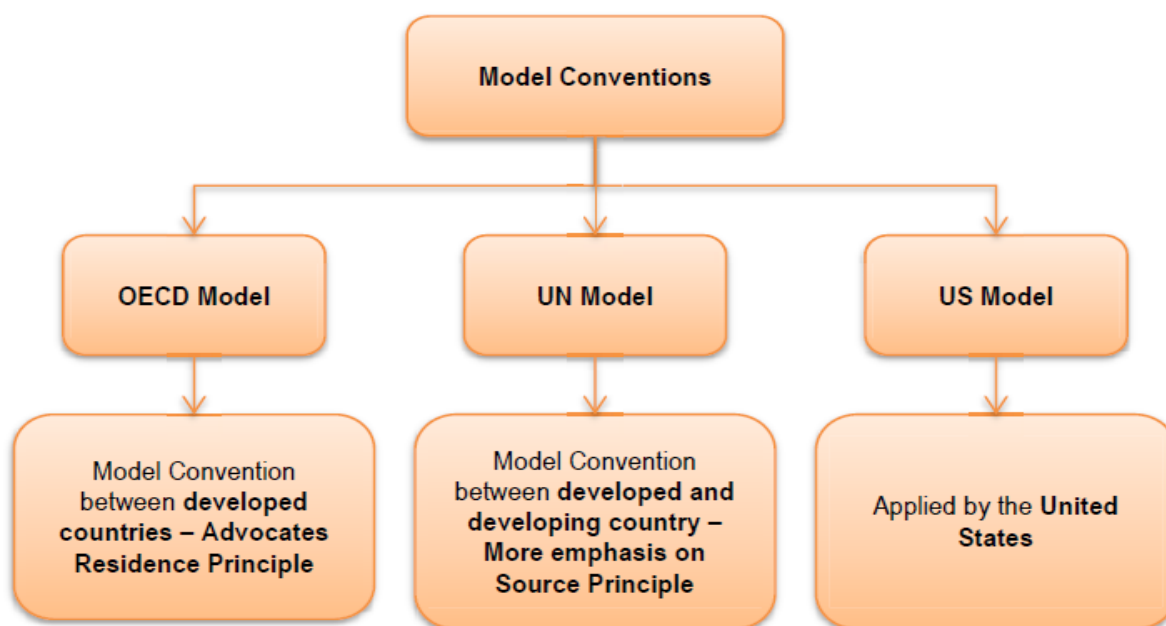


Overview of Model tax Convention

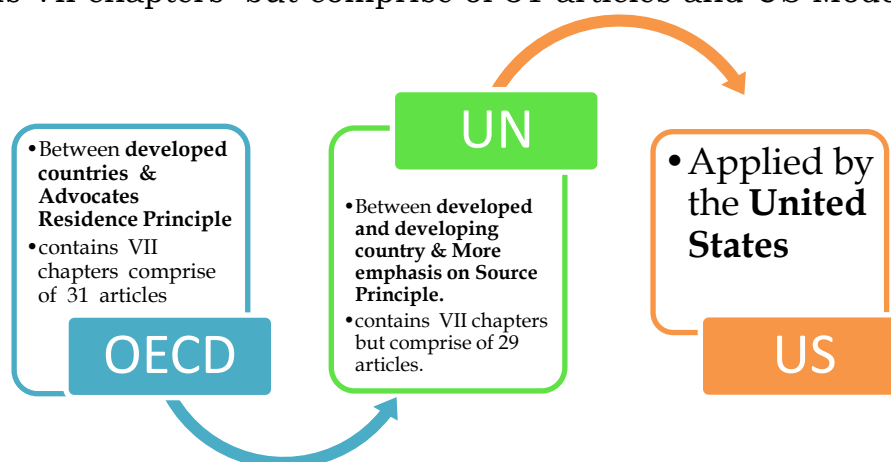
What do you mean by Model Tax Conventions

In order to enable various countries, to enter into treaties, which are standardized to some extent, **OECD and the United Nations (UN)** have developed certain Model Tax Treaties, which various countries can take as a starting point for negotiations between themselves and other countries



