E/C.18/2017/CRP.7

Distr.: General
30 March 2017

Original: English

Committee of Experts on International Cooperation in Tax Matters
Fourteenth Session
New York, 3-6 April 2017
Item 3 (a) (ii) of the provisional agenda*
Base erosion and profit-shifting

Proposed Base Erosion and Profit-Shifting Related Changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries

Summary

This paper suggests changes that could be made to the text of the UN Model Tax Convention and its Commentaries to help address base erosion and profit shifting. It was prepared by the Coordinator of the Committee's Base Erosion and Profit Shifting Subcommittee, Carmel Peters, in consultation with that Subcommittee. Part A of this paper addresses possible changes relating to permanent establishments (Article 5) while Part B addresses possible changes to various articles and Commentaries to address the granting of treaty benefits in inappropriate circumstances. Issues relating to the revision of Article 1 and the Commentary to Article 1 and Article 29 and related commentary are dealt with in separate papers.

* E/C.18/2016/15

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PART A – ARTICLE 5 CHANGES

Interpretation of Article 5

Comment

At the 12th and 13th meetings the Committee discussed the fact that there are differences in views among countries regarding the interpretation of paragraph 4 of Article 5. In particular there is a question as to whether all items under the existing paragraph 4 are excluded from constituting a PE regardless of whether they have a preparatory or auxiliary character or not. However, the proposed changes to paragraph 4 of Article 5 will make it explicit that all the activities are subject to the condition of having a preparatory or auxiliary character regardless of particular country views on the interpretation of the previous provision.

This issue also arose in relation to the OECD Model. The solution for both Models is to add text to the Commentary on paragraph 1 of Article 5 to clarify that these changes to Article 5 do not affect the interpretation of those Articles prior to the changes.

Proposed change to the United Nations Model Convention Commentary to Include New Paragraph 3.1

3.1 In 2017, a number of changes were made to Article 5 and, consequently, to this Commentary. Changes related to the addition of paragraph 4.1 and the modification of paragraphs 4, 5 and 6 of the Article that were made as a result of the adoption of the Report on Action 7 of the OECD/G20 Base Erosion and Profit Shifting Project are prospective only and, as such, do not affect the interpretation of the former provisions of the United Nations Model Tax Convention and of treaties in which these provisions are included, in particular as regards the interpretation of paragraphs 4 and 5 of the Article as they read before these changes.

Article 5, paragraph 3

Anti-contract splitting rule

Comment

At the 12th and 13th meetings the Committee discussed two distinct but related problems with the splitting up of contracts which were brought to the attention of the Committee. They are related because they both address concerns that enterprises can artificially split up contracts, or projects or activities to circumvent the permanent establishment threshold.

The first issue is that there is a problem with the splitting up of contracts, which was also an issue addressed in the work on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). This is already a concern identified in the United Nations Model Convention. The general concern is the avoidance of time thresholds in the construction site rule in paragraph 3 or any other similar time thresholds for service permanent establishments and similar rules. One option is to rely on the Principal Purpose Test (PPT) to counter contract splitting. (Note that examples J and K are in the Commentary examples where contract splitting to avoid the PE threshold breaches the PPT.)

Another approach to resolve this problem that the Committee discussed is to include a specific provision in the double tax agreement. The Committee discussed a proposal that the Commentary be amended to include an anti-contract splitting rule. There are two options for this rule - one is based on the OECD proposal, and the other on a formulation used in double tax agreements.

The second issue relates to the use of the phrase "same or connected project" in Article 5, paragraph 3. At the 13th meeting the Committee agreed to omit that phrase.

Proposed change to United Nations Model Commentary

Paragraph 3

11. In this connection, the OECD Commentary observes, with changes in parentheses to take account of specific UN differences including the different time periods in the two Models:

> 18. The [six] month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses). *[rest of the paragraph is moved to paragraph 18.1]*

18.1 The [six] month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period of less than [six] months and attributed to a different company which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, ~~countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.~~ ***these abuses could also be addressed through the application of the anti-abuse rule of paragraph 9 of Article 29, as shown by example J [and example K] in paragraph [17] of the Commentary on Article 29. Some States may nevertheless wish to deal expressly with such abuses. Moreover, States that do not include paragraph 9 of Article 29 in their treaties should include an additional provision to address contract splitting. Such a provision could, for example, be drafted along the following lines:***

> ***For the sole purpose of determining whether the [six] month period referred to in paragraph 3 has been exceeded,***
>
> ***a) where an enterprise of a Contracting State carries on activities in the other Contracting State at a place that constitutes a building site or construction or installation project and these activities are carried on during one or more periods of time that, in the aggregate, exceed 30 days without [six] months, and***
>
> ***b) connected activities are carried on at the same building site or construction or installation project during different periods of time, each exceeding 30 days, by one or more enterprises closely related to the first-mentioned enterprise,***
>
> ***these different periods of time shall be added to the aggregate period of time during which the first-mentioned enterprise has carried on activities at that building site or construction or installation project.***

The concept of "closely related enterprises" that is used in the above provision is defined in subparagraph b) of paragraph 6 of the Article (see paragraphs 38.8 to 38.10 below).

18.2 For the purposes of the alternative provision found in paragraph 18.1, the determination of whether activities are connected will depend on the facts and circumstances of each case. Factors that may especially be relevant for that purpose include:

- ***whether the contracts covering the different activities were concluded with the same person or related persons;***
- ***whether the conclusion of additional contracts with a person is a logical consequence of a previous contract concluded with that person or related persons;***
- ***whether the activities would have been covered by a single contract absent tax planning considerations;***

- ***whether the nature of the work involved under the different contracts is the same or similar;***
- ***whether the same employees are performing the activities under the different contracts***

The Committee points out that measures to counteract abuses would apply equally in cases under Article 5, paragraph 3, subparagraph (*b*). ***The anti-contract splitting rule provided in paragraph 18.1 of the OECD Commentary can be amended to also counteract abuses under subparagraph (b). A further possibility is to include the following text immediately after subparagraph (b), which is based on a similar provision found in the 2016 treaty between Chile and Japan, but utilizes the closely related enterprise wording contained in the OECD provision:***

> ***The duration of activities under subparagraphs (a) and (b) shall be determined by aggregating the periods during which activities are carried on in a Contracting State by ~~associated enterprises~~ closely related enterprises, provided that the activities of such ~~an associated enterprise~~ a closely related enterprise in that Contracting State are connected with the activities carried on in that Contracting State by its ~~associated enterprises~~ closely related enterprises. The period during which two or more ~~associated enterprises~~ closely related enterprise are carrying on concurrent activities shall be counted only once for the purpose of determining the duration of activities. ~~An enterprise shall be deemed to be associated with another enterprise if one participates directly or indirectly in the management, control or capital of the other, or the same person or persons participate directly or indirectly in the management, control or capital of both enterprises.~~***

The Commentary of the OECD Model Convention continues as follows:

> 19. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, *e.g.* if he installs a planning office for the construction. *[the six subsequent sentences have been moved to new paragraph 19.1]* If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts ***all or*** parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project ***for purposes of determining whether a permanent establishment exists for the general contractor***. ***In that case, the site should be considered to be at the disposal of the general contractor during the time spent on that site by any subcontractor where circumstances indicate that, during that time, the general contractor clearly has the construction site at its disposal by reason of factors such as the fact that he has legal possession of the site, controls access to and use of the site and has overall responsibility for what happens at that location during that period ~~(this, however, does not address the separate question of how much profits should be attributed to a permanent establishment that could result from that conclusion)~~.*** The subcontractor himself has a permanent establishment at the site if his activities there last more than *[six]* months

The Commentary of the OECD Model Convention continues as follows:

> 19.2 In the case of fiscally transparent partnerships, the *[six]* month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds twelve month***s***, the enterprise carried on ~~by~~ ***through*** the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site. ***Assume for instance that a resident of State A and a resident of State B are partners in a partnership established in State B which carries on its construction activities on a construction site situated in State C that lasts 10 months. Whilst the tax treaty between States A and C is identical to the OECD Model, paragraph 3 of Article 5 of the treaty between State B and State C provides that a construction site constitutes a permanent establishment only if it lasts more than 8 months. In that case, the time threshold of each treaty would be applied at the level of the partnership but only with respect to each partner's share of the profits covered by that treaty; s~~S~~ince the treaties provide for different time-thresholds, State C will have the right to tax the share of the profits of the partnership attributable to the partner who is a resident of State B but will not have the right to tax the share attributable to the partner who is a resident of State A. This results from the fact that whilst the provisions of paragraph 3 of each treaty are applied at the level of the same enterprise (i.e. the partnership), the outcome differs with respect to the different shares of the profits of the partnership depending on the time-threshold of the treaty that applies to each share.***
>
> 20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases the fact that the work force is not present for [six] months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts for more than [six] months.

12. [new paragraph 12 commentary discussed in the next section]

[paragraphs 13 – 17 are not amended]

"Same or connected project"

<u>Comment</u>

The second issue the Committee discussed at the 12th and 13th meetings relates more specifically to Article 5, paragraph 3(b) regarding concerns with the "same or connected project" requirement. It was drawn to the attention of the Committee that it can be difficult to apply (both administratively and interpretatively). There are concerns that the inclusion of those words in paragraph 3(b) has been abused and that it is difficult for developing countries to counter this abuse.

In view of these difficulties the Committee decided to eliminate the words "same or connected project" from paragraph 3(b) of Article 5 and redraft paragraphs 9 and 12 of the Commentary. In addition, the Committee decided to include the current wording of paragraph 3(b) as an alternative provision if needed.

<u>Proposed change to Article 5, paragraph 3 of the United Nations Model Convention</u>

3. The term "permanent establishment" also encompasses:

(*a*) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

(*b*) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue ~~(for the same or a connected project)~~ within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

<u>Proposed change to United Nations Model Convention Commentary</u>

<u>Replace paragraph 9 of the Commentary on Article 5 with the following:</u>

9. Article 5, paragraph 3, subparagraph (*b*) deals with the furnishing of services, including consultancy services, the performance of which does not, of itself, create a permanent establishment in the OECD Model Convention. Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits. In the 2011 revision of the United Nations Model Convention, the Committee agreed to a slight change in the wording of subparagraph (*b*) of paragraph 3, which was amended to read: "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned", rather than, "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period", as it formerly read. This was seen as providing greater

consistency with the approach taken in Article 14, paragraph 1, subparagraph (*b*). ***In the 2017 revision the Committee made a further change to subparagraph (b) to remove the words in parenthesis "(for the same or a connected project)" altogether. This change is discussed in more detail in paragraph 12 below.***

Replace paragraph 12 of the Commentary with new paragraphs 12 and 12.1:

12. Until the 2017 update the UN Model contained the words "(for the same or a connected project)" in subparagraph (b). This wording was removed as the "project" limitation was easy to manipulate and created difficult interpretive issues and factual determinations for tax authorities, which in particular for developing countries is an undesired administrative burden. Moreover, from a policy perspective, if a non-resident provides services in a country for more than 183 days, the non-resident's involvement in the commercial life of that country clearly justifies the country taxing the income from those services whether the services are provided for one project or multiple projects. The degree of the non-resident's involvement in the source country's economy is the same, regardless of the number of projects involved. It has been argued that taxpayers can more easily monitor the location of the activities of their employees and independent contractors on a project-by-project basis. However, requiring enterprises, even large enterprises with multiple projects, to keep records with regard to the countries in which their employees and independent contractors are working does not appear to be unduly onerous or unreasonable – especially in light of technological advances. However, for countries that are concerned about the uncertainty involved in adding together unrelated projects and the undesirable distinction it creates between an enterprise with, for example, one project of 95 days duration and another enterprise with two unrelated projects, each of 95 days duration, one following the other, may add the words "(for the same or a connected project)" in paragraph 3 subparagraph (b).

12.1 The Committee observed in general terms that broadening the scope of subparagraph 3(b) means that the revised provision will apply in certain circumstances instead of the new Article 12A in relation to technical service fees.

Article 5, paragraph 4: preparatory or auxiliary activities

Comment

At the 12th and 13th meetings the Committee discussed a proposal that Article 5, paragraph 4 be amended to ensure that the specific activity exemptions cannot be used to artificially avoid PE status. The proposal is based on the recommendations of the G20 and OECD in the 2015 Final Report on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). The amended Article 5, paragraph 4 will still omit the words "or delivery".

<u>Changes to paragraph 4 of Article 5 of the United Nations Model Convention</u>

4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:

(*a*) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(*b*) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(*c*) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(*d*) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(*e*) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity ~~of a preparatory or auxiliary character.~~***;***

(*f*) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (*a*) to (*e*), ~~provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.~~**,**

provided that such activity or, in the case of subparagraph (f), the overall activity of the fixed place of business, is of a preparatory or auxiliary character.

<u>Proposed change to United Nations Model Convention Commentary</u>

16. ***In 2017, the Committee agreed to include in the update to the United Nations Model Convention, an amended paragraph 4 of Article 5. The changes made were based on the recommendations of the OECD/G20 Final Report on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). Paragraph 4 was modified so that all of the activities covered by paragraph 4 are subject to the condition that they are preparatory or auxiliary.***

17. ~~This paragraph reproduces Article 5, paragraph 4 of the OECD Model Convention with one substantive amendment~~: ***The new paragraph 4 of Article 5 in the United Nations Model Tax Convention still omits the reference to*** ~~the deletion of~~ "delivery" in subparagraphs (*a*) and (*b*). ***The deletion of the word "delivery" reflects the majority view of the Committee that a "warehouse" used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment.***

17.1 In view of the similarities to ***the recommended text***~~the OECD Model Convention provision~~ and the general relevance of its Commentary, the general principles of Article 5, paragraph 4 under both Models are first noted below and then the practical relevance of the deletion of references to “delivery” in the United Nations Model Convention is considered.

