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Policy statement

The revision of the UN Model Tax Convention between developed and developing countries and related issues

Commission on Taxation, 24 November 1995

Submitted to the UN Ad Hoc Group of Experts on International Cooperation in Tax Matters (meeting on 11-15 December 1995, Geneva)

In the forthcoming meeting in December of this year the United Nations ad hoc Group of Experts on International Cooperation in Tax Matters (UN Group) will be considering the draft revision of the United Nations Model Tax Convention Between Developed and Developing Countries of 1980 (the UN Model) and the commentaries thereon. The UN Group will also discuss the subject of transfer pricing and the tax treatment of new financial instruments.

These three issues are of particular importance for the international business community. The ICC therefore takes this opportunity to present its views to the UN Group. The ICC's representatives will be pleased to elaborate on the comments at the December meeting.

This paper is structured as follows:

Part I: Comments on the draft revision of the UN Model Tax Convention and its commentaries

Part II: Special comments on Transfer Pricing Annex: ICC Statement of 1993 on Transfer Pricing (Doc. No 180/373)

A paper on the tax treatment of financial instruments is being submitted separately.

Part I: Comments on the draft revision of the UN Model Tax Convention and its commentaries

1. General remarks

The ICC appreciates being offered the opportunity to comment on the draft revision of the UN Model and its commentaries. Since the UN Model tends to influence to a large extent the solutions adopted in bilateral tax treaties negotiated between developing and developed countries, it is highly desirable that new developments in the field of international taxation are embodied in the UN Model and its commentaries which date back to 1980.

The ICC welcomes all efforts to harmonize the UN and the OECD models. It notes with satisfaction that many of the 1992 amendments to the OECD Model as well as substantial parts of the revised OECD commentaries are taken up in the revised UN draft. The ICC is clearly of the opinion that in view of increasingly close international economic cooperation it is no longer possible to justify having both an OECD Model and a UN Model, the latter of which actually creates impediments to international economic exchanges. The ICC is convinced that such provisions are not in the long term interest of those countries. Enterprises in both developed and developing countries are dependent upon each other and it is generally acknowledged today that economic development is based largely on international exchanges and foreign direct investments (see e.g. the UN World Investment Report 1992, entitled "Transnational Corporations as Engines of Growth").

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The ICC would strongly recommend that the new and positive appreciation of the role of multinational enterprises and of foreign direct investments be reflected in the revised UN Model and in particular in the commentaries. Cooperation and not confrontation will be the guiding principle for the future. It would be highly desirable if the UN Group could pay special attention to this i ssue when considering the revised draft.

The ICC is aware of the fact that from the point of view of the governments involved concluding a treaty for the avoidance of double taxation means negotiation on the sharing of revenues. Due to the imbalances in direct investments and income flows between developing and developed countries, equal sharing of the overall tax revenue will, however, not always be possible. The profits from a particular transaction have to be shared on a reasonable and equitable basis and any double or multiple taxation must be eliminated. Tax treaties are concluded in order to foster international investments and economic growth. Their objective is to eliminate fiscal obstacles which are harmful to the cross-border exchange of goods and services and the movement of capital and persons. The ICC would like to urge governments to pay due regard to this aspect in their tax treaty negotiations and, in particular, not to insist on provisions which do not effectively eliminate double taxation or by which the total tax burden is not alleviated.

In this context it has to be borne in mind that extensive source taxation may weaken a country's competitive position with respect to foreign direct investments. Furthermore, high taxes at source, e.g. on interest and royalties, usually lead to higher charges for the payer and may add substantially to the costs of a project. They may therefore well be to the detriment of countries which are in need of foreign capital and technology.

The draft revision of the UN Model moves the ICC to renew some of the recommendations it made in earlier ICC statements (see ICC Statements on the UN Model Double Taxation Convention, 1985, Doc. No 180/262; on the ICC Resolution of International Tax Conflicts, 1984, Doc. No 180/240) and to urge that equitable resolution of the problems it has identified be embodied in a revised model.

