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INTERNATIONAL CO-OPERATION IN TAX MATTERS

Report of the *Ad Hoc* Group of Experts on International Co-operation in Tax Matters on the Work of its Fifth Meeting

UNITED NATIONS

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Department of International Economic and Social Affairs

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INTRODUCTION

A. Terms of reference of the Ad Hoc Group of Experts

1. As defined in Economic and Social Council resolutions 1980/13 of 28 April 1980 and 1982/45 of 27 July 1982, the terms of reference of the Ad Hoc Group of Experts on International Co-operation in Tax Matters encompass the following tasks:

(a) Formulation of guidelines for international co-operation to combat international tax evasion and avoidance;

(b) Continuing examination of United Nations Model Double Taxation Convention between Developed and Developing Countries 1/ and consideration of the experiences of countries in bilateral application of that Model Convention;

(c) Study of the possibilities of enhancing the efficiency of tax administrations and formulation of appropriate policy and methodology suggestions;

(d) Study of the possibilities of reducing potential conflicts among the tax laws of various countries and formulation of appropriate policy and methodology suggestions.

B. Attendance at the fifth meeting

2. Pursuant to Economic and Social Council decision 1980/155 of 18 July 1980, the membership of the Ad Hoc Group of Experts was increased from 20 to 25. The Secretary-General appointed 24 members of the Group on the nomination of the Governments of the following States: Argentina, Austria, Brazil, Chile, Egypt, Finland, France, Federal Republic of Germany, India, Indonesia, Israel, Jamaica, Japan, Kenya, Mexico, Morocco, Netherlands, Nigeria, Pakistan, Spain, Switzerland, Syrian Arab Republic, United Kingdom of Great Britain and Northern Ireland, United Republic of Cameroon and United States of America.

3. The following experts attended the fifth meeting of the Ad Hoc Group of Experts, held at Geneva from 6 to 12 December 1989: Messrs. Antonio H. Figueroa (Argentina), Alfred Philipp (Austria), Jose Rodolfo Hülse attending on behalf of Eivany Antonio Da Silva (Brazil), Andre Titty (Cameroon), Hugo Hanisch-Ovaille (Chile), Rainer Söderholm (Finland), Dominique Gibrat (France), Thomas Menck (Federal Republic of Germany), R. Mansury (Indonesia), Mayer Gabay (Israel), Canute R. Miller (Jamaica), Naoki Oka (Japan), Mohamed Chkounda (Morocco), Koenraad Van der Heeden (Netherlands), Julius Olasoji Akinmola (Nigeria), M. Taraq (Pakistan), D. Jose Ramon Fernandez-Perez (Spain), Daniel Lüthi (Switzerland), Maurice H. Collins (United Kingdom), and Mordecai S. Feinberg (United States of America).

4. The meeting was attended by observers for Member States of the United Nations: Messrs. M. O. Scheerlinck (Belgium), M. T. Omran and A. A. Shayani (Iran, Islamic Republic of), J. B. Shepherd (United Kingdom of Great Britain and Northern Ireland), S. Shresta (Nepal) and an observer for the Republic of Korea, Mr. Ki-Jong Woo.

5. The meeting was also attended by the following observers for international and regional organizations and other institutions: Mr. L. Maktouf (International

Monetary Fund); Mr. J. H. Kraus (International Chamber of Commerce); Mr. R. J. P. Owens and Mr. J. M. Dery (Organisation for Economic Co-operation and Development); and Mr. B. P. Dik (International Bureau for Fiscal Documentation).

C. Documentation

6. The Ad Hoc Group had before it the following documents:

(a) Annotated provisional agenda (ST/SG/AC.8/L.57);

(b) Working paper (ST/SG/AC.8/L.58);

(c) International taxation: discussion papers prepared by members of the Ad Hoc Group and addendum (ST/SG/AC.8/L.59 and Add.1);

(d) Operation of the mutual agreement procedure in settling disputes arising out of double taxation agreements (ST/SG/AC.8/L.60);

(e) Tax-sparing credit in selected countries (ST/SG/AC.8/L.61).

7. The working paper, prepared by the Sub-Group of the Ad Hoc Group of Experts on International Co-operation in Tax Matters, was the main document on which the Ad Hoc Group concentrated its work. The other papers were used as background material.

D. Opening of the meeting

8. The fifth meeting of the Ad Hoc Group of Experts on International Co-operation in Tax Matters was opened on 6 December 1989 by Mr. Tahar Hadj-Sadok, Chief of the Fiscal and Financial Branch of the Department of International Economic and Social Affairs of the United Nations Secretariat.

E. Election of officers

9. The Ad Hoc Group of Experts unanimously re-elected Mr. Maurice H. Collins (United Kingdom of Great Britain and Northern Ireland) as Chairman and elected Mr. Reksoprajitno Mansury (Indonesia) as Vice-Chairman.

10. Tahar Hadj-Sadok and Andrew Agochukwu Ezenkwele of the United Nations Secretariat served respectively as Secretary and Deputy Secretary of the Group. The Group appointed the following members to the Sub-Group which would prepare the agenda and working documents for the next meeting of the Group: Mr. Feinberg, Mr. Hülse, Mr. Lüthi, Mr. Mansury, Mr. Miller and Mr. Van der Heeden.

F. Adoption of the agenda

11. The Ad Hoc Group of Experts adopted the following substantive agenda for the fifth meeting:

(a) Mutual consultation procedure with special emphasis on the manner in which time-limits affect the efficient operation of the mutual consultation procedure;

(b) Monitoring of the Model Convention: an in-depth consideration of a number of points of detail in connection with articles 5 and 7 of the Model Convention;

(c) Tax-sparing relief;

(d) Other topics: a brief general discussion of any other points that members wish to bring to the attention of the Ad Hoc Group of Experts, possibly for more detailed discussion at a later meeting;

(e) Arrangements for the next meeting.

G. Substantive work for the sixth meeting

12. The Ad Hoc Group decided to consider, at its sixth meeting, the following substantive topics:

(a) The procedures, processes and modalities of exchanges of information under tax treaties, how such exchanges between developed and developing countries may be improved and enlarged and examples of types of cases in which such exchanges may be of special value;

(b) Problems arising out of the taxation of income from the transfer of technology, including patents and other forms of intellectual property, the provision of technical services and related topics;

(c) The impact of the United Nations Model Double Taxation Convention on the negotiation and application of bilateral tax treaties with special reference to:

(i) The meaning, in article 71 of the Model, of "sales ... of goods or merchandise of the same or similar kind as those sold through that 'permanent establishment'" and "other business activities carried on ... of the same or similar kind as those effected through that permanent establishment"; and

(ii) Articles 10 (Dividends), 11 (Interest) and 12 (Royalties, etc.) of the Model including, in relation to article 10, the concept of a branch profits tax;

(d) The collection and exchange of information about the organization of national tax administrations and the channels for communication between them.

Members of the Group agreed to prepare brief notes on these topics. The Group agreed that all material submitted should reach the Secretariat by the end of December 1990.

I. THE MUTUAL CONSULTATION PROCEDURE UNDER THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION

13. The "mutual agreement" or "mutual consultation" or "competent authority" procedure in tax treaties is essentially a means by which a taxpayer who feels that he has suffered tax in a manner which is not in accordance with the relevant tax treaty can call upon the competent authorities of one of the contracting States to take the matter up with the competent authorities of the other contracting State in order to get his tax treatment, if possible, amended and to remove his grievance. The United Nations Model Double Taxation Convention of 1979 provides the taxpayer with this kind of opportunity in its article 25.

14. Article 25 was drafted on the foundation of earlier work by the League of Nations and the Organisation for Economic Co-operation and Development (OECD). The 1943 Mexico and the 1946 London draft tax treaties of the League of Nations both recognized that, in certain circumstances, a taxpayer might need to be put into a position by the terms of a tax treaty to be able to call upon the competent authorities of the contracting States to consult with each other with a view to reaching an agreement for the equitable relief of double taxation in his case.

15. Later international discussions developed this basic theme further, and the 1979 United Nations Model Convention provides not only an opportunity for taxpayers to initiate competent authority discussions or consultations for the purpose of resolving problems arising in individual cases, but also a requirement in more general terms for the competent authorities to resolve by mutual agreement any difficulties and doubts arising as to the interpretation or application of the treaty. In addition it provides an opportunity for them to consult together for the elimination of double taxation in cases not provided for in the treaty. Furthermore, the Model makes it clear in this article that the competent authorities may communicate with each other directly for these purposes (that is to say, they do not need to conduct these discussions through diplomatic channels).

A. Article 25. Mutual agreement procedure

16. The terms of the Model Article are as follows:

> "1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.
>
> 2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time-limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure."

17. Paragraphs 1, 2 and 3, and the first sentence of paragraph 4 of the Model Article are identical with the corresponding provisions of article 25 of the 1977 OECD Model Double Taxation Convention. The remainder of paragraph 4 differs from the OECD Model Article in providing for the development of appropriate techniques for carrying out the mutual agreement procedure. (This development is itself to be achieved in some respect by mutual consultation.) The OECD Model, which is less comprehensive, simply highlights one possible such technique - oral discussions through a commission of representatives of the competent authorities.

18. Experience of the mutual consultation process, under articles in bilateral treaties which follow the general lines of article 25 of the United Nations Model, varies widely from country to country. It appears from the comments of members of the Ad Hoc Group that the greater number of cases has arisen between countries that have a high volume of trade with and investment in each other. For that reason - the comment was made - it was a process that had been most frequently used between developed countries. The use of the mutual consultation procedure between developed and developing countries was often made difficult for the competent authorities of both by the fact that their countries were geographically distant from each other and that the process therefore was likely to be costly in comparison with discussions between countries nearer at hand. Developing countries in fact generally had little experience in operating the procedure.