Difference between Model Convention

OECD Model contains VII chapters comprise of 32 articles and UN Model also contains VII chapters but comprise of 31 articles and US Model comprises of 30



Tie Breaker Rule [Remember DTAA bilateral Relief]	
Where an individual is a resident of both Contracting States. A series of tie-breaker rules are provided to determine single state of residence for an individual.	
1 st Test	<p>The 1st test is based on where the individual has a permanent home, mean a dwelling place available to him at all times continuously and not occasionally and includes place taken on rent for a prolonged period of time.</p> <ul style="list-style-type: none"> ♣ where the individual has a permanent home available to him in neither Contracting State. then preference is given to the Contracting State where the individual has an habitual abode. ♣ If the individual has habitual abode in both Contracting States or in neither of them, he shall be treated as a resident of the Contracting State of which he is a national. ♣ If the individual is a national of both or neither of the Contracting States, the matter is left to be considered by the competent authorities of the respective Contracting States.
2 nd Test	<p>If he has permanent home available in both Contracting States, he will be considered a resident of the Contracting State where his personal and economic relations are closer,</p> <p>Thus, preference is given to family and social relations, occupation, place of business, place of administration of his properties, political, cultural and other activities of the individual.</p>

UN Model	
Title	<p><i>“Convention between (State A) and (State B) for the elimination of double taxation with respect to taxes on income and capital and the prevention of tax avoidance and evasion”</i></p> <p>Meaning in simple Language: There is now a specific reference to “the prevention of tax avoidance and evasion” in the title to emphasize its significance in the Model Convention.</p>
Preamble	<p><i>“(State A) and (State B), Desiring to further develop their economic relationship and to enhance their cooperation in tax matters, Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion (including through treaty-shopping arrangements aimed at obtaining reliefs provided in</i></p>

	<p>this Convention for the indirect benefit of residents of third States)”</p> <p>The Title and Preamble to the OECD Model Convention is almost identical to that of the UN Model Convention.</p> <p>Meaning in simple Language: The Preamble now clearly indicates that the UN and OECD Model Conventions do not intend to create opportunities for non-taxation or reduced taxation through tax avoidance or evasion including through treaty shopping arrangements.</p>
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Article 1 Person Covered

The OECD and UN Model Convention would apply to persons who are residents of one or both of the Contracting States.

Language in treaty: income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State shall be considered to be income of a resident of a Contracting State. However, the same would be treated as income only to the extent that the income is treated, for purposes of taxation by that State, as the income of a resident of that State.

Meaning in simple Language: The Taxation shall be based on residency rule.

Example: India has a treaty with Pakistan. A payment has been made by Indian company to the firm in Pakistan. Both the partner of firm divides the profits in equal ratio, partner Mirza is a resident of Pakistan and partner Galib is the resident of Iraq [but has partnership in Pakistan] here if OECD or UN Model is adopted then only mirza's income is taxable in Pakistan because only he is resident in Pakistan

Article 2 Taxes Covered

The OECD and UN Conventions would apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied

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

Meaning in simple Language: The Treaty would apply to all type of taxes levied by Both the government irrespective of the manner in which they are levied.

Example: India and Australia were in treaty in 2011 & in 2017 GST was introduced by India now by default the Treaty will apply to GST as well.



Article 4 Residency

A taxpayer has to demonstrate that he is a resident of one or both Contracting States to be able to gain access to a tax treaty and avail the benefits thereunder.

Language in treaty

UN Model: "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, **place of incorporation**, place of management or any other criterion of a similar nature.

OECD: Similar Words however the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature

Meaning in simple Language: Means a person who is liable to Pay Tax.

How to determine Resident: an individual is a resident of both Contracting States, then his status shall be determined as follows:

- He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
- If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
- If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
- If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.


Article 5 Permanent Establishment

The comparable term to PE under the Indian tax law is "business connection" [Section 9(1)(i)]. Generally speaking, **the concept of "business connection" is wider than PE** and hence, a business connection may exist even without a PE, but the absence of a "business connection" may indicate absence of a PE.

