

DOUBLE TAXATION – REVIEW OF THE UN MODEL

*Jatinder Aneja**

*Bhavna Singh**

Income tax the world over is to be charged in the hands of the person at the place where he or she derives the income or where he or she resides. However, with the growth of global trade and commerce we are faced with the problem of double taxation. Double taxation occurs when the resident of one state derives his income in another state (called the source state) then unless there exists a double taxation treaty between the two countries the individual may have to pay taxes in both the resident and the source states. This will increase his cost and deter international trade.

Developed countries enter into double taxation treaties because they want their citizens to take part in international trade and commerce whereas developing countries enter into double taxation treaties so that they attract more investment in their countries. Thus these treaties are all double taxation avoidance treaties.

The importance of these treaties has grown tremendously in this century and after the Second World War, a number of Asian and African countries gained independence and the need to promote greater inflow of foreign investment on politically acceptable conditions arose. This has been affirmed time and again in resolutions of the General Assembly, the UN Economic and Social Council and the UN Conference on Trade and Development. In 1968, the Secretary-General of the UN set up the *ad hoc* group of experts on tax treaties between developed and developing countries. This groups of experts drafted the final Model Convention which was published by the United Nations in 1980 along with commentaries.¹

The UN Model Convention represents a compromise between the source principle and the residence principle of taxation although more weightage is given to the source principle. The provisions are based on the recognition by the source country:

- (a) that taxation of income from foreign capital would take into account expenses allocable to arrive at the net taxable income.
- (b) that taxation would not be so high as to discourage investment.
- (c) that it would take into account the appropriateness of the sharing of revenue with the country providing the capital.

* IV Year B.A., LL.B. (Hons.), NLSIU.

1 K. Srinivasan, *Guide to Double Taxation Avoidance Agreements*, 1.8-1.10 (1994)

The model applies to cases in which the resident of one country earns income in another country between which a treaty adopting the UN Model of double taxation exists. The country to which the person belongs is the state of residence and the country in which he earns the income is the state of source. The Articles of the model provide two methods for Elimination of Double Taxation, i.e., the exemption method with progression (Article 23A) and the ordinary credit method (Article 23B). The two methods can be explained better with the help of an example in figures:²

Suppose the total income of "A" is 100,000, out of which 80,000 is derived from the state of residence (State R) and 20,000 is derived from the state of source (State S). Assume in State R income of 100,000 is taxed at 35% and an income of 80,000 is taxed at 30% whereas in State S the rate of taxation is 20%. Under the two methods tax payable by the person in States R and S will be:-

(a) Exemption with progression

State R imposes tax on income earned in their state i.e., 80,000 at the rate applicable to total income (100,000) wherever it arises, i.e., at 35%.

| | |
|---------------------------------|--------|
| Tax in State R at 35% of 80,000 | 28,000 |
| Tax in State S at 20% of 20,000 | 4,000 |
| Total tax payable by A | 32,000 |

In the present case if total income of 100,000 would have been derived from State R then the tax payable by A would have been 35,000, therefore relief given by State R to A is 7000.

(b) Ordinary Credit

State R computes tax on total income of 100,000 at 35% and allows the deduction of the tax due in State S, on the income from S, but in no case it allows more than the portion of tax in State R attributable to the income from S. The maximum deduction at 35% of 20,000 will be 7000 in this case.

| | | |
|--------------------------------------|---|--------|
| Tax in State R at 35% of 100,000 | = | 35,000 |
| Less Tax in State S at 20% of 20,000 | = | 4,000 |
| Tax due in State R | = | 31,000 |

Therefore the total tax payable by A is 35,000 out of which 31,000 is payable in State R and 4,000 is payable in State S.

Under both the methods the amount of tax payable in State of Source (S) is the same but the tax payable in state of Residence (R) is more in the case of

2 *Supra* n. 1 at 2.132-2.134.