19. Nevertheless, it seemed to members that it was a process of relevance to both developed and developing countries and might become of greater relevance as time went by. Some developing countries, it was pointed out, might feel that the process was not of great value to them since it could be time-consuming and might lead to a loss of revenue. Others had largely taken the view, at least in the past, that they would not be usefully employed in intervening in disputes between their taxpayers and the tax authorities of other countries. On the other hand, it was suggested that to engage in a mutual consultation process could be useful to tax authorities themselves in enabling them to resolve difficulties in matters of principle in a manner satisfactory to the tax authorities of both contracting States. It was also suggested that the fact that the process was available and that taxpayers were confident that they could invoke it could make them less anxious about the possibility of suffering taxation that they thought was unfair and more ready, in consequence, to invest in the country concerned and put themselves into a taxable situation. Consequently, it seemed valuable for the Ad Hoc Group to discuss the experience of those countries that had operated the

process and to supplement the discussion of the topic which appeared in the Guidelines published in 1979 (United Nations publication, Sales No. E.79.XVI.3).

20. It was suggested, however, that much could be done to prevent situations in which the mutual consultation article needed to be invoked. If the taxation authorities of a country were prepared to make arrangements to listen regularly to taxpayers or to their representative bodies, including foreign investors or their representative bodies, and to discuss in general terms with them the way the tax system impinged on the activities of industries and investments, they were likely to hear of the possibility of problems, or of cases in which problems were likely to arise, far in advance of the problems getting to the stage where it became necessary to seek solutions by a formal invocation of the procedure.

21. In addition, it was suggested, that if tax administrations took positive steps to inform taxpayers of the ways in which their tax laws operated (for example, by publishing leaflets, newspaper or magazine articles, giving lectures, etc.), taxpayers would possibly gain a better understanding of these matters, and the difficulties giving rise to a need for a mutual agreement procedure might be less likely to occur. It would also be very helpful if tax authorities supplied the tax authorities of their treaty partner countries with full and up-to-date information about their tax laws and practices so as to facilitate their treaty partners' knowledge and understanding of these matters and to enable them to advise their own taxpayers where need be about the tax consequences of activities in the country supplying the information. Even more helpful, it was suggested, would be the publication by tax authorities of statements of policy in particular areas, making clear their view of the impact of tax laws or particular situations.

22. In general, tax authorities who had experience with the procedure believed that it was working well. It was infrequent that a solution could not be found by the process, although the solutions accepted might not always be wholly acceptable to tax administrations or taxpayers, in all cases. A significant problem was the time that it often took to bring a mutual agreement procedure to a conclusion. The Group recommended that tax administrations should make every effort possible to keep such delays to a minimum.

23. It was pointed out that if an agreed solution could not be found, then the domestic law and practice of each of the two States had to apply. Consequently, it might not be possible to avoid double taxation, although some countries at least would be able to mitigate the full impact of this double taxation by allowing the relevant foreign tax to be deducted in arriving at the income or profits taxable in those countries.

24. The result of an inability to reach agreement in an important case or range of cases, however, might be that either or both countries would recognize that it was necessary to revise the treaty or amend their domestic law.

25. In the Group's experience, however, that situation was exceptional. So far, it had usually been possible to find a solution, often a compromise, to most problems arising in that context. However, there were situations in which there was no room for compromise. Such situations might arise, for example, where the question was whether a person was a resident or domiciled in a particular country, whether a taxpayer had a permanent establishment in a particular country, whether income was attributable to a permanent establishment, or whether a person was suffering from discriminatory taxation.

26. In such cases, where an agreed solution could not be achieved, it would, in the view of one developed country, be highly desirable to draw up, within the framework of the United Nations Model Convention, a standard clause explicitly empowering the competent authorities that were in disagreement to seek the opinion of outside experts. It would even be appropriate in that country's view to consider the possibility of making the mechanism binding in some measure - either by making recourse to experts mandatory, even if the competent authorities were not bound to act in accordance with their opinion, or by leaving such recourse optional but, in that case, making the experts' point of view mandatory. There was little support in the Group for the use of experts.

27. The possibility that the mutual agreement procedure might fail to produce results satisfactory to all parties gave rise to suggestions that the competent authorities should be required, if they could not agree on a satisfactory solution to a problem, to submit the problem to independent arbitration. However, the question of a formal arbitration procedure to deal with otherwise unresolvable mutual consultation cases was discussed at length at the Group's third meeting in 1987. The Group's view at that time was that it was not appropriate to raise the issue again.

28. Many cases seemed to be settled by correspondence, and although in some cases a considerable effort might have to be made by both tax administrations and by the taxpayer by way of face-to-face meetings and the provision of a good deal of information, that was by no means always the case.

29. The process might be invoked in relation to any article of the Model Convention. The process had, in fact, been invoked in a wide variety of cases, as the following examples illustrate - for example, questions as to:

(a) Transfer pricing issues (those cases were perhaps the most numerous in the context in some countries);

(b) The residence of a taxpayer for the purposes of a treaty;

(c) The existence or not of a permanent establishment and of the profits attributable to such a permanent establishment;

(d) Whether payments described as being made for services or the rent of equipment were correctly so described or were payments for the use of an intangible right, such as royalties;

(e) Whether the air transport and shipping profits article applied to leased ships or aircraft;

(f) The application of the teachers' exemption found in some bilateral treaties;

(g) Whether the non-discrimination article applied;

(h) The source of the items of income;

(i) The interpretation of a provision in a treaty providing matching relief for tax spared;

(j) Whether one or the other of the treaty partner countries should withhold tax from or change tax on the remuneration of migrant or cross-border workers or entrepreneurs;

(k) The definition of terms used in the relevant convention.

30. The mutual agreement procedure in fact seems to be most widely used in endeavours to resolve difficulties arising in the application of tax treaties to particular taxpayers' affairs. The power to use mutual agreement to resolve difficulties about the interpretation of treaties in cases initiated by the competent authorities themselves is at present less frequently used, although the solution of individual cases sometimes does lead to the agreement of a more general interpretation of particular terms of a treaty, and the procedure is occasionally used simply to agree on an interpretation of terms of a treaty without reference to any specific actual case. (Such consultations may often be conveniently carried out by way of informal contacts between representatives of the competent authorities.) The power to arrive by mutual agreement at the elimination of double taxation "in cases not provided for in the Convention" seems, in the experience of the Group, not to be widely used at present. It does not yet seem to have been necessary for competent authorities to develop formal bilateral procedures, conditions, methods or techniques for the implementation of the relevant articles in bilateral treaties, but some countries have devised formal unilateral procedures to regulate the use of the procedure by their own taxpayers.

B. Interaction of the mutual agreement procedure and domestic law

31. Article 25 of the United Nations Model Convention provides that a taxpayer entitled to ask the competent authorities of a contracting State to enter into a mutual agreement procedure may do so "irrespective of the remedies provided by the domestic law" of either of the contracting States. It provides also that "any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the contracting States". If a bilateral treaty contains an article along the lines of article 25 of the Model in which these provisions appear, then it is possible to avoid some, though not all, of the problems concerned with the interrelationship of the mutual agreement procedure and the operations of the domestic law of the contracting States. However, a bilateral treaty may for one reason or another not contain such provisions - perhaps because the treaty was negotiated before the publication of the Model, or perhaps because the domestic law of one or other of the contracting States does not allow the inclusion of such provisions in a treaty. (The legislatures of some countries would find it difficult if not impossible to accept that agreements between officials should take precedence over domestic law.)

32. It, therefore, seemed useful to the Group to devote some attention to the problems that might arise in the absence of such provisions. Also, since the Model Article only provides an overriding of domestic law in the case of time-limits, it seemed useful to the Group to consider what happened or might happen when a mutual agreement between competent authorities conflicted with some other aspects of domestic law. The Group made no recommendations in that context. A selection of comments made by the members of the Group is given below to illustrate how, in practice, a variety of countries approach the problem of potential conflict between the mutual agreement procedure and domestic legal rules or court decisions. These illustrations are not to be taken as suggestions by the Group that any particular approach should be followed.

33. If a bilateral treaty allows a taxpayer to ask for a mutual agreement procedure to be begun irrespective of the remedies which may be available to him under the domestic laws of the contracting States, then there does not seem to be any possibility of either competent authority being in a position to require the taxpayer to give up his rights of appeal or other recourse to the law courts of either country as a condition of entering into a mutual agreement process. In theory, this could allow the taxpayer to seek to use both the mutual agreement procedure and the court procedure and opt for the result which gives him most advantage. Some members felt that this could give taxpayers an undue benefit and that a taxpayer should be required to choose whether to follow one path or the other, and if he had chosen of his own volition to go to the courts, he should abide by the result of his choice. Other members thought that it would be unfair to require a taxpayer to give up his right of recourse to the courts in favour of recourse to the mutual agreement procedure if he could not be sure of a satisfactory outcome by way of the mutual agreement procedure. In practice, however, the ability of taxpayers to opt for the most advantageous result of the two processes does not yet seem to have created serious problems. Moreover, some members expressed the view that it was proper that the taxpayer should be able to use both procedures.

34. A member from one developed country pointed out that some competent authorities had taken the view that a taxpayer should seek to remedy his grievance first through the courts and seek to invoke the mutual agreement procedure only if the court decision was unsatisfactory to him. That attitude was prompted by the desire to avoid the necessity for competent authorities to engage in mutual consultations under the article when the matter might be settled satisfactorily by the ordinary operation of domestic law procedures. If the outcome of those procedures was not satisfactory to the taxpayer however, it was pointed out, the result would be to delay considerably the beginning of mutual consultation. Moreover, if the court decision was not satisfactory to the taxpayer, he could not hope to get a more satisfactory result by invoking the mutual agreement procedure, unless the result of that could take precedence over the decision in the relevant court. In some countries that was possible, but in others it was not. But it could not in any case be guaranteed that the result of the mutual agreement procedure would be satisfactory to him either.

35. If the taxpayer was required to start one or the other of the processes first, it seemed to some members that the most satisfactory one to start first would be the mutual agreement procedure, since if it proved unsatisfactory to the taxpayer, it would be less difficult in a number of countries to override the decision of the competent authorities than to override a decision of the courts. But to do that, in some countries the taxpayer would have to take some positive legal steps, such as making a formal appeal against an assessment, in order to preserve his right to take the matter to the courts at a later stage.