The main aspects of the draft revision requiring amendments in the ICC's view are briefly discussed in the following paragraphs.

2. Definition of Permanent Establishment

The ICC notes with concern that the concept of permanent establishment (PE) is still markedly wider than in the OECD model. In particular, some of the provisions under which a PE is deemed to exist are highly unsatisfactory. ICC urges the UN Group to further restrict this concept.

In the case of supervisory activities (e.g. para. 3a of Article 5) it should be clarified that such activities must take place essentially within the country where the building site or project is situated.

In the light of marked liberalisation in the field of services (e.g. General Agreement on Trade in Services-GATS) the provision of para. 6 of Article 5 which excludes insurance activities from the ordinary rules of para. 1 (fixed place of business) are no longer acceptable. The reasons mentioned in the commentaries for such special treatment are not at all convincing to the ICC.

The ICC is also strongly against the introduction of an additional criterion based on the level of remuneration in order to determine whether a PE is deemed to exist (as mentioned as an alternative for the provision of para 3a (projects) and 3b (services) of Article 5). Notional amounts are arbitrary and have nothing to do with the PE concept. The ICC would very much recommend that those references in the commentaries be deleted.

Para. 4e of Article 5 should be amended in order to allow the rendering of preparatory or auxiliary services not only strictly for the enterprise, but also for related enterprises of the same group. In practice, information or representation offices of multinational groups often act for different members

of a group, but their activity is still of a preparatory nature and does not in itself give rise to any income. The ICC proposes that a wording be chosen which would cover related enterprises as well.

3. Force of attraction of the permanent establishment
The ICC notes with great concern that the "force of attraction" principle is still envisaged in para. 1 of Article 7 of the draft revision. This principle is in clear contradiction to the attribution principle that governs the taxation of business income.

The ICC does not see any justification for the force of attraction principle. It is motivated by the fear of abuses and reflects a regression to practices believed to be long outdated. In practice, the force of attraction principle can have very far reaching tax consequences for an enterprise and creates conceptual problems (e.g. what profit shall be attributed to a PE from direct sales). It is absolutely normal that an enterprise makes, e.g. sales, partly through the PE and partly directly through the head office. As it is demonstrated by the OECD model and numerous bilateral tax treaties, abusive constructions can be countered in practice without such a far-reaching approach.

The UN Group seems to be aware of these problems. But instead of dropping the principle, it proposes a provision in the draft which obliges an enterprise to demonstrate (to the satisfaction of the tax authorities) that it had valid business reasons for not acting through the PE. Such reversal of the burden of proof is by no means justified. The guiding principle is the attribution principle. The profits are reflected in the books of the PE. If the tax authorities want to deviate from this principle it is up to them to show that transactions were in reality made through the PE.

From practical experience, the business community has good reasons to believe that such a provision will give rise to difficulties, lead to uncertainty and considerably weaken the taxpayer's position. A taxpayer can of course explain why he structured a transaction in a certain manner. However, realistically, this can not be done for each transaction. Furthermore, whether tax authorities consider his reasons to be legitimate depends entirely on the tax authorities' judgement. Yet legal certainty about their tax position is one of the important benefits taxpayers rightly expect from a tax treaty.

The ICC therefore urges the UN Group to entirely drop the outdated and archaic force of attraction concept and to follow the principles of the OECD Model for determining the income attributable to the PE.

4. Attribution of income to turnkey projects
One major difficulty with which enterprises acting in the business of setting up plant and equipment (in particular so-called turnkey projects) are often confronted in developing countries is the attribution of income. In order to avoid uncertainty in this respect and to make sure that only local activities (i.e. activities physically conducted in the host country) will be subjected to local tax, the ICC would strongly recommend an addition to the text of Article 7 of the UN Model, which could read as follows:

"In the case of contracts for outfitting, for construction or for installation of equipment, of industrial, commercial or scientific establishments or of public works, where the enterprise has a permanent establishment in the other Contracting State, the profits of such permanent establishment shall not be determined on the basis of the total amount of the contract, but shall be determined only on the basis of that part of the contract that is effectively carried out by the permanent establishment in that State. In particular, profits derived from furnishing materials to be incorporated into the plant, public work or establishment shall not be allocated to the permanent establishment.

