978.

income of their residents.[159]

- taxing royalties at source minimizes the possibility of tax evasion.

Taking these considerations into account is important in setting a reasonable withholding tax rate that serves the objectives of both Contracting States.

Moreover, there is a perception that a higher withholding tax rate may have a negative effect on technology transfers.

This perception was reinforced in a United Nations Conference on Trade and Development (UNCTAD) study, which concluded that a higher withholding tax could have a negative effect on technology transfers.[160]

### 3.3 Royalty income: the definition.

With reference to royalties' definition, it is contained in Article 12(3) of the UN Convention. The Article reproduces Article 12(2) of the OECD Model Convention's structure, but it has a broader scope than the latter, since it does not incorporate the 1992 amendment thereto which erases equipment rental from the activities capable of producing royalty income. Moreover, paragraph 3 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Convention.

Hence, under the OECD Model, profits deriving from the performance of these activities are treated as business income, thus falling under the scope of Article 7.

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[159]K.BROOKS, *Tax Treaty Treatment of Royalty Payments from Low Income Countries: a Comparison of Canada and Australia Policies*, p.194, 2007.
[160]UNCTAD, *Taxation and Technology Transfer: Key Issues*, 2005.

The different scope clearly expands the right to tax of the source State, as, under the royalties characterization, taxation is certain (albeit limited), whilst, in characterizing the income as business profits, source states would have a taxing right conditional on the existence of a PE of the non-resident subject.[161]

The following portions of the OECD Commentary are relevant:

"Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience.

The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned. […] The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right."[162]

### 3.3.1 Know-how and service income.

Thus, the term "royalties" includes, in first instance, payments for the use, or right to use, copyright of literary, artistic or scientific work, which correspond to the notion of "know-how".

One of the main problems related to the taxation of know-how is the not always easy distinction between know-how and technical service.

[161] E.O.MELONI, *Taxation of Royalties under Treaty Law: How Far Can a Source State Go?*, in *Bulletin for International Taxation*, Vol.64 No.6, 2010.

[162] Paragraph 8 of the Commentary on article 12, paragraph 3 of the OECD Model Tax Convention on Income and on Capital.

In general, the know-how contract involves the transfer of knowledge and experience from one party, the grantor, to the other, the grantee.

The information thus imparted, which have practical application in the operation of an enterprise, have not been patented and remain unrevealed to the public.

Moreover, the grantor is not required to play any part in the application of the granted formula, nor does he guarantee the result thereof.

The characterization of the income, as deriving from the provision of services rather than from royalties' payment, leads to significant consequences, since payments made under a provision of service contract generally fall under Article 7 (or under Article 14 of the UN Convention).

Being the OECD Model applied, technical fees may be taxable in the source State if they are deemed business profit that is connected to a PE in that country. But, that technical assistance may lead to the performer of the service having a PE in the source country, is certainly possible but not very likely under the OECD Model Convention, as evidenced in the previous chapter.

In fact:

(1) in many cases the foreign performer of services will not have nor need a fixed place of business in the source country, but merely performs his services in the factory, offices or other facilities of the customers, which is not enough to assume a PE exists with respect to the performer of services.[163] If the latter only uses the premises to perform his contract

[163] K.VOGEL, *Double taxation Conventions,* in *Kluwer,* p.287, 1997

with the client, and has no relations with other (possible) clients, is use of the premises does not constitute a PE.[164]

(2) The servicing of a know-how contract, even if done through a "fixed place of business" is an activity that has a preparatory or auxiliary character, and cannot, in itself, lead to taxation in the source country. Technical assistance is after all always required when a machine or production line is purchased, and such service should not be seen as separated from the main contract.[165]

(3) Technical services are often accessory to another contract, for instance the sale of a machine, a plant or know-how. The provisions of the OECD Commentary concerning after-sale service are relevant in this regard, as they clearly indicate that such services have, in principle, a preparatory or auxiliary character.[166]

(4) Also, the OECD Commentary concerning the leasing of equipment is relevant, as it states that for the leasing of tangibles and intangibles (such as know-how) such activity usually does not lead to having a PE even if "the lessor supplies personnel after the installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee".[167]

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[164] A.SKAAR, *Permanent Establishment. Erosion of a tax treaty principle,* in *Kluwer,* p.304, 1991.

[165] E. van der BRUGGEN, *Source taxation of Consideration for Technical Services and Know-How with Particular Reference to the Treaty Policy of China, India and Thailand,* in *Asia-Pacific tax Bulletin*, p.44, 2001.

[166] Paragraph 25 of the Commentary on Article 5 of the OECD Model Tax Convention on Income and on Capital.

[167] Paragraph 8 of the Commentary on Article 5 of the OECD Model Tax Convention on Income

The UN Model, instead, extends the meaning of PE with regard to the furnishing of services. Even though the enterprise has no fixed place of business in the source country, the fact that the service or consultancy is supplied, means it is deemed to have a PE, being the following requirements fulfilled:

1) the activity of furnishing services or consultancy continues for more than six months for the same or a connected project;
2) the six-month requirement must be fulfilled within any 12-month period;
3) the activity is performed within the territory of the source State. This is a major difference with taxation of technical fees as royalties, since, in the latter case, only the source of the payment is relevant.[168]

Thus, taxation as royalties is only appropriate if (i) the technical fee fits the definition of a royalty and (ii) the grantor has no PE or fixed base in the source country.

The difference between services and know-how is specifically addressed by the OECD Commentary, quoted by the UN Commentary:

"in the know how contract, one of the parties agree to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. Know how differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party.

and on Capital.

[168]E. van der BRUGGEN, *Source taxation of Consideration for Technical Services and Know-How with Particular Reference to the Treaty Policy of China, India and Thailand,* cit., p.44, 2001.

Thus, payments for the consideration for after-sale services, services rendered by a seller under a guarantee, for pure technical assistance or for expert opinions given by an engineer, an advocate, or an accountant do not constitute royalties within the meaning of paragraph 2."[169]

Hence, the criterion adopted by both the OECD and UN Conventions is the one based on the principal of imparting.

"Imparting" is passing on knowledge as a teacher does to a student. The purpose of the exchange for the receiver is to learn how to do something, so that he knows how to do it himself the next time. Applied to know how it paying for information on certain industrial, commercial or scientific experience, with the purpose of using that information and experience to perform that industrial, commercial or scientific process.

The UN Convention Commentary refers to the OECD Commentary, in listing a number of borderline activities which should not be considered as know-how:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a warranty,
- payments for pure technical assistance,
- payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has

[169] Paragraph 11 of the Commentary on Article 12, paragraph 2 of the OECD Model tax Convention on Income and on Capital.

provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),

- payments for an opinion given by an engineer, an advocate or an accountant, and
- payments for advice provided electronically, for electronic communications with technicians or fir accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.[170]

The UN Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries specifically addresses the question of payments for technical assistance and know-how in Guideline 12. In the discussion it was raised that technical services were not sufficiently distinguished from know-how in the OECD Model DTC and that the UN Model should adopt a provision, either in the definition of royalties or in a Protocol, excluding payments of this kind from treatment as royalties. Other disagreed and argued that technical services should be included in the definition of “information concerning industrial, commercial or scientific experience”.