36. It was suggested that the problems of maintaining a satisfactory relationship between the mutual agreement procedure and the legal procedures open to a taxpayer could often be solved by arrangements to defer the hearing of court cases until mutual agreement procedures had been completed and had been either successful or unsuccessful in producing a solution to the satisfaction of the taxpayer. (For that to be done, it was pointed out, it would ordinarily be necessary for the competent authorities of the country in which the court procedure was being used to agree with the appellant taxpayer that the hearing could be deferred. The competent authorities of the other country would have no rights to intervene in the matter.)

37. The Group noted that in cases of that sort where legal hearings were deferred, a prudent tax administration might need to take measures of conservancy to ensure that tax due or potentially due in the case but not already collected remained available for collection when the matter was settled.

38. It was suggested that informal consultations between competent authorities could be helpful in minimizing potential conflict between the judicial process and the mutual agreement procedure in certain circumstances. If, for example, a taxpayer had appealed against a charge to tax, or made a claim to relief in Country R on the grounds that he had paid tax in Country S, he would have formally started a legal process in Country R. But he need not necessarily at that point have firmly decided to go to the courts and could be simply protecting his rights to do so in the future if the tax authority did not accept his appeal or claim. If it so happened that the tax authorities of Country R had charged the tax or refused the claim because they held that Country S, if it had complied with the tax treaty between the two countries, should not have charged the tax, then it might well be sensible for the competent authorities of Country R to discuss the matter informally with the competent authorities of Country S to see if that country could give up its charge to tax, even if the taxpayer had not asked them to consult their opposite numbers. If countries could do so then there probably would be no objection on the part of the taxpayer, but it would be courteous to consult him about entering into the discussions before doing so. If the outcome of the discussions was a compromise agreed between the competent authorities, then the taxpayer would have to be asked whether or not he accepted the compromise. If he did, then the legal process he had formally started would be unnecessary. If he did not, then the legal process could be pursued.

39. In this area time-limits are matters of considerable importance. There are two aspects:

(a) The time-limit within which the procedure must be invoked;

(b) Other time-limits in the domestic law of the contracting States which interfere with the ability of the competent authorities to give effect to any results achieved.

40. Some countries, it was pointed out, do not feel the need for the first kind of time-limit in their bilateral treaties, because their domestic time-limits are very limited. It was emphasized by several members that there is a need for some time-limit to be set to ensure that the request for mutual agreement is made within a reasonable time so that the relevant facts and documents will still be in the files of the tax administration and can, therefore, be made available to the competent authorities of both countries when they are called upon to operate the procedure. If the domestic time-limits are overridden by the treaty, as they would be under the Model Article, then, it was pointed out, a provision may be needed in the Article itself - as provided in the Model - limiting the time within which the procedure can be set in motion, or the taxpayer would be able to set it in motion at any time. Because the mutual agreement procedure can often only start quite late in the process of dealing with a tax assessment, it was suggested that tax treaties should allow as long a period as possible to the taxpayer to invoke the procedure, and that tax authorities should be as flexible as possible about accepting requests to invoke the procedure, even if they were not yet fully documented (provided that they were adequately documented in reasonable time, whether or not this occurred before or after the expiry of the relevant

time-limit). A comment was made that this kind of flexibility might not be easy to maintain - a tax authority would often need at least sufficient documentation to know accurately enough for its purposes what the point for discussion was before it could accept that it had in fact received a request for the invocation of the procedure. It was suggested, however, that the extent of the information required in such cases could be determined either by the treaty negotiations in the course of their discussions or, on the basis of experience, by competent authority agreement at a later stage. It was also suggested that tax authorities could help by being prepared to accept late requests if good cause could be shown for the lateness.

41. As concerns time-limits in domestic law which interfere with the implementation of the results of the mutual agreement procedure, if these cannot be overridden or mitigated in the same way as suggested above in the case of time-limits in the treaty, then the Group underlined its recommendation that every effort should be made by the authorities to ensure that a mutual agreement procedure, once started, should be carried out as quickly as possible.

C. Need for flexibility and compromise

42. It had been accepted that the process was essentially one of compromises. The implementation of agreements reached by competent authorities in their discussions might, however, be hindered if their internal law did not provide sufficient flexibility to enable them to make satisfactory compromises within the law, and it seems desirable that treaties should be so drafted as to provide as much flexibility in that context as possible.

D. Deferment of tax

43. It was suggested that in order to prevent the taxpayer from suffering double taxation for the period while a mutual agreement procedure was in progress, one or other of the two countries concerned should defer collection of the tax in dispute. Typically, the mutual agreement procedure would be invoked where it was a question of whether tax on business profits, for example, should rightly be paid to the country of residence of the taxpayer or to the country of source of the income. One of the two countries will already have charged tax on the income before the other, and tax will have been paid in the first country. The other country also claims the right to tax the income, and formally charges it to tax. The taxpayer will then have to pay tax in the second country, after already having paid tax in relation to those profits in the first. To prevent this from happening, it was suggested that the tax treaty between the two countries should expressly provide that if the mutual agreement procedure was invoked, the second country should be required to defer payment of its tax until the finalization of the procedure.

44. It was agreed, however, that it would not always be appropriate that the first country to impose its tax should collect it while the second country had to wait. The possibility was also raised that both countries might defer the tax.

45. In the discussion it was pointed out that it would not be possible to defer the payment of tax in some countries where a taxpayer needed to show that he had paid some proportion of the tax due under an assessment before he could appeal

against the assessment and thus provide a legal basis for a request to the competent authority to begin the mutual agreement procedure. On the other hand, some countries that were geographically and culturally very close to each other had in fact come to an arrangement with each other under which tax paid to one of the countries could in certain circumstances be regarded for this kind of purpose as tax paid to another, and, if the issue was essentially which country it could be paid to, it could, if necessary, be transferred directly from one country to the other when, as a result of a mutual agreement procedure, it was accepted that it was rightly due to that other country. If the payment of tax could not be co-ordinated in this way, one member suggested it could be beneficial both to taxpayers and tax authorities to arrive at some co-ordinated arrangement to deal with any payment or charging of interest by the tax authorities on overpayments and underpayments of tax.

E. Grounds on which request for procedure may be denied

46. Under the law in one developed country, the competent authority may refuse to introduce a mutual agreement procedure if a taxpayer has acted in bad faith; that is the case, for instance, if the information submitted by the taxpayer to the tax authorities of one of the contracting States differs from that submitted by it on the same matter to the other contracting State in order to obtain tax benefits. In addition, the introduction of a mutual agreement procedure may be refused if the general interests of that country abroad could be exposed to risk; in such a case the effects of taxation contrary to a convention could, however, be alleviated or avoided by internal measures. Furthermore, a mutual agreement procedure cannot be carried out where a convention expressly allows double taxation; nor would it be initiated where the procedure has led to no result in comparable cases.

47. Some members thought that it followed from the wording of the Model Article (under which the procedure could only be initiated by a competent authority if that authority accepted that the taxpayer's complaint seemed to be justified), that bad faith on the part of the taxpayer would invalidate the request for the invocation of the procedure. On the other hand, the view was expressed that it was undesirable to penalize a taxpayer twice, once by penalties for fraud or other varieties of bad faith under the domestic law, and again by refusing to enter into discussions for the purpose of relieving his double taxation. The view was also expressed that a competent authority should not regard a failure to reach a satisfactory agreement with another competent authority on a certain set of facts as automatic grounds for refusal to attempt to reach an agreement in other cases on similar sets of facts, although it had to be recognized that if a country had clearly refused to accept a particular kind of claim in one case, there would be little point in raising others of the same kind, at any rate for some time.

F. Appeal against a decision not to begin the mutual agreement procedure

48. If a competent authority refuses to undertake mutual agreement or consultation discussions with another competent authority when asked to do so by a taxpayer, in some countries the taxpayer may be able to go to the administrative procedure or to the law courts of the country concerned and seek to compel the competent authority to enter into such discussions. But the competent authority may not compel the other competent authority to enter into them.

49. If a mutual agreement procedure cannot be started or the competent authorities are unable to reach a satisfactory solution and the relevant country is unable to solve the problem unilaterally, there is clearly a risk that the taxpayer will be left bearing some double taxation. In this situation some countries would be able to mitigate the double taxation to a certain extent by allowing the other country's tax as a deduction in computing taxable income. The Group's feeling, however, was that every effort should be made to provide complete relief from double taxation wherever possible.

G. Provision of illustrative examples

50. Some countries were able to illustrate the application of the process by providing summaries of particular cases or groups of cases. Others had been deterred by considerations of confidentiality or other reasons from providing examples. The possibility was examined of providing guidance on how to deal with particular matters by means of such summaries, but it was thought there were insufficient cases for that to become a reality at this time. Moreover, it was argued by some members that since the solutions so often depended on the special and particular facts of each case, the building up of a volume of procedures was not as promising a prospect as it might seem on the surface. Confidentiality would usually prevent the publication of full details and, while the publication of anonymous summaries of cases might get round this particular difficulty, it could well mislead the reader into thinking that a case quoted was exactly similar to another one, and should be followed in deciding the issue arising in that other case, when, if the full facts were known, it would be seen that they were not wholly similar and should be treated differently. Moreover, it was argued by a member from a developed country that because the facts of each case would be special to each case, the attempt to decide other cases by using earlier decisions as precedents could give rise to a rigidity in the decision process which could make for less satisfactory decisions than a process of examining each case on its own. On the other hand, examples showing how the process of mutual consultation had gone in particular cases could be instructive, provided they were clearly understood not to be regarded as precedent material and, in fact, a few cases are summarized below purely as instructive illustrations.

51. It should be clearly understood that these examples merely illustrate the ways in which the procedure has been used in particular instances by particular countries. It does not follow that other countries would or should solve similar problems in the same way.

52. A developed country gave evidence of interpretative consultation procedures with its neighbouring countries. The agreements reached define with respect to specific activities the relevant circumstances that would imply that a permanent establishment exists in the other country. These agreements are, and actually have been, subject to change because of changing circumstances and guidance given by court decisions.

