Introduction

In September 2008 a sell-out crowd of 650 tax experts from over 100 countries worldwide will come together for two days at the Organisation for Economic Co-operation and Development (OECD) in Paris to celebrate a seemingly obscure event that took place 50 years ago - the publication of the first draft of what was to become the OECD Model Tax Convention on Income and Capital. Indeed, it was in 1958 that the Fiscal Committee of the Organisation for European Economic Co-operation (OEEC, which became the OECD a few years later) published that first draft text. The September event will also mark the publication of the latest update to the OECD Model, which was approved by the OECD Council of Ministers on 17 July 2008.

The extraordinary interest in this 50th Anniversary Conference is a reflection of the significance achieved by the OECD Model over the past five decades. The Model, which includes both the text of model treaty Articles and extensive Commentaries on each Article, serves as the basis for the negotiation and application of bilateral tax treaties. A tax treaty is an international agreement concluded by countries for the avoidance of double taxation and the prevention of fiscal evasion. As such, tax treaties play a crucial role in removing tax-related barriers to cross-border trade and investment and in ensuring the full and fair enforcement of tax laws in a globalized economy. Fifty years ago, there were only a few dozen such agreements in force between governments, but today there are more than 3,000 tax treaties in force around the world based on the OECD Model.

Some history

While work had been carried out in the first half of the twentieth century to develop model tax conventions (e.g., by the League of Nations), no single model had achieved widespread acceptance by mid-century. The increasing economic interdependence of countries in the post-war years clearly showed the need for a broader and more harmonized network of tax treaties to prevent international double taxation.

The OEEC was formed in 1947 to administer American and Canadian aid under the Marshall Plan for the reconstruction of Europe after World War II. The Council of the OEEC adopted its first Recommendation concerning double taxation on 25 February 1955. The Fiscal Committee set to work in 1956 and issued its first Report in 1958, exactly fifty years ago. From 1958 to 1961, the Fiscal Committee prepared four interim Reports, before submitting in 1963 its final Report entitled “Draft Double Taxation Convention on Income and Capital.” In the meantime, the OEEC had evolved into the OECD by 1961, with broader membership and an expanded commitment to contribute to the development of the world economy.

The Fiscal Committee and its successor, the Committee on Fiscal Affairs, later undertook the revision of the 1963 Draft Convention to take account of the experience gained by member countries in the negotiation and practical application of tax treaties. This resulted in the publication in 1977 of a new Model Convention. Since then, the pressure to update and adapt the OECD Model to changing economic conditions has progressively increased.

In 1991, recognizing that the revision of the Model had become an ongoing process, the Committee on Fiscal Affairs adopted the concept of an ambulatory Model, providing periodic and timelier updates and amendments without waiting for a complete revision. This led to the publication in 1992 of the Model Convention in a loose-leaf format, which was considered as the first step of an ongoing revision process intended to produce periodic updates and thereby ensure that the OECD Model continues to reflect accurately the views of member countries at any point in time. To date, there have been updates in 1995, 1997, 2000, 2003, 2005 and 2008.

Purposes and benefits of tax treaties

Countries conclude tax treaties for several reasons, the most important ones being the elimination of double taxation and the prevention of tax evasion. Other relevant reasons are the certainty tax treaties bring about and the prevention of discriminatory taxation.

Elimination of double taxation

Double taxation can be generally defined as the imposition of taxes in two countries on the same taxpayer in respect of the same income. The detrimental effects of double taxation on international trade and investment are self-evident: if a French company sells its products in France and derives income from those sales, it will pay taxes only in France, but if the French company sells its products in the UK, it may well be that it has to pay tax on the same income both in France (its country of residence) and in the UK (the country where the income arises).

Tax treaties protect taxpayers from potential double taxation primarily through the allocation of taxing rights between the two countries. This allocation takes several forms. First, the treaty has a mechanism for resolving the issue of residence in the case of a taxpayer that otherwise would be considered to be a resident of both countries under their domestic laws. Second, with respect to each category of income, the treaty assigns the primary right to tax to one country, usually the country in which the income arises (the “source” country), and the residual right to tax to the other country, usually the country of residence of the taxpayer (the “residence” country). Thus, a tax treaty will typically contain specific Articles assigning taxing rights over various categories of income. Third, the treaty provides rules for determining which country will be treated as the source country for each category of income. Finally, the treaty establishes the obligation of the source country to eliminate double taxation that otherwise would arise from the exercise of concurrent taxing jurisdiction by the two countries, typically either by exempting income derived from the source country or by providing a credit for the taxes imposed on that income by the source country.