The Group of Experts reached a compromise; Guideline 12 qualifies payments for technical services as business profits, but the definition of PE has

[170]Paragraph 11.4 of the Commentary on Article 12, paragraph 2 of the OECD Model Tax Convention on Income and on Capital.

been changed to include the provision of the services if they take longer than six months.[171]

**3.4 Other differences between the UN and OECD Models in royalties' treatment.**

According to the UN Model Convention the term “royalties” moreover includes payments received as a consideration for the “use of, or right to use, industrial, commercial or scientific equipment”[172].

These words have been erased from the corresponding OECD's paragraph on July 1992, through the Report entitled “The Revision of the Model Convention”, even though some OECD members have entered reservations on this point.

Paragraphs 4 of both the Conventions exclude the application of the previous Articles when royalties are beneficially owned by a person having a PE in the source source country, and the right or property from which the royalties derive is effectively connected with the PE, or a fixed base being the UN Model applied.

In addition to royalties excluded from the application of paragraph 1 by paragraph 3 of the OECD Article, paragraph 4 of the UN Convention excludes royalties which are received in connection with business activities described in subparagraph (c) of Article 7(1), namely, business activities of the same or similar

[171] E. van der BRUGGEN, *Source taxation of Consideration for Technical Services and Know-How with Particular Reference to the Treaty Policy of China, India and Thailand*, cit., p.52, 2001.
[172] Article 12, paragraph 3 of the UN Model Double Taxation Convention between Developed and Developing Countries.

kind as those of a permanent establishment in the source country, accordingly to the limited force of attraction principle provided therein.

Another important difference existing between the UN and OECD Conventions is that, under the UN Model, royalties are deemed to arise in the country where the one who pays them is a resident, but also royalties borne by a permanent establishment of a resident in another country (contracting state or not) fall under the scope the UN Model DTC Article 12.[173]

In fact, paragraph 5, which is an innovation of the UN Model, since no corresponding provision is to be found within the OECD text, provides that "royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State.

Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base, in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated."[174]

Thus, Article 12(4) of the UN Model provides that royalties that are effectively connected with a PE are covered by Article 7. Article 12(5) defines the source of royalties to be the payer's residence country. However, if the payer has a PE in one of the treaty countries and the royalties are incurred in connection with

[173] E. van der BRUGGEN, *Source taxation of Consideration for Technical Services and Know-How with Particular Reference to the Treaty Policy of China, India and Thailand*, cit., p.52, 2001.

[174] Article 12, paragraph 5 of the UN Model Double Taxation Convention between Developed and Developing Countries.

the PE and are borne by such PE, whether or not the payer is a resident of that country, the royalties are deemed to arise in that country. In other words, the “base-erosion” test trumps the payer's residence test.[175]

Finally, paragraph 6 of the UN Model provides that, if by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of royalties, in excess of the arm's length amount, is not eligible for the reduced rate.

**4 Capital gains: preliminary remarks.**

Capital gains are the last components of the so-called passive income to be disciplined by the UN and OECD Conventions.

There is no generally accepted approach to allocating the right to tax such income between source countries and residence countries properly.

The source rule for capital gains was officially introduced to the international tax world in 1940 by the League of nations.[176]

Most countries at that time only taxed non-residents on capital gains or exchange of real property, rather than stock sales.

For example, with reference to the American practise of taxation of capital gains, an important evolution with reference to their tax liability can be noticed. Around fifty years ago, the American Congress decided to exempt foreign persons

[175] J.LI, *The Great Fiscal Wall of China: Tax Treaties and Their Role in Defining and Defending China's Tax Base*, in *Bulletin for International Taxation,* Vol.66 No.9, 2012.
[176] S.SIMONTACCHI, *Taxation of Capital Gains Under the OECD Model Convention: with Special Regard to Immovable Property, Kluwer,* p.5, 2007.

on most non-business capital gains. In fact, the tax could only be collected through a withholding tax on the gross amount of profits. Thus, during the years, foreign companies invested on American real properties without being taxed on their plus-values , unless the latters were effectively connected to a business activity in the United States. However, in 1980, the FIRTA law eliminated this exemption, not only on capital gains from real properties sales, but also on plus-values generated by the sale of shares belonging to companies holding real estate properties.[177]

Following the customary international law and treaty practise before 1940, the right to tax capital gains from sales or exchanges of real property is attributed to the country in which the property is situated without mush dispute.[178]

Nevertheless, taxation of gains from sales or exchanges of capital assets other than real property, where a PE is not involved, triggered different approaches to the attribution of the right to tax between the source country and residence country.

The source countries claim the right based on the benefit principle, i.e., that they provided regulatory protection and legal benefit to non-resident taxpayers before they received capital gains.

The residence countries won the right to tax such capital gains in the 1946 Draft Model Tax Convention proposed by the League of Nations in London (1946 London Draft), in the absence of most source country representatives.[179]

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[177] N. MELOT, *Territorialité et mondialité de l'impot*, cit., p.99.

[178] X.SHI, *Source Rule for Capital Gains from Stock Sales- History and Evolution,* in *Asia-Pacific Tax Bulletin,* Vol.19 No.1, 2013.

[179] SIMONTACCHI, t*axation of Capital Gains Under the OECD Model Convention: with Special*

As a result, capital gains from sales of capital assets other than real property and business properties became taxable only in the residence country of the recipient.

The text of Article 13 of the UN Model resulted from a compromise that the former Group of Experts considered would be acceptable for both developed and developing countries. In fact, some members from developed countries wished to use the OECD version of Article 13, which (1) allows the source country to tax capital gains from the alienation of immovable property and from movable property that is a part of a permanent establishment or pertains to a fixed place for performing independent personal services and (2) reserves to the residence country the right to tax gains on the alienation of other types of property.

On the other hand, developing countries advocated the right to enhance their taxation powers, and to extend them to situations not covered by the OECD provisions.

In particular, Article 13, paragraph 1 of the UN Model reproduces the corresponding OECD paragraph, and reads as follows:

"Gains derived by a resident of a Contracting State from the alienation of immovable property [...] and situated in the other Contracting State may be taxed in that other State".[180]

Thus, gains deriving from the alienation of an immovable good can be taxed in the State where the good was located, namely a source taxation is provided. This rule is completed by the one provided by paragraph 4, which applies to gains

*Regard to Immovable Property,* cit., p. 115, 2007.

[180] Article 13, paragraph 1 of the UN Model Double Taxation Convention between Developed and Developing Countries.

from the alienation of all or part of the shares in a company holding immovable property.

Neither the UN nor the OECD Models give a detailed definition of capital gains; the OECD Commentary specifies that the words “alienation of property” are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.[181]

Paragraphs 2 of both the Conventions deal with movable property forming part of the business property of a PE.

The terms “movable property” cover all property other than immovable property. Gains from the alienation of these assets can be taxed in the State where the PE is located.