Language in the Article:

OECD Model Convention: a building site or construction or installation project constitutes a PE if it lasts more than twelve months.

The UN Model: makes a specific reference to Service PE which is absent in the OECD Model. "The furnishing of services, including consultancy services, by



an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days in any 12 month period commencing or ending in the fiscal year concerned”.

In the absence of a Service PE reference in OECD Model, the presence has to be ascertained through general principles under Article 5(1). Paraphrasing Article 5(1), **a PE exists if the following conditions are satisfied cumulatively:**

- *There is an “enterprise”.*
- *Such enterprise is carrying on a “business”;*
- *There is a “place of business”;*
- *Such place of business is at the disposal of the enterprise (may be owned / rented but must be one which the enterprise has the effective power to use);*
- *The place of business is “fixed”, that is, it must be established at a distinct place with a certain degree of permanence*

*The business of the enterprise is carried on wholly or partially through this fixed place of business. A **PE does not exist unless all the aforesaid conditions are satisfied.***

In simple Language: *How to determine the PE.*

Article 7 Business Profit

Business profits of an enterprise can only be taxed by the Residence State. Right of Source State to tax business profits of an enterprise only exists if a PE exists in its jurisdiction

Language of Treaty:

OECD model: once a PE is proven, the Source State can tax only such profits as are attributable to the PE. The UN Model Convention amplifies this attribution principle by a **limited** Force of Attraction rule (FOA). ↓

The FOA rule implies that when a foreign enterprise sets up a PE in State of Source, it brings itself within the fiscal jurisdiction of that State (State of Source) to such a degree that profits that the enterprise derives from Source State of Source, whether through the PE or not, can be taxed by it (State of Source State).

UN Model: , if the enterprise carries on business in the other Contracting State through a PE, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to:

- (a) that PE;
- (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that PE
- (c) other business activities carried on in that other State of the same or similar kind as those effected through that PE.

Article 11 Interest

Right to Residence State to tax interest: Generally, the interest is taxed in the Source State at a given rate on gross basis. however, it also confers right to the Source State to tax interest.

However, if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged cannot exceed a specified percentage of the gross amount of the interest. **The OECD Model specifies the percentage as 10%, but the UN Model leaves this percentage to be established through bilateral negotiations.**

Article 12 Royalties

OECD MODEL: under the OECD Model does not include the following: (a) rentals for films or tapes used for radio or television broadcasting and (b) equipment rentals like rentals for industrial, commercial or scientific equipment. **As per the OECD Model, royalties arising in Source State and beneficially owned by resident of the Residence State are taxable only in Residence State.**

UN Model: the UN Model provides that royalties may be taxed in the Residence State. Hence, the UN Model departs from the principle of exclusive right to tax provided to Residence State in the OECD Model.


Article 12A Fees for Technical Services

The UN Model has inserted a specific article pertaining to Fees for Technical Services (FTS). **There is no specific reference to FTS in the OECD Model.**

The FTS may be taxed in the Residence State but does not provide that the FTS is exclusively taxable in the Residence State. Paragraph 2 establishes the right of the country in which FTS arises to tax in accordance with its domestic law, subject to the limitation on the maximum rate of tax, if the beneficial owner is a resident of the other Contracting State. The maximum rate of tax is to be established through bilateral negotiations.

Article 13 Capital Gains

- ⌘ Both the Models have been updated and are identical
- ⌘ The right to tax income from capital gains may be exclusively with the



Residence State, or shared between the Residence and Source States. **The Article does not specify what is a capital gain and how is to be computed, this being left to the applicable domestic law.** Rights are conferred to the Source State if more than 50 percent of the value of shares during the preceding 365 days is derived from immovable property in such Source State.

Article 14 Independent & personal Services

It is only present now in the UN Model. It was deleted from the OECD Model on 29-4-2000[income derived from Professional Services etc., is now dealt with as 'Business Profits' (Article 7) under the OECD MC.]

