Organization for Economic Cooperation and Development [OECD]
1992 Model Convention - Commentaries
With 1994, 1995, and 1997 Updates

Commentary on Article 1
Concerning the Persons Covered
by the Convention

1. Whereas the earliest conventions in general were applicable to "citizens" of the Contracting States, more recent conventions usually apply to "residents" of one or both of the Contracting States irrespective of nationality. Some conventions are of even wider scope because they apply more generally to "taxpayers" of the Contracting States; they are, therefore, also applicable to persons, who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. It has been deemed preferable for practical reasons to provide that the Convention is to apply to persons who are residents of one or both of the Contracting States. The term "resident" is defined in Article 4.

Application of the Convention to partnerships

2. The domestic laws of the various OECD Member countries differ in the treatment of partnerships. The main issue of such differences is founded on the fact that some countries treat partnerships as taxable units (sometimes even as companies) whereas other countries disregard the partnership and tax only the individual partners on their shares of the partnership income.

3. These differences in views have many effects on the application of the Convention in the case of partnerships, especially where one or more partners are not residents of the State in which the partnership was created or organised. First, the question arises whether a partnership as such may invoke the provisions of the Convention. Where a partnership is treated as a company or taxed in the same way, it may reasonably be argued that the partnership is a resident of the Contracting State taxing the partnership on the grounds mentioned in paragraph 1 of Article 4 and therefore, falling under the scope of the Convention, is entitled to the benefits of the Convention. In the other instances mentioned in para-graph 2 above, the application of the Convention to the partnership as such might be refused, at least if no special rule covering partnerships is provided for in the Convention.

4. Moreover, different rules of the Convention may be applied in the Contracting States to income derived by a partner from the partnership, depending on the approach of such States. In States where partnerships are treated as companies, distributions of profits to the partners may be considered to be dividends (paragraph 3 of Article 10), whilst for other States all profits of a partnership, whether distributed or not, are considered as business profits of the partners (Article 7). In many States, business profits of partnerships include,

for tax purposes, all or some special remuneration paid by a partnership to its partners (such as rents, interest, royalties, remuneration for services), whilst in other States such payments are not dealt with as business profits (Article 7) but under other headings (in the above-mentioned examples: Articles 6, 11, 12, 14 and 15, respectively).

5. Finally the capital invested in a partnership or the alienation of a participation in a partnership may be treated, depending on the approach, under paragraph 2 of Articles 22 and 13 (permanent establishment) or paragraph 4 of Articles 22 and 13 (other movable property).

6. The concurrent application of different Articles of the Convention in the two Contracting States (or even the non-application of the Convention in one of them) may result not only in double taxation, but also in non-taxation. However the practical application of double taxation conventions, whether or not based on the Model Convention, and discussions in the Committee on Fiscal Affairs when the 1977 Model Convention was being drafted have shown that the opinions of the OECD Member countries differ too much and that it is extremely difficult to find a uniform solution that would be acceptable to all or even to the great majority of Member countries. The Convention does not, therefore, contain any special provisions relating to partnerships. Contracting States are however left free to examine the problems of partnerships in their bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate.
(Amended on 23 July 1992; see HISTORY)

Improper use of the Convention

7. The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, irrespective of double taxation conventions, to exploit differences in tax levels between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.

8. Moreover, the extension of the network of double taxation conventions still reinforces the impact of such manoeuvres by making it possible, using artificial legal constructions, to benefit both from the tax advantages available under domestic laws and the tax relief provided for in double taxation conventions.

9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell

the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.

10. Some of these situations are dealt with in the Convention, e.g. by the introduction of the concept of "beneficial owner" (in Articles 10, 11 and 12) and of special provisions, for so-called artiste-companies (paragraph 2 of Article 17). Such problems are also mentioned in the Commentaries on Article 10 (para-graphs 17 and 22), Article 11 (paragraph 12), and Article 12 (paragraph 7). It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.