In case of partnerships, special problems may arise; in fact, both the Commentaries explain that the paragraph is applicable only to property which was owned by the alienator, either wholly or jointly with someone else.

Under the laws of some countries partnerships or other associations are treated as body corporate for tax purposes, distinct from their members, the participation in such entities being dealt with in the same way as shares in a company. Capital gains derived from the alienation of such participations, like capital gains from the alienation of shares, are so taxable only in the residence State of the alienator.

[181] Paragraph 5 of the Commentary on Article 13 of the OECD Model Tax Convention on Income and on Capital.

### 4.1 Land-rich companies.

Article 13(4) of the UN Model Convention preserves a source country taxing rate in cases where land in a country is not itself alienated, but an entity, including an offshore entity, which own the land, and the principal property of which is land in that country (that is, it is a “land-rich” company) is alienated instead.[182]

Its purpose is that of preventing the avoidance of taxes on the gains from the sale of immovable property.

This is an instance where a UN Model Convention provision seeking to preserve taxing rights in such cases was later adopted in the OECD Model Convention.

The UN Model provision is more detailed than the OECD's one, in fact, in 1999, the former Group of Experts decided to amend paragraph 4, in order to expand its scope and include interests in partnerships, trusts and estates which own immovable property.

At the same time, subparagraph (a) of paragraph 4 specifies that the rules provided therein shall not apply to those entities , when their property consists directly or indirectly principally of immovable property used by them in their business activities.

This exception for land used in business, unless it is the business of managing such land, does not appear in the OECD Model Convention.

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[182]M.LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments*, cit., Vol.49 No.08, 2009.

This is an instance where there is, in one respect, less possibility of source taxation under the UN Model Convention than under the OECD Model Convention.[183]

According to subparagraph (b), the term “principally” related to the ownership of an immovable property means that the value of it exceeds 50 per cent of the aggregate value of all assets owned by such company, partnership, trust or estate.

**4.2 Taxation of gains on shares.**

Paragraph 5 of the UN Model represents an innovation, since no corresponding provision is to be found in the OECD Model Convention.

In fact, this paragraph provides for taxation of a gain on shares other than those mentioned in paragraph 4.

Some countries hold the view that a Contacting State should be able to tax a gain on the alienation of shares of a company resident within their territory.

However, this provision is limited to companies resident in the source country, whereas the land-rich companies' provision applies wherever that company is resident, because the local link is provided not through the residence of the company but through the ownership of the local land.

In fact, the UN Model recognizes that not all countries tax capital gains, especially that from stock sales. Therefore, in order to prevent double non-

[183] M.LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments*, cit., Vol.49 No.08, 2009.

taxation, it is not reasonable to attribute the right to tax “catch-all” capital gains solely to the residence countries.

As foreign direct investments tend to use offshore special purpose vehicles (SPV) structures to seek tax deferral or avoidance benefits, double non-taxation may occur more easily if the source countries are not provided with the right to tax the capital gains from stock sales.[184]

However, for administrative reasons, the right to tax has been limited to the alienation of shares of a company, in the capital of which the alienator possessed a relevant participation, at any time during the 12-month period preceding the alienation.

The substantial participation is determined according to the percentage shareholding to be decided through bilateral negotiations; thus, even though a substantial shareholding is alienated through small subsequent sales, the taxing right granted by the paragraph will however apply if the shares transferred were alienated at any time during the 12-month period.

Gains from the alienation of property, other than that mentioned in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

# CHAPTER IV

[184] X.SHI, *Source Rule for Capital Gains from Stock Sales- History and Evolution,* cit., Vol.19 No.1, 2013.

# Transfer Pricing.

## 1. Introduction

Thanks to rapid advances in technology, transportation and communication, a large number of multinational enterprises (MNEs) has arisen. These companies have the flexibility and ability to place their subsidiaries all around the world.

A significant volume of global trade, nowadays, consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE group; such transfers are called "intra-group transactions".[185]

At the same time, fiscal deficits around the world have reached record high levels, making tax authorities hungry for revenues.

The audit and controversy environment is at its dynamic best in both developed and emerging economies. Tax authorities around the world are aggressively pursuing compliance actions and enforcements initiatives.[186]

In these circumstances, it has become more and more important for tax authorities to settle and control the appropriate price, namely the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services.

Thus, the term "transfer pricing" means the action of pricing cross-border

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[185] Paragraph 1.1.3 of the UN Practical Manual on Transfer Pricing for Developing Countries.
[186] S. MUKHERJEE and R. MEHTA, *Column: The Rise of Transfer Pricing Issues,* in *Asia-Pacific Tax Bulletin,* 2013, p.29.

and intra-group transactions between associated enterprises; in fact, according to the International Tax Glossary, transfer pricing is “the area of tax law and economics that is concerned with ensuring that prices charged between associated enterprises for the transfer of goods, services and intangible property accord with the arm’s length principle.[187] These transactions taking place between associated enterprises are often referred to as “controlled transactions”.

For purposes of business economics, the definition of “transfer price” is the “amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization”.[188]

In the area of taxation this expression simply refers to the shifting of the tax base from one tax jurisdiction to another by MNEs. From a financial perspective, transfer pricing is probably the most important tax issue in the world. It is assumed that between 60% and /0% of all cross-border trade is carried out within MNEs.[189]

That is the reason why transfer pricing has emerged as one of the most important and most contentious tax disputes in the world, since nothing can guarantee that the relationship among members of the same MNE will reflect conditions that would govern dealings between independent parties.

## 1.2 Motivations of transfer pricing strategies

[187] International Tax Glossary.

[188] C.T. HORNGREN, W.O. STRATTON and G.I. SUNDEM, *Introduction to management accounting, Prentice hall International Inc.* 2002, pp. 396.

[189] L.G. ABLET, *The UN Practical Manual on Transfer Pricing for Developing Countris: Should it Depart from the OECD Transfer Pricing Guidelines?*, in *International Transfer pricing Journal*, 2012, p.10.

Globally, economic activity and investment shifted from the West to the Asia-Pacific area, rendering latter countries' tax authorities cautious and wary of transfer pricing strategies adopted by MNEs.

The determination of a transfer price is, therefore, necessary in order to define the income of the parties involved in a transaction and, consequently, in order to identify the tax base of the countries involved in cross-border transactions. In fact, when a country's tax authority applies an adjustment on the profits of a MNE's member, this operation can affect the other country's tax base.

It has been argued that the losses of tax revenue by developing countries due to tax evasion and tax avoidance are estimated to exceed by far all the Official Development Assistance international donors are providing annually[190]; and, although transfer pricing should not be confused with tax evasion and tax avoidance, it could be used by MNEs for that purpose.[191]

With reference to the motivations underlying transfer pricing manipulations, they can be several: the most frequent one is the MNEs' attempt to reduce their aggregate tax burden. This may involve profit shifting through non-arm's length transfer pricing, in order to reduce the overall tax bills of the MNE.

The simplest way to achieve this goal is the practise of shifting profits from associated enterprises in higher tax countries to associated parties in lower tax countries, through either under-charging or over-charging the associated entity for intra-group trade.

