THE CONTRAST IN FAVOURING THE DEVELOPED AND DEVELOPING NATIONS: UN MODEL CONVENTION AND THE OECD MODEL CONVENTION

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ABSTRACT

Tax treaties are considered as the agreements between independent tax jurisdictions, whose main purpose is to allocate the taxing rights between these states. It can be understood that an individual or a corporate body has to pay tax in the country in which the income is earned and also in the country in which the person is a resident, in essence to say the source jurisdiction and the Resident jurisdiction. It is clear that here the person would be charged double for the single income he earned and therefore tax treaties are entered into so as to avoid double taxation.

There are two major treaties
1. OECD (Organization for Economic Co-operation and Development Model Convention on Income and on Capital) Model Convention on Income and on Capital.
2. UN (United Nations) Model Double Taxation Convention between Developed and Developing Countries.

Both The OECD and UN model income tax treaties were designed in a way to reduce the proportion of income that would be allocated to source countries, with the residue allocated to residence countries.

But over the years it can be understood that the OECD Model Convention favours more to the side of developed countries with respect to tax treaties whereas the UN Model Convention is made to favour the developing countries and is considered a very important treaty for developing countries to refer to while entering into a tax treaty.

In this paper we will analyse the reasons as to how and why these treaties are made in such a way.

INTRODUCTION

The Model tax conventions are drafted in a standard format and are made for the purpose of assisting in better negotiation for the bilateral agreement of tax between States.

Treaties are not meant to allocate taxing right to the countries but restricting their taxing right to so to prevent double taxation. Certain treaties limit the source country's taxing right and leaves more room for the host country in which the investor or the business person is a resident of to collect tax. In cases where two capital exporting countries are involved it generally has a low impact on the source country's taxing right as both the jurisdiction sacrifice to the other's taxing right. Where one country is capital importing then the treaty shifts that taxing right to the richer country from the poorer one.[1]

In general, in the OECD Model the source state may tax the business profits derived from activities within the source state. The state in which the company is tax resident is, by means of the specific tax treaty, not allowed to tax those profits, although this

[1] Veronika Daurer & Richard Krever, *Choosing between the UN and OECD Tax Policy Models: an African Case Study*, CADMUS, 12 (2012), https://cadmus.eui.eu/bitstream/handle/1814/24517/RSCAS_2012_60rev.pdf?sequence=3.

resident state would tax the profits based on its domestic legislation. By means of the tax treaty, double taxation is avoided.

Though the United Nations Model Double Taxation Convention for taxation (hereinafter "UN MC") draws heavily on the OECD Model Convention the OECD in general is considered as more favourable convention for developed countries since it shifts more taxing powers to the capital exporting countries whereas the UN MC is considered as better option for the developing and least developed countries as it reserves the right of taxation to capital importing countries, also designed with a view to have better negotiations between developing and developed nations. It is not because the conventions are biased due to the composition of it member countries that is to say OECD member countries out of 37 are mostly developed countries. It is due to the fact that there are some minute changes in the OECD convention Articles as compared to the UN MC.

This can be understood by studying different treaty mechanisms of different countries which includes OECD convention or UN MC as their guiding factor. The Countries which relied on the OECD model may reveal the degree to which it is willing to pay a price by way of reduced tax revenue in the short term to generate hoped-for benefits over the longer term. Whereas countries basing their reliance more on the UN MC were able to retain more taxing rights.

The OECD model often mitigates or eliminates double taxation as it requires the source country to give up taxing right on certain categories or sometimes completely give up its taxing rights for the income earned by the resident of the other treaty country. It is to be understood that this feature works well when the flow of trade between the countries is certainly equal and the resident country taxes any income which has not been taxed by the source country. Whereas the OECD Model won't be considered appropriate in the countries which entered into agreement through the treaty as capital importing one. As a result the developing countries need UN MC.[2]

BASIS OF MODEL TAX TREATIES

The model treaties and actual treaties based on them use three mechanisms to divide taxing rights. The first one is considered on the face of it as the most draconian option which is to entirely remove the source country's taxing right to a particular kind of income and allocating that right to tax the income completely and exclusively to the resident country. Some tax treaties use this mechanism for business profits unless the non-resident earns that profit through a permanent establishment or an actual fixed place of business. Both OECD and UN MC adopt this rule but with certain substantial differences.