The part of the contract which is carried out by the head office of the enterprise, such as planning, drawing of blueprints or basic and detailed engineering as well as technical services, shall be taxable only in the State of which the enterprise is a resident."

Furthermore, the ICC proposes that specific OECD publications (e.g. the 1994 OECD Report "Attribution of Income to Permanent Establishments") be referred to in the commentaries (in addition to the OECD commentaries) as guidelines for the resolution of specific problems on the attribution of income and in particular with respect to the deduction of expenses referred to in para. 3 of Article 7.

5. Related enterprises - Transfer pricing
The ICC would like to refer to its earlier comments on transfer pricing (in particular as it relates to primary products, cost sharing arrangements and the provision of services) in the annexed ICC

Statement on Transfer Pricing of 1993, and on the special remarks on the proposed para. 3 and 4 of Article 9 in Part B of this paper.

6. Excessive taxation in the host country
The ICC regrets that the Model does not contain limits on the rates of withholding tax on dividends, interests and royalties. Experience shows that this often leads developing countries to request unreasonably high rates and results in ensuing disputes in bilateral negotiations which may delay or even hinder the conclusion of a tax treaty or - if the other State agrees - may result in an excessive rate of withholding tax, which is not in the long-term interest of the country of source.

As a matter of principle, only the net income underlying the gross payments should be taxed. However, for practical reasons and partly because the source country is not in a position to determine the costs attributable to the gross payments, a withholding tax is applied to the gross payment. The rates must therefore be limited to low levels so as to avoid prohibitive taxation of the underlying net income.

With respect to dividends, the ICC would like to draw the attention of the UN Group to the fact that between industrialised countries (partly because of the Parent/Subsidiary Directive of the European Union) there is a strong tendency to provide for a zero withholding tax on dividends from participations in the residence country of the parent company. A withholding tax on such dividends can often not be credited against a tax in the residence country and therefore simply represents an additional charge on the profits earned by the subsidiary. In the UN Model a rate of 5% for participation and 15% for portfolio dividends could be envisaged, as currently set out in the OECD Model.

Withholding taxes on interest and royalties have traditionally been justified with the argument that tax revenue from passive income should be shared between the source and the residence countries and that double taxation is eliminated by the tax credit in the residence country.

However, in particular for banks and multinational groups (which are lenders of borrowed funds) a withholding tax on interest payments almost invariably results in the totality of tax revenue remaining with the country of source. A limit on withholding taxes applicable to portfolio investors is necessary to avoid double taxation of such income. For commercial enterprises such as banks, interest should properly be governed by the business profits article of the Model treaty and only taxed, like other commercial profits, if effectively connected to a permanent establishment. In any event, the amount subject to the withholding tax should never exceed the net margin (e.g. on a loan of 100 granted at 10% with funds borrowed at 9,5%, the net margin is 0.5% per annum). A tax based upon true economic criteria will help developing countries which are in need of foreign capital. Taxes that exceed the economic profit will have the opposite effect.

This situation is highly unsatisfactory, both in terms of tax revenue sharing and in terms of taxation of the lender, who cannot deduct the surplus withholding tax from the tax due on the margin, nor obtain reimbursement of the tax credit in the absence of profits. As mentioned before, such result is also to the detriment of developing countries which are in need of foreign capital or foreign technology.