[190] ITC, press release, *Partners of the International Tax Compact Agree Upon Further Cooperation Commitments to Fight Tax Avoidance.*
[191] L.G. ABLET, *The UN Practical Manual on Transfer Pricing for Developing Countries: Should it Depart from the OECD Transfer Pricing Guidelines?,* cit., pp.10 - 11.

The UN Practical Manual on Transfer Pricing furnishes the following example: if, for example, the parent company in a MNE group has a tax rate in the residence country of 30 per cent, and has a subsidiary resident in another country with a tax rate of 20 per cent, the parent may have an incentive to shift profits to its subsidiary to reduce its tax rate on these amounts from 30 per cent to 20 per cent. This may be achieved by the parent being over-charged for the acquisition of property and services from its subsidiary.[192]

Another factor which can influence a MNE's decision to operate a transfer pricing manipulation is the desire of obtaining tax benefits in the parent company's State of residence; for example using a tax loss, which can be either a current year loss or a loss that has been carried forward from a prior year by an associated company.

## 2. Arm's length principle

The most common way to properly allocate profits between two parts of a single enterprise is the so-called "arm's length principle", which is embodied in Article 9 of the OECD and UN Model Conventions and can be considered as the international standard, generally adopted for determining transfer pricing for tax purposes.

It requires associated enterprises to charge, in relation to a controlled transaction, the same prices that would be charged by independent parties in an

[192] Paragraph 1.2.5 of the UN Practical Manual on Transfer Pricing for Developing Countries.

uncontrolled transaction in otherwise comparable circumstances.[193]

An alternative to the arm's length principle might be a Global Formulary Apportionment Method which would allocate the global profits of an MNE group amongst the associated enterprises on the basis of a multi-factor weighted formula (using factors as property, payroll and sales for example).

A formulary apportionment approach is currently used by some states of the USA, cantons of Switzerland and provinces of Canada.

However, the solution adopted by both the UN and OECD Models is based on the first-mentioned method, since Article 9 of the Conventions deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms".

It should be considered in conjunction with Article 25 on mutual agreement procedure and Article 26 on exchange of information.[194]

The arm's length principle's genesis goes back to 1933, when the Fiscal Affairs Committee of the League of Nations approved a "Draft Convention for the Allocation of Business Profits Between States for the Purposes of Taxation".[195] The 1933 Convention relied on the concept that Permanent Establishments had to be considered as independent enterprises, operating under the same or similar conditions of their parent companies; this assumption leads to the consequence according to which PEs should be taxed on the basis of their separate accounts.

[193]IBFD International Tax Glossary.
[194] Paragraph 1 of the Commentary on Article 9 of the UN Model Double Taxation Convention Between Developed and Developing Countries.
[195] R. RUSSO, *Application of Arm's Length Principle to Intra-Company Dealings :Back to the Origins,* in *International Transfer Pricing Journal,* 2005, p.7.

The arm's length principle therefore sees the light in the field of intra-company dealings and it is only subsequently extended to transactions between separate legal entities.[196]

**3. Conventions on transfer pricing issues**

The OECD Transfer Pricing Guidelines (OECD Guidelines) as amended and updated, were first published in 1995; this followed previous OECD reports on transfer pricing in 1979 and 1984. The OECD Guidelines represent a consensus among OECD members, mostly developed countries.[197]

Another transfer pricing framework of note which has evolved over time is represented by the USA Transfer Pricing Regulations (26 USC 482).

The OECD Guidelines have emerged out of Article 9 of the OECD Model Convention, and they have also been applied in the context of the UN Model Double Tax Convention. However, developing countries have found it very difficult to implement such guidelines in practise.

[196] H. HAMAEKERS, *Arm's length- How long?,* in *International Transfer Pricing Journal,* 2001, p.30.
[197] Paragraph 1.3.2 of the UN Practical Manual on Transfer Pricing for Developing Countries.

### 3.1 The UN Manual.

As the drafters of the UN Manual for developing counties rightly pointed out, Article 9 of tax treaties is not self-executing as to domestic application. Countries still need to create and implement detailed transfer pricing regulation in their domestic tax law.

For that reason, in order to protect their tax bases, in 1995, the OECD Member countries reached a consensus and published the OECD Guidelines based on their historical and economic backgrounds.

Most developing countries still lack regulations, and for those that have attempted to issue some, the regulations can be unclear and lack detail.

As a response to developing countries' requests of assistance, in its Annual Session of 15-19 October 2012, the United Nations Committee of Experts on International Tax Cooperation (the Committee) approved the text put forward by its Transfer Pricing Subcommittee for the new United Nations Practical Manual on Transfer Pricing for Developing Countries (the Manual).[198]

The Foreword to the Manual explains the goals the Manual is and is not seeking to achieve; in particular, the Manual:

- is a response to the need for clearer guidance on the policy and administrative aspects of applying transfer pricing analysis to some of the transactions of MNE;

[198] M. LENNARD, *The New United Nations Practical Manual on Transfer Pricing for Developing Countries*, in *Asia-Pacific Tax Bulletin*, 2013, p.32.

- reflects the arm’s length approach to evaluating the pricing of transactions between different parts of a multinational group, because that is the approach taken in Article 9 (Associated Enterprises) of the UN Model Convention. Under the arm’s length principle, if associated enterprises’ transactions take place on arm’s length conditions, each country will receive an appropriate amount of revenue from controlled transactions and a reduction in the risk of double taxation;
- acknowledges that setting prices on transfers is a normal incident of the operations of multinational enterprises, with nothing inherently wrong about it, but also recognises that abuses occur, and that without an effective response, country development will suffer.

The reasons and the particular needs which have lead to the creation of the UN Manual are reflected in its contents.

In particular, Chapters 1 to 4 reflect the focus of the Manual on developing countries as they are not reflected in the OECD Transfer Pricing Guidelines. These Chapters deal with assistance that developing tax administrations require in implementing and administering transfer pricing rules.[199]

The first chapter contains a general introduction to the Manual as a whole, it represents a survey of transfer pricing issues for developing countries, in particular, the issues of the general complexity of transfer pricing issues, the frequent lack of knowledge and skills and of readily available data about comparable transactions.

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[199] M. LENNARD, *The New United Nations Practical Manual on Transfer Pricing for Developing Countries,* cit., p.32.

These issues are dealt with more detail in the following chapters of the Manual.

Chapter 2, “*Business Framework*”, provides a general outline of the business background to transfer pricing. This Chapter recognises the importance for those tax policy makers and administrators involved in transfer pricing, of understanding the motivations and operations of MNEs in particular. Such an understanding will help them use their limited resources for engaging in transfer pricing policy and administration in a way that operates effectively while having the least possible negative impact on the investment climate.

Chapter 3, “*General Legal Environment*”, examines transfer pricing legislation in a global context and seeks to identify the key practical issues from the perspective of developing countries. Chapter 3 notes that no model legislation that works in every situation, thus, every legislation should be adapted to the needs and legal environment of a particular developing country.

