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**Committee of Experts on International  
Cooperation in Tax Matters  
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Item 3 (1) of the provisional agenda

Article 7 (Business Profits) of the UN Model Convention, including the “force of attraction” principle, and its application in the case of EPC (engineering, procurement and construction) contracts

***Summary***

This note is presented for discussion and guidance (not for final approval) at the meeting of the Committee to be held in Geneva on 15-18 October 2019.

1. Ms. Yan Xiong, a current member of the Committee, submitted the following issue for consideration:

“The limited force of attraction rule in the UN model was designed to catch sales or other business activities “carried on in that other State of the same or similar kind as those effected through that permanent establishment”, but in treaty implementation, there can be an application of this rule to activities that are not carried on in that other state, and therefore to income that’s not derived from (does not arise in) that state.

A typical case scenario of such kind is the EPC (engineering, procurement and construction) contract in which the home office of an enterprise of a Contracting State undertakes the provision of goods or merchandise (composed of engineering and procurement activities conducted in the home country), and the permanent establishment of the enterprise situated in the other Contracting State undertakes the assembly or installation activities in connection with such goods or merchandise and has no involvement in the provision of the goods or merchandise.

Some countries would apply the force of attraction rule in the treaty to attribute to the PE the profits derived from the provision of goods or merchandise conducted by the home office. But the provision of goods or merchandise is not an activity of the same or similar kind as those effected through the PE (which undertakes assembly or installation activities only), and more importantly, all activities related to the provision of goods or

merchandise including engineering and procurement are conducted by the home office in the home country.

Some countries may do so even without having the force of attraction rule in the treaty, in which case they should have attributed to that permanent establishment only the profits resulting from the activities undertaken by the permanent establishment.

I'm thinking that the above is a quite common treaty practice that deserves observation and discussion by the Committee, which is looked upon to come up with reasonable and balanced policy suggestions and help countries interpret and implement the treaty in a way that is intended.”

2. Article 7 of the UN Model governs the taxation by a Contracting State of business profits if a permanent establishment or fixed base exists in that State. Paragraph 1 of Article 7 reads as follows:

“1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.”

3. Subparagraphs 1(b) and 1(c) are together commonly referred to as the so-called “force of attraction” rule, which, as is stated in paragraph 6 of the Commentaries to Article 7 of the UN Model, amplifies the scope of business profits that may be taxed by the State in which the permanent establishment is situated beyond what is allowed in the OECD Model. Commentary paragraph 6 states “This allows the country in which the permanent establishment is located to tax not only the profits attributable to that permanent establishment but other profits of the enterprise derived in that country to the extent allowed under the Article.”

4. In the example posed by Ms. Xiong, the home office, under an EPC contract, engages in activities in the home office State to create goods or merchandise which the home office provides to the permanent establishment. The permanent establishment in turn undertakes to assemble or install the goods and merchandise provided by the home office.

5. The first question of interpretation is whether, under the terms of the UN Model Article 7(1), the profits of the home office from the creation in the home office State and provision of

the goods and merchandise maybe be taxed by the State in which the permanent establishment is situated as the business profits of the permanent establishment.

6. It seems clear that the profits in question would not fall within the scope of Article 7(1)(a), because the profits are not “attributable to that permanent establishment”. Article 7(2) provides that “there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.” There can be no doubt that if the permanent establishment were an enterprise separate and independent from its head office, it would not derive profits from the activities undertaken abroad by an independent enterprise acting for itself.

7. Similarly, it seems clear that Article 7(1)(b) is not relevant, because that subparagraph refers to profits from sales activities.

8. Finally, it also seems clear that Article 7(1)(c) is equally not applicable, because that subparagraph refers only to activities “carried on in the other State [that is, the State in which the permanent establishment is situated]” and that are “of the same or similar kind as those effected through” the permanent establishment. As the goods and merchandise are produced by the home office in the home office State, the relevant activity is clearly not carried on in the State in which the permanent establishment is situated.

9. As for the requirement that the activity giving rise to the business profits in question must be carried on in the State in which the permanent establishment is situated before taxation by the State in which the permanent establishment is situated can be considered under Article 7(1)(c), the existing Commentary to Article 7 paragraph 1, while it implies this interpretation, is not explicit. The second half of Commentary paragraph 6 provides:

“Members from developing countries pointed out that the force of attraction approach avoids some administrative problems because, under that approach, it is not necessary to determine whether particular activities are related to the permanent establishment or the income involved attributable to it. **That was the case especially with respect to transactions conducted directly by the home office within the country that are similar in nature to those conducted by the permanent establishment...**

10. The Committee may wish to consider the following new paragraphs to the Commentaries to Article 7 to provide further guidance on the application of Article 7(1)(a) and to make explicit the point above regarding the force of attraction rule. Proposed paragraphs 6.1 and 6.2 are drawn from paragraphs 36 and 37 of the OECD Commentaries to Article 7 and address the issue in the context of applying Article 7(1)(a) of the UN Model. Proposed paragraphs 6.3 and

6.4 relate to the application Article 7(1)(b) and 7(1)(c). The new paragraphs would be inserted after existing paragraph 6:

“6.1. The application of clause (a) can sometimes be problematic for certain types of permanent establishment, such as construction sites and construction and installation projects. These problems arise chiefly when goods are provided, or services are performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. In these circumstances, it is necessary to pay close attention to the general principle that profits are attributable to a permanent establishment only with respect to activities carried on by the enterprise through the permanent establishment.

6.2 For example, where such goods are supplied by the other parts of the enterprise, the profits rising from that supply do not result from the activities carried on through the permanent establishment and are not attributable to it. Similarly, profits resulting from the provision of services (such as planning, designing, drawing blueprints, or rendering technical advice) by parts of the enterprise operating outside the State where the permanent establishment is located do not result from the activities carried on through the permanent establishment and are not attributable to it.

6.3 While they apply in different circumstances, clauses (b) and (c) share one underlying theme: in both cases, the activities that give rise to the taxable business profits must be performed within the Contracting State in which the permanent establishment is situated. Accordingly, in the case of clause (b), the sale of the referenced goods or merchandise that are of the same or similar kind as those sold through the permanent establishment must take place within the Contracting State where the permanent is situated, and profits from any sales that take place outside of that State may not be taxed by that State.

6.4. Similarly, in the case of clause (c), the business activity or activities conducted by the enterprise that are of the same or similar nature as the business activity of the permanent establishment must take place within the Contracting State in which the permanent establishment is situated. Therefore, profits arising from a business activity conducted within the home office State would clearly not be taxable by the State in which the permanent establishment is situated.”