Chapter 8. Tax Treaties

Tax treaties represent an important aspect of the international tax rules of most countries. Well over 2,000 bilateral income tax treaties are currently in effect, and the number is growing. The overwhelming majority of treaties between developed countries are based in large part on the OECD Model Treaty. Treaties between developing countries or between developed and developing countries tend to rely on the UN Model Treaty. The two treaties have many common features and tend to differ mostly in detail. In general, the UN model is more favorable to source countries and the OECD model is more favorable to resident countries. Both of these models are discussed below.

In addition, the OECD has developed a Model Agreement on Exchange of Information on Tax Matters (2002). As the name suggests, tax treaties based on this model deal only with information exchange. Most tax treaties that follow this model are between OECD countries and certain low-tax countries that are thought to operate as tax havens. These low-tax countries are not themselves seeking information from their treaty partners. They generally enter into these treaties to avoid the international pressures that may be applied to countries thought to facilitate international tax evasion, money laundering, and other fiscal crimes.

Some multilateral income tax treaties have been negotiated, although their impact so far has been modest. The Nordic nations have entered into a multilateral agreement on matters of tax administration. In addition, the OECD and the Council of Europe have sponsored a Multinational Convention on Mutual Administrative Assistance on Tax Matters, which had 15 signatories as of 2007. The General Agreement on Tariffs and Trade (GATT), as renegotiated in 1994, and the General Agreement on Trade in Services, both of which were consolidated as part of the Agreement Establishing the World Trade Organization in 1994, contain some important provisions relating to income taxation. The provision in those trade agreements are designed primarily to prevent the use of income tax provisions as disguised trade barriers or as export incentives.

Section 8,A, below provides an overview of the legal nature of tax treaties, their relationship with domestic law, their objectives, and the interpretation of treaties. The main features of the OECD Model Treaty are described in some detail in section 8,B, in order to give readers a basic understanding of a typical tax treaty. Features of the UN Model Treaty that are not included in the OECD Model Treaty are also discussed. Some special topics, including treaty shopping and nondiscrimination, resolution of disputes, administrative cooperation, and tax avoidance through tax treaties are analysed in section 8,C.

B. Contents of a Typical Tax Treaty

This section describes some of the major provisions of a typical bilateral tax treaty based on the OECD and UN Model Treaties. Section 8,B,1 identifies the parties to the treaty and the persons whose tax obligations are affected by it, describes the scope of the treaty, and summarizes the rules governing its ratification, termination and amendment. Sections 8,B,2 — 8,B,6 describe the treatment of various categories of income under the typical tax treaty. Section 8,B,7 describes certain rules designed to promote cooperation and fair play between the treaty partners.
Every tax treaty includes some provision for relieving or mitigating double taxation. In the OECD and UN Model Treaties, relief from double taxation is provided either by Article 23A (Exemption Method) or Article 23B (Credit Method). Methods of providing double taxation relief are discussed in Chapter 5,C.

To prevent fiscal evasion or avoidance, the domestic tax laws of most countries give the tax authorities the power to adjust prices set by a taxpayer with respect to a transaction with a related person to reflect the prices that would have prevailed if the transaction had taken place at arm’s length with an unrelated person. Article 9 (Associated Enterprises) of the OECD and UN Model Treaties provides that the Contracting States are permitted (indeed expected) to recompute the profits of related enterprises in accordance with this so-called arm’s length standard. The arm’s length standard and the many problems that arise in applying it are described in Chapter 6.

B,1. Coverage, Scope, and Legal Effect

2. Business Income

The taxation of business income is governed by Articles 3, 5, and 7 of the OECD and UN Model Treaties. Article 7 (Business Profits) provides that “an enterprise of a Contracting State” generally is exempt from tax on its profits derived from business carried on in the other Contracting State unless those profits are attributable to its permanent establishment (PE) located in that other Contracting State. This major limitation on a country’s source jurisdiction is discussed in Chapter 2,C, above. The definition of a PE is provided in Article 5 (Permanent Establishment). Article 3 (General Definitions) describes “an enterprise of a Contracting State” as “a resident of a Contracting State.”

An enterprise of a Contracting State that has a PE in the other Contracting State it is taxable only on the taxable income attributable to the PE. Article 7(2) of the OECD and UN Model Treaties provides that the profits of a PE should be determined under the arm’s length principle. The difficulties that arise in applying the arm’s length principle to determine the gross income and deductions properly attributable to a PE are addressed in Chapter 6,C.