Chapter 4, “*Establishing Transfer Pricing Capability in Developing Countries*”, deals with the issues of creating a dedicated Transfer Pricing Unit in the tax administration. It recognises that the success this unit would depend by the taking into account of a series of factors  widely recognised to be key features of modern tax administrations.

These include factors such as:

- relationships between tax policy and tax administration;
- the need to evaluate current capabilities and gaps to be filled;
- the need for a clear vision, a mission and a culture that reflects them;

- organizational structure;
- approaches to building team capability;
- the need for effective and efficient business processes;
- the advantages of staged approaches to reaching long-term goals; and
- the need for monitoring to assess effectiveness and for fine tuning.

The chapter then uses those aspects as a framework for consideration of issues arising when setting up a governmental transfer pricing capability.[200]

Another important Chapter, revealing the UN Manual's focus on developing countries is Chapter 10; in fact, it contains a description of the various transfer pricing strategies adopted by countries, and in particular by developing ones. Currently, the experiences presented are those of Brazil, China, India and South Africa, but the number will grow over time.

## 4 Transfer Pricing and the UN Model Convention.

As above-mentioned, transfer pricing issues are dealt by Article 9 of the UN Model, whose first paragraph provides that:

"Where:

a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

[200] M. LENNARD, *The New United Nations Practical Manual on Transfer Pricing for Developing Countries*, cit., p.32.

b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.[201]"

Thus, Article 9.1 allows tax authorities to rewrite and correct an enterprise's accounts when they do not show the proper amount of taxable profits, because of a special relationship with another company which caused the application of special conditions between them.

In other words, the transactions between two related parties must be based on the arm's length principle. This term is not specifically used in Article 9.1, but is well accepted by countries.

The rationale for the arm's length principle itself is that because the market governs most of the transactions in an economy it is appropriate to treat intra-group transactions as equivalent to those between independent entities. Thus, intra-group transactions may be adjusted if the transfer prices are found to deviate from comparable arm's length transactions.

The UN Manual suggests the following steps in order to arrive at the

[201] Article 9 of the UN Model Double Taxation Convention Between Developed and Developing Countries.

appropriate arm's length price:

- comparability analysis;
- evaluation of transactions;
- evaluation of separate and combined transactions;
- use of an arm's length range or a central point in the range;
- use of multiple year data;
- losses;
- use of customs valuation.[202]

## 5 Associated enterprises

Transfer pricing rules and the power of the tax authorities to adjust profits between enterprises apply only when the parties of the scrutinized transaction are related enterprises.

The definition of "associated enterprises" is therefore very important in determining the subjective scope of application of an international transfer pricing regime.

It is clear that in Article 9, the term "associated enterprises" is given a very broad meaning.[203]

In fact, the status of being associated persons is triggered by a participation in either the capital, management or control of another enterprise, but it is not

[202] Paragraph 1.4.14 of the UN Practical Manual on Transfer Pricing for Developing Countries.
[203] P. BAKER, *Double Taxation Conventions and International tax Law*, London, 1994, p.217.

clear from the wording of the provision how the various forms of association outlined in Article 9 relate to each other. In particular, a point of confusion lies in the fat that “control” is presented as one of the various types of association relationship among enterprises, rather than as the main core of the notion furnished by Article 9.

Neither the Articles nor the Commentaries of the UN contain any further specification concerning the meaning of “participation in control”. Hence, the term “control” is regarded as an undefined term, falling within the scope of Article 3.2 of the UN Model:

> “As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.”[204]

The application of Article 9 is one of the cases in which the interpretation of the treaty requires a reference to the context (i.e. to the intention of the treaty partners in signing the treaty under the principle of reciprocity) in order to effectively achieve the main goal of the treaty itself, namely the avoidance of double taxation. In the case of Article 9, the context seems particularly to require an interpretation of the same Article based on the legislation of the other treaty

[204] Paragraph 2 of Article 3 of the UN Model Double Tax Convention Between Developed and Developing Countries.

partner.[205]

Of course, the notions of control actually endorsed under the various domestic transfer pricing regimes around the world are significantly different from each other. This can lead to situations of economic double taxation which can be particularly difficult to solve in practice.

This risk stresses the importance and need for harmonization efforts in this field, which efforts could be made at the UN level.

Narrowing the range of differences among the notions of "associated persons" endorsed various countries and providing a pattern to be followed by the new jurisdictions only now facing the issue of transfer pricing will certainly result in positive effects vis-à-vis the goal of preventing and avoiding economic double taxation.

## 6 Transfer pricing methods.

There are several acceptable transfer pricing methods, but nor the UN neither the OECD Model suggest the method to be considered as the most appropriate, since no single method is considerable as the most suitable for every situation.

Chapter 6 of the UN Manual, "*Transfer Pricing Methods*", describes the methods that can be used to determine an arm's length price and it describes how to apply these methods in practise to calculate or test the arm's length nature of prices or profits. The Chapter notes some of the issues in selecting and applying

[205] C.ROTONDARO, *The Notion of "Associated Enterprises": Treaty Issues and Domestic Interpretations – An Overview*, in *International Transfer Pricing Journal*, 2000, p. 4.

appropriate methods in practice. For example, transfer pricing methods typically use information on comparables, and the lack of such comparables can make a particular method . even one that might seem initially preferred – inapplicable, and a different method more reliable.[206]

The Chapter covers the "traditional transaction methods" as well as the transactional profit methods, and it looks at the sorts of cases to which each of the methods are generally best or least suited.

It acknowledges that a number of jurisdictions also apply "other methods" which are considered to provide arm's length results; however, the Manual notes that this does not give the authority a blank cheque, namely, such methods must be consistent with the arm's length principle to meet Article 9 obligations.

No particular hierarchy of methods is advocated in the Manual, with the "most suitable method" to be chosen taking into consideration the facts and circumstances, such as the type of transaction, the functional analysis, comparability factors, availability of comparable transactions and the possibility of making adjustments to the data to improve comparability.

Transfer pricing methods can be divided into two main categories: transaction based methods and profit based methods.

The Comparable Uncontrolled Price (CUP), Resale Price Method (RPM) and Cost Plus (C+) belong to the first group.

### 6.1 Comparable Uncontrolled Price

According to Paragraph 6.2.1.1. of the UN Manual, the Comparable

[206] M. LENNARD, *The New United Nations Practical Manual on Transfer Pricing for Developing Countries*, cit., p.32

Uncontrolled Price (CUP) Method compares the price charged for property or services transferred in a controlled transaction, to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances. The CUP Method may also sometimes be used to determine the arm's length royalty for the use of an intangible asset.[207]

**6.2 The advantages and disadvantages of the CUP method**

A CUP is one of the most direct ways of ascertaining an arm's-length price of a controlled transaction.

The OECD Guidelines state: 'Where it is possible to locate comparable uncontrolled transactions, the CUP method is the most direct and reliable way to apply the arm's-length principle. Consequently, in such cases the CUP method is preferable over all other methods.[208]

In practice, many potential CUPs are rejected because they cannot match one or more of the comparability criteria, such as similar markets, volumes and position in the supply chain. In many industries, even a small difference between the circumstances of two transactions could impact the price.

