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Proposal for amendments to article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries*

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* Prepared by members of the subcommittee on modified permanent establishment definition (Coordinator: Stig Sollund), building on a paper prepared by Hans Pijl and Ramona Piscopo that was submitted to the Committee in December 2005; the views and opinions expressed are those of the authors and do not necessarily represent those of the United Nations.



I. Introduction

1. At the first session of the Committee of Experts on International Cooperation in Tax matters in December 2005, a subcommittee comprising of experts and observers was appointed to propose improvements to the commentary on article 5 of the United Nations Model Double Taxation Convention between Developed and Developing Countries, taking into consideration amendments to the Organization for Economic Cooperation and Development (OECD) commentary and placing emphasis on useful examples and the specific needs of developing countries (see E/2005/45-E/C.18/2005/11, para. 85).

2. The following were members of the subcommittee: Stig Sollund (Coordinator), Andrew Dawson, Wolfgang Lasars, Ofir Levy, Habiba Louati, Ron van der Merwe and Hans Pijl.

II. Inputs received by the subcommittee

3. The subcommittee invited comments from interested parties through the United Nations website. The following contributors provided their comments: David Davies, Gishlain Joseph, Michael McIntyre, Rajendra Nayak, PriceWaterhouseCoopers India and Liao Tizhong. The subcommittee would like to thank them for their valuable contributions, which were most helpful in its discussions.

III. Points for possible further study

4. Some of the contributions went beyond the subcommittee's mandate; the subcommittee recommends that those suggestions be studied further in the context of changing the articles concerned. Subcommittee members themselves also made suggestions for changing article 5. In particular, the deletion of article 14 and the consequential amendment of article 5 attracted support. But it was felt that proposing such a change at the present stage would be premature and it should receive further study, particularly in the light of the work on the taxation of services that OECD is currently undertaking.

5. In short, the subcommittee suggests that the Committee of Experts mandate a further study into the following subjects:

- (a) The deletion of article 14 and its integration in article 5;
- (b) A definition of "business" in article 3;
- (c) Amendments to article 5 itself, especially in the context of services (article 5(3)(b)).

6. One member of the subcommittee is of the opinion that the wording of the second sentence of article 5(7) could create a problem in interpretation, which could also be regarded as a subject for further study.

7. The Committee may also wish to examine the clarification of the right of the source State to tax income derived from the exploitation of fishing. One suggestion received by the subcommittee was to amend article 6(2) of the Model Convention,

(defining “immovable property”) to include a “fishery” addition. The subcommittee leaves it to the discretion of the Committee whether it wishes to further study that suggestion, also taking into account some treaty practice bringing fishery under a separate offshore article.

IV. General considerations of the subcommittee

8. The subcommittee also considered the form which any amendments to the commentary should take. It was not clear to the members of the subcommittee that the current presentation of the United Nations model commentary was necessarily the most helpful. An option, for example, would be to confine the commentary to those features of the United Nations model that are different from the OECD model. Such an approach has a variety of attractions and drawbacks. However, the subcommittee recognized that such a proposal was outside its remit and could only be sanctioned by the full Committee. If adopted, it would clearly have to apply to the whole of the commentary and not just the commentary on article 5. Another alternative would be to draft the commentary as a text in itself, extensively using the OECD commentary as the basis for that text, adding to it and amending it where required.

9. Partly for that reason, the subcommittee has at the present stage refrained from proposing an actual text for the commentary to article 5, and leaves it to the Committee to decide on the required presentation.

10. In any case, the subcommittee has restricted itself to making substantive suggestions, leaving the form those changes should take to later.

V. Relationship to the OECD commentary

11. The current United Nations Model Convention was last amended in 2001. The amendments in 2000 to the OECD Model Convention were, it would seem, taken into account in that 2001 amendment. The OECD Model Convention (and its commentary) were further amended in 2003 and 2005.

The subcommittee has therefore examined the United Nations commentary to article 5 in the light of subsequent OECD revisions and recommends that the United Nations commentary be based on the OECD commentary, with the exception of the issues indicated below.

12. In general, it is useful to monitor changes to the OECD commentary and possibly amend the United Nations commentary accordingly since (a) clarification is always beneficial; (b) negotiation between countries is facilitated when the starting point between the negotiating parties is similar; and (c) it would be beneficial to make use of OECD resources by basing possible United Nations amendments on amendments to the OECD Model Convention and commentary.

13. In formulating its proposals, the subcommittee was guided by elements of practicality and effectiveness. Not only must the amendments to the United Nations commentary be beneficial to all United Nations Member States but such amendments should also facilitate the negotiating parties’ coming to an agreement. The subcommittee has taken into account that, in general, most of the OECD

changes to the commentary have resulted in the widening of the permanent establishment concept, such as the conclusion that, in some circumstances, no human presence is required to constitute a permanent establishment.

14. Many of the OECD paragraphs in the commentary to article 5 contain references to abusive situations. Although those references may have lost some relevance since the inclusion in the OECD commentary to article 1 of more general and far-reaching statements on treaty abuse, the subcommittee suggests retaining those references and even extending them in those cases where abuse threatens, if only to help negotiators and tax authorities to be aware of that danger. Alternatively, the commentary to article 5 could more generally stress that the general anti-abuse remarks in the commentary to article 1 may also apply in the context of article 5.