53. In a second case, the tax authorities of one country disallowed as an expense deduction part of the royalty payments made by a subsidiary company to its parent company in another country on the grounds that the rate of royalty under the agreement between parents and subsidiary was excessively high. The subsidiary appealed against the disallowance, but the first country's tax authorities maintained their position. At this point, the parent company, which had paid tax

on the royalties in the second country, asked the competent authorities of that country for their help in the matter. They then wrote to the competent authorities of the first country. An exchange of letters, accompanied by background reports and exhibits, explained the respective views supporting the positions taken. While inconclusive, the correspondence served to define more clearly the points in disagreement. It was then followed up by a meeting of representatives of the competent authorities at which those of the second country discussed the comparability of the royalty agreement to similar agreements between the parent company and related companies, and the comparability of the effective rate of the royalty payments with rates payable industry-wide.

54. In their turn, the representatives of the first country produced data to show that the ratio of total royalties paid by subsidiaries in their country to other parent companies in the second country was smaller than the ratio in the case in point. Agreement was still not reached at this stage, but both sides concurred in the need for more exchange and analysis of additional information. As a result of that, agreement was reached that a deduction could be allowed for a rather higher rate of royalty than originally contended for by the first country's authorities, and that relief for the economic double taxation remaining could be given by the tax authorities of the second country to the parent company.

55. A third case concerned a question of residence. The taxpayer, a citizen of Country A, had reported his income during a four-year period on the basis that he was a resident of that country during this time. Subsequently, the tax agency of a treaty country (Country B) assessed a deficiency on the ground that he had, in fact, been a resident of the treaty country during each of the four years. The taxpayer requested competent authority assistance on the basis that, as a citizen and resident of Country A, he was not subject to the higher tax rates of Country B.

56. In correspondence with his foreign counterpart, the competent authority of Country A pointed out a number of factors supporting the claim to be a resident of Country A, including the individual's physical presence and full-time employment in the country during a major part of the period. Conversely, the foreign competent authority cited several factors in support of its position, including: the individual's physical presence and employment in Country B during the initial part of the four years and his wife's presence there throughout the entire period; the individual's "immigrant" visa to the treaty country, which placed no restrictions on his stay there; residential property and furnishings in the treaty country owned jointly by the individual and his wife and the absence of such property in Country A; use of a Country B address in filing property tax returns in that country; and the use of bank accounts located, and a driver's licence issued, in the treaty country, neutralized as factors by similar Country A accounts and a Country A licence.

57. In view of these conflicting factors, the case was resolved by an agreement to treat the taxpayer as a resident of Country B during the first two years in question and a resident of Country A during the latter two years. Thus a reasonable solution, acceptable to both countries and the taxpayer, was achieved through the co-operation of the competent authorities. The case illustrates the point that divergent views in these situations can justify a result which neither the tax agencies nor the taxpayers involved would reach independently.

58. Two further cases illustrate a co-operative effort on the part of two sets of competent authorities to agree on reasonable, consistent rules of treaty

application resulting in agreement in one case on Country A's approval and in the other on that of Country B.

59. Two separate cases were controlled by the same treaty provisions. Each case involved payments received by corporations of Country A from wholly-owned subsidiaries in the same country (Country B). The common issue in both cases was whether the payments qualified under the treaty as "industrial and commercial profits" or, alternatively, were royalties paid for the use of technical information. If the former, they could not be taxed by the foreign country under a treaty article exempting such profits, provided the parent company did not maintain a "permanent establishment" in the foreign country. (Applying a treaty definition of the term, it was clear that neither company had such an establishment.) If, on the other hand, the payments were royalties, then they were properly subject to the foreign country's tax under the treaty. In both cases, the foreign tax agency had treated the payments as royalties and accordingly had imposed a foreign withholding tax.

60. The fundamental question to be answered in each case was the nature of the element which Country A companies supplied in exchange for the payments. If technical, financial and other advisory services were the essential element furnished, the payments received would fall within the class of exempt industrial and commercial profits. On the other hand, if the essential element of the agreements was the right to use property in the form of patents, secret processes, formulas, and so on, which had been reduced to plans, blueprints, instructions and other documentary material, then the payments would constitute royalties. The third possibility was divisibility of the payments into portions attributable to services and use of property.

61. A substantial body of data was requested and received from the Country A companies in both cases. This was analysed to determine the nature of the transactions and, in turn, the payments in question. The cases were complicated by the fact that both services and documentary information were furnished to the Country B subsidiaries by the parent companies.

62. Applying pertinent criteria to the facts of one case, it was determined that the furnishing of services was the basic and indispensable element of the transaction. Accordingly, the payments in question should qualify as exempt industrial and commercial profits rather than taxable royalties. No portion of the payments was allocatable to the use of certain non-exclusive patent licences covered under the agreement. The consideration for their use was reciprocal use of patents developed by both companies rather than periodic payments - that is, the Country B company allowed the Country A company use of its patents in turn for use of the Country A's patents. Moreover, the patent agreement was independent from the services agreement: the latter was terminable, whereas the former was not.

63. These factors and the tax result which should follow under the treaty, in the view of Country A authorities, were set forth in a detailed explanation to the competent authority of Country B. The Country A position was subsequently accepted, and Country B's tax agency allowed substantial refunds to the parent company.

64. Applying the same criteria to different facts, the opposite result was reached in the second case. In that instance, the substance of the transaction was found to be the transfer of property in the form of technical documents (for example,

manufacturing drawings and specifications, manuals and handbooks). While the agreement also called for the parent company to furnish certain services to the subsidiary, a close examination led to the conclusion that these were completely auxiliary to the documentary information and solely for the purpose of its effective and expeditious use. Accordingly, the competent authority of Country A agreed that the payments were taxable in full as royalties by Country B. Since the payments were derived from a foreign source, the parent company was allowed a credit against Country A's tax for the withholding taxes imposed by the foreign country, thereby avoiding double taxation.

65. A sixth case illustrates a way in which the mutual agreement procedure may lead to revision of the treaty.

66. This example involved the standard treaty article that exempts income derived from operating ships and aircraft registered in one treaty country from the tax of the other country. In this instance, the issue was whether income received by a Country A airline company from leasing spare aircraft to a Country B airline qualified for this exemption. The contract in question involved a so-called "dry" rather than "wet" lease; that is, the planes were leased without accompanying crews to operate them.

67. The competent authorities of both Country A and Country B were in agreement that wet leases qualified for exemption on the basis that payments thereunder represented income derived from the "operation of aircraft" by the lessor company. The competent authority of Country A had also adopted the view that dry leases qualified if they were helpfully adjunct to the lessor's business; if the planes were acquired for use in the lessor's transportation business, the lessor made every reasonable effort to use them prior to leasing, the leases were relatively short-term, and leasing activities and income were incidental to the lessor company's transport operations. The lease in question met these tests.

68. However, as a result of certain precedents, the competent authority of Country B was unwilling to concur with the broad construction of the exemption provision. For a brief time, it appeared that an impasse had been reached. This would have posed a serious problem to the lessor. If a treaty country tax were withheld from the lease income, various factors (loss carry-overs, investment credits) would have prevented its utilization as a credit against tax in Country A.

69. Following further communications with Country B's competent authority, a provisional solution was reached. A statute of that country permitted special reciprocal exemption agreements with a foreign country when implemented by an order issued by the Government. Accordingly, under that provision, it was agreed to treat aircraft leasing activities of the character in question as exempt from Country B's, or Country A's, tax depending upon the country in which the aircraft was leased.

70. The agreement by its terms ceased to have effect if and when a new income tax treaty entered into force. In this connection, a new treaty was negotiated and became effective approximately two years after the interim agreement. Pursuant to an exchange of notes accompanying the new treaty, it was agreed that the revised shipping and aircraft provision therein operated to exempt income from the leasing of ships and planes involved in international traffic.

H. Recommendations

71. The following recommendations were made by the Ad Hoc Group:

(a) Competent authorities should be prepared to make more use of the mutual agreement or mutual consultation procedure in the future, since it gives the taxpayer an assurance that, if difficulty arises about the correct application of a tax treaty, he can, in effect, enlist the assistance of the competent authorities of both contracting States (the experts in these matters) in solving the problem. In order to be able to do this, the competent authority should, as early as possible in the discussions with the competent authorities of the contracting States (for example, during the negotiation of the relevant treaty itself), seek to arrive, with the other competent authorities at a good understanding of what would be involved in a mutual agreement procedure between them, such as the modalities of the procedure, the legal limitations on taking up consultations or implementing agreements arrived at and the means of shortening the time likely to be taken;

(b) Tax authorities should endeavour to obviate, as far as possible, the necessity for invoking the procedure by publicizing, to those likely to be affected by them, their tax rules and practices;

(c) For that purpose among others, competent authorities should provide each other with the fullest possible information, not only of changes in their tax law but also of official publications, explanatory pamphlets, published rulings, and so on, relating to their tax laws, regulations, policies and practices;

(d) Competent authorities should always approach requests to enter into the mutual agreement bearing in mind that the procedure was designed in the first place to protect the taxpayer; they should be ready to apply as much flexibility as possible, within the relevant law, to ensure that the taxpayer is treated in conformity with the treaty and should make every effort to carry out the procedure as quickly as possible, where the taxpayer's request to begin it seems to them to be justified.

I. Conclusions

72. The members of the Group were of the opinion that the discussions had been very helpful. They had illuminated the uses and possible usefulness of the mutual agreement procedure, the techniques which could be employed in carrying it out, the problems involved and some possible solutions. The Group thought that it would be very useful to look at the matter again in this form in due course in the light of developments. The Group also felt that the present report should be given the widest possible circulation so that others could benefit from the discussions.

73. It was valuable to hear the different views brought out in the discussion and to note the variation between the approaches of the developed countries on the one hand and the developing countries on the other, on such matters as the differing views about the relationship between the mutual agreement procedure and the normal domestic remedies, especially those involving court proceedings.

II. MONITORING THE IMPACT OF THE UNITED NATIONS MODEL CONVENTION ON BILATERAL NEGOTIATIONS

74. The Ad Hoc Group made a very detailed study, as recently as 1985, of the way in which the United Nations Model Convention was being used in bilateral negotiations. The Group expressed the view that, while it was not yet time for a major revision of the model, it was desirable to keep the model under more or less continuous review in order to identify particular problems and the solutions that were or could be proposed for them. It was decided, therefore, to keep the topic as a permanent item on the agenda for all subsequent meetings until further notice.