7. Branch profits remittance tax

The ICC is against a branch remittance tax as it is provided for in the new para. 6 of Article 10 of the UN Model. Such tax represents an additional burden on the profits of the PE which cannot be credited in countries applying the exemption method for PE profits. If the UN Group intends to maintain this provision in the new Model it should at least be made clear that the withholding tax shall in no case exceed the rate provided for dividends from participation and that such tax shall only be envisaged if there is no discrimination between resident and non-resident enterprises.

8. Tax treatment of leasing, software and technical services

For the reasons mentioned above the ICC would generally recommend that royalty payments be taxable only in the country of residence of the recipient. In case the UN Group intends to maintain a withholding tax on such payments, a narrow definition of royalties should be adopted.

Leasing income

Under the 1992 revision of the OECD Model, income from rental of industrial, commercial or scientific equipment is no longer considered as income falling under Article 12, but as business income to which Articles 5 and 7 apply. The reason for this change is evident: leasing of equipment is a normal business activity and, considering the relatively small profit margins in this kind of activity, there is no room for all withholding tax on the gross amount. The ICC therefore urges the UN Group to reconsider its position and to follow the OECD in the question of leasing in order to allow lessees in developing countries to make use of this form of business on competitive terms.

Software

Export and import of software is rapidly growing in importance, not only for developed countries but also for developing countries. There is a tendency, particularly in developing countries, to generally classify such income as royalties in order to get a share out of this income by levying a withholding tax. The ICC is strongly against such a treatment which is not in line with the wording and the concept of Article 12. Due to the variety of software arrangements being entered into today, the tax treatment of software payments must be made on the basis of all facts and circumstances of a particular transaction, specifically including the terms of the relevant contract between the parties.

Technical services

Since the UN Model applies the concept of a deemed PE for the furnishing of services, a clearcut distinction between payments for services and payments for know-how is of great importance in practice. The ICC is of the opinion that this is not yet the case in the revised draft and would like to recommend to the UN Group that it should be at least clearly stated in the Model or the commentaries that in particular payments received for studies or surveys of a scientific or technical nature, or for consultant or supervisory services should be deemed to be profits of an enterprise to which the provisions of Article 7 or 14 apply.

The ICC would generally recommend that a narrow definition of royalties be adopted in case the UN Group intends to maintain a withholding tax on royalties.

9. Capital gains from shares

The ICC is of the view that the right to tax capital gains from the alienation of shares of the capital stock of a company, regardless of whether those shares constitute a portfolio investment or a substantial participation, should remain only with the home country of the investor. The host country has a right to tax the profits of the company, and it can tax hidden reserves when the company is liquidated or transferred abroad. The host country is, however, practically never in a position to grant effective tax relief to the investor for depreciation and losses on such investments or participations. Since the concept of taxing the capital gains of non-resident shareholders is usually not applied in the domestic tax law of developed countries, that provision is one-sided. Furthermore, it leads to inconsistencies and is to the detriment of the home country that has to take the depreciations and losses on participations into account but is deprived from the taxing right of the gains.

The ICC urges the UN Group to reconsider the issue. One of the generally accepted purposes of a tax treaty is the removal of tax curbs on international investment. Amending the UN Model in the way indicated would constitute an important step towards achieving this purpose by ensuring that host country taxation is kept to a reasonable level.

10. Taxation of managerial officials
Article 16 of the UN Model provides for the right to tax top-level managerial company officials in the country of residence of the company. Contrary to board members, such persons are employees and are taxable as such (under the concept of Article 15) in their country of residence. In practice, the provision of the UN Model gives rise to considerable problems (deter-mination of the function and the salary; conflicts with tax rules in conventions with third countries) and constit utes a real obstacle to the free movement of such persons. The ICC therefore strongly recommends that this highly controversial provision be deleted from the UN Model and that the OECD approach (taxation under Article 15), which is already widely used in conventions between developed and developing countries, be followed.