11. Improper uses of the Convention are discussed in two reports from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Base Companies" and "Double Taxation Conventions and the Use of ConduitCompanies".1 As indicated in these reports, the concern expressed in paragraph 9 above has proved to be valid as there has been a growing tendency toward the use of conduit companies to obtain treaty benefits not intended by the Contracting States in their bilateral negotiations. This has led an increasing number of Member countries to implement treaty provisions (both general and specific) to counter abuse and to preserve anti-avoidance legislation in their domestic laws. (Replaced on 23 July 1992; see HISTORY)

12. Several solutions have been considered but, for the reasons set out in the above-mentioned reports, no definitive texts have been drafted, no strict recommendations as to the circumstances in which they should be applied made, and no an exhaustive list of such possible counter-measures given. The texts quoted below are merely intended as suggested benchmarks that treaty negotiators might consider when searching for a solution to specific cases. In referring to them there should be taken into account:

- the degree to which tax advantages may actually be obtained by conduit companies;
- the legal context in both Contracting States, and
- the extent to which bona fide economic activities that might be unintentionally disqualified by such provisions.

(Added on 23 July 1992; see HISTORY)

13. A solution to the problem of conduit companies would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a "look-through" provision might have the following wording:

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

Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.
(Amended on 31 March 1994; see HISTORY)

14. The "look-through approach" seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities.
(Added on 23 July 1992; see HISTORY)

15. Conduit situations can be created by the use of tax-exempt (or nearly tax-exempt) companies that may be distinguished by special legal characteristics. The improper use of tax treaties may then be avoided by denying the tax treaty benefits to these companies (the exclusion approach). The main cases are specific types of companies enjoying tax privileges in their State of residence giving them in fact a status similar to that of a non-resident. As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause such as the following:

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

The scope of this provision, could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).
(Amended on 23 October 1997; see HISTORY)

16. Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.
(Added on 23 July 1992; see HISTORY)

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

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

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company,

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

The concept of "substantial interest" may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.
(Amended on 23 October 1997; see HISTORY)

18. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (cf. paragraph 21 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies."
(Added on 23 July 1992; see HISTORY)

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

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

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)."
(Amended on 23 October 1997; see HISTORY)

20. A provision of this kind appears to be the only effective way of combatting "stepping-stone" devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underly the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind intheir convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.
(Added on 23 July 1992; see HISTORY)

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

a) General bona fide provision

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

b) Activity provision

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

c) Amount of tax provision

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

d) Stock exchange provision

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

e) Alternative relief provision

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

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the

source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.
(Added on 23 July 1992; see HISTORY)

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and of possible ways to deal with them such as "substance-over-form" rules and "sub-part F type" provisions have also been analysed.
(Added on 23 July 1992; see HISTORY)

23. The large majority of OECD Member countries consider that such measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. One could invoke the spirit of the Convention, which would be violated only if a company, which is a person within the meaning of the Convention, ended up with no or almost no activity or income being attributed to it, and the Contracting States took divergent views on the subject, with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers (cf. paragraph 2 of Article 9). A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use.
(Added on 23 July 1992; see HISTORY)

24. It is not easy to reconcile these divergent opinions, either in theory or in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. The dissenting view argues that to give domestic rules precedence over treaty rules as to who, for tax purposes, is regarded as the recipient of the income shifted to a base company, would erode the protection of taxpayers against double taxation (e.g. where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.
(Added on 23 July 1992; see HISTORY)

25. While these and the other counteracting measures described in the reports mentioned in paragraph 11 above are not inconsistent with the spirit of tax treaties, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be appropriate to grant him the protection of the treaty network.
(Added on 23 July 1992; see HISTORY)

26. The majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, but believe that such measures should be used only for this purpose. It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer.
(Added on 23 July 1992; see HISTORY)

Observation on the Commentary

27. The United States believes that the business activities referred to in sub-paragraph b) of paragraph 21 of the Commentary should exclude "the business of making or managing investments, unless these activities are banking or insurance activities carried on by a bank or insurance company." Absent this language, a third-country resident could set up a classic treaty shopping conduit operation-a personal investment company-and argue that the company is engaged in a substantive business operation (the managing of the third-country owner's personal portfolio) and the income in respect of which benefits are claimed (dividends and interest) is connected with those business operations.
(Added on 23 July 1992; see HISTORY)

Reservations on the Article

28. The United States reserves the right to tax its citizens and residents (with certain exceptions) without regard to the Convention.
(Renumbered on 23 July 1992; see HISTORY)

Commentary on Article 2

Concerning Taxes Covered By the Convention

1. This Article is intended to make the terminology and nomenclature relating to the taxes covered by the Convention more acceptable and precise, to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, by means of the periodical exchange of lists and through a procedure for mutual consultation.