75. It seems useful, in the first place, to note the kind of comments that were made in contributions to the work of the Group on the occasion of the 1989 meeting, even though, to a large extent, the comments indicated that countries still held very much the same views they had held in 1985 about the ways in which the model varied from what they would regard as the ideal. In general, it seemed that the model continued to be regarded as very useful in facilitating the negotiation of treaties between developed and developing countries, even though, as is true with all model treaties, bilateral treaties inevitably vary in some detail from it.

76. However, it was proposed that an examination in more depth than had been possible during the wide-ranging review carried out in 1985 should be made by the Group of a limited number of topics at each meeting with the object, for example, of clarifying the meaning of phrases shown to be imprecise or illuminating the different views that might have been taken of particular concepts or terms, or perhaps indicating possible compromises if the negotiating partners either could not accept the model as it stood or could not accept the other country's alternative.

77. It was emphasized in the Group's discussions that in considering the impact of the United Nations Model, it should not be forgotten that the Model represented in itself a considerable compromise between the views of developing countries, and those of developed countries, and that in following it, each group of countries would, in many cases, have gone a long way already towards meeting the views of the other.

78. Nevertheless, it had to be recognized that in practice, it was not always possible for either a particular developed or a developing country to follow the Model in every detail. Consequently, it seemed useful to the Group to examine some of the variations adopted in bilateral treaties between developed and developing countries in order to illustrate how far such variants approached the Model or diverged from it.

79. It was decided that articles 5 and 7 of the Model should be considered in some detail.

A. Article 5. Permanent establishment

80. Article 5 is as follows:

Article 5

PERMANENT ESTABLISHMENT

"1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly carried on.

"2. The term "permanent establishment" includes especially:

(a) a place of management;

(b) a branch;

(c) an office;

(d) a factory;

(e) a workshop;

(f) a mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

"3. The term "permanent establishment" likewise encompasses:

(a) A building site, a construction, assembly or installation project or supervisory activities in connexion therewith, but only where such site, project or activities continue for a period of more than six months; and

(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 where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

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

(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

"5. Notwithstanding the provisions of paragraphs 1 and 2, where a person - other than an agent of an independent status to whom paragraph 7 applies is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that 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:

(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 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of the paragraph; 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.

"6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

"7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.

"8. 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."

B. Deliveries

81. One developed country explained how it had dealt in bilateral negotiations with the problem that it found the deletion, from the paragraphs 4 (a) and 4 (b) of the Model, of the word "delivery" inappropriate. In the view of that country, the use of facilities or the maintenance of a stock of goods merely for the purpose of delivering goods or merchandise should not rise to the level of a permanent establishment. For example, if a company of Country A is selling an item of merchandise directly to individuals residents of a developing country and is shipping the goods directly to the purchasers, with no sales activity or presence in the developing country, there would be no permanent establishment and no local tax on the company. If, however, the word "delivery" is deleted and instead of shipping each item separately to the purchasers, the company shipped several of the

items to an independent warehouse in the developing country and they were then delivered from the warehouse to each purchaser, the company would have a permanent establishment and would be subject to tax. It is difficult in the developed country's view to distinguish these substantively between cases. Furthermore, it is difficult to identify the income properly attributable to the permanent establishment in the latter case. Where, however, another country has insisted on broadening the permanent establishment definition in this regard, the developed country concerned sought a compromise in one of three ways:

(a) The preferred solution has been to add to the list in paragraph 2 of fixed places of business which constitute a permanent establishment, "a store or other premises used as a sales outlet". The word "delivery" is retained in paragraphs 4 (a) and 4 (b), but the following phrase is added to each of those subparagraphs: "... other than goods or merchandise held for sale by such enterprise in a store or premises used as a sales outlet". Thus, mere delivery could constitute a permanent establishment only if the delivery is from a store or other sales outlet. The sort of case described in the example above would not constitute a permanent establishment;

(b) A less desirable solution from that country's point of view, but one used in that country's treaties with a few developing countries, is to delete the word "delivery" from paragraphs 4 (a) and 4 (b), but to add a new paragraph 5, which states:

> "Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall not be deemed to include the use of facilities or the maintenance of a stock of goods or merchandise belonging to the enterprise for the purpose of occasional delivery of such goods or merchandise.";

(c) A result similar to that of (b) is achieved by modifying paragraphs 4 (a) and 4 (b) to specify that "occasional delivery" is not a permanent establishment.

82. Approaches (b) and (c) are intended to exclude from the definition of a permanent establishment the activity of a company shipping items of merchandise to an independent warehouse in the developing country, each of the items being delivered separately to the purchasers from that warehouse. However, the consequence of using either of these approaches is that in order to determine whether or not tax is chargeable, the tax authorities of the developing country would need to make an inquiry as to the fact to determine the frequency and regularity of such deliveries. This would inevitably make the impact of the provision less certain than for example, the approach detailed in (a).

C. Dependent agent delivering from a stock of goods

83. A similar difficulty faced the same developed country in using paragraph 5 (b) of article 5 of the United Nations Model. The inclusion of this paragraph will cause a dependent agent to be a permanent establishment by virtue of merely maintaining a stock of goods from which he makes delivery. In that country's view this activity (not being in itself an income producing activity) is not sufficient to create a permanent establishment. To make paragraph 5 (b) acceptable to it, the developed country in question seeks to ensure that an income-producing activity is associated with the stock of goods before a permanent establishment is deemed to exist. It therefore adds the following phrase to the end of the subparagraph:

"... and additional activities conducted in that State on behalf of the enterprise have contributed to the conclusion of the sale of such goods or merchandise". It should be noted that these additional activities need not be carried on by the agent. They may be carried on by the home office or by another agent. This remains a broader test for a permanent establishment than the OECD Model provides, but it does require some sales-related activity to have taken place in the country before a permanent establishment can be deemed to exist.

84. Group members from developing countries recognized that this was a real attempt to achieve an acceptable compromise solution, but a number of them emphasized that they would not find it acceptable. The view was expressed that if an agent delivered from a stock of goods on a regular basis, it was difficult to accept the argument that the principal did not have a permanent establishment where the stock was situated. He was in any case carrying on an activity with a view to making a profit, and the profit should be taxed somewhere. There was no obvious reason - the argument continued - why that should be in the seller's country of residence - which would normally be a developed country - rather than in the country where the stock was maintained. Moreover, modern means of communication made it easier than in the past to sell goods without using the limited categories of methods which developed countries would normally regard as a permanent establishment, and in order to offset the consequent loss of revenue to developing countries, it was important to maintain as broad a definition of permanent establishment as possible. Members from both developed and developing countries pointed out, moreover, that the compromise suggested meant that the incidence of taxation on the entrepreneur was less certain than it would be under the provisions of either the United Nations or the OECD Model.

D. Article 5, paragraph 3. The furnishing of services

85. In the experience of one developing country, the absence of a furnishing services provision in a bilateral tax treaty, such as that of paragraph 3 (b) of article 5 of the United Nations Model, has created difficulties in determining whether the premises used to provide services to a resident of a source country can be considered as a permanent establishment or not. In such a treaty, there are no conditions specified under which the furnishing of services which would be considered as a permanent establishment. Consequently, the definition of "permanent establishment" depends simply on whether or not a fixed place of business exists in the source country.

86. From the commentary on article 5, paragraph 1 of the OECD Model (reproduced in the commentaries to the United Nations Model), it is clear that a place of business does exist if there are any premises, facilities or installations used for carrying on the business of the enterprise, without taking into consideration whether such premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise.

87. It was suggested by the member from the developing country concerned, that it seemed reasonable that the place or the premises used by the enterprise to render the services should be considered a permanent establishment. However, in his experience, that argument was often only reluctantly accepted by the competent authorities of the residence country who would argue that the premises used by the enterprise were not at the disposal of the enterprise to carry on its business but rather only to make the provision of services possible.

88. The Group noted the point, which reflected a well-known difference of approach between developed and developing countries. It did not appear that compromise provisions had emerged to bridge the difference if developed countries concerned were unable to accept the United Nations Model's provision.

89. The following other points were also brought to the attention of the Group in the context of paragraph 3 of article 5 of the Model.

90. A developed country expressed the view that service activities taking the form of supervision of the assembly or installation of industrial or commercial plant or equipment by the enterprise selling the equipment cannot, regardless of their duration, constituted a permanent establishment if the expenses incurred in connection with such activities were incidental to the sale and the conditions for there to be a permanent establishment of the enterprise were not otherwise met. It was not logical, in that country's view, for an enterprise to be considered to have a permanent establishment solely on the grounds that its activity was carried on within the framework of an establishment owned by another enterprise (or by a public body, in the case of a site or project).

91. In the experience of another developed country, payments for the furnishing of services may, for practical reasons, be subject in some countries to a withholding tax on the gross amount instead of the income tax (or corporation tax) on net profits. However, the consequence of that different way of taxing such payments should not, in that country's view, be that they became passive income; on the contrary, it held the view that the restrictions provided for in paragraph 3 (b) should also apply when the payments are taxed by way of withholding. (That is to say, that tax should only be withheld where the furnishing of services continued - for the same or a connected project - within the country for a period or periods aggregating more than six months during any 12-month period.)

92. Developing countries in general continued to take the view that article 5 (3) (b) of the United Nations Model represented the limit of any compromise which they could feel justified in accepting.

E. Construction or building site, or installation project

93. With respect to building sites, etc., (article 5 (3) (a) of the Model), a number of countries asked for a time period of less than six months. It was explained by a member from a developing country that it was desirable in the view of developing countries in order to take account of improvements in technology and the price of investment. In the view of one developed country, a period of six months was too short to constitute a permanent establishment, since if such a short period were taken, it would have the effect of treating almost every building site as a permanent establishment. The Group did not achieve any compromise solution to that difference of opinion.