The second mechanism is dividing the taxing rights between the two contracting states. This allows the capital importing/ the source country to impose its domestic tax laws on the income repatriated to foreign investors but it also imposes a cap on the domestic taxing rights. This is generally done for three types of income derived by non- resident investors: interest, dividend and royalties. It sets a cap on the maximum withholding tax

[2] Brian J Arnold, *An introduction to tax treaties*, UNITED NATIONS, 3 (2015), https://www.un.org/esa/ffd//////wp-content/uploads/2015/10/TT_Introduction_Eng.pdf.

rate that the source country may impose on these types of income. If the rate is lower, then it gives the benefit to the resident state in imposing a higher tax rate on these income. Finally, the third type allows the capital importing country to retain its full right on imposing tax but only for certain types of income. The capital exporting country in which investors and businesses are resident retains its ordinary taxing rights on income derived by its residents but must give priority to the source country's taxing rights. If the residence country wishes to use its residual rights and impose tax on the foreign source income, it must provide residents with a credit for the tax imposed by the source country. [3]

KEY DIFFERENCES (ANALYSIS THROUGH THE ARTICLES OF OECD MODEL CONVENTION AND THE UN MC)

Article 5- Permanent Establishment[4]

- Article 5 of the OECD which talks about "Permanent Establishment" in para 3 provides that a building site and construction or installation project constitutes a PE whereas the UN MC in addition also includes consultancy services provided by an employee or other personnel who is engaged by the enterprise and continue to do so within the contracting state for a period of not less than 183 days of any 12 month period. It can be interpreted that UN MC gives a wider scope for taxation right to the host/ resident country as it includes consultancy services as a part of PE which also constitutes a good portion of services provided in the international business front.
- Para 4 of both the Conventions are the same except OECD MC includes the word "delivery" in the provision which excludes the use of facilities belonging to the enterprise and the maintenance of a stock of goods from the purview of PE. This omission of the word "delivery" by the UN MC can be considered as an important benefit which a host country can gather by having a stock of goods used for prompt delivery of goods facilitating the sales.
- Para 6 of OECD and the UN MC do no correspond to each other in any aspect as the UN MC includes the provision for insurance business stating that Insurance business shall be considered as part of PE if it collects premium in that territory of the other state or insures risk situated therein. The UN MC gives the advantage to insurance businesses of not being taxed unlike OECD MC. OECD MC does not impose tax on a dependent insurance agent who normally had no authority to conclude the contract and therefore under UN MC this provision allowed to deem a PE to exist with respect to para 7 of the UN MC including dependent agents also. This provision for taxation was made as it was considered desirable for the country where the premium was being paid and should be paid independently from the status of the agent. But it is still only based on the assumption that the person who is paying the premium is present in that country.

Article 6- Income from immovable Property[5]

[3] Veronika Daurer & Richard Krever, *Choosing between the UN and OECD Tax Policy Models: an African Case Study*, CADMUS, 14 (2012), https://cadmus.eui.eu/bitstream/handle/1814/24517/RSCAS_2012_60rev.pdf?sequence=3

[4] Article 5, United Nations Model Double Taxation Convention, 2011; Article 5, and Model Tax Convention, 2017.

[5] Article 6, United Nations Model Double Taxation Convention, 2011; Article 6, and Model Tax Convention, 2017.

- Paragraph 4 of Article 6 of OECD MC says that income derived by a resident of a contracting state from immovable property situated in the other contracting state may be taxed in that particular state and shall apply to income derived from direct use, letting others use in any other form of immovable property which is applicable only to income from immovable property of an enterprise. Where as in UN MC, conditions are applicable to income from immovable property of an enterprise and is subject to tax under income from immovable property used for the performance of independent personal services also.

Article 7- Business Profits[6]

- The UN MC follows the "force of attraction rule" as compared to the OECD. The rule always expands the right of the source country to tax the business profits of an enterprise. This helps the source country to tax profits from direct sale of similar good/ services in the source country without the involvement of a PE. Article 7 states that the amount of profit which is calculated from the activities attributable to the source country is required to be treated as separate from the enterprise of which is it a PE of.
- This means that the tax authorities of the source country should look at the separate sources of profits that the enterprise derives from its country and apply to each the PE test.[7] An enterprise setting up a PE in the source country to process certain business activities etc., only the profits from a PE are taxable in the source country. Article 7 of the OECD rejects the FoA rule thereby not only restricting the benefit of taxation of business profits but also other profits like dividends, royalties and interests arising from the sources of the source country.
- OECD follows the rule under which the profits of the non-resident enterprise which are not related to the PE will not be taxed by the host country. The UN MC also provides some clarifications with respect to the deductions in determining the PE unlike the OECD which does not provide for the same.
- The UN Model Convention adopts a limited force of attraction rule which allows the source country to tax profits attributable to sales in the source country of goods or merchandise of the same or similar kind as those sold through the PE or other business activities carried on in the source country of the same or similar kind as those effected through the PE. This functions as a limited anti-avoidance rule.[8]
- In the case of *Roxon OY (2007)*[9], the tribunal held that the scope of Article 7 only extends to the activities carried out by a foreign enterprise in the source state considering that it is similar to the activities carried out through its PE in the source State but not to all the activities of such an enterprise.
- In the case of *Linklaters & Paines*[10], the tribunal interpreted the words 'profits indirectly attributable to the PE' incorporates a force of attraction principle in the India-UK tax treaty. The basic understanding of the force of attraction rule is that when an enterprise sets up a PE in another state, that