Paragraph 1

2. This paragraph defines the scope of application of the Convention: taxes on income and on capital; the term "direct taxes" which is far too imprecise has therefore been avoided. It is immaterial on behalf of which authorities such taxes are imposed; it may be the State itself or its political subdivisions or local authorities (constituent States, regions, provinces, départements, cantons, districts, arrondissements, Kreise, municipalities or groups of municipalities, etc.). The method of levying the taxes is equally immaterial: by direct assessment or by deduction at the source, in the form of surtaxes or surcharges, or as additional taxes (centimes additionnels), etc.

Paragraph 2

3. This paragraph gives a definition of taxes on income and on capital. Such taxes comprise taxes on total income and on elements of income, on total capital and on elements of capital. They also include taxes on profits and gains derived from the alienation of movable or immovable property, as well as taxes on capital appreciation. Finally, the definition extends to taxes on the total amounts of wages or salaries paid by undertakings ("payroll taxes"; in Germany, "Lohn-summensteuer"; in France, "taxe sur les salaires"). Social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received, shall not be regarded as "taxes on the total amount of wages".

4. Clearly a State possessing taxing powers-and it alone-may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.

5. The Article does not mention "ordinary taxes" or "extraordinary taxes". Normally, it might be considered justifiable to include extraordinary taxes in a model convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects,

etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

Paragraph 3

6. This paragraph lists the taxes in force at the time of signature of the Con-vention. The list is not exhaustive. It serves to illustrate the preceding para-graphs of the Article. In principle, however, it will be a complete list of taxes imposed in each State at the time of signature and covered by the Convention.

Paragraph 4

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. This provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its taxation laws.

8. Each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes imposed during that year.

Observation on the Commentary

9. In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, New Zealand would wish to make it clear that the term "tax" does not include penalties, or interest on overpayment or underpayment of tax.
(Amended on 21 September 1995; see HISTORY)

Reservations on the Article

10. Australia, Canada and the United States reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

11. Japan and Korea reserve their position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital.
(Amended on 23 October 1997; see HISTORY)

12. Greece holds the view that "taxes on the total amounts of wages or salaries paid by enterprises" should not be regarded as taxes on income and therefore will not be covered by the Convention.
(Added on 21 September 1995; see HISTORY)

Commentary on Article 3

Concerning General Definitions

1. This Article groups together a number of general provisions required for the interpretation of the terms used in the Convention. The meaning of some important terms, however, is explained elsewhere in the Convention. Thus, the terms "resident" and "permanent establishment" are defined in Articles 4 and 5 respectively, while the interpretation of certain terms appearing in the Articles on special categories of income ("income from immovable property", "dividends", etc.) is clarified by provisions embodied in those Articles. In addition to the definitions contained in the Article, Contracting States are free to agree bilaterally on definitions of the terms "a Contracting State" and "the other Contracting State". Furthermore, Contracting States are free to agree bilaterally to include in the possible definitions of "Contracting States" a reference to continental shelves.
Paragraph 1

The term "person"

2. The definition of the term "person" given in sub-paragraph a) is not exhaustive and should be read as indicating that the term "person" is used in a very wide sense (cf. especially Articles 1 and 4). The definition explicitly mentions individuals, companies and other bodies of persons. From the meaning assigned to the term "company" by the definition contained in sub-paragraph b) it follows that, in addition, the term "person" includes any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (fondation, Stiftung) may fall within the meaning of the term "person". Special considerations for the application of the Convention to partnerships are found in paragraphs 2 to 6 of the Commentary on Article 1.

The term "company"

3. The term "company" means in the first place any body corporate. In addition, the term covers any other taxable unit that is treated as a body corporate according to the tax laws of the Contracting State in which it is organised. The definition is drafted with special regard to the Article on dividends. The term "company" has a bearing only on that Article, paragraph 7 of Article 5, and Article 16.