94. Some members from developing countries argued that modern methods and technology had made it easier than ever before to complete construction works quickly and that the six months' period was becoming less easy to accept. One member from a developing country mentioned the case of two similar construction projects in a developing country, one carried out by an enterprise of a developing country and the other by an enterprise of a developed country. The enterprise of the developing country would almost inevitably be using older methods and

technology, while the enterprise of the developed country would fairly certainly be using more up-to-date methods and equipment and consequently would be able to finish the job in much less time; he wondered why that enterprise should avoid paying tax in the country where the construction was being done while the other had to pay tax, because it took longer to complete its work. A member from a developed country commented that there were always bound to be differences in competence and capability between enterprises, but it was impractical to seek to compensate for those differences in the tax treatment of the different enterprises. Members from developing countries, however, saw an enterprise carrying out a construction project in a country as an enterprise carrying on an economic activity in that country the profits from which, in principle, should be taxed in the country where the activity was carried on. In fact, some members from developing countries regarded the length of time needed to carry out such a project as immaterial and would regard it as logical to tax whenever a construction project existed. Construction firms could always, they argued, arrange to keep within whatever time test period was laid down.

95. A member from a developed country argued that the result of taxing non-residents on the profits from construction projects was merely to induce the construction enterprises to recover the tax by inflating the price charged to the customer. Another member from a developed country commented that a purpose of tax treaties was to encourage industry from outside a country to invest and carry on business therein. It seemed to him more likely that it would be encouraged by excluding short-term construction activity from taxation than by seeking to tax it. He observed that a treaty which merely restated the taxing rules and thresholds of the source country's internal law served no purpose at all.

96. A member from a developing country commented that there was a practical need to maintain a balance between upholding what was thought to be a proper right to tax and the need to encourage inward investment and industry from abroad. He did not think that it would always be possible for construction enterprises to recover tax by increasing prices - other factors, such as competition, would modify that possibility. The technology available to construction enterprises was related to the proximity of the country concerned to other more technologically advanced countries. It also had to be borne in mind that if a developing country was unable to tax non-resident construction enterprises for any reason, it not only felt the loss of tax revenue but also of foreign exchange.

97. Several members from developing countries expressed the view that tax was not such an important factor, as was sometimes argued, in deterring investors or entrepreneurs from investing in a country or starting up a business, and that, similarly, the absence or reduction of tax was not as important a factor, as was sometimes suggested, in inducing them to invest or start up a business in a country.

98. A member from a developing country sought clarification of the following issues:

(a) If it was supposed that a building or construction site or project had existed for more than the time test period, the site then constituted a permanent establishment and, consequently, the activity of such a site could be taxed in the source country. The question arose: how about other projects which were not connected with that site, but are performed by the same enterprise? Should they also be taxed, even though the time test did not apply to each of these projects?

There was some guidance provided in the commentary on the model, but some further consideration of the matter might be useful;

(b) After a building or construction project was completed, if the enterprise did not have any further project for a long period - for example, for two years - did the article provide a right to tax the enterprise on the grounds that it was a permanent establishment before?

99. The commentary on the model is silent about any views which those drafting the model may have held on these matters, but it quotes as relevant the commentary on the OECD model (which has a twelve-month time test period) as follows:

> "The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses)".
>
> "A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of bad weather conditions or a lack of materials but resumed work on 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts parts of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project. The sub-contractor himself has a permanent establishment at the site if his activities there last more than twelve months".
>
> "The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months."

100. A member from a developed country commented that he saw some possibility, if the activities of a construction enterprise were connected and were basically concerned with the same project, that it could be argued that all the activities should be considered together and treated for tax purposes as part of one project, but that should only be done, in his view, if the activities really were all part of the same project. He was of the view that inquiries should be made to ascertain whether that was the case before they were treated as part of one project. Similarly, he did not think that it would be appropriate to treat a construction site or project as a permanent establishment simply because, some years or months before, the enterprise had in fact been engaged in construction in the country and the relevant site, project or activities had then been treated as a permanent enterprise. In any case, in relation to question (a) (see para. 98), the result would depend on whether the relevant treaty incorporated the limited force of attraction rule in article 7 of the United Nations Model.

101. A member from a developing country commented that a permanent establishment, after a few years, might change its status by officially informing the tax authority that it has already ceased its business in the source country and had changed to become a representative office whose only function was to supply information. By doing so, the enterprise expected that it would not be liable to tax in the source country. The suspicion might arise, he continued, that the change reported by the permanent establishment was designed only to avoid taxes in the source country, since it had already established its own business link with the local market and arranged the whole business through the representative. However, he commented, it was difficult to produce evidence to prove such abuse. In that respect, he suggested that the model should clarify the interpretation of the phrase "of an auxilliary character" in the context of a representative office. The Group, however, did not feel that it was appropriate to seek to do that at the present time. Another member from a developing country expressed the view, nevertheless, that the matter should be approached on the basis that an activity which generated profits should be taxed where the activity was carried on.

F. Independent agents

102. Paragraph 7 of article 5 of the United Nations Model, which deals with independent agents is, in the view of one developed country, too broad. Under that provision, an otherwise independent agent becomes a dependent agent of an enterprise if his activities are wholly or almost wholly on behalf of the enterprise. The dependence, or independence, of an agent is determined by economic factors - that is, who bears the entrepreneurial risk - not by the number of enterprises the agent represents. Under the United Nations formulation, if an independent agent in a contracting State represents three enterprises, and two of the three stop dealing with that agent, the third enterprise will suddenly find that it has permanent establishment in that State, even though nothing has changed in the relationship to the agent. In order to make the language acceptable in its treaties, by focusing on the economic relationship between the agent and the enterprise, the member raising the point adds the following language to the end of the paragraph "... if the transactions between the agent and the enterprise were not made under arm's length conditions". He explained that if the agent was in fact a dependent agent this formulation was not relevant; only where the agent was independent would it be necessary to look for non-arm's length transactions. The Group took note of the point. A member from a developed country, while agreeing that paragraph 7 was too broad, felt that the compromise formulation suggested was

unsatisfactory because it lost some of the clarity and precision of the wording of the model. Some members from developing countries also felt that the compromise suffered from a lack of clarity and precision.

G. Short-time threshold rules

103. Where short-time threshold rules are provided in article 5, and particularly where the limited force of attraction rule of article 7 of the United Nations Model is used, one developed country frequently adds an additional rule dealing with the existence of a permanent establishment only a few days during the taxable year. If a treaty provides that a permanent establishment exists when a particular activity is carried on for, say, 183 days or more in a twelve-month period, and the activity is carried on from 20 December 1989 until 20 June 1990, that activity will constitute a permanent establishment. Since the 183 days span two calendar years, any rule to the contrary notwithstanding, there will be a permanent establishment in both years. In the general case, very little income will have been generated during the few days of the permanent establishment's existence in 1989, and in that event, there seems to be little reason to require the enterprise to comply with the requirements of the host country's tax law for that year. In other cases, the enterprise may have been carrying on similar activities directly during 1989 in the country where the permanent establishment is located prior to the establishment of the permanent establishment, and because of the force-of-attraction rule in article 7, a substantial amount of income could be taxable to the enterprise because of the brief presence of the permanent establishment during that year. In order to avoid either result, the developed country concerned adds a rule to such time threshold provisions in article 5 which states that, notwithstanding the basic (e.g., 183-day) rule, "... a permanent establishment shall not exist in any taxable year in which such activity continues within that State for a period or periods aggregating less than 30 days in that taxable year". Thus, in the example given above, while the period from 20 December through 31 December 1989 would be counted in order to determine whether the 183-day threshold test had been met, for purposes of subjecting the enterprise to tax, a permanent establishment would be deemed to exist only in 1990. The Group took note of the point. A comment was made that the illustrations were not related to permanent establishments resulting from oil or petroleum exploration or exploitation activities to which, in the view of some countries, different conditions might perhaps apply.

H. Article 7. Business profits

104. Article 7 of the United Nations Model is as follows:

> "1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

"2. Subject to the provisions of paragraph 3, 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.

"3. 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. 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, 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 head office of the enterprise or any of its other offices.

"4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

"5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

"6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.

"(NOTE: the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)"

105. A major issue for one developed country in negotiations with developing countries has been the characterization and treatment of income from the rental of tangible moveable property (for example, machinery and equipment). The developed country concerned and other developed countries, too, believe that such activity generates business profits. Developing countries frequently seek to treat the income as passive income, taxable (often under the royalty article) on a gross basis.

106. The OECD Model defines royalties to include certain rental income. This characterization is continued under the United Nations Model. Under the OECD Model, however, royalties are exempt from tax at source, while under the United Nations Model, they are taxable at source. Since the publication of the United Nations Model OECD has recommended that in treaties where royalties are taxable at source, business profits treatment should be accorded such rental payments.

107. The developed country that raised the question fully supported the recent OECD decision with respect to rental income. In its view, such rental income should be taxable only when attributable to a permanent establishment and only on a net basis since substantial expenses were often associated with income (for example, interest, depreciation, research and development). The developed country accomplished that in its own model treaty (with respect to both developed and developing countries) by inserting a paragraph in article 7 (Business profits) defining business profits to include income from the rental of tangible personal property. However, with respect to those developing countries that seek to withhold at source on gross rental income, it recognized that business profits treatment would deny the developing country partner the right to tax the income in many cases. That was because, under the permanent establishment definition of the OECD Model, the lessor of the equipment would frequently not have a permanent establishment to which the rental income could be attributed.

108. In order to satisfy the developing country partner that it would, in a broad range of cases, be able to tax rental income, albeit on a net rather than gross basis, the developed country concerned has inserted a provision in article 5 that "the maintenance of substantial equipment or machinery within a contracting State" would constitute a permanent establishment "... but only if such equipment or machinery was maintained within that State for a period of more than _____ consecutive days". Several of its treaties used a 120-day threshold test. He quoted as an example a computer company which was a resident of that country which had no office or other fixed place of business in a developing country and which leased a computer to an enterprise in that developing country. If such rental income was treated as business profits, the computer company would never have a permanent establishment under the OECD Model definition of permanent establishment, and the rental income would never be taxable by the developing country. The addition of the 120-day rule would give the developing country the right to tax net rental income in all but short-term lease cases. The compromise, therefore, was that the developing country would give up the right to tax the gross rental income, limiting its taxing right to the net income, and the developed country would give up the normal permanent establishment protection under which even the net income would frequently not be taxable.