~~17. The deletion of the word “delivery” reflects the majority view of the Committee that a “warehouse” used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment.~~

18. Following the changes to the OECD Commentary to reflect the changes to paragraph 4 of Article 5 of the OECD Model Convention, the OECD Commentary now reads as follows:

> 21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which ~~are not~~ ***, when carried on through fixed places of business, are not sufficient for these places to constitute*** permanent establishments~~, even if the activity is carried on through a fixed place of business~~. ***The final part of the paragraph provides that these exceptions only apply if the listed activities have a preparatory or auxiliary character.*** ~~The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in~~***Since*** subparagraph *e)* ***applies to any activity that is not otherwise listed in the paragraph (as long as that activity has a preparatory or auxiliary character), the provisions of the paragraph*** ~~which~~ actually amount~~s~~ to a general restriction of the scope of the definition ***of permanent establishment*** contained in paragraph 1 and, when read with that paragraph, provide a more selective test~~,~~ by which to determine what constitutes a permanent establishment. To a considerable degree***, these provisions*** ~~it~~ limit~~s~~ th***e***~~at~~ definition ***in paragraph 1*** and exclude~~s~~ from its rather wide scope a number of ~~forms of business organisations which, although they are carried on through a fixed place of business~~ ***fixed places of business which, because the business activities exercised through these places are merely preparatory or auxiliary,*** should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. *[the last two sentences and the last part of the preceding one have been moved from paragraph 23 to this paragraph]* Moreover subparagraph *f)* provides that combinations of activities mentioned in subparagraphs *a)* to *e)* in the same fixed place of business shall be deemed not to be a permanent establishment, ***subject to the condition, expressed in the final part of the paragraph,*** ~~provided~~ that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State~~,~~ if it ***only*** carries on ~~in that other State,~~ activities of a purely preparatory or auxiliary character in that State. ***The provisions of paragraph 4.1 (see below) complement that principle by ensuring that the preparatory or auxiliary character of activities carried on at a fixed place of business must be viewed in the light of other activities that constitute complementary functions that are part of a cohesive business and which the same enterprise or closely related enterprises carry on in the same State.***

21.1~~24.~~ It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise~~,~~ does not exercise a preparatory or auxiliary activity.

21.2 As a general rule, an activity that has a preparatory character is one that is carried on in contemplation of the carrying on of what constitutes the essential and significant part of the activity of the enterprise as a whole. Since a preparatory activity precedes another activity, it will often be carried on during a relatively short period, the duration of that period being determined by the nature of the core activities of the enterprise. This, however, will not always be the case as it is possible to carry on an activity at a given place for a substantial period of time in preparation for activities that take place somewhere else. Where, for example, a construction enterprise trains its employees at one place before these employees are sent to work at remote work sites located in other countries, the training that takes place at the first location constitutes a preparatory activity for that enterprise. An activity that has an auxiliary character, on the other hand, generally corresponds to an activity that is carried on to support, without being part of, the essential and significant part of the activity of the enterprise as a whole. It is unlikely that an activity that requires a significant proportion of the assets or employees of the enterprise could be considered as having an auxiliary character.

21.3 Subparagraphs a) to e) refer to activities that are carried on for the enterprise itself. A permanent establishment~~, however,~~ ***would therefore*** exist~~s~~ if ***such activities were performed on behalf of other enterprises at the same fixed place of business*** ~~the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises~~. If, for instance, an ~~advertising agency~~ ***enterprise that maintained an office for the advertising of its own products or services*** were also to engage in advertising ~~for~~ ***on behalf of*** other enterprises ***at that location***, ~~it~~ ***that office*** would be regarded as a permanent establishment of the enterprise by which it is maintained.

22. Subparagraph *a)* relates ~~only to the case~~ ~~in which an enterprise acquires the use of~~ ***to a fixed place of business constituted by*** facilities ***used by an enterprise*** for storing, displaying or delivering its own goods or merchandise. ***Whether the activity carried on at such a place of business has a preparatory or auxiliary character will have to be determined in the light of factors that include the overall business activity of the enterprise. Where, for example, an enterprise of State R maintains in State S a very large warehouse in which a significant number of employees work for the main purpose of storing and delivering goods owned by the enterprise that the enterprise sells online to customers in State S, paragraph 4 will not apply to that warehouse since the storage and delivery activities that are performed through that warehouse, which represents an important asset and requires a number of employees, constitute an essential part of the enterprise's sale/distribution business and do not have, therefore, a preparatory or auxiliary character.*** ~~Subparagraph b) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or~~

~~delivery. Subparagraph c) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph d) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".~~

22.1 ***Subparagraph a) would cover, for instance, a bonded warehouse with special gas facilities that an exporter of fruit from one State maintains in another State for the sole purpose of storing fruit in a controlled environment during the custom clearance process in that other State. It would also cover a fixed place of business that an enterprise maintained solely for the delivery of spare parts to customers for machinery sold to those customers. Paragraph 4 would not apply, however, where*** ~~A permanent establishment could also be constituted if~~ an enterprise maintain***ed***~~s~~ a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers ***and, in addition,*** ~~where, in addition, it~~ ***for the*** maint~~ain~~***enances*** ~~s~~ or repairs~~s~~ ***of*** such machinery, as this ***would*** go~~es~~ beyond the pure delivery mentioned in subparagraph *a)* ~~of paragraph 4~~ ***and would not constitute preparatory or auxiliary activities*** ~~***S***~~*s*ince these after-sale ***activities constitute*** ~~organisations perform~~ an essential and significant part of the services of an enterprise vis-à-vis its customers.~~, their activities are not merely auxiliary ones~~ [*the preceding two sentences have been moved from paragraph 25 to this paragraph*].

22.2~~26.1~~***Issues may arise concerning the application of the definition of permanent establishment to*** ~~Another example is that of~~ facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where ~~they~~***these*** facilities constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether ***subparagraph a)*** ~~paragraph 4~~ applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a),* which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e)* also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a)* would be applicable. ~~An additional~~***A separate*** question is whether the cable or pipeline could ~~also~~ constitute a permanent establishment for the customer of the operator of the cable or pipeline, *i.e.* the enterprise whose data, power or property is transmitted or transported from one place to another. In such a case, the enterprise is merely obtaining transmission or transportation services provided by the operator of the cable or pipeline and does not have the cable or pipeline at its disposal. As a consequence, the cable or pipeline cannot be considered to be a permanent establishment of that enterprise.

22.3 Subparagraph *b)* relates to the ***maintenance of a stock of goods or merchandise belonging to the enterprise*** ~~stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery~~. ***This subparagraph is irrelevant in cases where a stock of goods or merchandise belonging to an enterprise is maintained by another person in facilities operated by that other person and the enterprise does not have the facilities at its disposal as the place where the stock is maintained cannot therefore be a permanent establishment of that enterprise. Where, for example, an ~~independent~~ logistics company operates a warehouse in State S and continuously stores in that warehouse goods or merchandise belonging to an enterprise of State R to which the logistics company is not closely related, the warehouse does not constitute a fixed place of business at the disposal of the enterprise of State R and subparagraph b) is therefore irrelevant. Where, however, that enterprise is allowed unlimited access to a separate part of the warehouse for the purpose of inspecting and maintaining the goods or merchandise stored therein, subparagraph b) is applicable and the question of whether a permanent establishment exists will depend on whether these activities constitute a preparatory or auxiliary activity.***

22.4 Subparagraph *c)* covers the situation ~~case in which~~ ***where*** a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise~~,~~ on behalf of, or for the account of, the first-mentioned enterprise. ***As explained in the preceding paragraph, the mere presence of goods or merchandise belonging to an enterprise does not mean that the fixed place of business where these goods or merchandise are stored is at the disposal of that enterprise. Where, for example, a stock of goods belonging to RCO, an enterprise of State R, is maintained by a toll-manufacturer located in State S for the purposes of processing by that toll-manufacturer, no fixed place of business is at the disposal of RCO and the place where the stock is maintained cannot therefore be a permanent establishment of RCO. If, however, RCO is allowed unlimited access to a separate part of the facilities of the toll-manufacturer for the purpose of inspecting and maintaining the goods stored therein, subparagraph c) will apply and it will be necessary to determine whether the maintenance of that stock of goods by RCO constitutes a preparatory or auxiliary activity. This will be the case if RCO is merely a distributor of products manufactured by other enterprises as in that case the mere maintenance of a stock of goods for the purposes of processing by another enterprise would not form an essential and significant part of RCO's overall activity. In such a case, unless paragraph 4.1 applies, paragraph 4 will deem a permanent establishment not to exist in relation to such a fixed place of business that is at the disposal of the enterprise of State R for the purposes of maintaining its own goods to be processed by the toll-manufacturer.***

22.5 The first part of subparagraph d) relates to the case where premises are used solely for the purpose of purchasing goods or merchandise for the enterprise. Since this exception only applies if that activity has a preparatory or auxiliary character, it will typically not apply in the case of a fixed place of business used for the purchase of goods or merchandise where the overall activity of the enterprise consists in selling these goods and where purchasing is a core function in the business of the enterprise. The following examples illustrate the application of paragraph 4 in the case of fixed places of business where purchasing activities are performed:

- ***Example 1: RCO is a company resident of State R that is a large buyer of a particular agricultural product produced in State S, which RCO sells from State R to distributors situated in different countries. RCO maintains a purchasing office in State S. The employees who work at that office are experienced buyers who have special knowledge of this type of product and who visit producers in State S, determine the type/quality of the products according to international standards (which is a difficult process requiring special skills and knowledge) and enter into different types of contracts (spot or forward) for the acquisition of the products by RCO. In this example, although the only activity performed through the office is the purchasing of products for RCO, which is an activity covered by subparagraph d), paragraph 4 does not apply and the office therefore constitutes a permanent establishment because that purchasing function forms an essential and significant part of RCO's overall activity.***
- ***Example 2: RCO, a company resident of State R which operates a number of large discount stores, maintains an office in State S during a two-year period for the purposes of researching the local market and lobbying the government for changes that would allow RCO to establish stores in State S. During that period, employees of RCO occasionally purchase supplies for their office. In this example, paragraph 4 applies because subparagraph f) applies to the activities performed through the office (since subparagraphs d) and e) would apply to the purchasing, researching and lobbying activities if each of these was the only activity performed at the office) and the overall activity of the office has a preparatory character.***

22.6 The second part of subparagraph d) relates to a fixed place of business that is used solely to collect information for the enterprise. An enterprise will frequently need to collect information before deciding whether and how to carry on its core business activities in a State. If the enterprise does so without maintaining a fixed place of business in that State, subparagraph d) will obviously be irrelevant. If, however, a fixed place of business is maintained solely for that purpose, subparagraph d) will be relevant and it will be necessary to determine whether the collection of information goes beyond the preparatory or auxiliary threshold. Where, for example, an investment fund sets up an office in a State solely to collect information on possible investment opportunities in that State, the collecting of information through that office will be a preparatory activity. The same conclusion would be reached in the case of an insurance enterprise that sets up an office solely for the collection of information, such as statistics, on risks in a particular market and in the case of a newspaper bureau set up in a State solely to collect information on possible news stories without engaging in any advertising activities: in both cases, the collecting of information will be a preparatory activity.

23. Subparagraph *e)* ***applies to*** ~~provides that~~ a fixed place of business ***maintained solely for the purpose of carrying on, for the enterprise, any activity that is not expressly listed in subparagraphs a) to d); as long as that activity*** ~~through which the enterprise exercises solely an activity which~~ has ~~for the enterprise~~ a preparatory or auxiliary character, ***that place of business*** is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of ~~exceptions~~ ***the activities to which the paragraph may apply, the examples listed in subparagraphs a) to d) being merely common examples of activities that are covered by the paragraph because they often have a preparatory or***

auxiliary character. ~~Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1~~ *[(the following part of the paragraph has been moved to paragraph 21):* ~~*and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of business activities which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question.]*~~ ~~Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.~~ *[that last sentence has been moved to paragraph [24]*

24. ~~It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity~~ *[the preceding three sentences have been moved to paragraph 21.1]*. Examples ***of places of business covered by subparagraph e)*** are fixed places of business ***used*** solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character *[this sentence currently appears at the end of paragraph 23]*. ***Paragraph 4 would not apply, however,*** ~~This would not be the case, where, for example,~~ ***if a*** fixed place of business ***used for the supply of information would*** ~~does~~ not only give information but ***would*** also furnish~~es~~ plans etc. specially developed for the purposes of the individual customer. Nor would it ~~be the case~~ ***apply*** if a research establishment were to concern itself with manufacture *[these two sentences currently appear at the end of paragraph 25]*. ***Similarly,*** ~~W~~***w***here~~, for example,~~ the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of ***paragraph 4*** ~~subparagraph *e)*~~. A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If ***an*** enterprise~~s~~ with international ramifications establish***es*** a so-called “management office” in ***a*** State~~s~~ in which ~~they~~***it*** maintain***s*** subsidiaries, permanent establishments, agents or licensees, such office having supervisory and coordinating functions for all departments of the enterprise located within the region concerned, ***subparagraph e) will not apply to that “management office” because*** ~~a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a “place of management” within the meaning of subparagraph *a)* of paragraph 2. T~~***t***he function of managing an enterprise, even if it only covers a certain area of the operations of the concern,

constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of ~~subparagraph *e)* of~~ paragraph 4.