In addition to reducing potential double taxation, tax treaties also reduce potential “excessive” taxation by reducing withholding taxes that are imposed at source. The application of withholding taxes on a gross basis determines in many instances that the taxpayer will be subject to an effective rate of tax that is significantly higher than the tax rate that would be applicable to net income in either the source or residence country. In some cases, the withholding tax levied on a gross basis may be even higher than the net income itself derived by the taxpayer (e.g., in the case of bank interest). Tax treaties alleviate this burden by setting maximum levels for the withholding tax that the treaty partners may impose on these types of income.

As a complement to these substantive rules regarding allocation of taxing rights, tax treaties provide a mechanism for dealing with disputes between the countries regarding the application of the treaty, either in connection with individual cases submitted by taxpayers or more generally. This “mutual agreement procedure” allows specified officials from the two governments (the “competent authorities”) to consult together to resolve such disputes.

Fighting tax evasion

In a globalized world, tax evasion has become a fundamental challenge for policy makers and administrators. Tax treaties provide mechanisms, such as the exchange of information and the assistance in collection, to fight tax evasion in an effective manner, through indispensable co-operation...
between the authorities. Under tax treaties, the competent authority of one country may request from the other competent authority information that may be relevant for the proper administration of the first country’s tax laws; the information provided pursuant to the request is subject to the strict confidentiality protections that apply to taxpayer information domestically.

Banning discriminatory taxation
In the trade and investment area, the non-discrimination principle is a fundamental aspect of the WTO agreements and of bilateral investment agreements. In the tax area, there is a need to balance this fundamental principle with the need to allow legitimate distinctions that take account of the different situations of local and foreign taxpayers. This difficult balancing act is the role of the non-discrimination provisions of tax treaties, which have two main objectives: to prevent discrimination of any kind in taxing nationals of the other country and to prevent source countries from discriminating against residents of the other country who participate in certain ways directly or indirectly in the economic life of the source country.

Giving certainty to investors
The conclusion of a tax treaty is a signal to the outside world and gives certainty to investors: certainty that the rules will not change from one year to the next, certainty that unilateral domestic law changes will not generally affect their tax situation, and certainty that double taxation will in most cases be eliminated. All these elements contribute to foster the economic relations between the countries which are parties to the treaty.

The OECD Model Tax Convention: a success story
The OECD Model offers a widely accepted approach to drafting treaty text to address the major areas tax treaties need to cover:

- the scope of the treaty;
- definitions of key terms;
- distributive rules to allocate taxing rights between the two Contracting States on various categories of income (eg. dividends, interest, royalties, capital gains, business profits, income from real property, employment income, pensions, etc.);
- the taxation of capital;
- the obligation to provide double tax relief;
- special provisions, such as the non-discrimination clause, the mutual agreement procedure and the exchange of information article; and finally
- provisions dealing with the entry into force and the termination of the treaty.

The Commentaries on the Model are quite extensive and provide guidance on the accepted interpretation of the Model text. They are regularly updated and expanded through the work of experts from the member country governments working under the auspices of the Committee on Fiscal Affairs, and they have come to serve as a very useful reference to taxpayers, tax administrations and courts, both within OECD countries and far beyond, on how to interpret bilateral treaties based on the OECD Model. For example, the Commentaries have been cited as interpretive guidance in court decisions in virtually all member countries and are increasingly cited by courts in non-member countries as well.

It would be difficult for the Model to retain its status as a living instrument if all its content had to be unanimously agreed by all OECD member countries. While all member countries are in agreement with the aims and main provisions of the Model, there is a process by which individual members can record their disagreement with either a specific Model provision or an interpretation in the Commentaries through the entry of a reservation or observation.

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The Model has been a successful instrument because it provides a means of settling on a uniform basis the most common problems that arise in the field of international taxation. The existence of the OECD Model has facilitated bilateral negotiations and made possible a significant harmonization of tax treaties for the benefit of both taxpayers and national administrations. In addition, the capacity to adapt international tax rules to the changing business environment on the one hand, and the involvement of non-member countries on the other, has also greatly contributed to the success of the OECD Model.