As a consequence, true CUPs are most commonly available for transactions in products that are traded on commodity-type markets.

Furthermore, whilst adjustments to CUPs are permitted, many practitioners prefer to use an alternative method rather than apply somewhat arbitrary adjustments to a CUP, arguing that every 'adjustment' distances the CUP from

[207] Paragraph 6.2.1.1 of the UN Practical Manual on Transfer Pricing for Developing Countries.
[208] (OECD Transfer Pricing Guidelines 2010 para 2.14).

what was actually agreed in the open market.[209]

## 6.3 Resale Price Method

The Resale Price Method can be defined in the following way:

"The resale price method begins with the price at which a product that has been purchased from an associated enterprise is resold to an independent enterprise. This price (the resale price) is then reduced by an appropriate gross margin on this price (the "resale price margin") representing the amount out of which the reseller would seek to cover its selling and other operating expenses and, in the light of the functions performed (taking into account assets used and risks assumed), make an appropriate profit. What is left after subtracting the gross margin can be regarded, after adjustment for other costs associated with the purchase of the product (e.g. customs duties), as an arm's length price for the original transfer of property between the associated enterprises. This method is probably most useful where it is applied to marketing operations.[210]

An appropriate resale price margin is easiest to determine where the reseller does not add substantially to the value of the product. In contrast, it may be more difficult to use the resale price method to arrive at an arm's length price where, before resale, the goods are further processed or incorporated into a more complicated product, so that their identity is lost or transformed (e.g. where components are joined together in finished or semi-finished goods). Another example where the resale price margin requires particular care is where the

[209] E. HUGHES and W. NICHOLLS, *The different methods of TP: pros and cons* ,in *International Tax Bulletin*, 2010.
[210] Paragraph 2.14 of the OECD Transfer Pricing Guidelines, 2010.

reseller contributes substantially to the creation or maintenance of intangible property associated with the product (e.g. trademarks or trade names) which are owned by an associated enterprise. In such cases, the contribution of the goods originally transferred to the value of the final product cannot be easily evaluated”.[211]

### 6.4 Advantages and disadvantages of the RPM

One of the disadvantages of the RPM is that it can be very problematic to identify whether the comparable businesses do or do not employ valuable marketing intangibles in their business.

The presence of such intangibles may allow the comparable entity to enjoy a higher level of profitability compared with those marketing/selling companies without such an intangible. Without the ability to undertake a functional analysis of the comparables the practitioner is always uncertain on this point.

Moreover, small product differences can make a large difference to the gross margin that a company earns. For example, some products ‘sell themselves’, whilst for others the marketing company has to make significant efforts to make even a low level of sales. In the latter case one might expect that the distributor should receive a higher gross margin to cover its additional selling costs.[212]

### 6.5 Cost Plus Method

In a controlled transaction involving tangible property, the Cost Plus Method focuses on the related manufacturing company as the tested party in the

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[211] Paragraph 2.22 of the OECD Transfer Pricing Guidelines, 2010
[212] E. HUGHES and W. NICHOLLS*, The different methods of TP: pros and cons,* cit, 2010.

transfer pricing analysis. The Cost Plus Method may also be used in the case of services rendered.

The Cost Plus Method begins with the costs incurred by the supplier of property (or services) in a controlled transaction for property transferred or services provided to a related purchaser. An appropriate cost plus mark-up is then added to this cost, to make an appropriate gross profit in light of the functions performed, risks assumed, assets used and market conditions.

The method evaluates the arm's-length nature of an inter-company charge by reference to the gross profit mark-up on costs incurred by suppliers of property (or services) for tangible property transferred (or services provided). It compares the gross profit mark-up earned by the tested party for manufacturing the product or for providing the service to the gross profit mark-ups earned by comparable companies.[213]

### 6.6 Advantages and disadvantages of the Cost Plus method

For many businesses, the Cost Plus method has the clear advantages of being simple to understand and easy to implement through most accounting systems. Once the 'plus' has been determined, invoices can be raised and payments made without the need for complex spreadsheets to determine profit allocations or margins, as required by some other methods.

The simplicity of implementation can also mean that the Cost Plus method is one of the methods that is most often inappropriately applied. For example, taxpayers may use a Cost Plus method for pricing the sale of goods by a

[213] Paragraph 6.2.13 of the UN Practical Manual on Transfer Pricing for Developing Countries.

manufacturer to a related party even when the manufacturer may be the owner and developer of valuable intangibles.

This can result in the distributor, in transfer pricing terms the ‘simpler’, less risk bearing party, being the one that takes the residual profit or loss and the one whose profitability fluctuates the most.

The usual reason for adopting this approach is the ease of implementing a Cost Plus policy on management accounting systems that are set to capture standard costs and overheads.

The theory is simple but in practice determining the mark-up on costs through benchmarking analysis can be difficult. One key issue is the potential inconsistency between costs that some companies record in their cost of goods sold and other companies may record in operating expenses.

The potential for mark-ups to be distorted in this way is hard to overcome, given the typically limited information about comparable companies available in the public domain.

To overcome this, many practitioners identify comparable companies’ mark-ups based on their total costs (i.e. cost of goods sold plus operating expenses), which is in effect a profit-based method.

**6.7 Other methods**

The most important profit-based methods can be categorised as profit-comparison methods (Transactional Net Margin Method or TNMM/Comparable Profits Method or CPM) and profit-split method.

Profit comparison methods (TNMM/CPM) seek to determine the level of profits that would have resulted from controlled transactions by reference to the return realised by the comparable independent enterprise. The TNMM determines the net profit margin relative to an appropriate base realised from the controlled transactions by reference to the net profit margin relative to the same appropriate base realised from uncontrolled transactions.

Profit-split methods take the combined profits earned by the two related parties from one or series of transactions and then divide those profits using an economically valid defined basis that aims at replicating the division of profits that would have been anticipated in an agreement made at arm’s length.

All these methods are widely accepted by national tax authorities.

## 7 Adjustments to profits and economic double taxation

National tax authorities will use the arm’s length principle to make adjustments to the terms of dealing between associated enterprises. As a result, the profitability of an associated enterprise will be increased in one tax jurisdiction. Consequently, if transfer prices are being adjusted by a tax authority in one country, double taxation will occur if the tax authority in the other country does not use the same transfer method and allow a corresponding transfer pricing adjustment.[214]

Once paragraph 1 has been applied, and adjustments to profits realised, a situation of economic double taxation could arise.

Thus, Article 9.2 of the UN Convention provides that, when a certain amount of profit is taxed upon an enterprise of a Contracting State, because of a profit adjustment under Article 9.1, and the same profit had already been taxed in the hands of its associated enterprise in the other Contracting State, the second-mentioned State shall make an appropriate adjustment to the amount of taxes levied on that profit.