25. ***Also, where an enterprise that sells goods worldwide establishes an office in a State and the employees working at that office take an active part in the negotiation of important parts of contracts for the sale of goods to buyers in that State without habitually concluding contracts or playing the principal role leading to the conclusion of contracts (e.g. by participating in decisions related to the type, quality or quantity of products covered by these contracts), such activities will usually constitute an essential part of the business operations of the enterprise and should not be regarded as having a preparatory or auxiliary character within the meaning of subparagraph e) of paragraph 4. If the conditions of paragraph 1 are met, such an office will therefore constitute a permanent establishment.*** ~~A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.~~

~~26. Moreover, subparagraph *e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph *e*).~~

~~26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a*), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e*) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a*) would be applicable […].~~

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide ~~for~~ exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph *f)* ~~of paragraph 4~~, the fact that one fixed place of business combines any of the activities mentioned in subparagraphs *a)* to *e)* ~~of paragraph 4~~ does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary**,** a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. ~~The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of subparagraph *e)* (see paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a)* to *e)*, disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in subparagraph *f)*.~~

27.1 ***Unless the anti-fragmentation provisions of paragraph 4.1 are applicable (see below),*** ~~S~~***s***ubparagraph *f*) is of no ***relevance*** ~~importance~~ in a case where an enterprise maintains several fixed places of business ***to which*** ~~within the meaning of~~ subparagraphs *a*) to *e*) ***apply*** ~~provided that they are separated from each other locally and organisationally,~~ as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. ~~Places of business are not "separated organisationally" where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.~~

28. The fixed places of business ~~mentioned in~~***to which*** paragraph 4 ***applies do not*** ~~cannot be deemed to~~ constitute permanent establishments so long as ~~their~~***the business*** activities ***performed through those fixed places of business*** are restricted to the ***activities referred to in that paragraph*** ~~functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment~~. This will be the case even if the contracts necessary for establishing and carrying on the***se*** business ***activities*** are concluded by those in charge of the places of business themselves. ***The conclusion of such contracts by these employees will not constitute a permanent establishment of the enterprise under*** ~~The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of~~ paragraph 5 ***as long as the conclusion of these contracts satisfies the conditions of paragraph 4 (see paragraph 33 below)***. ~~A case in point would be a research institution~~ ***An example would be where*** the manager of ~~which~~ ***a place of business where preparatory or auxiliary research activities are conducted*** ~~of which~~ ~~is authorised to~~ conclude***s*** the contracts necessary for ***establishing and*** maintaining ***that place of business*** ~~the institution and who exercises this authority within the framework~~ ***as part of the activities carried on at that location*** ~~functions of the institution~~. ~~A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were~~

~~also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.~~

29. If, ***under paragraph 4,*** a fixed place of business ~~under paragraph 4~~ is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity ***at that place*** ~~in such installation~~ (see paragraph 11 above and paragraph 2 of Article 13). ~~Since~~***Where***, for example, the display of merchandise during a trade fair ***or convention*** is excepted under subparagraphs *a)* and *b),* the sale of th***at***~~e~~ merchandise at the termination of ***the***~~a~~ trade fair or convention is covered by ***subparagraph e) as such sale is merely an auxiliary activity***~~this exception~~. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

30. ***Where paragraph 4 does not apply because a***~~A~~ fixed place of business used ***by an enterprise*** ~~both~~ for activities ***that are listed in that*** ~~which rank as exceptions~~ ~~***of***~~ ~~(~~paragraph ~~4)~~ ***is also used*** ~~and~~ for other ***activities that go beyond what is preparatory or auxiliary***, ***that place of business*** constitutes a single permanent establishment ***of the enterprise and the profits attributable to the permanent establishment with respect to*** ~~as regards~~ both types of activities ***may be taxed in the State where that permanent establishment is situated***. ~~This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.~~

19 The Committee noted that some members saw a connection –in the nature of an overlap- between the 2017 changes to paragraph 4 and the limited force of attraction in Article 7. These members queried whether the new paragraph 4 meant the provisions in Article 7(1) were still needed. However, no decision was taken by the Committee to revise Article 7 in light of the change to paragraph 4.

19.1 The Committee took note that some members thought that the scope of paragraph 4 is too wide and poses challenges (see above paragraph 18 quoting paragraph 21.1 of the OECD Commentary) which may be particularly difficult for developing countries to handle due to the lack of administrative capacity. Countries that have those concerns may consider eliminating the paragraph entirely. Another option that may also be considered for those that want to limit the scope of the paragraph is to eliminate subparagraphs which may be regarded as too extensive in scope, in particular members mentioned subparagraphs e) and f). However, negotiators of an agreement should make sure that the application of the remaining paragraph is limited by the preparatory or auxiliary requirement in order for the paragraph to only eliminate from the permanent establishment concept in paragraph 1, work being of no or very little significance in view of the other work performed by the enterprise.

~~Subparagraph (*f*) was added to Article 5, paragraph 4 in 1999. It follows the OECD Model Convention and provides that "the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (*a*) to (*e*)" is not a permanent establishment if "the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".~~

19.2 It was also noted that some States may consider that the activities in paragraph 4 are intrinsically preparatory or auxiliary in nature and take the view that these activities should not be subject to the preparatory or auxiliary condition since any concern about

the inappropriate use of these exceptions are addressed through the provisions of paragraph 4.1. States that share this view are free to amend paragraph 4 as follows (and may also agree to delete some of the activities listed in subparagraphs a) to d) below if they consider that these activities should be subject to the preparatory or auxiliary condition in subparagraph e)):

> ***4. Notwithstanding the preceding provisions of this Article, the term "permanent establishment" shall be deemed not to include:***
>
> ***(a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;***
>
> ***(b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;***
>
> ***(c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;***
>
> ***(d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;***
>
> ***(e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.***
>
> ***(f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.***

19.3 Under this alternative formulation as under paragraph 4 as it read before 2017, a fixed place of business is deemed not to constitute a permanent establishment if the only activities carried on at that place are activities to which one of the subparagraphs a) to d) apply.

20. As noted above, the United Nations Model Convention, in contrast to the OECD Model Convention, does not refer to "delivery" in subparagraphs (*a*) or (*b*). The question whether the use of facilities for the "delivery of goods" should give rise to a permanent establishment has been debated extensively. A 1997 study revealed that almost 75 per cent of the tax treaties of developing countries *included* the "delivery of goods" in the list of exceptions in subparagraphs (*a*) and (*b*) of paragraph 4. Nevertheless, some countries regard the omission of the expression in the United Nations Model Convention as an important point of departure from the OECD Model Convention, believing that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country.

21. In reviewing the United Nations Model Convention, the Committee retains the existing distinction between the two Models, but it notes that even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into attributing too much income to this activity if they do not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties. Therefore, although the

reference to "delivery" is absent from the United Nations Model Convention, countries may wish to consider both points of view when entering into bilateral tax treaties, for the purpose of determining the practical results of utilizing either approach.

Article 5, paragraph 4.1: new anti-fragmentation rule

Comment

At the 12th and 13th meetings the Committee discussed a proposal to add an anti-fragmentation rule immediately following paragraph 4 of Article 5, paragraph 4.1 as a new paragraph 4. The main idea in paragraph 4.1 is to prevent fragmentation of activities by an enterprise or a closely related enterprise to come within the specific activity exemptions and thereby avoid the existence of a permanent establishment of the enterprise.

This new provision uses the concept of a "closely related enterprise" which is defined in a proposed amendment to paragraph 7 under the proposal relating to dependent agent permanent establishments in Article 5, paragraphs 5 and 7.

Proposed addition of Article 5, paragraph 4.1 to the United Nations Model Convention

4.1 Paragraph 4 shall not apply to a fixed place of business that is used or maintained by an enterprise if the same enterprise or a closely related enterprise carries on business activities at the same place or at another place in the same Contracting State and

(a) that place or other place constitutes a permanent establishment for the enterprise or the closely related enterprise under the provisions of this Article, or

(b) the overall activity resulting from the combination of the activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, is not of a preparatory or auxiliary character,

provided that the business activities carried on by the two enterprises at the same place, or by the same enterprise or closely related enterprises at the two places, constitute complementary functions that are part of a cohesive business operation.

Proposed change to United Nations Model Convention Commentary

Paragraph 4.1

21.1 In 2017 the Committee decided to adopt a new paragraph 4.1 in Article 5. The new paragraph 4.1 is an anti-fragmentation rule that was recommended for the OECD Model Tax Convention in the OECD/G20 Final Report on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). The purpose of this new paragraph is to prevent an enterprise from fragmenting its activities – either within the enterprise or between closely related enterprises – in order to qualify for the specific

activity exemptions in paragraph 4 of Article 5. The Final Report also includes new Commentary to provide guidance on the application of paragraph 4.1 to situations where an enterprise or a group of closely related enterprises attempt to circumvent the preparatory or auxiliary activity rule in paragraph 4 by fragmenting a cohesive business operation into several small operations. The new OECD Commentary states:

> ***30.2 […] Under paragraph 4.1, the exceptions provided for by paragraph 4 do not apply to a place of business that would otherwise constitute a permanent establishment where the activities carried on at that place and other activities of the same enterprise or of closely related enterprises exercised at that place or at another place in the same State constitute complementary functions that are part of a cohesive business operation. For paragraph 4.1 to apply, however, at least one of the places where these activities are exercised must constitute a permanent establishment or, if that is not the case, the overall activity resulting from the combination of the relevant activities must go beyond what is merely preparatory or auxiliary.***
>
> ***30.3 The concept of "closely related enterprises" that is used in paragraph 4.1 is defined in subparagraph b) of paragraph 6 of the Article (see paragraphs 38.8 to 38.10 below).***
>
> ***30.4 The following examples illustrate the application of paragraph 4.1:***
>
> – ***Example A: RCO, a bank resident of State R, has a number of branches in State S which constitute permanent establishments. It also has a separate office in State S where a few employees verify information provided by clients that have made loan applications at these different branches. The results of the verifications done by the employees are forwarded to the headquarters of RCO in State R where other employees analyse the information included in the loan applications and provide reports to the branches where the decisions to grant the loans are made. In that case, the exceptions of paragraph 4 will not apply to the office because another place (i.e. any of the other branches where the loan applications are made) constitutes a permanent establishment of RCO in State S and the business activities carried on by RCO at the office and at the relevant branch constitute complementary functions that are part of a cohesive business operation (i.e. providing loans to clients in State S).***
>
> – ***Example B: RCO, a company resident of State R, manufactures and sells appliances. SCO, a resident of State S that is a wholly-owned subsidiary of RCO, owns a store where it sells appliances that it acquires from RCO. RCO also owns a small warehouse in State S where it stores a few large items that are identical to some of those displayed in the store owned by SCO. When a customer buys such a large item from SCO, SCO employees go to the warehouse where they take possession of the item before delivering it to the customer; the ownership of the item is only acquired by SCO from RCO when the item leaves the warehouse. In this case, paragraph 4.1 prevents the application of the exceptions of paragraph 4 to the warehouse and it will not be necessary, therefore, to determine whether paragraph 4, and in particular subparagraph 4 a), applies to the warehouse. The conditions for the application of paragraph 4.1 are met because***

- ***SCO and RCO are closely related enterprises;***
- ***SCO's store constitutes a permanent establishment of SCO (the definition of permanent establishment is not limited to situations where a resident of one Contracting State uses or maintains a fixed place of business in the other State; it applies equally where an enterprise of one State uses or maintains a fixed place of business in that same State); and***

The business activities carried on by RCO at its warehouse and by SCO at its store constitute complementary functions that are part of a cohesive business operation (i.e. storing goods in one place for the purpose of delivering these goods as part of the obligations resulting from the sale of these goods through another place in the same State).

Article 5, paragraphs 5 and 7: dependent agents

Comment

Article 5, paragraph 5

At the 12th and 13th meetings the Committee discussed proposals to amend Article 5, paragraphs 5 and 7 to broaden the scope of the dependent agent PE rule to counter structures aimed at the avoidance of a PE (including commissionaire arrangements).

Two options for an amended paragraph 5 were discussed at the 13th meeting. Option 1 was based on the OECD/G20 proposal in the Final Report on Action 7 (Preventing the Artificial Avoidance of Permanent Establishment Status). Option 2 was also based on the OECD/G20 recommendations except it proposed to remove the words "that are routinely concluded without material modification by the enterprise". Following discussions of options the Committee decided to adopt the first option.

Article 5, paragraph 7

The Committee also discussed proposed amendments to Article 5, paragraph 7 following the OECD/G20 recommendations. In addition a further change of substance to the United Nations Model Convention was discussed by the Committee is in relation to the situation when the activities of an agent are devoted wholly or almost wholly on behalf of an enterprise and the agent is therefore not an agent of independent status. It was noted that paragraph 7 the United Nations Model Convention currently provides that even in this situation an agent is still independent if it deals with the enterprise on an arm's length basis. It was also noted that this exception has never appeared in the OECD Model Convention with the result that, the OECD Model Convention has a more limited concept of independent agent than the United Nations Model Convention. The Committee considers that in proposing amendments to paragraph 7 it should remove this feature of its rule.

Article 5, paragraph 5

Proposed change to Article 5, paragraph 5 of the United Nations Model Convention

5. Notwithstanding the provisions of paragraphs 1 and 2 ***but subject to the provisions of paragraph 7***, where a person~~ — other than an agent of an independent status to whom paragraph 7 applies —~~ is acting in a Contracting State on behalf of an enterprise ~~of the other Contracting State~~, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(a) ~~Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise,~~ ***habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and these contracts are***

(i) in the name of the enterprise, or
(ii) for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or
(iii) for the provision of services by that enterprise,

unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(b) ~~Has no such authority, but~~ ***the person does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but*** habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

Proposed Change to United Nations Model Convention Commentary

Paragraph 5

22. ***In 2017 the Committee decided to modify paragraphs 5 and 7 of Article 5. The new paragraphs address the artificial avoidance of PE status through commissionaire arrangements and similar strategies. These changes to the United Nations Model Convention and relevant Commentary are in line with recommendations for the OECD Model Convention in the OECD/G20 Final Report on Action 7, (Preventing the Artificial Avoidance of Permanent Establishment Status).***

22.1 It is generally accepted that, if a person acts in a State for an enterprise in such a way as to closely tie up the activity of the enterprise with the economic life of that State, the enterprise should be treated as having a permanent establishment in that State—even if it does not have a fixed place of business in that State under paragraph 1. Paragraph 5 achieves this by deeming a permanent establishment to exist if the person is a so-called dependent agent who carries out on behalf of the enterprise an activity specified in subparagraph (*a*) or (*b*).

22.2 Subparagraph (*a*) follows the substance of the OECD Model Convention and proceeds on the basis that if a person ~~with the authority to~~ ***habitually*** concludes contracts in the name of the enterprise, ***for the transfer of ownership or the granting of the right to use the enterprise's property, or for the provision of services by that enterprise*** creates for that enterprise a sufficiently close association with a State ***(or if they are habitually playing the principal role leading to the conclusion of such contracts)***, then it is appropriate to deem that such an enterprise has a permanent establishment there. The condition in subparagraph (*b*), relating to the maintenance of a stock of goods, is discussed below.