[6] Article 7, United Nations Model Double Taxation Convention, 2011; Article 7, and Model Tax Convention, 2017.

[7] OECD MODEL CONVENTION AND UN MODEL CONVENTION: A COMPARISON, https://shodhganga.inflibnet.ac.in/bitstream/10603/241545/10/10_chapter%202.pdf (last visited Sep 20, 2020).

[8] Brian J Arnold, *An introduction to tax treaties*, UNITED NATIONS, 3 (2015), https://www.un.org/esa/ffd/////wp-content/uploads/2015/10/TT_Introduction_Eng.pdf.

[9] Deputy Commissioner of Income Tax v. Roxon Oy, (2007) 106 ITD 489 Mum.

[10] Linklater LLP v Income Tax Officer, 4896/5085/Mum/03.

country gets the right to tax the profits the enterprise derives in its jurisdiction regardless of the fact whether the transactions are routed and performed through a PE or not. Thus, entire profits related to services rendered by the taxpayer, whether rendered in India or outside, with respect to Indian projects is taxable in India.[11]

Article 8- Shipping, Inland Waterways Transport and Air Transport[12]

- Though alternative A for both UN MC and OECD are the same stating that profits from operation of ship or aircraft in intentional traffic, operation of both engaged in inland waterways profits from the participation in a pool, a joint business or an international operating agency shall be taxable only in the contracting state in which the place of effective management of the enterprise is situated.[13] But there is an another alternative provided by the UN MC for a limited source country taxation stating that if the shipping activities arising in the other contracting state are more than casual then the profits may be taxed by the other state. This gives rise to the right of the source country to tax certain profits from the operation. According to the commentary of UN MC "more than casual" means a scheduled or planned visit of a ship to a particular country to pick up passengers or freight.[14]
- Therefore, it can be understood that the UN MC tries to give the source country a taxing right for the shipping, waterways and air transport operations which were not provided by the OECD since it restricts their right. For a developing country it is beneficial since the profits to be taxed in the source state will be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations.[15] It also lays down in certain situation where the effective management of the shipping enterprise is aboard a ship or boat then the home country will have the right. If we looks at the provision it become easy to interpret that how the UN MC has tries to include the home country in the taxing right as the UN MC members include developing or least developed countries.

Article 10- Dividends[16] and Article 11- Interest[17]

- There no major difference between the two conventions but the UN MC does not provide for a rate of maximum dividend withholding tax nor does it provide for the maximum limit for the rate of interest allowed to the source country and therefore it impliedly gives power to adjust it through bilateral negotiations between the countries.

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[11] PRESS READER.COM – YOUR FAVORITE NEWSPAPERS AND MAGAZINES, https://www.pressreader.com/india/the-hindu-business-line/20130624/281822871371093 (last visited Sep 24, 2020).

[12] Article 8, United Nations Model Double Taxation Convention, 2011; Article 8, and Model Tax Convention, 2017.

[13] OECD MODEL CONVENTION AND UN MODEL CONVENTION: A COMPARISON, https://shodhganga.inflibnet.ac.in/bitstream/10603/241545/10/10_chapter%202.pdf (last visited Sep 20, 2020).

[14] United Nations Model Double Taxation Convention between Developed and Developing Countries United Nations New York. (2011) pg 246.

[15] Article 8 (Alternative B) Para 2, United Nations Model Double Taxation Convention between Developed and Developing Countries.

[16] Article 10, United Nations Model Double Taxation Convention, 2011; Article 10, and Model Tax Convention, 2017.

[17] Article 11, United Nations Model Double Taxation Convention, 2011; Article 11, and Model Tax Convention, 2017.