However, the adjustment is not meant to be automatic. In fact, the other Contracting State shall apply the Convention's provision only when it considers that the adjustment thus made properly reflects what the profits' amount would have been, had the enterprises dealt at arm's length conditions. Quoting the OECD Commentary, "the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis."[215]

## 8 Differences between the UN and the OECD Model Conventions

Articles 9 of the UN and OECD Conventions are broadly identical to each other, and even the Commentary on Article 9 of the UN Model reflects the

[214] L.G. ABLET, *The UN Practical Manual on Transfer Pricing for Developing Countris: Should it Depart from the OECD Transfer Pricing Guidelines?*, cit., pp.10 - 11.
[215] Paragraph 5 of the Commentary on Article 9, paragraph 2 of the OECD Convention on Income and on Capital.

common origin of the provisions, expressing acknowledgement of the OECD Transfer Pricing Guidelines as relevant to the application of the arm's length principle.[216]

However, Article 9 of the OECD Model has two paragraphs, while Article 9 of the UN Model adds a third paragraph, introduced into the Model by the Group of Experts in 1999, which restricts the scope of application of the second paragraph on correlative adjustments. In fact Article 9.3 establishes that:

"The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default."[217]

It is clear that the intention is to grant a form of permission to the contracting parties to apply a different treatment (apart from Article 9.1 and 9.2) where there is a strong misbehaviour on the part of the taxpayer, such as tax fraud and the like.

Apart from the similarities between the two Conventions, it should be noted that the last sentence of Article 9.2 remits to the other provisions of a tax treaty in the following terms: "in determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the

[216] S. SOLLUND and M.A.PEREIRA VALLADAO, *The Commentary on Article 9- The Changes and Their Significance and the Ongoing Work on the UN Transfer Pricing Manual,* in *Bulletin for International Taxation,* 2012, p.608.
[217] Article 9, paragraph 3 of the UN Model Double Taxation Convention Between Developed and Developing Counties.

Contracting State shall, if necessary, consult each other”[218].

Accordingly, considering the existing differences between other Articles of both the UN and OECD Models, it can be said that, despite the fact that the texts are exactly the same, there is an intrinsic difference between Article 9 of the two Models. In other words, because there are differences in other Articles of the Models, the reference in Article 9.2 to such other Articles may have different results.[219]

**9. The Future for the Manual**

Apart from the differences in the Articles’ structure of the two Conventions, it has already been mentioned as the UN Manual on Transfer Pricing is, unlike the OECD Guidelines, extremely focused on developing countries.

Since the Manual is conceived as a “living work”, that should be regularly revised and improved, including by the addition of new chapters and additional material of special relevance to developing countries (including country practices), it can be argued that its relevance will grow over time.

The successful completion of this project also exemplifies that UN work on tax cooperation is not merely focused on tax treaties, but has a wider purview in accordance with its broad mandate – including a special emphasis on practical solutions to practical tax problems for developing countries, wherever they lie, and however intractable they might appear to be.

[218] Article 9, paragraph 2 of the UN Model Double Taxation Convention Between Developed and Developing Counties.
[219] S. SOLLUND and M.A.PEREIRA VALLADAO, *The Commentary on Article 9- The Changes and Their Significance and the Ongoing Work on the UN Transfer Pricing Manual*, cit., p.610.

What is being developed is not a new set of guidelines to compete with the OECD Transfer Pricing Guidelines, but, rather, a practical, useful and explanatory tool for developing countries.

In contrast to the OECD Transfer Pricing Guidelines, which through the Recommendation adopted by the OECD Council, the administrations of OECD Member countries are committed to following, the UN Transfer Pricing Manual will not be a binding authoritative document. [220]

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[220] S. SOLLUND and M.A.PEREIRA VALLADAO, *The Commentary on Article 9- The Changes and Their Significance and the Ongoing Work on the UN Transfer Pricing Manual,* cit, p.608.

# CONCLUSIONS

Both the UN and OECD Model Conventions are designed to encourage investments by preventing double taxation of profits. While this goal is shared by both the Models, the main reason for the existence of two Conventions is the difference, in certain cases, about where the balance of source country and residence country taxation should lie in avoiding double taxation.

Since, under the credit or exemption article of tax treaties, the residence country must at least give a credit for taxes paid in other country, the residence country will only be assured of full taxing rights if the source country agrees that it will not be allowed to tax that same item of income, otherwise the residence country can only be assured of being able to tax to the extent that its tax on the profits exceeds that of the source country.[221]

Hence, the most important issue while negotiating a double taxation agreement is, generally, whether the source country will give up its taxing rights over certain types of income.

In this context, the UN Model is intended to provide an alternative to the OECD Model, and an alternative that better reflects the interests of developing countries. In general, therefore, the UN Model allows greater source country taxing rights compared to the OECD Model.[222]

There is obvious tension between the members of the Committee of Experts

[221]M. LENNARD, *The Purpose and Current Status of the United Nations Tax Work,* in *Asia-Pacific Tax Bulletin,* 2008, p.25.
[222]B. J. ARNOLD, *Tax Treaty News: An Overview of the UN Model (2011),* in *Bulletin for International Taxation,* 2012, p.523.

from developing and developed countries, being the latter ones generally wedded to the provisions of the OECD Model.

Thus, critics have been moved to the UN Model for its provisions being either too similar to the OECD Model or too different from it.

As evidenced in the previous chapters, the objective and subjective scopes of the Conventions coincide, as well the proposed solutions for cases of dual residence.

Differences between the Models start to appear with the following Articles, and they are shortly summarized below.

Article 5 contains the discipline of Permanent Establishment (PE) and addresses the economic nexus required before source country taxing rights may be exercised under the tax treaty. The definition of permanent establishment is the same in both the Conventions, but, in general, the UN Model Convention preserves greater source country taxation rights in Article 5.

In particular:

*Building sites*

Under the UN Model a six-month duration test is provided for building and construction PEs, rather than the twelve-month test provided by the OECD Model.

*Treatment of services*

Art. 5.3.b of the UN Model Convention addresses so- called “services permanent establishments” in a way that forms a clear line of demarcation between the UN and OECD approaches.[223]

In fact, the provision of services by itself can constitute a PE, if performed for over six months, while the OECD Model Convention has no special provisions for services, and recent OECD work has reiterated that under its Model Convention, services provision is treated in the same way as provision of goods. In other words, the same sort of economic presence in the territory is required to justify source country taxation, a presence having a certain degree of fixed physical presence in that country over a certain period of time.

This difference is of the striking importance, as evidenced in Chapter 2, paragraph 2.3.1, which illustrates the Morgan Stanley case and evidences how the application of the UN Model led to conclusions which would have been of the opposite kind, had the OECD Model been applied.

*Delivery*

The term “delivery” has been deleted from the list of activities which are not able to trigger a PE, because of their preparatory or auxiliary character.

*Dependent Agent*

Under Article 5.5.b of the UN Model Convention there can be, in contrast to the OECD Model Convention, a dependent agent situation if the agent maintains stock, even though that agent does not conclude contracts for the principal. Similarly as for the delivery exception, this is founded upon a view that the presence of stock, and the delivery of it by the agent, constitutes a sufficient economic nexus to the host country so as to justify taxation by the host country.