23. In relation to subparagraph (*a*), a dependent agent causes a "permanent establishment" to be deemed to exist only if ~~his authority is used~~ ***he*** repeatedly ***concludes contracts or plays the principal role leading to the conclusion of contracts*** and not merely in isolated cases. The OECD Commentary states further:

> ~~32.1 Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.~~
>
> ***32.1 For paragraph 5 to apply, all the following conditions must be met:***
>
> - ***a person acts in a Contracting State on behalf of an enterprise;***
> - ***in doing so, that person habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise, and***
> - ***these contracts are either in the name of the enterprise or for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise.***
>
> ***32.2 Even if these conditions are met, however, paragraph 5 will not apply if the activities performed by the person on behalf of the enterprise are covered by the independent agent exception of paragraph 6 or are limited to activities mentioned in paragraph 4 which, if exercised through a fixed place of business, would be deemed not to create a permanent establishment. This last exception is explained by the fact that since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for the purposes of preparatory or auxiliary activities is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes should not create a permanent establishment either. Where, for***

example, a person acts solely as a buying agent for an enterprise and, in doing so, habitually concludes purchase contracts in the name of that enterprise, paragraph 5 will not apply even if that person is not independent of the enterprise as long as such activities are preparatory or auxiliary (see paragraph 22.5 above).

32.3 A person is acting in a Contracting State on behalf of an enterprise when that person involves the enterprise to a particular extent in business activities in the State concerned. This will be the case, for example, where an agent acts for a principal, where a partner acts for a partnership, where a director acts for a company or where an employee acts for an employer. A person cannot be said to be acting on behalf of an enterprise if the enterprise is not directly or indirectly affected by the action performed by that person. As indicated in paragraph 32, the person acting on behalf of an enterprise can be a company; in that case, the actions of the employees and directors of that company are considered together for the purpose of determining whether and to what extent that company acts on behalf of the enterprise.

32.4 The phrase "concludes contracts" focuses on situations where, under the relevant law governing contracts, a contract is considered to have been concluded by a person. A contract may be concluded without any active negotiation of the terms of that contract; this would be the case, for example, where the relevant law provides that a contract is concluded by reason of a person accepting, on behalf of an enterprise, the offer made by a third party to enter into a standard contract with that enterprise. Also, a contract may, under the relevant law, be concluded in a State even if that contract is signed outside that State; where, for example, the conclusion of a contract results from the acceptance, by a person acting on behalf of an enterprise, of an offer to enter into a contract made by a third party, it does not matter that the contract is signed outside that State. In addition, a person who negotiates in a State all elements and details of a contract in a way binding on the enterprise can be said to conclude the contract in that State even if that contract is signed by another person outside that State.

32.5 The phrase "or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" is aimed at situations where the conclusion of a contract directly results from the actions that the person performs in a Contracting State on behalf of the enterprise even though, under the relevant law, the contract is not concluded by that person in that State. Whilst the phrase "concludes contracts" provides a relatively well-known test based on contract law, it was found necessary to supplement that test with a test focusing on substantive activities taking place in one State in order to address cases where the conclusion of contracts is clearly the direct result of these activities although the relevant rules of contract law provide that the conclusion of the contract takes place outside that State. The phrase must be interpreted in the light of the object and purpose of paragraph 5, which is to cover cases where the activities that a person exercises in a State are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, i.e. where that person acts as the sales force of the enterprise. The principal role leading to the conclusion of the contract will therefore typically be associated with the actions of the person who convinced the third party to enter into a contract with the enterprise. The words "contracts that are routinely concluded without material modification by the enterprise" clarify that where such principal role is performed in that State, the

actions of that person will fall within the scope of paragraph 5 even if the contracts are not formally concluded in the State, for example, where the contracts are routinely subject, outside that State, to review and approval without such review resulting in a modification of the key aspects of these contracts.

32.6 The phrase "habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise" therefore applies where, for example, a person solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods belonging to the enterprise are delivered and where the enterprise routinely approves these transactions. It does not apply, however, where a person merely promotes and markets goods or services of an enterprise in a way that does not directly result in the conclusion of contracts. Where, for example, representatives of a pharmaceutical enterprise actively promote drugs produced by that enterprise by contacting doctors that subsequently prescribe these drugs, that marketing activity does not directly result in the conclusion of contracts between the doctors and the enterprise so that the paragraph does not apply even though the sales of these drugs may significantly increase as a result of that marketing activity.

32.7 The following is another example that illustrates the application of paragraph 5. RCO, a company resident of State R, distributes various products and services worldwide through its websites. SCO, a company resident of State S, is a wholly-owned subsidiary of RCO. SCO's employees send emails, make telephone calls to, or visit large organisations in order to convince them to buy RCO's products and services and are therefore responsible for large accounts in State S; SCO's employees, whose remuneration is partially based on the revenues derived by RCO from the holders of these accounts, use their relationship building skills to try to anticipate the needs of these account holders and to convince them to acquire the products and services offered by RCO. When one of these account holders is persuaded by an employee of SCO to purchase a given quantity of goods or services, the employee indicates the price that will be payable for that quantity, indicates that a contract must be concluded online with RCO before the goods or services can be provided by RCO and explains the standard terms of RCO's contracts, including the fixed price structure used by RCO, which the employee is not authorised to modify. The account holder subsequently concludes that contract online for the quantity discussed with SCO's employee and in accordance with the price structure presented by that employee. In this example, SCO's employees play the principal role leading to the conclusion of the contract between the account holder and RCO and such contracts are routinely concluded without material modification by the enterprise. The fact that SCO's employees cannot vary the terms of the contracts does not mean that the conclusion of the contracts is not the direct result of the activities that they perform on behalf of the enterprise, convincing the account holder to accept these standard terms being the crucial element leading to the conclusion of the contracts between the account holder and RCO.

32.8 The wording of subparagraphs a), b) and c) ensures that paragraph 5 applies not only to contracts that create rights and obligations that are legally enforceable between the enterprise on behalf of which the person is acting and the third parties with which these contracts are concluded but also to contracts that create

obligations that will effectively be performed by such enterprise rather than by the person contractually obliged to do so.

32.9 A typical case covered by these subparagraphs is where contracts are concluded with clients by an agent, a partner or an employee of an enterprise so as to create legally enforceable rights and obligations between the enterprise and these clients. These subparagraphs also cover cases where the contracts concluded by a person who acts on behalf of an enterprise do not legally bind that enterprise to the third parties with which these contracts are concluded but are contracts for the transfer of the ownership of, or for the granting of the right to use, property owned by that enterprise or that the enterprise has the right to use, or for the provision of services by that enterprise. A typical example would be the contracts that a "commissionnaire" would conclude with third parties under a commissionnaire arrangement with a foreign enterprise pursuant to which that commissionnaire would act on behalf of the enterprise but in doing so, would conclude in its own name contracts that do not create rights and obligations that are legally enforceable between the foreign enterprise and the third parties even though the results of the arrangement between the commissionnaire and the foreign enterprise would be such that the foreign enterprise would directly transfer to these third parties the ownership or use of property that it owns or has the right to use.

32.10 The reference to contracts "in the name of" in subparagraph a) does not restrict the application of the subparagraph to contracts that are literally in the name of the enterprise; it may apply, for example, to certain situations where the name of the enterprise is undisclosed in a written contract.

32.11 The crucial condition for the application of subparagraphs b) and c) is that the person who habitually concludes the contracts, or habitually plays the principal role leading to the conclusion of the contracts that are routinely concluded without material modification by the enterprise, is acting on behalf of an enterprise in such a way that the parts of the contracts that relate to the transfer of the ownership or use of property, or the provision of services, will be performed by the enterprise as opposed to the person that acts on the enterprise's behalf.

32.12 For the purposes of subparagraph b), it does not matter whether or not the relevant property existed or was owned by the enterprise at the time of the conclusion of the contracts between the person who acts for the enterprise and the third parties. For example, a person acting on behalf of an enterprise might well sell property that the enterprise will subsequently produce before delivering it directly to the customers. Also, the reference to "property" covers any type of tangible or intangible property.

32.13 The cases to which paragraph 5 applies must be distinguished from situations where a person concludes contracts on its own behalf and, in order to perform the obligations deriving from these contracts, obtains goods or services from other enterprises or arranges for other enterprises to deliver such goods or services. In these cases, the person is not acting "on behalf" of these other enterprises and the contracts concluded by the person are neither in the name of these enterprises nor for the transfer to third parties of the ownership or use of property that these enterprises own or have the right to use or for the provision of services by these

other enterprises. Where, for example, a company acts as a distributor of products in a particular market and, in doing so, sells to customers products that it buys from an enterprise (including an associated enterprise), it is neither acting on behalf of that enterprise nor selling property that is owned by that enterprise since the property that is sold to the customers is owned by the distributor. This would still be the case if that distributor acted as a so-called "low-risk distributor" (and not, for example, as an agent) but only if the transfer of the title to property sold by that "low-risk" distributor passed from the enterprise to the distributor and from the distributor to the customer (regardless of how long the distributor would hold title in the product sold) so that the distributor would derive a profit from the sale as opposed to a remuneration in the form, for example, of a commission.

33. The ~~authority to conclude~~ contracts ***referred to in paragraph 5*** ~~must~~ cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person ~~had authority to~~ ***concluded employment contracts*** ~~engage employees~~ for the enterprise to assist that person's activity for the enterprise or if the person ~~were authorised to~~ conclude***d***, in the name of the enterprise, similar contracts relating to internal operations only. Moreover***, whether or not a*** ~~the authority has to be~~ ***person*** habitually ~~exercised~~ ***concludes contracts or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*** ~~in the other State;~~should be determined on the basis of the commercial realities of the situation. ~~A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation.~~ The mere fact~~, however,~~ that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has ~~exercised in that State an authority to~~ conclude***d*** contracts ***or played the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*** ~~in the name of the enterprise~~. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. ~~Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.~~

33.1 The requirement that an agent must "habitually" ~~exercise an authority to~~ conclude contracts ***or play the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise*** reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is "habitually~~ exercising"~~ ***concluding contracts or playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise"*** ~~contracting authority~~ will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination

~~24. The Committee's view is that where paragraph 33 of the OECD Commentary above refers to "[a] person who is authorised to negotiate all elements and details of a contract", this should be taken to include a person who has negotiated all the essential elements of the contract, whether or not that person's involvement in the negotiation also extends to other non-essential aspects.~~ *[the OECD is removing the sentence to which this paragraph corresponds]*

24. The Committee discussed the significance of the phrase contracts "that are routinely concluded without material modification by the enterprise." The Committee noted that, even if the enterprise makes material modifications to some contracts (and even to the majority of contracts resulting from the activities of the local sales force) before the contracts are approved, as long as there is a person who habitually plays a principal role leading to the conclusion of other contracts that the enterprise concludes without any material modification, a dependent agent PE will still arise as a result of the activities of that person. Some Committee members still preferred to omit that phrase because they thought it narrowed the scope of the new paragraph 5 unnecessarily. They also thought it would encourage enterprises to claim that the condition was not met and to artificially avoid having a PE. Countries that share this concern are free to omit these words.

25. With the addition of paragraph 5, subparagraph (*b*), relating to the maintenance of a stock of goods, this paragraph is broader in scope than paragraph 5 of the OECD Model Convention. Some countries believe that a narrow formula might encourage an agent who was in fact dependent to represent himself as acting on his own behalf.

26. The former Group of Experts understood that paragraph 5, subparagraph (*b*) was to be interpreted such that if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment.[1] The former Group of Experts noted, however, that if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a permanent establishment may exist.[2]

Article 5, paragraph 7

<u>Proposed change to Article 5, paragraph 7 of the United Nations Model Convention</u>

7. ~~An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that~~

[1]See paragraph 25 of the Commentary on Article 5 of the 1999 version of the United Nations Model Convention.

[2]Ibid.

~~other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.~~

> ***(a) Paragraph 5 shall not apply where the person acting in a Contracting State on behalf of an enterprise of the other Contracting State carries on business in the first-mentioned State as an independent agent and acts for the enterprise in the ordinary course of that business.*** ~~However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.~~ ***Where, however, a person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related, that person shall not be considered to be an independent agent within the meaning of this paragraph with respect to any such enterprise.***
>
> ***(b) For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise.***

Proposed change to United Nations Model Convention Commentary

Paragraph 7

30. The first sentence of this paragraph reproduces Article 5, paragraph 6 of the OECD Model Convention, with a few minor drafting changes. The relevant portions of the Commentary on the OECD text are as follows:

> 36. Where an enterprise of a Contracting State carries on business dealings through ~~a broker, general commission agent or any other agent of~~ an independent ~~status~~ ***agent carrying on business as such***, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of ~~his~~ ***that*** business (see paragraph 32 above). ~~Although it stands to reason that s~~***The activities of s***uch an agent, ***who*** represent~~sing~~ a separate ***and independent*** enterprise, ~~cannot constitute a~~ ***should not result in the finding of a*** permanent establishment of the foreign enterprise~~, paragraph 6 has been inserted in the Article for the sake of clarity and emphasis~~.
>
> ~~37. A person will come within the scope of paragraph 6, i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:~~
>
> - ~~he is independent of the enterprise both legally and economically, and~~
> - ~~he acts in the ordinary course of his business when acting on behalf of the enterprise.~~

37. The exception of paragraph 6 only applies where a person acts on behalf of an enterprise in the course of carrying on a business as an independent agent. It would therefore not apply where a person acts on behalf of an enterprise in a different capacity, such as where an employee acts on behalf of her employer or a partner acts on behalf of a partnership. As explained in paragraph 8.1 of the Commentary on Article 15, it is sometimes difficult to determine whether the services rendered by an individual constitute employment services or services rendered by a separate enterprise and the guidance in paragraphs 8.2 to 8.28 of the Commentary on Article 15 will be relevant for that purpose. Where an individual acts on behalf of an enterprise in the course of carrying on his own business and not as an employee, however, the application of paragraph 6 will still require that the individual do so as an independent agent; as explained in paragraph 38.7 below, this independent status is less likely if the activities of that individual are performed exclusively or almost exclusively on behalf of one enterprise or closely related enterprises.