Article 12- Royalties[18]

- Base erosion and profit shifting (BEPS) refers to the corporate tax planning strategies which are used by multinationals to shift their profits from higher tax jurisdiction to lower tax jurisdiction thereby eroding the tax base of higher tax jurisdictions.
- The OECD MC gives exclusive taxation right to the country where the owner of the country is a resident. It can be seen that usually the owner of the royalty is a resident of a developed country and thereby it strips off the developing countries from the right of taxing such royalties. This leads to base erosion.
- In this context, Article 12 and the newly added Article 12A of the UN MC may prove more appropriate for developing countries. [19] This give a shared attribution that is to say, primary taxing rights are given to the resident state and secondary taxing rights are given to source state.
- It is to be noticed that neither the OECD nor the UN MC provides for service payments under the definition of Royalties under Article 12. Further, services are usually provided through a digital platform which might create confusion as to deciding the taxing right and may lead to disputes as to where should the income be registered, the host country or the source state.[20]
- *Electronic Data Systems, Deutschland GmbH v Inspección tributaria*[21]
  The definition of royalty contained in the US Models differs from that of the OECD Model in that: –
  → a residual catch-all category of copyrighted intangibles is added (i.e. copyright of "other work" added to literary, artistic and scientific works);
  → a residual catch-all category of intangibles is added (i.e. "other like right or property" is added to patents, trademarks, designs or models, plans, secret formulas or processes); this residual category contained in the 1996 US Model was then excluded from the 2006 US Model;
  → Gains derived from the alienation of all intangibles that generate royalties are also characterized as a royalty to the extent these are contingent on the productivity, use, or disposition of the property.[22]
- Therefore, unlike Article 12 of the OECD Model Convention, Article 12 of the UN MC does not prevent the source country from imposing tax on royalties paid by a resident of the source country to a resident of the other country. [23]

Article 13 Capital Gains[24]

[18] Article 12, United Nations Model Double Taxation Convention, 2011; Article 12, and Model Tax Convention, 2017.

[19]ASPECTS RELATED TO THE BEPS PROJECT OF THE OCDE.xlsx, https://ciatorg.sharepoint.com/:x:/s/cds/EfUl0OKEdK9Dv97SROi_AYcBjBQganLHaETDJLx4Ql1wGg?rtime=YpZ9IP1b2Eg (last visited Sep 19, 2020).

[20] CIAT, TAXING SERVICE PAYMENTS AND ROYALTIES UNDER THE OECD AND UN MODEL TAX CONVENTIONS CIAT (2019), https://www.ciat.org/taxing-service-payments-and-royalties-under-the-oecd-and-un-model-tax-conventions/?lang=en (last visited Sep 22, 2020).

[21] Electronic Data Systems, Deutschland GmbH v Inspección tributaria

[22] Stefano Simontacchi and Erki Uustalu, *Treaty issues related to the provision of know-how: Comment on a Spanish Supreme Court decision*, IBFD, https://www.ibfd.org/sites/ibfd.org/files/content/pdf/A_Decade_Caselaw_chapter.pdf.

[23] Lodewijk Wisse & Robert van Asten, SOURCE STATE TAXATION IN MODEL TAX TREATIES UNIVERSITEIT LEIDEN (2012), https://leidenlawblog.nl/articles/source-state-taxation-in-model-tax-treaties (last visited Sep 19, 2020).

[24] Article 13, United Nations Model Double Taxation Convention, 2011; Article 13, and Model Tax Convention, 2017.

- Para 4 of UN MC that capital gains from sale of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property which directly or indirectly consists immovable property situated in a contacting state "may" be taxed by the resident state. Whereas the OECD Model states that it "shall" be taxed by the resident state only. This change in the words in the two model conventions plays a great role in restricting and allocating taxing rights of capital gains to the source country. The UN MC provides a scope for the source country to tax capital gains whereas the OECD is much rigid in its article by not providing any scope for the source country to tax capital gain. In my opinion the source country should have some right to tax over the property which exists in the other state since it give rise to more investment by the contracting state.

Article 18- Pensions and Social Security Payments[25]

- Under Article 18 of the OECD MC, individuals receiving pension on account of past employment generally are taxable only by the Contracting States in which they are a resident. The UN MC offers some scope for taxation at source. The alternative provision in the UN MC, i.e. Article 18B, provides for a sharing between the country of residence and the country of source for the pension of the right to tax pensions and other similar remuneration when the payments involved are not made within the framework of a public scheme which is part of the social security system of a country or a political subdivision or a local authority thereof. In the case where payments are made within the framework of such a public scheme, the right to tax belongs only to the source country.[26]
- This addition by the UN MC through Article 18B gives benefit to the person who is a resident of a higher taxing country by allocating taxing right over the pension to the source country which sometimes are countries imposing a lower tax rate. This provides an opportunity for the lower tax rate countries to charge some amount of tax from the pension received by the person who is now a resident of another country.