109. Members from developing countries recognized that there the developed country had attempted to solve an actual problem. Some developing countries, however, saw payments for the rental of equipment as essentially passive income and saw no technical grounds for treating them as business income in the absence of other

evidence indicating that they were receipts of an enterprise carrying on a business through a permanent establishment. Other evidence would include, for example, the fact that the lessor regularly carried out maintenance and repairs. The view expressed by one member of a developing country was that the right way to arrive at a satisfactory effective rate of tax on the net income was to negotiate an appropriate withholding rate within the ambit of article 12. However, he saw that a number of difficulties existed in accepting such a compromise. First, there was a conceptual difficulty in regarding the payment of a rent as giving rise to a permanent establishment. Secondly, there was a practical difficulty in that if it was sought to establish the net income as taxable, information was needed which would be difficult possibly to obtain and certainly to verify, since it would all be held by the non-resident receiving the payments. A member from a developing country suggested that it might be possible to tax the payments on a net basis if the treaty partner tax authorities would produce the necessary information under the exchange of information provisions of the relevant treaty, and he urged that the Group should look further into ways and means of improving the operation of such exchange of information provisions.

I. Article 7. Force of attraction

Profits attributable to the permanent establishment: article 7 (1)

110. With regard to the "force of attraction" rule, a developed country had indicated that in its view the taxable income of a permanent establishment could only be the income attributable to its own effective business activity. Consequently, earnings from activities conducted exclusively and directly by the home office with a customer established in the foreign country ought not to be ascribed to a permanent establishment which the enterprise might have in the country.

111. For the same reasons, the same developed country considered that provisions were needed which spelled out the procedures for determining the earnings attributable to a permanent establishment, particularly in the case of all-inclusive contracts of the "turn-key" type. It was unacceptable, in that country's view, for the separate enterprise principle to be diverted from its true purpose and used to ascribe to a permanent establishment a profit derived from the sale of equipment which it was responsible for installing when it had no part in the sale.

112. In the view of that developed country, only in the hypothetical case where it could be proved that the permanent establishment effectively participated in sales which, with a view to tax evasion, were not taken into account in determining its earnings, could improperly dissociated activities be attributed to the permanent establishment. For that reason, the country raising the point was prepared to consider the possibility of including, in convention provisions, the principles underlying articles 7 (1) (b) and 7 (1) (c), but only as a safeguard against abuse - not to be used systematically, but only for the purpose of rectifying clearly abnormal situations. The involvement of such a provision, is moreover, normally subordinate to the implementation of a procedure for agreement between the competent authorities.

113. A member from a second developed country commented that his country was often prepared to compromise in that regard and accept at least some elements of the

force of attraction rules. But its policy was that it would be necessary to establish that the same or similar activities were in fact involved. At some point, he thought, the Group might usefully consider what "same or similar" could be understood to mean.

114. A third developed country made reference to the vagueness of meaning of the expression "same or similar" and indicated that his country saw it as a disadvantage of the force of attraction rule since it reduced the certainty and clarity of tax treaties. In its treaties, his country sought to maintain tax neutrality and saw force of attraction rules as conflicting with that principle. Moreover, where divisions of multinational enterprises were involved in different trades and were acting independently of each other, they could be unfairly penalized by the operation of a force of attraction rule.

115. Another developed country pointed out that, in the course of negotiations, it has been asked on a number of occasions to include a force of attraction provision along the lines of articles 7 (1) (b) and 7 (1) (c) of the United Nations Model Convention. It has been argued by developing countries that it was an anti-evasion measure but it should, in that developed country's view, be circumscribed by safeguards in such a way that it covered only cases of abuse and not cases where there was no question of abuse whatsoever. To date, no effective way had been found to eliminate the overkill effect, which increased as the interpretation given to the words "same or similar kind" became broader.

116. Another developed country also was of the view that the force of attraction rule in paragraph 2 was too broad in its concept and rendered investments through branches unattractive. It held that the discrepancy between paragraph 2 (arm's length principle) and paragraph 3 (head office and branch are not treated as separate enterprises) gave rise to unsatisfactory situations.

117. A member from one developing country stressed that it regarded that question as most important. He appreciated that, from the viewpoint of a developed country, it was difficult to accept that sales which had nothing to do with the permanent establishment of an enterprise should be treated as though they contributed to its profits. But from the point of view of a developing country, the force of attraction concept was needed, because without it the tax administration would need to isolate the activity that was attributable to the permanent establishment, and that was extremely difficult to do. Arguments with developed countries over whether a force of attraction rule should be included in bilateral tax treaties negotiated by his country had often made it difficult to finalize the negotiations. In order to reach agreement, his country had sometimes accepted a compromise along the following lines:

> "Profits derived from the sale of goods or merchandise of the same or similar kinds as those sold, or from other business activities of the same or similar kind as those effected throughout the permanent establishment, may be considered attributable to that permanent establishment if it is proved, including by photocopy or tape recorder, that the permanent establishment was involved in this transaction in any way.
>
> "It is understood that a permanent establishment of an enterprise is considered to be involved in a transaction if such permanent establishment has signed a contract irrespective of the fact that the delivery is partly undertaken by its enterprise."

118. Other members from developing countries gave examples of cases where, in their view, the force of attraction rule was necessary to counter abuse. One was the case in which a permanent establishment acted as a bridge for the activities of its head office - for example, it did not itself enter into contracts but facilitated their conclusion. Another was the case of a head office selling products in a foreign country through a permanent establishment and, at the same time, making direct sales of the same products to customers from the head office without going through the permanent establishment. The head office credited the permanent establishment with a commission on the sale, but the commission was less than the profit margin achieved by the permanent establishment on the sales made by that establishment.

119. After having given careful consideration to the various points of view expressed, the Group came to no firm conclusion but felt that the topic deserved further study with special reference to the interpretation of the phrase "same or similar" in a variety of situations.

III. MATCHING RELIEF FOR TAX SPARED (TAX SPARING)

120. Many developing countries grant tax relief to foreign investors in order to encourage them to invest in those countries.

121. One way of doing this, under the terms of a tax treaty, is to reduce or eliminate the tax which a non-resident enterprise or investor would pay on the income derived from the source country. Thus, withholding tax on dividends which would ordinarily be charged at 20 per cent, for example, might be reduced to 10 per cent or nil.

122. Another way of doing this is to provide, under domestic law, a "tax holiday" for the enterprise or investor. Thus, an enterprise setting up a particular kind of development activity - sometimes known as a "pioneer industry" - in a developing country, may be relieved by that country from all tax on its profits from that activity for several years - perhaps as long as 10 years. Hence, the relief is often called a "tax holiday". The idea is to give the enterprise a long enough period without paying tax to enable it to become established and develop its activity to a point beyond which it could continue and perhaps expand without tax relief. Usually, where the activity is carried out by a subsidiary of a foreign parent company, the relief is conveyed to the parent by provisions exempting from the source country's tax the dividends paid by the subsidiary.

123. Where the recipient of income derived from an enterprise enjoying a tax holiday or other tax relief is a resident of another country, the provision of the relief is effective in giving him a tax advantage if the country of residence exempts that income from tax. (It may do this under a general provision exempting income from foreign sources or as a means of preventing double taxation under a treaty.) If the country of residence, however, does not exempt the foreign income but gives relief for double taxation by the credit method, the enterprise enjoying a tax holiday or other tax relief in the source country (or its shareholders) will not, other things being equal, be able to point to any foreign tax (or will be able only to point to a reduced amount of tax) for which credit can be given. The country of residence will thus charge its full tax on the relevant income, or if it reduces its tax by credit relief, will do so only to the extent of the reduced tax actually charged. This, it is argued, frustrates the intentions of the country giving the tax holiday and nullifies the incentive to investment which the tax holiday is designed to provide. The relief effectively goes to the treasury of the country of residence of the enterprise or investor.

124. Where residence countries are willing to do so, this "frustration" is sometimes avoided by the grant of credit to an enterprise enjoying a tax holiday in another country, as if it had suffered the source country tax which it has, in fact, been relieved from paying. This is known as "matching relief for tax spared". It is usually only given under the terms of a tax treaty.

125. Thus, for example, where withholding tax on dividends is reduced from 20 per cent to 10 per cent, "matching" credit is, nevertheless, given for 20 per cent. According to a number of developing countries, seeking matching credit relief of this type for the exclusive benefit of the taxpayer continues to be a fundamental policy issue for them when negotiating treaties with developed countries. Generally, such treaties will have the effect of reducing some applicable tax rates and of therefore also reducing the tax revenue of the source

country. The object of the reduction of rates, in the view of these developing countries, is to benefit the taxpayer; it is not to benefit the treasury of the treaty partner. In some cases, however, the matching credit is given only for part of the tax which is not paid. Thus, if the withholding tax on dividends is reduced from 20 per cent to 10 per cent, credit may be given for tax of 15 per cent.

126. It was thought by the Group that it would be useful to bring to the attention of other tax administrations the ways in which certain countries provide matching credit for tax spared and the circumstances in which they will agree to do so under tax treaties.

127. The following factual notes are therefore provided for information. They deal with the matching relief for tax spared which is given by Austria, Belgium, Denmark, Finland, Japan, the Netherlands, Norway, Spain, Sweden and the United Kingdom. It is understood that such relief is similarly given by France, Germany, Canada, Italy and Switzerland.

A. Netherlands

128. As in many other industrialized countries, over the years it has become more or less customary in the Netherlands to grant requests for tax-sparing credit in cases where the convention tax rate in question is sufficiently reduced. The Netherlands operates on the principle that it grants such credits only up to the percentage agreed upon in the convention for the relevant taxation at source. Such a restriction is desirable, because tax-sparing credits should not have the effect of allowing more credit than the normal level of taxation agreed upon between the Netherlands and the country in question. In principle, the way in which the treaty partner reduces its taxation at source to a rate below the percentage agreed upon in the convention is irrelevant. The only restriction laid down by the Netherlands is that the grounds for the reduction in the source State should be the promotion of a climate favourable to investment.

B. United Kingdom

129. The United Kingdom is prepared to agree to tax-sparing provisions with a developing State, provided that they are consistent with the overall balance of the agreement. Some 35 of the 56 treaties or protocols negotiated by the United Kingdom with developing States (including States in Eastern Europe) since 1961 (when the United Kingdom enabling legislation was first enacted) contain matching credit provisions.

