

Model Tax Treaties

A Comparison of the UN and OECD Models



Michael J. McIntyre
Professor of Law



What Is a Tax Treaty

Nature and Objective of Tax Treaties

- Legal Nature of Tax Treaties
 - ▶ Bilateral Agreement Between Sovereign States
 - ▶ Generally Relieving Only — They **Reduce** Taxes
 - ▶ Some Countries, e.g., France Impose Tax By Treaty
- Effect of Tax Treaties
 - ▶ Impact on Individuals Depends on Local Law
 - May be Self Enforcing under Constitution, e.g. France
 - May Be Supreme Law by Statute, e.g. Canada
 - May Have Complex Relationship to Domestic Law, e.g. US



Goals of Tax Treaties

Purpose of International Tax Treaties

- Eliminate or Mitigate Double Taxation
 - ▶ Facilitate Cross-Border Investment and Trade
 - ▶ Treat Residents of Different Countries Fairly
- Combat Tax Evasion and Fiscal Fraud
 - ▶ International Tax Evasion Gives Improper Incentive to Export of Capital
 - ▶ Results in Unfair Treatment of Residents



Model Conventions

Models Propounded by United Nations and OECD

- OECD Model Is Dominant
 - ▶ Initially Published in 1963, Major Revision in 1997
 - ▶ Another Major Revision in 1992 and Now Revised Frequently (Looseleaf Version)
 - ▶ Supplemented By Detailed Commentary
- United Nations Model Published in 1980
 - ▶ Based on OECD Model
 - ▶ Modified to Take Account of Special Issues for Developing Countries



OECD Model

Favors Capital Exporting Countries

- Gives Relief for Double Tax By Reducing Tax in Source County
 - ▶ Business Income Exempt Unless Foreign Resident has Permanent Establishment in Source State
 - ▶ Interest and Royalty Income Totally Exempt and Dividends Partially Exempt
- Assumes Rough Parity in Trade and Capital Flows



United Nations Model

Gives Some Additional Benefits to Source Country

- Adopted to Take Account of Special Circumstances of Developing Countries
- Makes It Somewhat Easier for Foreign Person to Have a Permanent Establishment (p.e.)
- Leaves Reduction in Withholding Rates to Bilateral Negotiations (Usually Allows Higher Withholding Rates)
- Promotes Tax Sparing



Commentary to Models

OECD and UN Have Detailed Explanations of Models

- Each Article of Model Treaty Explained, Often in Detail
- Legal Status of Commentary Unclear
 - ▶ Intended to be *** Official *** Interpretation
 - ▶ Commentary Changes to “Update” Existing and New Treaties
 - ▶ Countries Register Their Objections to Particular Provision of Model and to Commentary in the Commentary



Tax Treaty Interpretation

Treaty Interpretation Governed By International Law

- Vienna Convention on Law of Treaties, Art. 31(1): “A treaty should be interpreted in good faith and in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.”
- OECD and UN Models, Art. 3(2): Meaning of Undefined Terms of Treaty Based on Domestic Law



Organization of Treaties

Chapters in All Model Treaties

- Chapter 1: Scope
- Chapter 2: Definitions
- Chapter 3: Taxation of Income
- Chapter 4: Taxation of Capital
- Chapter 5: Elimination of Double Taxation
- Chapter 6: Special Provisions
- Chapter 7: Entry into Force and Termination



Contents of Tax Treaties

Overview of Major Provisions in Model Tax Treaties

- Coverage and Scope
- Business Income
- Employment and Personal Services Income
- Income and Gains from Immovable Property
- Reduction in Withholding Rates
- Other Types of Income
- Fair Dealing and Cooperation



Scope of Tax Treaty

When, Where, Who and What are Covered

- Time — When Does Treaty Start and End
- Territory Covered
- Persons Covered
- Taxes Covered



Scope of Tax Treaties: Time

When Do Treaties Start and End?

- Article 29: Entry into force
 - ▶ After Ratification by Both Countries and Exchange of Ratification Instruments
 - ▶ May Have Different Starting Dates for Withholding Taxes and Other Taxes
- Article 30: Termination
 - ▶ Minimum Notice of 6 Months
 - ▶ Usually some Fixed Minimum Term (e.g. 5 years)
 - ▶ No Maximum Term
 - ▶ May be Superseded by New Treaty (Protocol)



Scope of Tax Treaties: Territory

Defining the Territories of the Contracting States

- UN and OECD Model Do Not Define the Contracting States
- Many Treaties Define Certain Geographical Limits
 - ▶ Continental Shelf Included (E.g., Off-shore drilling)
 - ▶ Territories of States May Be Included or Excluded
 - Art. 29 of OECD Model Offers Suggested Rules for Extension to Territories If They Levy Substantially Similar Taxes
 - No Similar Rule in UN Model
 - Example — Old Netherlands/US treaty Extended to Netherlands Antilles, a tax haven (now voided by US)



Scope of Treaties: Persons

Who Is Covered By a Tax Treaty

- Article 1: “This Convention shall apply to persons who are residents of one or both of the Contracting States.”
- Article 3: Definition of Person — “. . . includes an individual, a company and any other body of persons”
- Article 4: Definition of Resident — person taxable “by reason of his domicile, residence, place of incorporation . . .”



Persons: Interpretative Issues

Issues Arising in Determining Persons Governed By Treaty

- Application to Legal Entities — Partnerships? Trusts? Estates? Limited Liability Companies?
- Treatment of Nationals, Especially US Citizens
- Treaty Shopping — *Bona Fide* Residents
- Non-discrimination Article (Art. 24) Applies to Non-Residents



Scope of Tax Treaties: Taxes

What Taxes Are Covered by A Tax Treaty

- Article 2 — Income and Capital Taxes (Usually Listed Specifically in Para. 3)
- Interpretative Issues
 - ▶ What Is Income (or Capital) Tax?
 - ▶ Can a Tax Based on Estimated Income Qualify?
 - ▶ Taxes Levied by Political Subdivisions Covered
 - Many States do not Accept, Partly for Constitutional Reasons
- Future “Identical or Substantially Similar” Taxes Covered