38. Whether a person ***acting as an agent is*** independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. ***In any event, the last sentence of subparagraph a) of paragraph 6 provides that in certain circumstances a person shall not be considered to be an independent agent (see paragraphs 38.6 to 38.11 below).*** ~~38.2~~ The following considerations should be borne in mind when determining whether an agent ***to whom that last sentence does not apply*** may be considered to be independent.

38.1 ***I***t should be noted that***, where the last sentence of subparagraph a) of paragraph 6 does not apply because a subsidiary does not act exclusively or almost exclusively for closely related enterprises,*** the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5 ***(see also paragraph 38.11 below)***. ~~But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.~~

38.*2*~~3~~ An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.***3***~~4~~ Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.*4*~~5~~ It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

38.5 Another factor to be considered in determining independent status is the number of principals represented by the agent. As indicated in paragraph 38.7, independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent, dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

38.*6*~~7~~ ***An independent agent*** ~~Persons~~ cannot be said to act in the ordinary course of ~~their own~~ ***its*** business ***as agent when it performs activities that are unrelated to that agency business*** ~~if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations~~. Where, for example, a ~~commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5~~ ***company that acts on its own account as a distributor for a number of companies also acts as an agent for another enterprise, the activities that the company undertakes as a distributor will not be considered to be part of the activities that the company carries on in the ordinary course of its business as an agent for the purposes of the application of subparagraph [6] a)***. ***Activities that are part of the ordinary course of a business that an enterprise carries on as an agent will, however, include intermediation activities which, in line with the common practice in a particular business sector, are performed sometimes as agent and sometimes on the enterprise's own account, provided that these intermediation activities are, in substance, indistinguishable from each other. Where, for example, a broker-dealer in the financial sector performs a variety of market intermediation activities in the same way but, informed by the needs of the clients, does it sometimes as an agent for another enterprise and sometimes on its own account, the broker-dealer will be considered to be acting in the ordinary course of its business as an agent when it performs these various market intermediation activities.***

~~38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent~~

~~agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.~~

38.7 The last sentence of subparagraph a) provides that a person is not considered to be an independent agent where the person acts exclusively or almost exclusively for one or more enterprises to which it is closely related. That last sentence does not mean, however, that paragraph 6 will apply automatically where a person acts for one or more enterprises to which that person is not closely related. Paragraph 6 requires that the person must be carrying on a business as an independent agent and be acting in the ordinary course of that business. Independent status is less likely if the activities of the person are performed wholly or almost wholly on behalf of only one enterprise (or a group of enterprises that are closely related to each other) over the lifetime of that person's business or over a long period of time. Where, however, a person is acting exclusively for one enterprise, to which it is not closely related, for a short period of time (e.g. at the beginning of that person's business operations), it is possible that paragraph 6 could apply. As indicated in paragraph 38.5, all the facts and circumstances would need to be taken into account to determine whether the person's activities constitute the carrying on of a business as an independent agent.

38.8 The last sentence of subparagraph a) applies only where the person acts "exclusively or almost exclusively" on behalf of closely related enterprises. This means that where the person's activities on behalf of enterprises to which it is not closely related do not represent a significant part of that person's business, that person will not qualify as an independent agent. Where, for example, the sales that an agent concludes for enterprises to which it is not closely related represent less than 10 per cent of all the sales that it concludes as an agent acting for other enterprises, that agent should be viewed as acting "exclusively or almost exclusively" on behalf of closely related enterprises.

38.9 Subparagraph b) explains the meaning of the concept of a "person closely related to an enterprise" for the purpose of the Article. That concept is to be distinguished from the concept of "associated enterprises" which is used for the purposes of Article 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent.

38.10 The first part of subparagraph b) includes the general definition of "a person closely related to an enterprise". It provides that a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. This general rule would cover, for example, situations where a person or enterprise controls an enterprise by virtue of a special arrangement that allows that person to exercise rights that are similar to those that it would hold if it possessed directly or indirectly more than 50 per cent of the beneficial interests in the enterprise. As in most cases where the plural form is used, the reference to the "same persons or enterprises" at the end of the first sentence of subparagraph b) covers cases where there is only one such person or enterprise.

38.11 The second part of subparagraph b) provides that the definition of "person closely related to an enterprise" is automatically satisfied in certain circumstances. Under that second part, a person is considered to be closely related to an enterprise if either one possesses directly or indirectly more than 50 per cent of the beneficial interests in the other or if a third person possesses directly or indirectly more than 50 per cent of the beneficial interests in both the person and the enterprise. In the case of a company, this condition is satisfied where a person holds directly or indirectly more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company.

38.12 The rule in the last sentence of subparagraph a) and the fact that subparagraph b) covers situations where one company controls or is controlled by another company does not restrict in any way the scope of paragraph 7 of Article 5. As explained in paragraph 41.1 below, it is possible that a subsidiary will act on behalf of its parent company in such a way that the parent will be deemed to have a permanent establishment under paragraph 5; if that is the case, a subsidiary acting exclusively or almost exclusively for its parent will be unable to benefit from the "independent agent" exception of paragraph 6. This, however, does not imply that the parent-subsidiary relationship eliminates the requirements of paragraph 5 and that such a relationship could be sufficient in itself to conclude that any of these requirements are met.

~~31. In the 1980 edition of the United Nations Model Convention,[3] the second sentence of paragraph 7 read: "However, when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph."~~

32. ~~It was subsequently recognized that this sentence had given rise to anomalous situations. The concern was that if the number of enterprises for which an independent agent was working fell to one, the agent would, without further examination, be treated as dependent.~~ In the 1999 revision of the Model, the wording was ~~therefore~~ amended ~~as follows:~~ ***to clarify that the essential criterion for treating an agent as not being of "an independent status" was the absence of an arm's length relationship.***

> ~~However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered as an agent of an independent status within the meaning of this paragraph.~~

33. ~~The revised version makes clear that the essential criterion for *automatically* treating an agent as not being of "an independent status" is the absence of the arm's-length relationship. The mere fact that the number of enterprises for which the independent agent acts has fallen to one does not of itself change his status from independent to dependent, though it might serve as an indicator of the absence of the independence of that agent.~~ ***In the 2017 update, the Committee decided that the lack of an arm's length relationship should not be a deciding factor in determining that an agent does not qualify as an agent of***

[3] United Nations Publication: ST/ESA/102: Sales No. E.80.XVI.3.

independent status and removed this requirement from the independent agent rule. In making its decision noted that removal of the arm's length condition was made because prior to the 2017 update, it was easier to qualify as "an independent agent" under the United Nations Model Convention than under the OECD Model Convention.

Article 5, paragraph 6: insurance businesses

Comment

Due to the Committee's concerns that Article 5, paragraph 6 can be abused and avoided in relation to re-insurance, the Committee discussed a proposal at the 12th and 13th meetings that the re-insurance exception be removed. The Committee also discussed a proposal that an alternate Article 5, paragraph 6 that allows the source state the right to tax insurance businesses without the existence of a permanent establishment be inserted into the model commentary as an option.

Proposed change to Article 5, paragraph 6 of the United Nations Model Convention

6. Notwithstanding the preceding provisions of this Article ***but subject to the provisions of paragraph 7***, an insurance enterprise of a Contracting State shall, ~~except in regard to re-insurance~~, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person ~~other than an agent of an independent status to whom paragraph 7 applies~~.

Proposed change to United Nations Model Convention Commentary

Paragraph 6

27. This paragraph of the United Nations Model Convention does not correspond to any provision in Article 5 of the OECD Model Convention and is included to deal with certain aspects of the insurance business. The OECD Model Convention nevertheless discusses the possibility of such a provision in bilateral tax treaties in the following terms:

> 39. According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD member countries ***before [next update]*** include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there—other than an agent who already constitutes a permanent establishment by virtue of paragraph 5—or insure risks situated in that territory through such an agent. The decision as to whether or not

a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. ***Also, the changes to paragraphs 5 and 6 made in [next update] have addressed some of the concerns that such a provision is intended to address.*** Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

28. Paragraph 6 of the United Nations Model Convention, which achieves the aim quoted above, is necessary because insurance agents generally have no authority to conclude contracts; thus, the conditions of paragraph 5, subparagraph (*a*) would not be fulfilled. If an insurance agent is independent, however, the profits of the insurance company attributable to his activities are not taxable in the source State because the provisions of Article 5 paragraph 7 would be fulfilled and the enterprise would not be deemed to have a permanent establishment.

28.1 Paragraph 6 of the United Nations Model Convention previously contained an exception for re-insurance. This was removed in the 2017 update due to concerns about the ease with which the provision could be abused and a permanent establishment thus avoided – contrary to the broader purpose of including a deemed permanent establishment rule for insurance. Countries that do not share this concern regarding reinsurance can continue to use the wording of Article 5, paragraph 6 as it read prior to the 2017 update.

29. Some countries, however, favour extending the provision to allow taxation even where there is representation by such an independent agent. They take this approach because of the nature of the insurance business, the fact that the risks are situated within the country claiming tax jurisdiction, and the ease with which persons could, on a part-time basis, represent insurance companies on the basis of an "independent status", making it difficult to distinguish between dependent and independent insurance agents. Other countries see no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. They also point to the difficulty of ascertaining the total amount of business done when the insurance is handled by several independent agents within the same country. In view of this difference in approach, the question how to treat independent agents is left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.

30. To address the difficulties faced in administering a provision that deems an insurance business to constitute a permanent establishment, for example in relation to the attribution of profits, some countries may instead prefer to include in Article 7 a provision which provides the source country with the right to tax insurance businesses without deeming a permanent establishment to exist. Over and above that, these countries may prefer to include a maximum rate of taxation permitted in the source country, with the rate to be determined in bilateral negotiations.

> ***[]. Notwithstanding the other provisions of this Article, an enterprise of a Contracting State that derives profits from any form of insurance, in the form of collecting premiums or insuring risks in the other Contracting State, may be taxed on such profits in that other Contracting State. However, the tax in the other Contracting State may not exceed ___ percent of the premiums collected.***

PART B – PROPOSED CHANGES TO ARTICLES OTHER THAN ARTICLE 5[4]

Tax policy considerations

Comment
At the 12th and 13th meeting, the Committee discussed a proposal that a section on tax policy considerations be inserted as new section C in the introduction of the commentary to the United Nations Model Convention and current section C be renamed D. This new section incorporates a reference to the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries which references the 2014 United Nations paper by Ariane Pickering and picks up the text of the new section being inserted into the OECD Model Convention.

<u>Proposed change to United Nations Model Convention Commentary</u>

C. TAX POLICY CONSIDERATIONS THAT ARE RELEVANT TO THE DECISION OF WHETHER TO ENTER INTO A TAX TREATY OR AMEND AN EXISTING TREATY

17.1 In 2005 the Committee established a Subcommittee on Negotiation of Tax Treaties – Practical Issues. This Subcommittee prepared an update to the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries which was adopted by the Committee in 2015 and published in 2016.[5] The aim of the Manual is to provide a guide to all aspects of treaty negotiation, including a brief description of the Articles of the United Nations Model Convention, to negotiators of tax treaties. While every country should form its own policy considerations and define its objectives in relation to tax treaties, the Manual seeks to provide practical guidance on all aspects of treaty negotiations, including on how to prepare for and conduct negotiations. It examined in depth the most common reasons why a country would enter into a tax treaty with another, for example, the facilitation of inbound and outbound investment by removing or reducing double taxation or excessive source country taxation, the reduction of cross-border tax avoidance and evasion through the exchange of information and mutual assistance in collection of taxes, or for political reasons. Treaty negotiators in developing countries are encouraged to use this Manual in preparing for tax treaty

[4] Principal purpose test and limitation on benefits issues will be separately addressed. A proposed revised Commentary on Article 1 will also be provided.

[5] New York: United Nations, 2016

negotiations, in the light of their countries policy framework and the intended outcomes they wish to achieve.

17.2 In particular, the Committee noted that the Manual provides the following useful checklist of the benefits and costs commonly associated with tax treaties:

Benefits:

- ***Increased foreign investment as a result of removal or reduction of tax barriers***
- ***Greater access to foreign technology and skills***
- ***Flow-on benefits to the local economy from increased foreign investment***
- ***Increased certainty for both taxpayers and tax administrations***
- ***Improved consistency for tax treatment***
- ***Protection for investment abroad***
- ***Avoidance of fiscal evasion***

Costs:

- ***Immediate revenue costs***
- ***Affect or limit on the operation of certain domestic tax laws***
- ***Risk of treaty-shopping and treaty abuse***
- ***Risk of double non-taxation***
- ***Need for changes and/or clarifications to domestic law to conform with tax treaties***
- ***Challenges to tax administration capacity to negotiate and administer tax treaties, including obligations under the mutual agreement procedure, exchange of information and, in some treaties, assistance in the collection of taxes***

17.3 Following the work by the OECD and G20 on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), the OECD will insert a section into the Introduction to the OECD Model Convention on the tax policy considerations that are relevant to the decision of whether to enter into a tax treaty, amend an existing tax treaty, or, as a last resort, terminate a tax treaty. The Committee took note of the considerations identified by the OECD and suggests to consider them additionally beside the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries The relevant section of the Commentary to the OECD Model Convention is as follows:

> ***15.1 In 1997, the OECD Council adopted a recommendation that the Governments of member countries pursue their efforts to conclude bilateral tax treaties with those member countries, and where appropriate with non-member countries, with which they had not yet entered into such conventions. Whilst the question of whether or not to enter into a tax treaty with another country is for each State to decide on the basis of different factors, which include both tax and non-tax***

considerations, tax policy considerations will generally play a key role in that decision. The following paragraphs describe some of these tax policy considerations, which are relevant not only to the question of whether a treaty should be concluded with a State but also to the question of whether a State should seek to modify or replace an existing treaty or even, as a last resort, terminate a treaty (taking into account the fact that termination of a treaty often has a negative impact on large number of taxpayers who are not concerned by the situations that result in the termination of the treaty).