The Article covers independent activities involving professional skills rendered by individuals on a principal to principal basis.

Income of Artists, Athletes and Sportsmen, etc. is not covered by this Article. Also, income from Fees from Technical Services is also not covered.

Article 21 Other Income

OECD approach envisages that the exclusive right to tax is with the Residence State. UN Model contains an additional paragraph, Article 21(3), which provides that Source State may also tax other income

Article 23A & 23B Elimination of Double Taxation

The OECD and UN Model Conventions specify two approaches- Exemption method (Article 23A) and Credit method (Article 23B).

Article 25 Mutual agreement procedure

There may be a situation wherein a tax payer may believe that the treatment accorded by either or both Contracting States is not in accordance with the provisions of the tax treaty. In such a case, there is a need for dispute resolution which is addressed by this Article.

The UN Model Convention provides two alternatives - Alternative A and Alternative B, for the article on Mutual Agreement Procedure which were introduced in 2011.

Under OECD Model the taxpayer may make a request to either Contracting State while UN Model (Alternative A) contemplates taxpayer going to Residence State or the country of his nationality. Alternative B of UN Model Article 25 contemplates reference to an arbitration process as part of the Mutual Agreement Procedure. The decision arrived at, through the process is binding unless a person directly affected does not accept it.



Article 26 Exchange of Information

The OECD and UN Model Conventions are similar with respect to this Article. A Contracting State cannot be expected to provide confidential financial information to another Contracting State unless it has confidence that the information will not be disclosed to unauthorized persons.

Questions

Question 1

Explain briefly the significant difference between the UN and OECD Model Tax Convention.

Answer

OECD Model is essentially a model treaty between two developed nations whereas UN Model is a model convention between a developed country and a developing country.

Further, OECD Model advocates the residence principle, i.e., it lays emphasis on the right of state of residence to tax the income, whereas the UN Model is a compromise between the source principle and residence principle, giving more weight to the source principle as against the residence principle.

Question 2


When does it become necessary to apply the tie-breaker rule? Discuss the manner of application of the tie-breaker rule.

Answer

Every jurisdiction, in its domestic tax law, prescribes the mechanism to determine residential status of a person. If a person is considered to be resident of both the Contracting States, relief should be sought from Article 4 of the Tax Treaty. A series of tie-breaker rules are provided in Paragraph 2 Article 4 of Model Convention to determine single state of residence for an individual.

The tie-breaker rule would be applied in the following manner:

- (i) The first test is based on where the individual has a **permanent home**. Permanent home would mean a dwelling place available to him at all times continuously and not occasionally and includes place taken on rent for a prolonged period of time.
- (ii) If that test is inconclusive for the reason that the individual has permanent home available to him in both Contracting States, he will be considered a resident of



the Contracting State where his personal and economic relations are closer, in other words, the place where lies **his centre of vital interests**. Thus, preference is given to family and social relations, occupation, place of business, place of administration of his properties, political, cultural and other activities of the individual.

- (iii) Paragraph (ii) establishes a secondary criterion for two quite distinct and different situations:
- 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;
 - The case where the individual has a permanent home available to him in neither Contracting State.
- In the aforesaid scenarios, preference is given to the Contracting State where the individual has an **habitual abode**
- (i) If the individual has habitual abode in both Contracting States or in neither of them, he shall be treated as a resident of the Contracting State of which he is **a national**.
- (ii) If the individual is a national of both or neither of the Contracting States, the matter is left to be **considered by the competent authorities** of the respective Contracting States.

Question 3

Explain the meaning of “interest” and “fees for technical services” under the UN Model Convention.

Answer

As per Article 11 of the UN Model Convention, “Interest” essentially means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment are not regarded as interest for the purpose of this Article.

As per Article 12A of the UN Model Convention, “Fees for technical services” is defined as payments for managerial, technical or consultancy services but excludes payment to an employee, payment for teaching in an educational institution or for teaching by an educational institution, payments by an individual for services for personal use