11. Preserving the effect of tax incentives
Of the two methods to avoid double taxation, viz. the exemption method and the credit method, the latter as set out in Article 23 B of the UN Model has the effect of transferring the benefit of a tax incentive that is intended for an investor to the treasury of that investor's country of residence. The ICC is therefore of the opinion that a special provision should be included in the Model under which the investor's country of residence also grants credit for taxes which a developing country has refrained from levying as a special incentive measure for foreign investors ("tax sparing credit"). The ICC would also recommend that foreign tax credit rules be structured in such way that the foreign taxes can effectively be credited (e.g. by an overall method and/or a credit carry forward system).

12. The mutual agreement procedure
The ICC is not satisfied with the mutual agreement procedure as now set out in both the OECD Model and the UN Model. The procedure requires significant changes in order to achieve fair and equitable treatment of all parties involved. In particular, the tax authorities should be required to reach agreement on a solution (e.g. by way of arbitration) and the taxpayer's involve-ment should be guaranteed by provisions that allow him to participate in the process and to approach the tax authorities of both countries.

Part II: Special comments on Transfer Pricing

Transfer pricing provisions in tax treaties are of fundamental importance to international trade. An important proportion of existing and newly developing international trade involves transactions between associated companies. It is essential that such companies can adopt transfer pricing policies which they may expect to be acceptable to the tax authorities of the countries concerned. Only then may retroactive challenges be avoided which, at best, will cause prolonged uncertainty and considerable administrative burden and, at worst, lead to unrelieved double taxation.

The ICC set out its views on transfer pricing in 1993 in its comments to the 7th meeting of the United Nations Ad Hoc Group of Experts on International Cooperation in Tax Matters (ICC Doc. No 180/373). These views are as relevant now as they were when the comments were submitted and the document is attached for convenient reference. In addition to this rather general statement the ICC wishes to offer specific comments on the changes proposed to Article 9 "Associated enterprises" and on the commentary to that article.

The proposed changes to Article 9 are cause for grave concern and it is unfortunate that the introduction to the commentary to Article 9 suggests that there is no change from the corresponding Article 9 of the OECD Model Convention. In actual fact, the text of paragraph 3 allows the application of national transfer pricing provisions which may be entirely at odds with the principle established in

paragraph 1, and paragraph 4 appears to allow the application of profit determination methods which are not compatible with the arm's length principle.

Paragraphs 3 and 4 take away the fundamental protection laid down in paragraph 1. Put very briefly, the effect of paragraph 1 is that a transfer price which meets the arm's length test (i.e. which could have occurred between unrelated parties) should not be adjusted. Paragraph 3 annihilates this protection by allowing any national law provision to override paragraph 1. It is difficult to see how such explicit wording in the text of an actual treaty might be mitigated by the proposed commentary on paragraph 3. Assuming nevertheless that the commentary gives the correct construction of paragraph 3, this paragraph still effectively says that a tax authority may replace a transfer price which passes the test of paragraph 1 by any other price provided it could have occurred between unrelated parties. This is manifestly unreason-able and would render any transfer price, however painstakingly determined in line with the principle of paragraph 1, vulnerable to adjustment. The effect of paragraph 4 is not much different. Because the reference to principles is not to those of paragraph 1 (but to those "contained in this article", which allows a circular argument) the meaning has become obscure and must be sought in the commentary, which effectively contains the same approach as the commentary on paragraph 3.

The ICC does of course accept that tax authorities must have the right to adjust transfer prices between associated companies if such prices are not in accord with the arm's length principle. But it is equally important that associated companies which have set prices in accordance with this principle enjoy the certainty that these will not be upset by later adjustment. The principle laid down in paragraph 1 meets both objectives fairly. Upsetting this principle would introduce grave uncertainty for trade between associated companies. The ICC urges the Ad Hoc Group of Experts to reject the paragraphs 3 and 4 of Article 9 of the Model which are incorporated in the draft now being considered.

Finally, as a drafting comment, the ICC observes that in the penultimate line of paragraph 1 of Article 9 of the Model the words "have accrued to one of the enterprises, but, by reason of those conditions," appear to have been omitted inadvertently.

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