15.2 Since a main objective of tax treaties is the avoidance of double taxation in order to reduce tax obstacles to cross-border services, trade and investment, the existence of risks of double taxation resulting from the interaction of the tax systems of the two States involved will be the primary tax policy concern. Such risks of double taxation will generally be more important where there is a significant level of existing or projected cross-border trade and investment between two States. Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between the two States and it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State. Where a State levies no or low income taxes, other States should consider whether there are risks of double taxation that would justify, by themselves, a tax treaty. States should also consider whether there are elements of another State's tax system that could increase the risk of non-taxation, which may include tax advantages that are ring-fenced from the domestic economy.

15.3 Accordingly, two States that consider entering into a tax treaty should evaluate the extent to which the risk of double taxation actually exists in cross-border situations involving their residents. A large number of cases of residence-source juridical double taxation can be eliminated through domestic provisions for the relief of double taxation (ordinarily in the form of either the exemption or credit method) which operate without the need for tax treaties. Whilst these domestic provisions will likely address most forms of residence-source juridical double taxation, they will not cover all cases of double taxation, especially if there are significant differences in the source rules of the two States or if the domestic law of these States does not allow for unilateral relief of economic double taxation (e.g. in the case of a transfer pricing adjustment made in another State).

15.4 Another tax policy consideration that is relevant to the conclusion of a tax treaty is the risk of excessive taxation that may result from high withholding taxes in the source State. Whilst mechanisms for the relief of double taxation will normally ensure that such high withholding taxes do not result in double taxation, to the extent that such taxes levied in the State of source exceed the amount of tax normally levied on profits in the State of residence, they may have a detrimental effect on cross-border trade and investment.

15.5 Further tax considerations that should be taken into account when considering entering into a tax treaty include the various features of tax treaties that encourage and foster economic ties between countries, such as the protection from discriminatory tax treatment of foreign investment that is offered by the non-discrimination rules of Article 24, the greater certainty of tax treatment for taxpayers who are entitled to benefit from the treaty and the fact that tax treaties provide, through the mutual agreement procedure, together with the possibility for Contracting States of moving to arbitration, a mechanism for the resolution of cross-border tax disputes.

15.6 An important objective of tax treaties being the prevention of tax avoidance and evasion, States should also consider whether their prospective treaty partners are willing and able to implement effectively the provisions of tax treaties concerning administrative assistance, such as the ability to exchange tax information, this being a key aspect that should be taken into account when deciding whether or not to enter into a tax treaty. The ability and willingness of a State to provide assistance in the collection of taxes would also be a relevant factor to take into account. It should be noted, however, that in the absence of any actual risk of double taxation, these administrative provisions would not, by themselves, provide a sufficient tax policy basis for the existence of a tax treaty because such administrative assistance could be secured through more targeted alternative agreements, such as the conclusion of a tax information exchange agreement or the participation in the multilateral Convention on Mutual Administrative Assistance in Tax Matters.[1]

[Footnote to paragraph 15.6:] Available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf

D.~~C.~~ MAIN FEATURES OF THIS REVISION OF THE UNITED NATIONS MODEL CONVENTION

Title and preamble

Comment

At the 12th and 13th meetings, the Committee discussed a proposal to amend the title and insert a text of a preamble for the United Nations Model Convention to clarify that treaties are not intended to be used to produce situations of double non-taxation. It was noted by the Committee that these proposed changes would be important in relation to the interpretation of the provisions contained in the treaty.

Currently, the United Nations Model Convention suggests that the preamble should be drafted according to the constitutional procedures of the Contracting States but it is proposed that this be replaced by a model preamble.

It was also noted that there are overlapping sections in the United Nations Model Convention Commentary and further work will be required to refine the proposed changes to the commentary and ensure that areas of overlap are sufficiently considered.

Proposed change to the title and preamble of the United Nations Model Convention

TITLE OF THE CONVENTION

Convention between (State A) and (State B) ***for the elimination of double taxation*** **with respect to taxes on income and on capital** ***and the prevention of tax avoidance and evasion***~~[6]~~

PREAMBLE OF THE CONVENTION~~[7]~~

(State A) and (State B),

~~[6]States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.~~

~~[7]The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of the Contracting States.~~

Desiring to further develop their economic relationship and to enhance their cooperation in tax matters,

Intending to conclude a Convention for the elimination of double taxation with respect to taxes on income and on capital without creating opportunities for non-taxation or reduced taxation through tax avoidance or evasion (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)

Have agreed as follows:

Proposed change to United Nations Model Convention Commentary

Introduction

4. The desirability of promoting greater inflows of foreign investment to developing countries on conditions which are politically acceptable as well as economically and socially beneficial has been frequently affirmed in resolutions of the General Assembly and the Economic and Social Council of the United Nations and the United Nations Conference on Trade and Development. The 2002 Monterrey Consensus on Financing for Development[8] and the follow up Doha Declaration on Financing for Development of 2008[9] together recognize the special importance of international tax cooperation in encouraging investment for development and maximizing domestic resource mobilisation, including by combating tax evasion. They also recognize the importance of supporting national efforts in these areas by strengthening technical assistance (in which this Model will play a vital part) and enhancing international cooperation and participation in addressing international tax matters (of which the United Nations Model Convention is one of the fruits).

5. The growth of investment flows between countries depends to a large extent on the prevailing investment climate. The prevention or elimination of international double taxation in respect of the same income - the effects of which are harmful to the exchange of goods and services and to the movement of capital and persons, constitutes a significant component of such a climate.

6. Broadly, the general objectives of bilateral tax treaties therefore include the protection of taxpayers against double taxation with a view to improving the flow of international trade and investment and the transfer of technology. They also aim to prevent certain types of

[8]United Nations 2002, A/CONF.198/11

[9]United Nations 2008, A/CONF.212/L.1/Rev.1

discrimination as between foreign investors and local taxpayers, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can confidently be carried on. With this background, tax treaties should contribute to the furtherance of the development aims of developing countries. In addition, the treaties seek to improve cooperation between taxing authorities in carrying out their functions, including by the exchange of information with a view to preventing avoidance or evasion of taxes and by assistance in the collection of taxes.

6.1 Finally, it has become clear as a result of international focus on base erosion and profit shifting that treaties are not intended to facilitate treaty shopping and other treaty abuses.

10. In 2005 the Ad Hoc Group of Experts was upgraded by conversion into a Committee structure, which remains its current form. The 25 members of the Committee of Experts on International Cooperation in Tax Matters are nominated by countries and chosen by the Secretary-General of the United Nations to act in their personal capacities for a period of 4 years. The Committee now directly reports to the ECOSOC**.** ~~and it now meets every year rather than every second year.~~

11. ***In 2013, 25 new members were appointed to the Committee of Experts.*** At the time of completion of this updated version of the United Nations Model Convention, the members of the Committee were as follows:[10]

~~Armando Lara Yaffar (Mexico) Chairperson of the Committee; Tizhong Liao (China) First Vice-Chairperson; Anita Kapur (India) Second Vice-Chairperson; Henry John Louie (United States of America) Third Vice-Chairperson; Bernell L. Arrindell (Barbados); Claudine Devillet (Belgium); Marcos Aurelio Pereira Valadao (Brazil); Iskra Georgieva Slavcheva (Bulgaria); Amr El Monayer (Egypt); Liselott Kana (Chile); Wolfgang Lasars (Germany); Kwame Adjei-Djan (Ghana); Enrico Martino (Italy); Keiji Aoyama (Japan); Mansor Hassan (Malaysia); , Noureddine Bensouda (Morocco); Robin Moncrieff Oliver (New Zealand); Ifueko Omoigui-Okauru (Nigeria); Stig Sollund (Norway); Farida Amjad (Pakistan); Sae Joon Ahn (Republic of Korea); El Hadji Ibrahima Diop (Senegal); Ronald van der Merwe (South Africa), Julia Martinez Rico (Spain), Jürg Giraudi (Switzerland).~~

[List of current members of Committee of Experts to be inserted]

[…]

16. The current revision of the United Nations Model Convention ***continues*** ~~is the beginning of~~ an ongoing process of review, which the Committee hopes will result in more frequent updates of particular Articles and Commentaries to keep up with developments, including in country practice, new ways of doing business, and new challenges. It will therefore operate as a process of continuous improvement. This means that some articles have not yet been substantively reviewed by the Committee.

17. The main objectives of this revision of the United Nations Model Convention have been to take account of developments in the area of international tax policies relevant for developing and developed countries. ~~The Committee also identified treaty policy~~ ***The***

[10] The countries nominating the members are listed for information only, because as noted above, members of the Committee act in their personal capacity, rather than as representatives of those countries.

Committee identified a number of issues that require further work***. In particular*** ~~and~~ it mandated one Subcommittee to address the issue of the taxation treatment of services in general and in a broad way including all related aspects and issues ***but*** ~~. Furthermore,~~ the issue of taxation of fees for technical services should ~~also~~ be addressed ***in particular. The Subcommittee therefore focused its work on the drafting of the new article with its commentary which is now included in the 2017 update of the Model.*** It was recognized***, however,*** that this was the initiation of extensive work ~~and it was agreed that there would not be any results ready for incorporation into this version of the Model Convention~~. In the future, if the Committee so decides, any potential conclusions that could be useful may ~~therefore~~ be presented as a Committee Report which may shape the next revision of the United Nations Model Convention. The work programme of the Committee, including that on services, will be made available as it develops on the Committee's website.[11]

17.1 In addition, the Committee has undertaken work on base erosion and profit shifting issues. Initially, the Committee focused on its own experiences and engaged with other relevant bodies, with a view to monitoring developments on base erosion and profit shifting issues and communicating on such issues with officials in developing countries (especially the less developed) directly and through regional and inter-regional organisations. This communication was done with a view to help inform developing countries on such issues, help facilitate the input of developing country experiences and views into the ongoing United Nations work and help facilitate the input of developing country experiences and views into the OECD/G20 Action Plan on Base Erosion and Profit Shifting. In 2014 the Committee commenced work on changes to the United Nations Model Tax Convention to address base erosion and profit shifting issues that arise out of the work of the G20 and OECD or relate specifically to issues that arose in respect of the Convention.

E. MAIN FEATURES OF THIS REVISION OF THE UNITED NATIONS MODEL CONVENTION

18. The main differences between the Articles of this version of the United Nations Model Convention and the previous version ~~revised in 1999 and published in 2001~~ ***published in 2012*** are as follows:

- ***A modified title of the convention and a new preamble of the convention;***
- ***A new version of Article 1 that includes a fiscally transparent entity clause, and a saving clause;***
- ***A modified version of Article 4 that includes a new tie breaker rule for determining the treaty residence of dual-resident persons other than individuals;***
- ***A modified version of Article 5 to prevent the avoidance of permanent establishment status;***
- ***A modified version of Article 10 to change the circumstances in which a lower rate applies for dividends on direct ownership of shares above a 25% threshold;***
- ***A new Article 12.A to provide for source taxation of fees for technical services;***
- ***A new version of Article 13, paragraph 4 to modify the scope of the land-rich company rule;***

- ***A modified version of Article 13, paragraph 5 for consistency with Article 13, paragraph 4;***
- ***Changes to Articles 23A and 23B to clarify that there is no obligation to provide relief for tax imposed on a solely residence basis;***
- ***A new Article 29 that contains provisions relating to entitlement to treaty benefits. These include a limitation on benefits rule, a third state permanent establishment rule and a principal purpose test.***

~~A modified version of Article 13, paragraph 5 to address possible abuses;~~

~~An optional version of Article 25 that provides for mandatory binding arbitration when a dispute cannot be solved under the usual Mutual Agreement Procedure;~~

~~A new version of Article 26 that confirms and clarifies the importance of exchange of information under the United Nations Model Convention, along the lines of the current OECD Model Convention provision; and~~

~~A new Article 27 on Assistance in the Collection of Taxes, along the lines of the current OECD Model Convention provision.~~

19. There have been changes to the Commentaries on the Articles to reflect the changes referred to above**.**~~, as well as~~:

~~Additions to the Commentary on Article 1 addressing the improper use of tax treaties (paragraphs 8-103);~~

~~A generally updated Commentary on Article 5;~~

~~Alternative text in the Commentary on Article 5 for cases where countries delete Article 14 and rely on Articles 5 and 7 to address cases previously covered by that Article (paragraphs 15.1-15.25);~~

~~An addition to the text of the Commentary on Article 7, noting that the OECD approach to Article 7 evidenced in the 2010 OECD Model Convention Commentary (and deriving from the 2008 OECD Report on the Attribution of Profits to Permanent Establishments) has not been adopted in relation to the significantly different United Nations Model Convention Article (paragraph 1) ;~~

~~Incorporation of revised text on beneficial ownership drawn from the OECD Model Convention in the Commentaries on Article 10 (paragraph 13), Article 11 (paragraph 18) and Article 12 (paragraph 5);~~

~~New text in the Commentary on Article 11 on the treatment of certain instruments which, while technically not interest bearing loans, are treated in the same fashion for treaty purposes. This is especially relevant for the treatment of certain Islamic financial instruments (paragraph 19.1-19.4); and~~

~~Revisions to the Commentaries on a number of Articles to quote wording from more recent versions of OECD Model Convention Commentaries, where these are considered as helpful in interpreting provisions based on the United Nations Model Convention.~~

Article 4, paragraph 3

<u>Comment</u>

At the 12th and 13th meetings the Committee discussed a proposal that the non-individual tiebreaker in paragraph 3 of Article 4 be amended to replace the place of effective management test with a requirement that the competent authorities should endeavour to resolve the question of residence by mutual agreement. The Committee noted that a similar provision already exists as an option in the Commentary of the United Nations Model Convention.

It was also noted that if there is a mandatory arbitration provision, this provision would not be applicable to Article 4, paragraph 3 because the consequences of not reaching mutual agreement are already set out in the provision.