Ordinary Credit method. It is the option of the states to decide which method is to be followed in the calculation of tax, there may arise a situation when the contracting states will adopt different models, if such a combination or amalgamation of the two methods is to be adopted. The exemption method does not apply to such items of income (Dividends, Interest and Royalties) which according to the convention may be taxed in the state of residence and in such a case the credit method is to be applied in accordance with paragraph 2 of Article 23A. Now the question of allocation of different types of incomes earned by a resident of one state in another state between the two contracting states for the purposes of imposition of tax needs to be examined:

(a) Business Profits

Under the OECD model, profits on purchase by enterprises of goods and merchandise were not to be attributed to the permanent establishment, the developing countries protested against this vehemently as they believed that if purchase made by the enterprise leads to the overall profit of the enterprise in the source state then a portion of the profits in the permanent establishment should be taxed, especially in the case of enterprises whose only activity is to purchase goods in the permanent establishment.

Despite this stiff opposition the UN model in Article 7 merely says that whether the enterprise is to be taxed on purchases made in the permanent establishment is to be determined by bilateral negotiations. The UN fails the developing countries here by not taking a clear stand. In all negotiations between developed and developing countries the developing countries are on a much weaker footing and have to agree to unfavourable terms.

To determine the tax liability of a company in a foreign country we usually rely on the Arms Length Rule. As per this rule the profits earned by a permanent establishment are those which would be earned by the permanent establishment as if it were an wholly independent entity dealing with its head office as if it was a distinct and separate enterprise operating and selling under regular market conditions.³

Once a method of allocation is used it cannot be changed merely because in a particular year another method gives more favourable results. In case of matters like dividends, royalties etc., which are dealt with separately under Articles 10 & 11, they will be determined under these articles and not under Article 7 which is a general provision.

One of the major lacunae in this article is that it does not deal with turn key projects which are completed before the permanent establishment is set up.

³ *Supra* n. 2 at 96.

(b) Shipping, Inland Waterways Transport and Air Transport

The UN Model provides for two alternative variations namely Article 8A and Article 8B for taxation in shipping and airline industry. Article 8A of the UN Model reproduces Article 8 of the OECD model convention which was mainly supported by developed countries. In their view, shipping should not be exposed to the tax laws of the numerous countries to which their operations extend and should be taxed only in the place of effective management. But most developing countries contended that they are not in a position to forgo the revenue to be derived by taxing foreign shipping enterprises as long as their own shipping industries are not fully developed. As a result of these conflicting viewpoints the model provides for two alternative modes of power of taxation and the choice is left to Bilateral negotiations.

- * Article 8A - This ensures that profits from the operation of ships or aircraft in international traffic and traffic in inland waterways will be taxed in the place of effective management of the enterprise (State of Residence).
- * Article 8B - As regards operation of ships and aircrafts in international traffic and traffic in inland waterways, profits are charged in the place of effective management,⁴ but if the shipping activities in the other state are more than casual then the profits will be taxed in the other state according to the proportion or allocation as decided by bilateral negotiations.⁵

c) Associated Enterprises

Associated enterprises are those that are under a common control like a parent and a subsidiary company. Article 9 must be read with Article 25 on mutual agreement procedure and Article 26 on exchange of information. To determine the tax liabilities between the head office and the office in the permanent establishment the Arms Length Rule is applied. If the accounts do not comply with the Arms Length Rule they may be rewritten.

Attempts to prevent double taxation when an associated enterprise in State A is taxed on profits made by its subsidiary in State B also in such cases the liabilities on State B to make such adjustments so that there is no double taxation. It has been left to bilateral negotiations to determine how long State B should wait to make these adjustments and whether these adjustments should be open ended.

d) Dividends, Interest and Royalty

The UN Model provides for similar modes of taxation of dividends, interest and royalty under Articles 10, 11 and 12 respectively. The general rule for all of

4 Paragraphs 1 and 3 of Article 8B of UN Model Double Taxation Convention Between Developed and Developing Countries, 1980.