[223] M. LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention - Current Points of Difference and Recent Developments*, cit., p.2.

*Insurance*

A special provision regarding insurance enterprises is provided by the UN Convention; there is no correspondence in any of the OECD provisions. In particular, Article 5.6 of the UN Model provides that insurance enterprises shall be deemed to have a PE within the territory of a Contracting State when they collect premiums or maintain a dependent agent therein.

*Independent Agent*

Independent agents can create a PE if they operate only for a client and do not deal at arm's length conditions, the different results deriving from the application of the UN rather than the OECD Convention are illustrated in Chapter 2, paragraph 2.6.1, which compares the Zimmer case to the Rolls Royce case.

*Active Income*

As previously mentioned, the UN Model leads to more situations in which a permanent establishment is present. Also, the consequences of having a PE in the other State are different in both Models.[224]

In fact, a fundamental difference exist between the UN and OECD Model Conventions since the UN Model provides for a limited force of attraction rule, thus allowing source countries to tax activities conducted within their territory when they are of the same or similar character of those conducted through the PE. This approach is not shared by the OECD Convention which only allows the taxation of those profits which are attributable to a PE.

Moreover, the UN Model limits the types of expenses for which deductions

[224] B. KOSTERS, *The United Nations Model Tax Convention and Its Recent Developments*, in *Asia-Pacific Tax Bulletin*, 2004, p.5.

are allowed, and, in particular, no deduction shall be allowed with reference to amounts paid to the head office by the PE.

*Transfer Pricing*

Both the Models encourage the application of the arm's length principle. The sole difference between the two Models' texts regards the possibility, explicitly allowed by the UN Model, to avoid the adjustment when there is a final court ruling that one of the parties has engaged in fraud.

*Passive Income*

Under Article 10 of the UN Model Convention, the maximum dividend withholding tax rate allowed to the source country is not specified, but is left subject to negotiation between prospective treaty partners.

This compares to a 5% maximum for foreign direct investment dividends and 15% maximum for portfolio investment dividends in the OECD Model Convention. Countries following the UN Model Convention (and indeed some OECD Member countries) generally have higher maximum rates than under the OECD Model Convention, i.e. they consider this is a fairer outcome for countries that tend to be net capital importers rather than exporters.

Moreover, under the UN Model, the threshold to qualify for foreign direct investment (FDI), as opposed to portfolio investment (and therefore to be entitled to the lower maximum withholding tax rate) is lower than under the OECD Model Convention (10% as compared with 25%).

This is explained in the Commentary on the basis that in some developing countries non-residents are limited to a 50% share ownership, and 10% is seen as a significant enough portion of such permitted ownership to qualify for the FDI categorization.

Article 11 (Interest) of the UN Model Convention does not provide particular withholding tax rates, for the same reasons as for dividends.

Article 12 (Royalties) of the UN Model Convention provides for source country taxation of royalties. This is an approach not provided for in Article 12 of the OECD Model Convention itself, but which is followed by about half of the OECD Member countries and is therefore addressed in the Commentary to the OECD Model Convention on this Article. Such an approach is premised upon the idea that the country of use of intellectual (including industrial) property has a right to tax profits from such use accruing to the intellectual property owner.[225]

With reference to capital gain taxation, the UN Model provides for special source taxation rights over shares in property-rich companies. Moreover, a source country taxation of shares is provided if the holding is over an agreed threshold.

An important issue to be addressed is to what extent have the provisions of the UN Model been included in actual treaties. In the late 1990s, the IBFD prepared a paper for the UN Ad Hoc Group of Experts on the impact of the UN Model.[226] The starting point was all the tax treaties concluded between January 1980 and April 1997; more than 800 treaties were examined, of which almost 700 concluded by developing countries.

With reference to PE, the period for building sites to constitute PE was

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[225] M.LENNARD, *The UN Model Tax Convention as Compared with the OECD Model Tax Convention - Current Points of Difference and Recent Developments*, cit., p.2.
[226] W.F.G.WIJNEN and M.MAGENTA, *The UN Model in Practice*, in *Bulletin for International Fiscal Documentation*, pp.574-585.

established in less than twelve months by more than 500 treaties, with more than 450 prescribing a period of 183 days or 6 months.

The provision regarding the furnishing of services was not as widespread, but was still included in 220 of the treaties studied.

The exclusion of delivery from the list of activities not leading to the presence of a PE could be found in 167 treaties.

The extension of the notion of dependent agent was adopted in 240 of the treaties, while the provision regarding independent agents can be found in over 280 of the tax treaties.

Also with respect to Article 7, the provisions of the UN Model have found their way to actual tax treaties. The limited force of attraction was included in over 160 of the treaties and also the inclusion of paragraph 3 appears to be quite popular as it was found in over 200 of the treaties.

With reference to royalties, the large majority of the treaties reproduced the UN model discipline, including the treaties concluded by developed countries; whilst, with respect to the taxation of capital gains, the provision on real estate companies was reproduced in almost half of the treaties concluded in the examined period.

It is equally interesting to observe that, albeit it may appear that the OECD solutions for avoiding double taxation are fully accepted by developed countries, the acceptance of that residence country orientation has changed over time within the OECD, as its membership has broadened over time, including countries as Australia, New Zealand, Mexico and some Eastern Europe countries, willing to propose different approaches.

These differences of view among the OECD members are expressed by making “reservations” to indicate that they do not agree with the text of an article of the Model.

For example, with reference to royalties taxation, it has already been mentioned as the OECD Convention provides for an exclusive residence country taxation, but almost half of the OECD members have “reserved” on this aspect of the Model. Hence, they do apply source taxation to royalties flowing from their country to the residence country, thus being in line with the UN Model.

As another example in areas like taxation of work pensions, many OECD members tend to favour sole residence country taxation of pensions, while about the same number of other OECD Member countries favour source country taxation, the source country being the country from where the pensions were sourced, that is the country where the work they relate to was done.[227]

Thus, the UN Model can represent a valid guidance, not exclusively for developing countries, but also for developed ones, in particular, the UN can play a key role for the promotion of international cooperation in tax matters, since, thanks to its universal membership and legitimacy, each country can express its needs and interests.

I would like to conclude with the opinions recently expressed by Durst and Rosenbloom: Durst pointed out that the “UN is the unique forum that can provide a great service to the world community by reflecting the needs and perceptions of

[227]M. LENNARD, *The Purpose and Current Status of the United Nations Tax Work,* in *Asia-Pacific Tax Bulletin,* 2008, p.27.

the widest possible range of national tax administrations”[228]; while, for Rosenbloom, “developing countries can and should make use of the UN as a vehicle for uniting on tax matters and expressing themselves”.[229]

[228] T.N.WRIGHT, *Practitioners Assess Need for UN to share OECD’s Role as Standard Setter in Developing International Tax Regimes*, 2011, p.92.
[229] L.G.ABLET, *The UN Practical Manual on Transfer Pricing for Developing Countries: Should it Depart from the OECD Transfer Pricing Guidelines?,* in *International Transfer Pricing Journal,* 2012, p.17.

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3 sub par. A.
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