It was proposed that the Commentary to Article 4 be updated to reflect the changes to the Model and to include the current paragraph 3 of Article 4 (place of effective management test or "POEM test") as an optional alternative.

<u>Proposed change to Article 4, paragraph 3 of the United Nations Model Convention</u>

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, ~~then it shall be deemed to be a resident only of the State in which its place of effective management is situated.~~ ***the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.***

<u>Proposed change to the United Nations Model Convention Commentary</u>

Paragraph 3

8. Paragraph 3, which reproduces Article 4, paragraph 3, of the OECD Model Convention, deals with companies and other bodies of persons, irrespective of whether they are legal persons. The OECD Commentary indicates in paragraph 21 that "~~[i]t may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is,~~

~~of course, possible if,~~ ***Cases where a company, etc. is subject to tax as a resident in more than one State may occur if,*** ~~-~~for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc. also, special rules as to the preference must be established". According to paragraph 22 of the OECD Commentary, "~~[i]t would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed~~ ***when paragraph 3 was first drafted, it was considered that it would not be an adequate solution to attach importance to a purely formal criterion like registration and preference was given to a rule based on the place of effective management, which was intended to be based on the place where the company, etc. was actually managed***~~.~~". ~~It may be mentioned that, as in the case of the OECD Model Convention, the word "only" was added in 1999 to the tie-breaker test for determining the residence of dual residents, other than individuals.~~

9. ***However, the OECD/G20 recommendation in the Final Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) resulted in changes to sole reliance on place of effective management to resolve cases of dual residence. In 2017 the Committee decided that the changes to the OECD Commentary should also be adopted as follows:***~~The OECD Commentary goes on to state:~~

> 23. ~~The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the "place of management" of the enterprise is situated; other conventions attach importance to its "place of effective management", others again to the "fiscal domicile of the operator".~~ ***In [2014], however, the Committee on Fiscal Affairs recognised that although situations of double residence of entities other than individuals were relatively rare, there had been a number of tax avoidance cases involving dual resident companies. It therefore concluded that a better solution to the issue of dual residence of entities other than individuals was to deal with such situations on a case-by-case basis.***
>
> 24. As a result of these considerations, ~~the "place of effective management" has been adopted as the preference criterion for persons other than individuals […].~~, ***the current version of paragraph 3 provides that the competent authorities of the Contracting States shall endeavour to resolve by mutual agreement cases of dual residence of a person other than an individual.***

~~10. It is understood that when establishing the "place of effective management", circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept. In this respect the OECD Commentary refers to some relevant country practices:~~

> 24.1 ~~Some countries, however, consider that cases of dual residence of persons who are not individuals are relatively rare and should be dealt with on a case-by-case basis. Some countries also consider that such a case-by-case approach is the best way to deal~~

~~with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing the paragraph by the following provision:~~

> ~~3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.~~

Competent authorities having to apply ***paragraph 3***~~such a provision to determine the residence of a legal person for purposes of the Convention~~ would be expected to take account of various factors, such as where the meetings of ***the person's***~~its~~ board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. ~~Also, since the application of the provision would normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25, the request should be made within three years from the first notification to that person that its taxation is not in accordance with the Convention since it is considered to be a resident of both Contracting States. Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.~~ [*the next sentence has been moved to new paragraph 24.2; the last sentence of the paragraph has been moved to new paragraph 24.3*]

24.2 ~~Also, since the~~ *A determination under paragraph 3* ~~application of the provision would~~ *will* normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25~~, the~~. *Such a* request *may be made as soon as it is probable that the person will be considered a resident of each Contracting State under paragraph 1. Due to the notification requirement in paragraph 1 of Article 25, it* should *in any event* be made within three years from the first notification to that person *of taxation measures taken by one or both States that indicate that reliefs or exemptions have been denied to that person because of its dual-residence status without the competent authorities having previously endeavoured to determine a single State of residence under paragraph 3. The competent authorities to which a request for* *determination of residence is made under paragraph 3 should deal with it expeditiously and should communicate their response to the taxpayer as soon as possible.*

24.3 Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

24.4 The last sentence of paragraph 3 provides that ***in the absence of a determination by the competent authorities, the dual-resident person shall not be entitled to any relief or exemption under the Convention except to the extent and in such manner as may be agreed upon by the competent authorities. This will not, however, prevent the taxpayer from being considered a resident of each Contracting State for purposes other than granting treaty reliefs or exemptions to that person. This will mean, for example, that the condition in subparagraph b) of paragraph 2 of Article 15 will not be met with respect to an employee of that person who is a resident of either Contracting State exercising employment activities in the other State. Similarly, if the person is a company, it will be considered to be a resident of each State for the purposes of the application of Article 10 to dividends that it will pay.***

10. While the place of effective management test was removed from Article 4, paragraph 3 in the 2017 update, some States may consider it to be preferable to deal with cases of dual residence of entities using such a test. These States may consider that this rule can be interpreted in such a way to prevent it from being abused and may wish to include the following version of paragraph 3, which appeared in the United Nations Model Convention prior to the 2017 update:

> ***3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.***

~~11. A particular issue, as regards a bilateral treaty between State A and State B, can arise in relation to a company which is under paragraph 1 of Article 4, a resident of State A, and which is in receipt of, say, interest income, not directly, but instead, through a permanent establishment which it has in a third country, State C. Applying the Model Convention has the effect that such a company can claim the benefit of the terms on, say, withholding tax on interest in the treaty between State A and State B, in respect of interest that is paid to its permanent establishment in State C. This is one example of what is known as a "triangular case". Some concern has been expressed that treaties can be open to abuse where, in the example given, State C is a tax haven and State A exempts the profits of permanent establishments of its resident enterprises. The situation is discussed in depth in the OECD study on the subject.[12] States which wish to protect themselves against potential abuse can take advantage of the possible solutions suggested there, by adopting additional treaty provisions.~~ *[this should be removed as triangular cases are now dealt with in Article 1]*

[12] Reproduced in Volume II of the full-length version of the OECD Model Convention at page R(11)-1.

Article 10, paragraph 2

<u>Comment</u>

At the 12th and 13th meetings the Committee discussed a proposal that the threshold for the reduced dividend withholding rate be increased to 25 per cent, but the rates themselves remain to be set through bilateral negotiations. The Committee also discussed a proposal that a 365-day holding period be inserted into paragraph 2(a).

<u>Proposed change to Article 10, paragraph 2 of the United Nations Model Convention</u>

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

(*a*) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least ~~10~~***25*** per cent of the capital of the company paying the dividends ***throughout a 365 day period that includes the day of the payment of the dividend (for the purpose of computing that period, no account shall be taken of changes of ownership that would directly result from a corporate reorganisation, such as a merger or divisive reorganisation, of the company that holds the shares or that pays the dividend)***;

(*b*) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

<u>Proposed change to the United Nations Model Convention Commentary</u>

Paragraph 2

4. This paragraph reproduces Article 10, paragraph 2, of the OECD Model Convention with certain changes which will be explained hereunder.

5. The OECD Model Convention restricts the tax in the source country to 5 per cent in subparagraph *a)* for direct investment dividends and 15 per cent in subparagraph *b)* for portfolio investment dividends, but the United Nations Model Convention leaves these percentages to be established through bilateral negotiations.

6. ***Prior to the 2017 update, the*** ~~Also, the~~ minimum ownership necessary for direct investment dividends ***was***~~is~~ reduced in subparagraph (*a*) from 25 per cent to 10 per cent. However, the 10 per cent threshold which determines the level of shareholding qualifying as a direct investment ~~is~~ ***was intended to be*** illustrative only. ~~When it last considered this issue,~~ ***T***~~t~~he former Group of Experts decided to replace "25 per cent" by "10 per cent" in subparagraph (*a*) as the minimum capital required for direct investment dividend status because in some developing countries non-residents are limited to a 50 per cent share ownership, and 10 per cent is a significant portion of such permitted ownership. ***However, as part of the 2017 update, the current Committee of Experts considered that 25 per cent is a more appropriate threshold for direct investment, in line with the OECD Model Convention.***

6.1 Also, in line with the changes to the recommendations in the OECD/G20 Final Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances), the Committee considered that in order to prevent abuse of the lower withholding rate for direct investment dividends, a 365 day holding period should be inserted into subparagraph (a). This 365 day holding requirement may be met either at the time of payment of the dividend or after the time the dividend is paid.

7. The former Group of Experts was unable to reach a consensus on the maximum tax rates to be permitted in the source country. Members from the developing countries, who basically preferred the principle of the taxation of dividends exclusively in the source country, considered that the rates prescribed by the OECD Model Convention would entail too large a loss of revenue for the source country. Also, although they accepted the principle of taxation in the beneficiary's country of residence, they believed that any reduction in withholding taxes in the source country should benefit the foreign investor rather than the treasury of the beneficiary's country of residence, as may happen under the traditional tax-credit method if the reduction lowers the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

8. The former Group of Experts suggested some considerations that might guide countries in negotiations on the rates for source country taxation of direct investment dividends. If the developed (residence) country uses a credit system, treaty negotiations could appropriately seek a withholding tax rate at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate not exceeding the tax rate in the residence country. The parties' negotiating positions may also be affected by whether the residence country allows credit for taxes spared by the source country under tax incentive programmes. If the developed country uses an exemption system for double taxation relief, it could, in bilateral negotiations, seek a limitation on withholding rates on the grounds that (*a*) the exemption itself stresses the concept of not taxing inter-corporate dividends, and a limitation of the withholding rate at source would be in keeping with that concept, and (*b*) the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and a limitation of the withholding rate at source, which would also benefit the investor, would be in keeping with this aspect of the exemption.

9. Both the source country and the country of residence should be able to tax dividends on portfolio investment shares, although the relatively small amount of portfolio investment and its distinctly lesser importance compared with direct investment might make the issues concerning its tax treatment less intense in some cases. The former Group of Experts decided not to recommend a maximum rate because source countries may have varying views on the importance of portfolio investment and on the figures to be inserted.

10. In 1999, it was noted that recent developed/developing country treaty practice indicates a range of direct investment and portfolio investment withholding tax rates. Traditionally, dividend withholding rates in the developed/developing country treaties have been higher than those in treaties between developed countries. Thus, while the OECD direct and portfolio investment rates are 5 per cent and 15 per cent, developed/developing country treaty rates have traditionally ranged between 5 per cent and 15 per cent for direct investment dividends and 15 per cent and 25 per cent for portfolio dividends. Some developing countries have taken the position that short-term loss of revenue occasioned by low withholding rates is justified by the increased foreign investment in the medium and long terms. Thus, several modern developed/developing country treaties contain the OECD Model rates for direct investment, and a few treaties provide for even lower rates.

11. Also, several special features in developed/developing country treaties have appeared: (*a*) the tax rates may not be the same for both countries, with higher rates allowed to the developing country; (*b*) tax rates may not be limited at all; (*c*) reduced rates may apply only to income from new investment; (*d*) the lowest rates or exemption may apply only to preferred types of investments (e.g. "industrial undertakings" or "pioneer investments"); and (*e*) dividends may qualify for reduced rates only if the shares have been held for a specified period. In treaties of countries that have adopted an imputation system of corporation taxation (i.e. integration of company tax into the shareholder's company tax or individual income tax) instead of the classical system of taxation (i.e. separate taxation of shareholder and corporation), specific provisions may ensure that the advanced credits and exemptions granted to domestic shareholders are extended to shareholders resident in the other Contracting State.

12. Although the rates are fixed either partly or wholly for reasons connected with the general balance of the particular bilateral tax treaty, the following technical factors are often considered in fixing the rate:

(*a*) the corporate tax system of the country of source (e.g. the extent to which the country follows an integrated or classical system) and the total burden of tax on distributed corporate profits resulting from the system;

(*b*) the extent to which the country of residence can credit the tax on the dividends and the underlying profits against its own tax and the total tax burden imposed on the taxpayer, after relief in both countries;

(*c*) the extent to which matching credit is given in the country of residence for tax spared in the country of source;

(*d*) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investment.

13. The Commentary on the OECD Model Convention contains the following passages:

[The United Nations Model Convention Commentary then quotes OECD commentary paras 11-22 - it will need to be checked if these are changing. The Commentary omits part of 12.2 , and 12.3-12.7]

Article 13, paragraphs 4 and 5

Comment

At its 12th and 13th meetings the Committee discussed a proposal to replace paragraph 4 of the current United Nations Model Convention with the provision recommended in the Action 6 Final Report (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances).

There are two significant changes to paragraph 4 in adopting this new provision.

First, the proposal arising out of the Action 6 Final Report (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances) amends Article 13, paragraph 4 to address the concern that there might be cases where assets are contributed to an entity shortly before the sale of the shares (or other comparable interests) in that entity in order to dilute the proportion of the value of these shares (or comparable interests) that is derived from immovable property situated in one Contracting State. The proposal is that paragraph 4 be amended to refer to situations where shares (or comparable interests) derive their value primarily from immovable property at any time during the 365 days preceding the alienation, as opposed to the time of alienation only. This proposal is consistent with issues currently raised in the United Nations Model Convention regarding circumvention of the threshold.

Second, in proposing to replace the current paragraph 4 with the new OECD provision, the Committee also considered a proposal to omit subparagraph (a) of the current provision be omitted in the 2017 update. It is considered that the provision does not reflect common practice - it is very rarely used and difficult to apply. Instead it will be included as an optional provision in the United Nations Model Convention Commentary.

The Committee noted existing paragraph 4 in Article 13 of the United Nations Model Convention is already broader than the OECD Model Convention by virtue of the fact that it already includes references to “an interest in a partnership, trust or estate”. Accordingly, the relevant changes made to the OECD Model Convention will make it more aligned with the United Nations Model Convention. However, the Committee proposes to include the reference to comparable interests in paragraph 5 so that the two models are fully aligned in scope.

Some minor consequential changes are also proposed to align aspects of paragraph 5 of Article 13 with the new paragraph 4.

Paragraph 99 of the United Nations Model Convention Commentary on Article 1 may need to be reconsidered. This is highlighted.