The term "enterprise"

4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No definition of the term "enterprise" has therefore been attempted in this Article.

The term "international traffic"

5. The definition of the term "international traffic" is based on the principle set forth in paragraph 1 of Article 8 that the right to tax profits from the operation of ships or aircraft in international traffic resides only in the Contract-ing State in which the place of effective management is situated in view of the special nature of the international traffic business. However, as stated in the Commentary on paragraph 1 of Article 8, the Contracting States are free on a bilateral basis to insert in sub-paragraph d) a reference to residence, in order to be consistent with the general pattern of the other Articles. In such a case, the words "an enterprise that has its place of effective management in a Contracting State" should be replaced, by "an enterprise of a Contracting State" or "a resident of a Contracting State".

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

The term "competent authority"

7. The definition of the term "competent authority" recognizes that in some OECD Member countries the execution of double taxation conventions does not exclusively fall within the competence of the highest tax authorities; some matters are reserved or may be delegated to other authorities. The present definition enables each Contracting State to designate one or more authorities as being competent.

The term "national"

8. The definition of the term "national" merely stipulates that the term applies to any individual possessing the nationality of a Contracting State. It was not judged necessary to include in the text of the Convention any more precise definition of nationality, nor did it seem indispensable to make any special comment on the meaning and application of the word. Obviously, in determining what is meant by "the nationals of a Contracting State" in relation to individuals, reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.
(Replaced on 23 July 1992; see HISTORY)

9. Sub-paragraph f) is more specific as to legal persons, partnerships and associations. By declaring that any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State is considered to be a national, the provision

disposes of a difficulty that often arises. In defining the nationality of companies, certain States have regard less to the law that governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.
(Replaced on 23 July 1992; see HISTORY)

10. Moreover, in view of the legal relationship created between a company and the State under whose law it is organised, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term "national".
(Replaced on 23 July 1992; see HISTORY)
Paragraph 2

11. This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly.
(Amended on 21 September 1995; see HISTORY)

12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.
(Added on 23 July 1992; see HISTORY)

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).
(Added on 23 July 1992; see HISTORY)

13.1 Paragraph 2 was amended in 1995 to conform its text more closely to the general and consistent understanding of Member states. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of

different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws. States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms.
(Added on 21 September 1995; see HISTORY)

Observation on the Commentary

14. For the purposes of Articles 10, 11 and 12, New Zealand would wish to treat dividends, interest and royalties in respect of which a trustee is subject to tax in the State of which he is a resident as being beneficially owned by that trustee.
(Renumbered on 23 July 1992; see HISTORY)

Reservations on the Article

15. (Deleted on 21 September 1995; see HISTORY)

16. Ireland reserves the right to omit the final phrase of paragraph 2, which gives tax law precedence over other laws.
(Added on 21 September 1995; see HISTORY)

Commentary on Article 4

Concerning the Definition of Resident

I. Preliminary remarks

1. The concept of "resident of a Contracting State" has various functions and is of importance in three cases:

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

b) in solving cases where double taxation arises in consequence of double residence;

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

2. The Article is intended to define the meaning of the term "resident of a Contracting State" and to solve cases of double residence. To clarify the scope of the Article some general comments are made below referring to the two typical cases of conflict, i.e. between two residences and between residence and source or situs. In both cases the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory.

3. Generally the domestic laws of the various States impose a comprehensive liability to tax-"full tax liability"-based on the taxpayers' personal attachment to the State concerned (the "State of residence"). This liability to tax is not imposed only on persons who are "domiciled" in a State in the sense in which "domicile" is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.

4. Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as "resident" and, conse-quently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on "residence" have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.

5. This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or situs. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference.

6. An example will elucidate the case. An individual has his permanent home in State A, where his wife and children live. He has had a stay of more than six months in State B and according to the legislation of the latter State he is, in consequence of the length of the stay, taxed as being a resident of that State. Thus, both States claim that he is fully liable to tax. This conflict has to be solved by the Convention.

7. In this particular case the Article (under paragraph 2) gives preference to the claim of State A. This does not, however, imply that the Article lays down special rules on "residence" and that the domestic laws of State B are ignored because they are incompatible with such rules. The fact is quite simply that in the case of such a conflict a choice must necessarily be made between the two claims, and it is on this point that the Article proposes special rules.