1. United Kingdom legislation

130. The relevant United Kingdom enabling legislation is S.788(5) Income and Corporation Taxes Act 1988. The provision states that the United Kingdom can accept for tax-sparing purposes only that incentive legislation passed in the other State "with a view to promoting industrial, commercial, scientific, educational or other development". The concept of "development" is fundamental to the United Kingdom in considering incentive legislation for tax-sparing purposes.

2. Acceptable incentive legislation

131. The majority of the legislation agreed upon concerns industrial and manufacturing projects. Generally, the United Kingdom has agreed to tax sparing in respect of well-defined development projects which will clearly help the other State strengthen its economic and industrial base.

3. Constraints on the United Kingdom's acceptance of incentive provisions

132. Tax sparing represents a cost to the United Kingdom Exchequer, and all tax treaties must be approved by Parliament before they can come into force. The United Kingdom Revenue must try to ensure that all tax-sparing provisions agreed can be defended to Parliament, both on the grounds of the domestic law of the United Kingdom and consistently with its economic policy in general.

4. Export incentives

133. The general policy of the United Kingdom is to refuse to accept for tax-sparing purposes incentive legislation specifically relating to the promotion of exports. There are three reasons for this: first, it could be argued that if a product is sufficiently well developed to be considered as export potential, it is by that very fact not within the terms of the development concept of United Kingdom domestic legislation. Secondly, the encouragement of exports does not necessarily encourage new development but may simply serve to divert production from domestic sales to production for export. Thirdly, the United Kingdom is party to the agreement of GATT not to introduce export incentives which take the form of remission of direct taxes on profits, and it could be argued that the United Kingdom might be in breach of that agreement if it were to provide matching credit for tax spared under the export incentive schemes of other countries.

5. Across-the-board matching credit

134. The United Kingdom has never conceded "across-the-board" matching credit on the grounds that under its system of allowing relief by means of a tax credit, the potential cost in terms of tax loss is unacceptably large. Control would also be more uncertain.

C. Austria

135. In negotiations with developing countries Austria uses the exemption method. The question of relief for tax spared is therefore relevant only in the field of taxing dividends, interest and royalties. But the deliberations made for Austria may, of course, also be relevant for countries that use the credit method overall.

136. For developing countries, a convention for the avoidance of double taxation has a second, very important, aim: it should help to increase the economic relations between the partner countries.

137. Developed countries may be prepared to give matching credit, therefore, only in cases where the second aim may be achieved by such a measure. They will be very hesitant to give such credit for small private holdings of shares but may perhaps be prepared to give it for substantial holdings, such as 25 per cent or more. They will not easily be persuaded to give matching credit for purely private loans but may accept big financing operations of special kinds. Royalties for copyrights of literary, artistic or scientific work or cinematographic films are of little interest in that field, but patents, trade marks, designs or know-how may well be of importance.

D. Japan

138. Japan has concluded 36 tax treaties, of which 14 treaties contain provisions for tax-sparing credit.

139. Under Japan's Corporation Tax Law, domestic corporations are entitled to claim a direct tax credit for foreign taxes they have paid and an indirect tax credit for foreign taxes paid by their subsidiaries operating in foreign countries on profits from which dividends have been paid (underlying foreign taxes). In the Japanese indirect tax credit system, a type of "grossing-up method" is used to compute taxable income of domestic corporations, in which dividends received from foreign subsidiaries are grossed up by the amount of underlying foreign taxes.

140. In Japanese tax treaty examples, tax-sparing is allowed for reduced/exempted tax of business profits, and so on, under special tax incentive laws and measures for the promotion of the economic development of the developing country; and for reduced/exempted withholding taxes under the tax treaty concerned. Generally, in Japanese practice, names and relevant article numbers of incentive tax laws and measures are specified in an Exchange of Notes, following authorization made by the treaty provision. As to tax incentive laws and measures for the promotion of economic development subsequently enacted after the tax treaty in question has been signed and has entered into force, tax-sparing credit may be granted for tax spared under them by a new Exchange of Notes.

141. In granting tax sparing for reduced/exempted withholding taxes under a treaty, in general the same types of tax-sparing granted by the Federal Republic of Germany - namely, "classic tax-sparing credit" (where tax spared is computed from the ordinary tax rate of the developing country applicable to the income concerned) and "deemed paid tax-sparing credit" (where tax spared is computed from a fixed tax rate) are also granted by Japan. In tax treaties concluded in recent years, however, only the latter type has been granted. While the "classic tax-sparing credit" is non-specific with respect to the amount of tax spared, the "deemed paid tax-sparing credit" grants tax sparing, at a maximum tax rate specifically set in the tax treaty - a tax rate which will not be affected by alteration of the tax rate in the domestic law of the developing country concerned. The rate is usually set at the same rate as the ceiling rate of withholding tax in the tax treaty concerned.

E. Denmark 2/

142. Denmark accepts the insertion of rules on tax-sparing credit in its double taxation agreements, when appropriate rules thereon are normally limited to

exemption from or reduction of Danish taxes in respect of tax relief granted by the other country in accordance with specific enactments enumerated in the agreement. A time limit for the validity of the rules may also be specified.

F. Finland 2/

143. Finland has provided in its double taxation agreements with developing countries for the use of tax-sparing credit methods. Credit allowed under those agreements is normally limited to relief from tax in respect of tax relief granted by the other country in accordance with specific enactments enumerated in the agreement. There is, in most agreements, a time limit for the application of the relevant provisions.

G. Norway 2/

144. Tax-sparing credits have been allowed in a number of Norway's double taxation agreements, but on strict terms. To qualify for the credit, tax sparing must be limited to that granted under specific legislation or programmes for the development of developing countries and must not otherwise be available to investment of a purely commercial or a speculative character. The credit will also only be granted for a limited number of years in order to review whether conditions are still met.

H. Sweden 2/

145. Sweden is prepared to give tax-sparing credit in double taxation agreements with developing countries. Such credit is normally limited to the exemption or reduction granted by the other country in accordance with specific enactments enumerated in the agreement. A time limit for the validity of the relevant provisions is specified in almost all agreements. If the developing country has reduced its withholding taxes substantially in the agreement, Sweden sometimes has undertaken to give a credit for more than the maximum amount of tax allowed to be withheld under the agreement. If, for example, the agreement calls for a maximum tax at source of 10 per cent, a credit may in such a case nevertheless temporarily be granted as if a tax of 15 per cent had been withheld.

I. Belgium

146. When negotiating conventions for the prevention of double taxation, Belgium applies the exemption method and does not grant any tax credit as such. However, Belgium does, in accordance with the provisions of those conventions, allow a fictitious reduction against its own tax by applying a fixed percentage for foreign tax. This fixed percentage generally amounts to 15 per cent of the transferable income collected and taxed abroad. Under certain conditions, however, the fixed percentage may amount to 20 per cent, even if the foreign transferable income has been exempted from tax in a foreign country in the context of measures designed to promote economic development there.

J. Spain

Tax spared clause

147. The underlying purpose of the "tax spared clause" (tax-sparing or matching credit, as the case may be), is that the tax sacrifices accepted by the State of source with a view to attracting investments should be shared with the State of residence, thus avoiding a situation whereby, when the credit method of avoiding double taxation is followed, the tax incentives established by the State of source - or simply the reduction of the tax rate agreed in the Convention - inure to the benefit only of the treasury of the State of residence rather than to that of the investor, as a result of which the beneficial effects are lost. A tax-sparing clause is generally included in the double-taxation conventions to which Spain is a party.

148. In conventions concluded with developing countries, Spain applies the provisions of this clause either by allowing a deduction at a rate higher than the limits prescribed by the Convention (in the case of articles 10, "Dividends"; 11, "Interest"; and 12, "Royalties"), or by allowing a tax deduction either at normal rates, in accordance with domestic legislation, or at reduced rates, in accordance with the Convention, regardless of whether the source State has granted a tax exemption or abatement in respect of the income concerned. In this case, the application of the tax spared clause is limited, within the Convention itself, to certain cases of exemption or abatement.

149. Obviously, sharing of the tax sacrifice (which depends on the actual rates applicable at source) must be subject to a limit which is compatible with the revenue requirements of the country or residence, taking into account the level of its economic surpluses and its own requirements for capital and the creation of employment.

IV. OTHER MATTERS

A. Dissemination of the reports and publications of the Group

150. The Group recommended that in order to assist the more rapid and useful dissemination of the information contained in their Report, it should be circulated directly to members, observers and tax ministries as well as through diplomatic missions.

B. Exchange of information

151. The Ad Hoc Group of Experts discussed the possibility for the United Nations Secretariat to prepare and disseminate, on a current basis, information listing addresses and structures of tax offices of member countries of the United Nations through United Nations diplomatic channels. In the course of the discussion, it was indicated that the OECD secretariat had already prepared similar information on the tax administrations of OECD member countries. The representative of the Secretary-General indicated that the Secretariat would carry out the request of the Ad Hoc Group of Experts in that special regard if the report of the Ad Hoc Group contained the recommendation and if it were approved by the Economic and Social Council.

152. It was suggested that the United Nations Secretariat should contact the OECD secretariat, as well as other entities that could provide information in that regard.

C. Possible increase in the membership of the Ad Hoc Group

153. The Ad Hoc Group of Experts briefly considered the question of including experts from centrally planned economy countries in the membership of the Group, especially since a number of those countries had concluded double taxation treaties with some developed, as well as developing countries. While the tax systems of those countries differed significantly from the tax systems of the market economy countries, it was conceivable nevertheless that not only would the participation by experts from some of those countries provide an opportunity for a useful exchange of experience, but it would also contribute in the broadening of the scope of the principles, rules and guidelines evolved in the course of the meetings of the Group and usable or applicable in the enhancement of international co-operation in tax matters. The Ad Hoc Group felt that it would recommend that the Economic and Social Council give consideration to that issue.

Notes

1/ United Nations publication, Sales No. E.80.XVI.3.

2/ The statement related to Denmark, Finland, Norway and Sweden is a quotation from the Finnish International Development Agency's (FINNIDA) publication: "Taxation as an instrument for attracting investment to the SADCC Member States from the Nordic Countries", Helsinki, April 1988. The report is written by Mr. Hillel Skurnik (Finland).

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