<u>Proposed change to Article 13, paragraphs 4 and 5 of the United Nations Model Convention</u>

~~4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:~~

~~(*a*) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.~~

~~(*b*) For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.~~

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.

5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company***, or comparable interests, such as interests in a partnership or trust,*** which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the ~~12-month period~~ ***365 days*** preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

<u>Proposed Change to the United Nations Model Convention Commentary</u>

Paragraph 4

8. This paragraph ***corresponds with paragraph 4 of the OECD Model Convention. Until the 2017 update, paragraph 4 of the United Nations Model Convention read as follows:***

> ***4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:***
>
> ***(a) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly***

principally of immovable property used by such company, partnership, trust or estate in its business activities.

(b) For the purposes of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.

Both formulations are ~~, which broadly corresponds to paragraph 4 of the OECD Model Convention, allows a Contracting State to tax a gain on an alienation of shares of a company or on an alienation of interests in other entities the property of which consists principally of immovable property situated in that State. It is~~ designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company. This is especially so where ownership of the shares carries the right to occupy the property. In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State. In 1999, the former Group of Experts decided to amend paragraph 4 to expand its scope to include interests in partnerships, trusts and estates which own immovable property. ~~It also decided to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities. However, this exclusion will not apply to an immovable property management company, partnership, trust or estate. In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or indirectly, such as, through one or more interposed entities. Contracting States may agree in bilateral negotiations that paragraph 4 also applies to gains from the alienation of other corporate interests or rights forming part of a substantial participation in a company. For the purpose of this paragraph, the term "principally" in relation to the ownership of an immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by such company, partnership, trust or estate.~~ ***In 2017, the Committee decided to adopt the updated provision from the OECD Model Convention, as the concept of a "comparable interest" is broadly equivalent to what was previously covered by paragraph 4 of the United Nations Model Convention.***

8.1 In addition to introducing the concept of a "comparable interest", paragraph 4 was expanded to cover situations where assets are contributed to an entity shortly before the sale of the shares (or comparable interests) in that entity in order to dilute the proportion of the value of these shares (or comparable interests) that is derived from immovable property situated in that other Contracting State. It achieves this by looking at whether the shares (or comparable interests) derived their value primarily from immovable property at any time during the 365 days preceding the alienation, as opposed to the time of alienation only.

8.2 In adopting the updated wording from the OECD Model Convention in 2017, the Committee decided to omit paragraph 4(a) from the United Nations Model Convention as it did not reflect common practice. It was found that the provision was very rarely used and was difficult to apply. However, countries may agree during bilateral negotiations to include the words from subparagraph (a) as it appeared prior to the 2017 update, at the end of paragraph 4, as follows:

4. Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State. Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.

Paragraph 5

9. Some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State. However, it is recognized that for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the ~~12-month period~~ ***365 days*** preceding the alienation, held, directly or indirectly, a substantial participation. ~~In this context, "12-month period" means the period beginning with the date which is one calendar year earlier than the date of the alienation and ending at the time of the alienation.~~ The determination of what is a substantial participation is left to bilateral negotiations, in the course of which an agreed percentage can be determined.

9.1 In 2017, the Committee decided to include the reference to "comparable interests" in paragraph 5. Prior to the 2017 update, paragraph 4 of the United Nations Model Convention was already broader than the OECD Model Convention by virtue of the fact that it included a reference to "an interest in a partnership, trust or estate". Accordingly the relevant changes made to the OECD Model Convention made it more aligned with the United Nations Model Convention. However, the Committee decided that the addition of "comparable interests" to paragraph 5 would make the two models fully aligned in scope.

10. This paragraph provides for taxation of a gain on the alienation of shares ***and comparable interests*** as contemplated in the paragraph above but excludes gains from the alienation of shares to which paragraph 4 of Article 13 of the Convention applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 12-month period preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12-month period.

11. It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in

determining the level of the alienator's direct or indirect holdings. The treaty text itself or associated documents could alternatively expand on the meaning of these concepts.

12. The question of laying down a concessionary rate of tax (compared with the normal domestic rate) on gains arising on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of companies principally owning immovable property, has also been considered. Since the gains arising on alienation of shares being taxed in a concessionary manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialization of the country, countries may consider discussing this matter during bilateral negotiations and making necessary provision in the bilateral tax treaties.

13. It is costly to tax gains from the alienation of quoted shares. In addition, developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares. Countries that wish to do so may include in their bilateral tax treaties the following:

> Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, excluding shares in which there is substantial and regular trading on a recognized stock exchange, may be taxed in that other State if the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least ___ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

The treaty text itself or associated documents could expand on the meaning of the phrases "substantial and regular trading" and "recognized stock exchange".

14. Some countries might consider that the Contracting State in which a company is resident should be allowed to tax the alienation of its shares only if a substantial portion of the company's assets are situated in that State and in bilateral negotiations might seek to include such a limitation.

15. Other countries engaged in bilateral negotiations might seek to have paragraph 5 omitted entirely, where they take the view that taxation in the source State of capital gains in these situations may create economic double taxation in the corporate chain, thus hampering foreign direct investment. This consideration is, in particular, relevant for countries that apply a participation exemption not only to dividends received from a substantial shareholding, but also to capital gains made on shares in relation to such substantial holdings.

16. If countries choose not to tax the gains derived in the course of corporate reorganizations, they are of course also free to do so.

Article 23: Proposed changes to paragraph 1 of Article 23 A and paragraph 1 of Article 23 B

Comment

At the 12th and 13th meetings, the Committee also agreed to consider a proposal to clarify that Article 23 A and Article 23 B do not require relief to be provided in respect of tax imposed exclusively because of the residence of an entity. The following proposal is based on the OECD provision recommended as a result of the follow up work undertaken following the release of the OECD/G20 Final Report on Action 6 (Preventing the Granting of Treaty Benefits in Inappropriate Circumstances). These changes are also related to the Committee's decision to adopt a new paragraph 2 of Article 1 regarding fiscally transparent entities.

At paragraph 14 of the Commentary extracts of OECD Commentary are inserted because they are applicable to Articles 23 A and 23 B. This Commentary is now being amended and includes:

- Changes to paragraph 9 and the addition of paragraph 9.1
- Insertion of two new paragraphs 11.1 and 11.2

Note that further consequential amendments will need to be made to the Commentary on Articles 10, 11 and 21.

Proposed change to Article 23 A, paragraph 1 of the United Nations Model Convention

1. Where a resident of a Contracting State derives income or owns capital which ***may be taxed in the other Contracting State***, in accordance with the provisions of this Convention ***(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)***~~, may be taxed in the other Contracting State~~, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

Proposed change to Article 23 B, paragraph 1 of the United Nations Model Convention

1. Where a resident of a Contracting State derives income or owns capital which ***may be taxed in the other Contracting State***, in accordance with the provisions of this Convention ***(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)***, ~~may be taxed in the other Contracting State,~~ the first-mentioned State shall allow:

a) as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State;

b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

<u>Proposed change to United Nations Model Convention Commentary</u>

14. The following extracts from the Commentary on Article 23 A and 23 B of the OECD Model Convention are applicable to Articles 23 A and 23 B:

[…]

> ***9.*** *Where a resident of the Contracting State R derives income from the same State R through a permanent establishment which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment (**paragraph 1 of Article 7 and** paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment situated in State E, notwithstanding the fact that the income in question originally arises in State R (see **also** paragraph 5 of the Commentary on Article 21). However, where the Contracting States agree to give to State R ~~which applies the exemption method~~ a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Article 10 or 11 ~~(see paragraph 5 of the Commentary on Article 21)~~, then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.*
>
> ***9.1 [the following is a slightly modified version of what is currently found in paragraph 5 of the Commentary on Article 21] Where, however, State R applies the exemption method, a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, State R, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11 notwithstanding the fact that it applies the***

exemption method. The State where the permanent establishment is situated would give a credit for such tax along the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit would not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.

11.1 In some cases, the same income or capital may be taxed by each Contracting State as income or capital of one of its residents. This may happen where, for example, one of the Contracting States taxes the worldwide income of an entity that is a resident of that State whereas the other State views that entity as fiscally transparent and taxes the members of that entity who are residents of that other State on their respective share of the income. The phrase "(except to the extent that these provisions allow taxation by that other State solely because the income is also income derived by a resident of that State)" clarifies that in such cases, both States are not reciprocally obliged to provide relief for each other's tax levied exclusively on the basis of the residence of the taxpayer and that each State is therefore only obliged to provide relief of double taxation to the extent that taxation by the other State is in accordance with provisions of the Convention that allow taxation of the relevant income as the State of source or as a State where there is a permanent establishment to which that income is attributable, thereby excluding taxation that would solely be the result of the residence of a person in that other State. Whilst this result would logically follow from the wording of Articles 23 A and 23 B even in the absence of that phrase, the addition of the phrase removes any doubt in this respect.

11.2 The principles put forward in the preceding paragraph are illustrated by the following examples:

- *Example A: An entity established in State R constitutes a resident of State R and is therefore taxed on its worldwide income in that State. State S treats that entity as fiscally transparent and taxes the members of the entity on their respective share of the income derived through the entity. All the members of the entity are residents of State S. All the income of the entity constitutes business profits attributable to a permanent establishment situated in State R. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S, on the other hand, will be required to provide relief under Article 23 A or 23 B with respect to the entire income of the entity as that income may be taxed in State R in accordance with the provisions of Article 7 regardless of the fact that State R considers that the income is derived by an entity resident of State R. In determining the amount of income tax paid in State R for the purposes of providing relief from double taxation to the members of the entity under Article 23 B, State S will need to take account of the tax paid by the entity in State R.*
- *Example B: Same facts as in example A except that 30 per cent of the income derived through the entity is interest arising in State S that is*

attributable to a permanent establishment in State R, the rest of the income being business profits attributable to the same permanent establishment. In that case, relief of double taxation with respect to the business profits other than the interest will be provided as described in example A. In the case of the interest, however, State R will be required to provide a credit to the entity under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State S by all the members of the entity without exceeding the lower of 10 per cent of the gross amount of interest (which is the maximum amount of tax that may be paid in State S in accordance with paragraph 2 of Article 11) or the tax payable in State R on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, on the other hand, will also be required to provide relief under Article 23 A or 23 B to the members of the entity that are residents in State S because that income may be taxed by State R in accordance with the provisions of paragraph 1 of Article 7. If State S applies the exemption method of Article 23 A, that suggests that State S will need to exempt the share of the interest attributable to the members that are residents of State S (see paragraph 5 of the Commentary on Article 21 and paragraph 9 of the Commentary on Articles 23 A and 23 B). If State S applies the credit method of Article 23 B, the credit should only be applicable against the part of the tax payable in State S that exceeds the amount of tax that State S would be entitled to levy under paragraph 2 of Article 11 and that credit should be given for the amount of tax paid in State R after deduction of the credit that State R itself must grant for the tax payable in State S under paragraph 2 of Article 11.

– *Example C: Same facts as in example A except that all the income of the entity is derived from immovable property situated in State S. In that case, in determining the tax payable by the entity, State R will be required to provide relief under Article 23 A or 23 B with respect to the entire income of the entity as that income may be taxed in State S in accordance with the provisions of Article 6 regardless of the fact that State S considers that the income is derived by the members who are residents of State S. State S, on the other hand, is not required to provide relief under Article 23 A or 23 B because the only reason why State R may tax the income in accordance with the provisions of the Convention is because of the residence of the entity (the result would be the same even if the income were attributable to a permanent establishment situated in State R: see the first sentence of paragraph 9 of the Commentary on Articles 23 A and 23 B).*

– *Example D: Same facts as in example A except that all the income of the entity is interest arising in State S which is not attributable to a permanent establishment. In that case, in determining the tax payable by the entity, State R will be required to provide a credit to the entity under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State S by all the members of the entity without exceeding the lower of 10 per cent of the gross amount of the interest (which is the maximum amount of tax that may be paid in State S in accordance with paragraph 2 of Article 11) or the tax payable in State R on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23*

B). State S, on the other hand, will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity since that income does not arise in State R and is not attributable to a permanent establishment in State R and the only reason why State R may tax the income is because the income is also income derived by a resident of State R. Paragraph 1 of Article 11 confirms State R's right to tax the interest as income derived by an entity resident of State R.

– *Example E: Same facts as in example D except that all the income of the entity is interest arising in State R. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S, on the other hand, will be required to provide a credit to the members under paragraph 2 of Article 23 A or paragraph 1 of Article 23 B for the amount of tax on the interest paid in State R by the entity without exceeding the lower of 10 per cent of the gross amount of the interest (which is the maximum amount of tax that may be paid in State R in accordance with paragraph 2 of Article 11) or the tax payable in State S on that interest (last part of paragraph 2 of Article 23 A and of paragraph 1 of Article 23 B). State S, however, will not be obliged to provide relief under Article 23 A or 23 B with respect to tax paid in State R in excess of the maximum amount of tax that may be levied in accordance with paragraph 2 of Article 11 since the interest is not attributable to a permanent establishment in State R and the only reason why State R may levy such additional tax is because the income is also income derived by a resident of State R. Whilst paragraph 2 of Article 11 and paragraph 3 of Article 1 confirm State R's right to tax the interest as interest arising in State R, State S considers that the interest is beneficially owned by a resident of State S, which explains why it does not take account of the tax levied in State R in excess of 10 per cent.*

– *Example F: Same facts as in example D except that all the income of the entity is interest arising in a third State. In that case, in determining the tax payable by the entity, State R will not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity as the only reason why State S may tax that income in accordance with the provisions of the Convention is because of the residence of the members of the entity. State S will also not be obliged to provide relief under Article 23 A or 23 B with respect to the income of the entity since that income does not arise in State R and is not attributable to a permanent establishment in State R and the only reason why State R may tax the income is because the income is also income derived by a resident of State R. Paragraph 1 of Article 21 confirms State R's right to tax the interest as income derived by an entity resident of State R. Paragraph 1 of Article 21 also confirms State S' right to tax the interest as income derived by the entity's members who are residents of State S.*