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**Committee of Experts on International
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Item 3 (b) of the provisional agenda

**Update of the UN Model Double Taxation Convention between Developed and
Developing Countries – Corrections to Art. 5(5) UN Model and the Commentary on
Art. 5**

Note by the Secretariat

Summary

This note includes proposed changes to Article 5 of the UN Model and its Commentary that would address mistakes that were identified in messages sent by Mr. Rajat Bansal to the Subcommittee on the UN Model Double Taxation Convention between Developed and Developing Countries.

At its twentieth session, the Committee is invited to have a first discussion of the proposed changes included in this note.

Introduction

1. In a message to the Subcommittee on the UN Model Double Taxation Convention between Developed and Developing Countries sent by Mr. Rajat Bansal on 13 May 2020, Mr. Bansal identified a few drafting/quoting errors related to Article 5 of the UN Model and its Commentary.
2. As a result of exchanges with Mr. Bansal, the Secretariat has prepared the proposals for changes that are included in this note.
3. At its twentieth session, the Committee is invited to have a first discussion of the proposed changes included in this note.

Correction of Art. 5(5)

4. The first correction should be made to subparagraph (b) of paragraph 5 of Article 5, the relevant parts of which read as follows in the 2017 UN Model:
 5. Notwithstanding the provisions of paragraphs 1 and 2 but subject to the provisions of paragraph 7, where a person is acting in a Contracting State on behalf of an enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, ***if such a person:***
 - (a) habitually concludes contracts, or ... under the provisions of that paragraph; or
 - (b) ***the person*** does not habitually conclude contracts nor plays the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise.
5. Since the opening part of paragraph 5 finishes with the words “if the person” (in bold italics above), subparagraph (b) should not repeat the words “the person”.
6. In order to correct that error and fix a typo in the verb “plays”, it is proposed to amend subparagraph (b) in the 2021 update so that it would read as follows:
 - (b) does not habitually conclude contracts nor play the principal role leading to the conclusion of such contracts, but habitually maintains in that State a stock of goods or merchandise from which that person regularly delivers goods or merchandise.

Revision of paragraph 67 of the Commentary on Article 5

7. The second change relates to paragraph 67 of the revised Commentary on Article 5 that is included in note E/C.18/2020/CRP.10 (Proposed changes to the Commentary on Article 5 - Permanent Establishment). Paragraph 67 as proposed in note E/C.18/2020/CRP.10 quotes the OECD Commentary on Art. 5(5) of the OECD Model and indicates that that Commentary is applicable to paragraph 5 of Article 5 of the UN Model. However, since paragraph 5 of Article 5 of the UN Model, unlike paragraph 5 of the OECD Model, includes two subparagraphs, the OECD Commentary is only applicable with respect to subparagraph (a) of the UN Model. This issue would be fixed by replacing paragraph 67 by the following (changes appear in **redline**):

~~2367.~~ In relation to subparagraph (a), a dependent agent causes a “permanent establishment” to be deemed to exist only if that person repeatedly, ***and not merely in isolated cases,*** concludes contracts or plays the principal role leading to the conclusion of contracts ~~and not merely in isolated cases.~~ The 2017 OECD Model Commentary states further: ***The Committee considers that the following part of the Commentary on paragraph 5 of Article 5 of the OECD Model***

Convention is applicable with respect to subparagraph (a) of paragraph 5 of Article 5 of this Model (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model):

84. For subparagraph (a) of 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.

85. Even if these conditions are met, however, subparagraph (a) of 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~~7 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 68 above).

86. 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 83, 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.

87. 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.

88. 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.

89. 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.

90. The following is another example that illustrates the application of *[subparagraph (a) 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.

91. The wording of ~~subparagraphs a), b) and c)~~ [subdivisions (i), (ii) and (iii)] ensures that [subparagraph (a) of] 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.

92. A typical case covered by these ~~subparagraphs~~ [subdivisions] 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 [subdivisions]~~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.

93. The reference to contracts “in the name of” in ~~subparagraph a)~~ [subdivision (i)] does not restrict the application of the [subdivision]~~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.

94. The crucial condition for the application of [subdivisions (ii) and (iii)] ~~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.

95. For the purposes of [subdivision (ii)]~~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.

96. The cases to which [subparagraph (a) of] 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.

97. The contracts referred to in paragraph 5 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 conclude~~^d employment contracts for the enterprise to assist that person’s activity for the enterprise or if the person concluded, in the name of the enterprise, similar contracts relating to internal operations only. Moreover, whether or not a 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 should be determined on the basis of the commercial realities of the situation. The mere fact 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 concluded contracts or played the principal role leading to the conclusion of contracts that are routinely concluded without material modification by 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.

98. The requirement that an agent must “habitually” 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” concluding contracts or playing the principal role leading to the conclusion of contracts that are routinely concluded without material modification by the enterprise²² 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 paragraphs ~~28 to 30~~ ⁶ would be relevant in making that determination.

Correction of paragraph 71 of the Commentary on Article 5

8. The third change relates to paragraph 71 of the revised Commentary on Article 5 that is included in note E/C.18/2020/CRP.10 (Proposed changes to the Commentary on Article 5 - Permanent Establishment). Paragraph 71 as proposed in note E/C.18/2020/CRP.10 quotes incorrectly paragraph 114 of the 2017 OECD Model. The preamble of paragraph 71 also indicates that the reference to the “2014” OECD Model would be replaced by “2017” even though the year “2014” does not appear in the UN Model. Both errors would be addressed by replacing paragraph 71 by the following (changes appear in redline):

~~27~~⁷¹. 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 Commentary of the ~~2014~~²⁰¹⁷ OECD Model Convention nevertheless discusses the possibility of such a provision in bilateral tax treaties in the following terms:

~~39~~¹¹⁴. 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 2017 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 2017 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.