

OECD vs UN Model Convention

- **Fiscally transparent entity is an entity which is not taxed. However, its real owners are taxed in respect of income of entity.**
- **OECD Model Convention** is a model treaty between **two developed nations**, whereas **UN Model Convention** is model treaty **between developed and developing nations**. The Model Conventions serve as starting point for countries to enter into treaty negotiations.
- Residence and source based taxation are two most fundamental rules of international tax theory. Residence based taxation states that the taxing rights with respect to income arising from cross border trade will be exercised in the resident country. Source based taxation states that the taxing rights with respect to income arising from cross border trade will be exercised in the source country, where the goods/services are consumed.
- Developed countries being capital exporting countries will emphasize on a residence based taxation, whereas developing countries being capital importing countries will emphasize on a source based taxation.
- The major differences between OECD Model Convention and UN Model Convention are because of this fundamental difference in approach of the developed and developing country. **OECD Model Convention advocates a residence based taxation whereas UN Model Convention advocates a source based taxation.**

In the light of the above background the material **differences between OECD and UN Model Convention are discussed below:**

Definition of Permanent Establishment

- Article 5 of both OECD Model Convention and UN Model Convention contains the definition of Permanent Establishment. The concept of permanent establishment is very important in the context of tax treaties as the business income can be taxed in the source state only if the business is carried out through permanent establishment.

For example, A Inc. is an US company engaged in manufacturing industrial equipment and exporting to various countries including India. The income which A Inc. earns from India can be taxed only if A Inc. has a permanent establishment in India.

- Article 5(1) and 5(2) which provide the basic definition of permanent establishment are identical in both the Model Conventions.
- Article 5(3) is different in the two Model Conventions. OECD Model Convention states that a building site or construction or installation project will constitute

a PE whereas UN Model Convention states that a building site, a construction, assembly or installation project or supervisory activities in connection thereof will constitute a PE. (Page 18 of Chapter 9)

- OECD Model Convention prescribes a threshold of 12 months for the installation/construction/building project for constitution of PE while a 6 months threshold has been prescribed by UN Model Convention. (Page 18 of Chapter 9)
- The concept of service PE is not there in OECD Model Convention but the same finds its place in the UN Model Convention.
- Article 5(3)(b) of UN Model Convention states that furnishing of services by an enterprise through employees or other personnel can constitute a PE but only if the activity of service provision continues for a period aggregating more than 183 days in a 12 month period. (Page 18 of Chapter 9)
- Article 5(4) lists down the exempted activities which will not constitute a PE provided that the activity is of a preparatory and auxiliary character.
- There is a basic difference in the Article 5(4) in as much as the activity of use of a fixed place for delivery of goods or maintenance of stock of goods for delivery does not constitute a PE in OECD Model Convention. Such activities have not been included in UN Model Convention as exempted activities for constituting a PE. (Page 19 of Chapter 9)
- Article 5(5) lays down the definition of an agency PE or how a PE can be constituted by the activities of a dependent agent. The definition of agency PE is similar to the definition of business connection as contained in Explanation 2 of Section 9 of the Act.

UN Model Convention states that activity of a dependent agent to habitually maintain stock of goods from which regular deliveries are made, will also constitute a PE (Business connection definition in Income Tax Act contains this provision). Such a clause is absent in OECD Model Convention.

- Article 5(6) which is there in UN Model Convention is absent in OECD Model Convention. Such clause states that the act of collecting premiums in a territory or insuring the risks in that territory through a person will constitute a PE (the activities of independent agent will not constitute a PE). (Page 24 of Chapter 9)

Attribution of profits to a permanent establishment

- Article 7(1) of the OECD Model Conventions states that the profits attributable only to the Permanent Establishment may be taxed in the source state. It is based on the principle that only the profits arising on account of activities of permanent establishment can be taxed in the source state.

- Article 7(1) of the UN Model Convention incorporates a limited force of attraction rule which states that once a PE is created not only the profits attributable to PE can be taxed but also the profits attributable to sale of goods, or merchandise which are same or similar kind as sold through PE or attributable to other business activities as same or similar to the activities carried out through PE, can be taxed in the sourced state.

The force of attraction principle implies that once a PE is constituted the fiscal jurisdiction of a state extends not only to the activities of the PE but also to the other activities of PE. Article 7(1) of UN Model Convention contains a limited force of attraction since the only profits attributable to sales or business activities which are same or similar to sales or activities carried out through PE may be taxed by the source state. (Page 27 of Chapter 9)

- Article 7(2) of OECD Model Convention specifically contains a reference to functional, asset and risk analysis for attribution of profits to PE. Such a reference is absent in UN Model Convention. (Page 29 of Chapter 9)
- Article 7(3) which is there in UN Model Convention allows the deduction of business expenses but limits the deductibility of expense in the hands of PE if such expense pertains to payment by PE to HO on account of royalty or other payment for use of intangibles, commission or interest (except in banking industry). Actual reimbursement of expenses pertaining to the above shall however be allowed as deduction. Similarly, the receipts by PE from HO on the account of above will not be included in the profits of PE.
- Article 7(4) which allows an apportionment based approach for attribution of profits to PE is present only in UN Model. It states that the same should be used only if it has been customary on part of two states to use this approach.
- UN Model Convention also states that unless there is a good and sufficient reason, same method of profit attribution should be used by a country year on year.

Taxation of royalty and fee for technical services

- OECD Model Convention provides the taxing rights with respect to the royalty only to the resident state. UN Model Convention grants the right to both the states. UN Model Convention prescribes a concessional rate of tax in the source state subject the fact that recipient of the royalty should be beneficial owner of the same and should be resident of the other country.
- UN Model Convention specifically includes consideration for use or right to use films or tapes used for radio or television broadcasting and also for the use or right to use any industrial, commercial or scientific equipment in the definition of royalty.
- UN Model Convention provides that royalty shall be deemed to arise in a state where the payer of royalty is resident. It has equated the source with the

residence of the payer. However, if the payer has a PE in another state in connection to which the liability to pay royalty was incurred, the royalty shall be deemed to arise in the state where the PE is situated.

- OECD Model Convention does not have a specific clause pertaining to fee for technical services (“FTS”). UN Model Convention specifically incorporates a clause for taxation of fee for technical services. It provides the right to the source state for taxation of FTS but at a concessional rate. Similar to clause for royalty source state has been equated with country where the payer of FTS is situated.
- UN Model Convention defines FTS as consideration for any service of a managerial, technical or consultancy services.