Because the influence of the OECD Model has extended far beyond the OECD member countries, it was decided that the revision process should be opened up to benefit from the input of non-member countries, international organisations and other interested parties. Pursuant to that decision, in 1996, it was decided to organise annual meetings to allow experts of member countries and non-member countries to discuss issues related to the negotiation, application and interpretation of tax treaties. Recognising that non-member countries could only be expected to associate themselves with the development of the OECD Model if they could retain their freedom to disagree with its contents, these countries were given the ability to record their positions on the Model and to identify the areas where they are unable to agree.

The section of the OECD Model on non-member countries’ positions now contains the position of the following 30 countries: Albania, Argentina, Armenia, Belarus, Brazil, Bulgaria, Chile, China, Democratic Republic of the Congo, Croatia, Estonia, Gabon, India, Israel, Ivory Coast, Latvia, Lithuania, Malaysia, Morocco, Philippines, Romania, Russia, Serbia, Slovenia, South Africa, Thailand, Tunisia, Ukraine and Vietnam. Considering the 30 member countries of the OECD2, this brings the total number of countries that have officially stated their position on the Model to 60, thus making clear to the outside world what the treaty policy of these countries is.

The OECD Model also benefits greatly from the input received from the private sector. Changes to the Model are always published in advance in draft form with an invitation for comments, often followed by a public consultation. Member countries’ delegates then discuss the comments received and decide whether or not they require further changes. The OECD sees the ongoing dialogue with business as a key factor in setting proper international tax rules. In certain cases, working groups where government officials and private sector representatives work together are set up for specific projects.

The 2008 update to the OECD Model
The 2008 update to the Model contains a number of changes, which are mostly the result of previous reports issued by the OECD over the past couple of years. Specifically, they relate primarily to the following matters:

- introduction of a mandatory, binding arbitration provision to resolve disputes that the competent authorities have not successfully resolved through the mutual agreement procedure, plus expanded and clarified Commentaries on how the mutual agreement procedure itself should most properly operate;
- clarifications on the methodology for determining the profits attributable to a permanent establishment through which a resident of one country carries on business in the other country (a topic of particularly keen interest to businesses operating in the financial sector);
- clarifications on the application and interpretation of the non-discrimination Article;
- optional provisions countries may wish to include in their bilateral treaties to address the taxation of distributions made by real estate investment trusts (REITs) established in one country to residents of the other country:
  - clarifications with respect to the concept of ‘place of effective management’, which is the tie-breaker test to solve cases of dual residency of corporations, and an alternative provision that countries can opt to use to solve such conflicts;
  - an alternative provision that lowers the threshold above which a resident of one country, through the provision of services in the other country, becomes taxable in that other country on its business profits earned there; and
- clarifications in relation to the scope of the definition of royalties for treaty purposes (eg. in relation to income earned from the distribution of software or from granting the use of, or the right to use, a design, model or plan).

While some changes to the Model will have practical effect only once countries agree to introduce them into their bilateral treaties, those changes that take the form of clarifications to the Commentaries’ interpretation of existing Model provisions will generally be relevant immediately to the manner in which the extensive network of existing treaties based on the Model is applied.

Concluding remarks
There is always room for improvement and this also applies to the OECD Model. In light of the Model’s great success, as reflected in the large number of existing treaties based on it, a very important looming challenge is to find ways to streamline the treaty amendment process so that changes agreed at the OECD level can be inserted into bilateral treaties in a timely manner.

The involvement of non-member countries, the OECD’s recently announced initiative to enlarge its membership and the effects of globalization in
general also suggest the need for a continual re-examination of the international tax principles on which the OECD Model is based, to see if those principles adequately reflect the policies appropriate to a changing world economy.

If the OECD Model is able to address these tough challenges, it will be as successful in the next fifty years as it has been in the past fifty. Meanwhile, the Model can take a well-deserved moment to close its eyes, make a wish and blow out the candles on its birthday cake.

1. The views expressed in the article are those of the author and do not commit the OECD or its member countries.
2. The OECD member countries are: Australia, Austria, Belgium, Canada, the Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, the Netherlands, New Zealand, Norway, Poland, Portugal, the Slovak Republic, Spain, Sweden, Switzerland, Turkey, and United Kingdom and the United States.