Article 7(1) of the UN Model Treaty employs a limited force-of-attraction principle in determining the income attributable to a PE. Under that principle, if an enterprise has a PE in a Contracting State, it is taxable not only on the income earned through that PE but also on income derived in that state from the sale of products similar to those sold through the PE or from business activities similar to those activities conducted through the PE. The approach taken in the UN Model Treaty introduces some uncertainty for companies seeking to minimize their taxes in the source country. The advantages of the rule from the government’s perspective are that it simplifies administration somewhat and reduces significantly the opportunities for tax avoidance.

Under Article 5(1) of the OECD and UN Model Treaties, a PE generally is “a fixed place of business through which the business of an enterprise is wholly or partly carried on.” This language is used in essentially identical form in almost all tax treaties. The OECD and UN Model Treaties provide in paragraph (2) that the following examples of business premises are included especially in the definition of a PE:
• a place of management
• a branch
• an office
• a factory
• a workshop
• a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources

The OECD Commentary takes the position, noted without approval or disapproval in the UN Commentary, that the examples listed above constitute a PE only if they meet the requirements of paragraph (1). This interpretation seems at odds with the language of paragraph (2), which states that the listed examples are “included especially” in the definition of a PE. The issue has little importance for items like a factory or workshop, which undoubtedly would constitute a PE under paragraph 1 in just about any conceivable situation. The issue does have some importance, however, in determining whether a set of activities characterized as a “branch” or “place of management” constitutes a PE.

According to the OECD Commentary, an enterprise has a “fixed place of business” in a Contracting State only if it operates at a specific geographical location and its activities at that location endure for more than a temporary period (generally for more than 6 months). The place where equipment, such as an oil pumping machine, is used can constitute a place of business even if that machine is unattended by human agents of the enterprise. For a place of business to be “fixed,” it is enough that it has a specific geographical location. For example, a marketplace can be the fixed place of business of an enterprise if the enterprise operates a movable stall within that marketplace on a regular basis. It is immaterial whether an enterprise rents or owns its premises in determining whether the premises constitute a PE.

In the UN Commentary on Article 5, it is suggested that fishing vessels might constitute a PE if the enterprise uses those vessels for commercial fishing within the territorial waters of a Contracting State. That issue, however, remains controversial. Many difficult issues arise in determining whether an enterprise has a PE in a Contracting State as a result of engaging in electronic commerce in that State. Those issues are addressed in Chapter 9.C.

The definition of a PE in the OECD Model Treaty includes certain dependent agents of an enterprise that act on behalf of the enterprise and have, and habitually exercise, an authority to conclude contracts on behalf of the enterprise. Most tax treaties treat such agents as PEs of their principals.

The agency rule in the UN Model Treaty is more expansive, extending to dependent agents that maintain a stock of goods from which they make deliveries on behalf of their principals. Some tax treaties follow the UN Model Treaty on this point. Some commentators argue that the definition of a PE should also be expanded to include most dependent agents carrying on substantial business on behalf of an enterprise whether or not they have the authority to conclude contracts. These commentators argue that the power to conclude contracts has little commercial significance because modern methods of communication permit nearly instantaneous contact between agents and their foreign principals.

In addition, the UN Model Treaty provides that an enterprise engaged in the sale of insurance in a Contracting State shall be deemed to have a PE in that State if it collects premiums in that State or ensures risks located in that State. This rule does not apply, however, if the insurance activities are conducted by an independent agent.
Most treaties provide that a building site, drilling operation, or other temporary project location constitutes a PE if the project continues for some minimum period. In the OECD Model Treaty, the minimum period is one year. The UN Model Treaty uses a minimum period of six months and defines the activities covered by the provision broadly enough to include an assembly site and supervisory activities conducted in connection with a building or assembly site. Developing countries typically adopt a six-month period or an even shorter minimum period in their tax treaties. For example, the minimum period in the India-United States treaty is four months. A few treaties between developed countries extend the minimum period beyond one year. The Japan-United States treaty, for example, has a twenty-four month period.

The UN Model Treaty provides that an enterprise has a PE in a Contracting State if it performs personal services in that State through employees or other personnel for a period of six months in any 12-month period. This provision is intended primarily to guarantee that management and consultancy activities may be taxable in the source state if those activities continue for an extended period. The OECD Model Treaty has no comparable provision.