II. Commentary on the provisions of the Article

Paragraph 1

8. Paragraph 1 provides a definition of the expression "resident of a Contracting tate" for the purposes of the Convention. The definition refers to the concept of residence adopted in the domestic laws (cf. Preliminary remarks). As criteria for the taxation as a resident the definition mentions: domicile, residence, place of management or any other criterion of a similar nature. As far as individuals are concerned, the definition aims at covering the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). It also covers cases where a person is deemed, according to the taxation laws of a State, to be a resident of that State and on account thereof is fully liable to tax therein (e.g. diplomats or other persons in government service). In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory. According to its wording and spirit the provision would also exclude from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. This, however, has inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended. The exclusion of certain companies from the definition would not of course prevent Contracting States from exchanging information about their activities (cf. paragraph 2 of the Commentary on Article 26). Indeed States may feel it appropriate to develop spontaneous exchanges of information about companies which seek to obtain treaty benefits unintended by the Model Convention.
(Amended on 23 July 1992; see HISTORY)

8.1 It has been the general understanding of most Member states that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding.
(Added on 21 September 1995; see HISTORY)

Paragraph 2

9. This paragraph relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States.

10. To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State. The facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.
(Amended on 21 September 1995; see HISTORY)

11. The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.

12. Sub-paragraph a) means, therefore, that in the application of the Con-vention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.

13. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily

of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).

14. If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.

15. If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

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

a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;

b) the case where the individual has a permanent home available to him in neither Contracting State.

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

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

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

19. In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, subparagraph b) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

20. Where, in the two situations referred to in subparagraph b) the individual has an habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them, subparagraph d) assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25.

Paragraph 3

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

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

23. The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the "place of management" of the enterprise is situated; other conventions attach importance to its "place of effective management", others again to the "fiscal domicile of the operator".
(Amended on 23 July 1992; see HISTORY)

24. As a result of these considerations, the "place of effective management" has been adopted as the preference criterion for persons other than individuals.
Observations on the Commentary

25. New Zealand's interpretation of the term "effective management" is practical day to day management, irrespective of where the overriding control is exercised.

26. Spain, due to the fact that according to its internal law the fiscal year coincides with the calendar year and there is no possibility of concluding the fiscal period by reason of the

taxpayer's change of residence, will not be able to proceed in accordance with paragraph 10 of the Commentary on Article 4. In this case, a mutual agreement procedure will be needed to ascertain the date from which the taxpayer will be deemed to be a resident of one of the Contracting States.
(Added on 21 September 1995; see HISTORY)
Reservations on the Article

27. Canada reserves the right to use as the test for paragraph 3 the place of incorporation or organisation with respect to a company.
(Amended on 23 July 1992 and renumbered on 21 September 1995; see HISTORY)

28. Japan and Korea reserve their position on the provisions in this and other Articles in the Model Tax Convention which refer directly or indirectly to the place of effective management. Instead of the term "place of effective management", these countries wish to use in their conventions the term "head or main office".
(Amended on 23 October 1997; see HISTORY)

29. France reserves the right to amend the Article in its tax conventions in order to specify that French partnerships must be considered as residents of France in view of their legal and tax characteristics.
(Replaced on 23 July 1992 and renumbered on 21 September 1995; see HISTORY)

30. Turkey reserves the right to use the "registered office" criterion (legal head office) as well as the "place of effective management" criterion for determining the residence of a person, other than an individual, which is a resident of both Contracting States because of the provisions of paragraph 1 of the Article.
(Added on 23 July 1992 and renumbered on 21 September 1995; see HISTORY)

31. The United States reserves the right to use a place of incorporation test for determining the residence of a corporation, and, failing that, to deny dual resident companies certain benefits under the Convention.
(Amended on 31 March 1994 and renumbered on 21 September 1995; see HISTORY)

32. Mexico reserves the right to be excluded from the application of the portion of subparagraph d) of paragraph 2 that addresses double nationality, because the Mexican Constitution does not allow Mexican nationals to be nationals of any other State.
(Added on 21 September 1995; see HISTORY)