5 Paragraph 2 of Article 8B of UN Model Double Taxation Convention Between Developed and Developing Countries, 1980.

them is that dividend or interest or royalty arising in one state paid to a resident of another state may be taxed in both the states. But in the case of the recipient being a beneficial owner, the state in which the dividends or interest or royalties arise shall not tax exceeding a particular percentage as established between the contracting countries by bilateral negotiations. In the case of dividends, different percentage is to be levied in the case of beneficial owners being a company as compared to any other case. The above mentioned taxes shall not be levied if the beneficial owner of the dividends or interest or royalties carries on business in the other state through a permanent establishment situated therein or performs independent personal services from a fixed base situated therein and in such cases Articles 7 and 14 will apply respectively.

In the case of a company being a resident of one state deriving income from the other state, tax can be levied by the other state on dividends paid by the company only if the dividends are paid to a resident of the other state or if the income is connected with a permanent establishment situated in that other state.⁶

e) Capital Gains

Capital gains have been dealt with under Article 13. While the developed countries felt that the source countries should be the one taxing all alienation of property movable or immovable and independent personal services and leaves the taxation of all other capital gains to the country of residence. The developing countries wanted capital gains to be taxed almost exclusively by the country of residence. The UN model does not define capital gains or how it should be computed. This is left to the internal working of the countries. In case the capital gains in both the countries leads to double taxation it should be decided by bilateral negotiations.

An addition to the OECD model is the inclusion of para 4 which taxes the gain made by the companies on the alienation of the company whether they are residents of the contacting state in which the property is situated or any other state.

Para 5 has been included and this allows a state to tax gains that arise by the sale of shares of a company whether the company is a resident of that state or not. The law states that even if the shares are not sold but substantial participation is sold, a state has a right to tax capital gains. However what is substantial participation is to be decided by bilateral agreements.

f) Non Discrimination

Article 24 of the UN model reproduces the OECD model on this subject. It tries to ensure that states do not discriminate between residence of other states and

⁶ Paragraph 5 of Article 10 of UN Model Double Taxation Convention Between Developed and Developing Countries, 1980.

their own residence. This article does not take away the power of a state to accord special taxation privileges and concession to its own nationals, as the article is worded negatively. Companies, associations and partnership are included in the definition of the nationals.

This article however does not define equal treatment and this has led to a wide range of activities which can be termed as equal treatment.

g) Mutual Agreements

The purpose of these agreements is two fold.

- a) A forum in which the residents of a state can protest actions not in accordance with the convention.
- b) A method for eliminating double taxation if not provided under the convention.

In case of violation of the above two instead of both the affected parties litigating in their respective states this method provides for an amicable settlement between the competent authorities of both states.

To set this procedure in motion the two requirements are that the issue must be raised before competent authorities of each state and within three years of the cause of action. A resident may go to the competent authorities of a state even if has not exhausted all the domestic remedies. Once the matter goes to the competent authorities they are to decide if there is a cause of action and then speedily dispose of the case. This may lead to denial of justice as a resident has to agitate before the very authorities who have wronged him.

SHORTCOMINGS OF THE MODEL

The UN model on double taxation is an attempt to have a comprehensive law on double taxation for the developing countries. However the model fails as it is clearly partial towards developed countries and suffers from a serious drawback in that it leaves most controversial levies to be decided by bilateral negotiations.

Under the present model for some types of income like Interest, Dividend and Royalties only the ordinary credit method is to be employed. This is where the fault lies as developing countries prefer exemption method over ordinary credit method, as the total tax payable by the assessee is less in the former, and this helps in attracting investments which is the aim of any double taxation treaty from the developing countries' view point.

Another instance of favourable treatment as regards developed countries is that for income from Shipping. Waterways and Airways two alternatives for apportioning the income between contracting states are provided. One of the above favours developed countries and the alternatives to be employed is to be decided

by bilateral negotiations. This is clearly pandering to the developed countries as they will have an upper hand in any bilateral negotiations.

There is a school of thought which questions the whole concept of an UN model on double taxation. The reason for this scepticism is that most MNCs use these treaties to evade taxes thus resulting in a loss of revenue to the source country. This is achieved as most foreign companies that invest in developing countries use loan capital instead equity to carry on their operations and thus avoid taxes altogether.