Under the UN Model Treaty, income from the performance of independent personal services is taxable under Article 14 and not under Articles 5 and 7. This approach also was followed under the OECD Model Treaty until Article 14 was dropped from that model in 2000. The taxation of independent personal services is discussed in section 8,B,3, below.

The OECD and UN Model Treaties generally provide that a facility used primarily for the purchase of goods for export, for the storage or display of goods, or for storage of goods for processing by another enterprise will not constitute a PE of that enterprise. The OECD Model Treaty allows a facility to be used for the delivery of goods without it being a PE. The UN Model Treaty does not provide for that exception in order to permit the source country to tax income derived from the operation of a warehouse. Certain facilities are also excluded from the definition of a PE under both models if they are maintained for activities “of a preparatory or auxiliary character.”

A major flaw in both the OECD and UN Model Treaties is that they do not impose any time limit on activities claimed to be preparatory or auxiliary. A fixed time limit of a year or two would provide greater certainty, reduce conflicts between the tax officials and taxpayers, and limit opportunities for tax avoidance. Some exemption for activities that are genuinely preparatory is consistent with the treaty goal of removing obstacles to cross-border trade. The exemption for auxiliary activities, however, is best explained by history rather than by sound tax policy.

A subsidiary does not constitute a PE of its parent company simply because the parent controls it. Similarly, a parent company is not automatically a PE of its subsidiary. These important rules have encouraged most multinational enterprises to operate outside their home country through affiliated companies rather than through foreign branches or PEs whenever their activities in a foreign country are likely to be substantial. When a multinational enterprise anticipates only minor contacts with the foreign country, it typically avoids having a PE in that country by operating through independent distributors.

The use of subsidiaries by multinational enterprises to penetrate foreign markets has become so widespread that the PE rules, as they apply to corporate branches, have limited practical significance for most types of multinational enterprises, despite the attention the PE rules are given in model tax treaties and in tax treaty negotiations. The PE rules are quite important, nevertheless for some types of business,
notably banks and insurance companies. Foreign branches are commonly used by banks and other financial intermediaries because of their need to report high capital reserves. They are also used by insurance companies for similar reasons.

A branch also may be used by a foreign corporation when it is first entering a foreign market if it anticipates that it will be incurring losses that it can utilize to reduce taxes in its country of residence. Branches also are commonly used by small businesses operating in a country that is contiguous to the country in which they are resident.

The treaty language that prevents a company from automatically having a PE if an affiliated company has a PE does not mean that the affiliated company cannot be its PE. For example, the affiliated company would constitute a PE of the company if it serves as the company’s dependent agent (and no other exception applies). Indeed, the actual treaty language provides only modest protection; that language merely prevents an affiliate from being a PE of a company “solely” because of its affiliate status. In practice, nevertheless, the exemption has been interpreted very broadly.

The taxation of business income derived from the operation of ships or aircraft is limited under Article 8 (Shipping, Inland Waterways Transport and Air Transport) of the OECD and UN Model Treaties. The OECD Model Treaty and alternative A of Article 8 of the UN Model Treaty assign the exclusive right to tax such income to the country where the shipping or aircraft operation is effectively managed, even if the shipping or aircraft enterprise has a PE in the source country. Other treaties assign the exclusive right to tax to the country of residence of the enterprise. Most treaties allow the source country to tax income derived from the purely domestic operation of ships and aircraft. For example, the taxation by the source state of income derived from the operation of river barges and ferry boats plying internal waters is not limited by Article 8. Alternative B of Article 8 of the UN Model Treaty permits the source country to tax income derived from shipping and aircraft activities if such activities are “more than casual.”

Rental income derived from movable property is considered to be business profits under the OECD Model Treaty. Therefore, such income is subject to tax by a country only if the taxpayer has a PE in the country and the rent is attributable to the PE. In both the 1963 and 1977 versions of the OECD Model Treaty, rental income from the use of movable property was included in the definition of royalties for purposes of Article 12 so that the source country was precluded from taxing such income. That provision was removed from the OECD Model Treaty in 1992, although it remains in many tax treaties. Article 12 of the UN Model Treaty, which permits taxation of royalties in the source country, includes income from equipment rental in the definition of royalties. The UN Model Treaty also treats income derived from the rental of audio and video tapes as royalty income.

Rent derived from immovable property is taxable by the source country in accordance with Article 6 of the OECD and UN Model Treaties. For example, income derived from renting an apartment building would be taxable in the Contracting State where the building is located. Article 6 is discussed in section 8.B.4, below.