After analysing some of the Articles it can be noticed that the OECD Model Convention does not provide for provisions related to services and in the recent times the OECD has reiterated that services is treated in the same way as the provisions of the good. We have observed the same through Article 5 and also Para 6 of Article 5 under the UN MC which specifically talks about insurance services. This aspect of OECD in my opinion makes if more harsh as sometimes the services takes a lot more expenditure than providing goods and imposition of high tax on those services by higher tax rate countries would lead to less investments by the resident who belongs to the source country. The OECD model requires that there should be some sort of economic presence in that country for a certain period of time.

Through the OECD and the UN MC it cannot be misunderstood that it replaces the domestic taxation law entirely. Taking an example, a person is a resident of country A according to its domestic laws and he is also a resident of another country B according to that country's domestic law. According to

[25] Article 18, United Nations Model Double Taxation Convention, 2011; Article 18, and Model Tax Convention, 2017.

[26] Brian J. Arnold & Michael J. Mc Intyr (2002) "International Tax Primer" Kluwer Law International, Business & Economics page 124.

Article 4 of both the UN MC and the OECD MC which provides a series of rules to make the person who is a resident of both the country a resident of only one country for the purpose of the taxing treaty. So the person stays as a resident of country A for the purpose of the treaty and resident of Country B for its domestic laws which are not affected by the treaty. So, if the person makes payment of dividends, interests, and Royalties to non-residents of the country B then that person would be obligated to pay such tax imposed by the domestic law of Country B as a resident of the country.

Standard Chartered Bank v. The Commissioner of Taxes, (2013)[27]
It was stated in this case that Bangladesh and U.K entered into the treaty giving consideration to both UN MC and OECD Model and incorporating both in their treaties so as to avoid double taxation and acquire benefit. This shows that countries prefer a mixture of both the conventions so as to obtain maximum benefit of their taxing right which they believe won't be possible by individually using the two conventions.

INDIA'S RESERVATIONS WITH RESPECT TO OECD

Since India is still a developing country it has certain reservations to the OECD Model Convention. India also doesn't actually fully implement the OECD model and takes more guidance from the UN MC model in its treaties. India has certain reservations with respect to the OECD model, it does not agree with the view that an agent working for an enterprise in the contracting state in some cases be considered as an independent agent. OECD also includes 'website' under PE which is not agreeable by India and it reserves that unless it leads to a significance economic presence of the enterprise it cannot be considered as a PE.

Furthermore, India has reservations with respect to: Collection of data for the purpose of determination or quantification of risk, by an enterprise in the business of managing risks such as insurance, is not an activity of preparatory or auxiliary character. With respect to terms not defined in a treaty it considers that can only have the meaning which is- is under the laws of the state. It also refuses to include the term 'recognised pension fund' from the definition of 'resident'. Relating to fiscally transparent entity, India has reserved its right not include any provisions with respect to same and thereby such entities would not be eligible for tax treaty benefit. Recently, India has decided8to accept transfer pricing MAP and bilateral APA applications regardless of the presence of Article 9(2) dealing with adjustment relating to transfer pricing (or its relevant equivalent Article) in the tax treaties.[28]

CONCLUSION

Since the OECD is an international organisation for the industrialised countries, so the OECD Model Convention is between these countries which are more or less at the same economic standard, usually high. Whereas the UN Model is explicitly meant to

[27] Standard Chartered Bank vs. The Commissioner of Taxes, LEX/BDHC/0370/2013.
[28]KPMG, *India's reservations on 2017 update to the OECD Model Tax Convention and Commentary*, TAX FLASH NEWS, (2017) https://home.kpmg/content/dam/kpmg/in/pdf/2017/12/KPMG-Flash-News-Indias-reservations-update-to-the-OECD-Model-Tax-Convention-and-Commentary-2.pdf.

provide guidance to the developing countries as the name of the convention also suggest United Nations Model Double Taxation Convention between Developed and Developing Countries. The fiscal knowledge of the governments of developing countries cannot be compared to the (academic) knowledge and level of education in the industrialised countries.

The UN MC provides a larger portion for the source state taxation thereby allowing them more profits to be derived from the activities in the source state which can be taxed by the source state itself. Since OECD members are more of a high income group of countries the OECD is quite feasible for them but if a lower income group country basis its treaty solely on the OECD Model while entering into agreement with a higher standard country then it may lead to restriction on the taxing right of the country which won't do any good to that country. The UN MC does follows the pattern which is set by the OECD Model Convention and many of it's the provision are identical so the UN MC cannot entirely be view as separate from the OECD.

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