15. The subcommittee has been mindful of the need to keep commentary changes within bounds: if the wording is overreaching, local courts might ignore the changes. In the subcommittee's view, it is better to avoid far-reaching statements unless they have a solid basis in customary case law.

VI. Specific considerations and proposals by the subcommittee

16. The subcommittee discussed paragraphs 4.5 and 4.6 of the OECD commentary, which indicate that a painter who repaints a building has the building at his disposal and a road-paving enterprise has at its disposal the location where the road is being paved. Most countries appear to accept this interpretation, and in line with its view that the whole OECD commentary should be included the subcommittee recommends the inclusion of those paragraphs. The subcommittee recognizes however, that one OECD member State disagrees with that interpretation and made an observation to the OECD commentary to that effect in 2005. One member of the subcommittee agreed with the result (recognition of a permanent establishment) only with reference to and subject to paragraph 3 (b) of article 5 of the United Nations Model Convention.

17. The subcommittee extensively discussed paragraph 6 of the OECD commentary, which reads:

“6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that

place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.”

18. The subcommittee believes that the principles expressed in paragraph 6 of the OECD commentary, which serve to widen the concept of a permanent establishment, can be justified and should therefore be retained. The majority of the subcommittee, however, also believes that the examples should be used with considerable care, since the general customary practice, especially that of the Courts, is not to recognize a permanent establishment unless the activity has been maintained for six months. One member of the subcommittee does not agree to the inclusion of paragraph 6 of the OECD commentary in the commentaries of the United Nations Model Convention on the grounds that courts should not recognize a permanent establishment solely because the activity has been maintained for more than six months, except in the cases mentioned in paragraph 3 (a) and (b) of article 5 of the United Nations Model Convention.

19. The subcommittee was hesitant to add an example to the second exception, as the majority believes that that paragraph should be handled with care. In circumstances where the enterprise in the resident State is a special purpose company without any substance or activities (except for those which are necessary to meet the legal requirements of existence), there is room for application of that exception. However, as in other cases where in the commentary examples are used, this example should not be taken *a contrario*, excluding other cases which do not meet the exact conditions of that example.

20. The subcommittee believes that a final sentence should be added to paragraph 18 of the OECD commentary to the extent that the measures signalled to deal with abuse are also extended to article 5(3)(b) United Nations Model Convention, e.g.: “This applies equally in cases of article 5(3)(b)”.

21. The subcommittee draws attention to paragraph 19, eighth sentence, of the OECD commentary, which reads: “If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts *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” (emphasis added). This exact wording is reflected in the United Nations commentary, paragraph 11, second indentation.

22. The use of the term “parts” of the project could be taken to mean that if an enterprise subcontracted *all* parts of the project, that would not amount to a permanent establishment of that enterprise in the host State. A majority of the subcommittee suggests adding a comment to paragraph 11 of the United Nations commentary to correct that interpretation; it is of the opinion that the rule applies equally where all parts of the projects are subcontracted. A minority of the subcommittee notes out that OECD has not finished its deliberations on this subject; it suggests that the wording of paragraph 11 of the United Nations commentary not be changed for the time being.

23. Paragraph 17 of the OECD commentary was amended in 2003. The amendments widen the definition of “building site or construction or installation project”. Post-2003, renovations and installations, planning and supervisory activities may amount to a permanent establishment. The third sentence of paragraph 17 reads: “On-site planning and supervision of the erection of a building are covered by paragraph 3”. That wording suggests that the amendments, while extending the definition of permanent establishment, limit “planning and supervision” to the erection of buildings and do not also encompass the complete wording of article 5(3) of the OECD Model Convention, which extends to planning and supervision of *construction or installation projects*. This is probably an oversight. The subcommittee’s suggestion is that the third sentence is meant to read: “On-site planning and supervision of the erection of a building, construction, assembly or installation project are covered by paragraph 3”. Article 5(3) of the United Nations Model Convention contains a reference to “supervisory activities”. “Planning”, however, is not included, so that an interpretative clarification of this issue is not superfluous. Thus, the corresponding United Nations commentary would be: “On-site planning and supervision of the erection of a building or in respect of a *construction, assembly or installation project* is covered by paragraph 3”.

24. Some members of the subcommittee are of the opinion that the classification of the pure planner as having a permanent establishment (which deviates from the interpretation of the treaty as was reflected in the pre-2003 OECD commentary) is a statement which needs explicit amendments of the treaty text itself in order to have effect.

25. Paragraph 33, fourth sentence, of the OECD commentary (as also quoted in paragraph 23 of the United Nations commentary) refers to the negotiation of “*all* elements and details”. The majority of the subcommittee suggests including a paragraph in the United Nations commentary indicating that that phrase is to be interpreted as meaning “the *essential* elements and details”. One member of the subcommittee was hesitant to make such an amendment and was of the opinion that it could lead to new difficulties in interpretation regarding the meaning of “essential”.

26. With regard to the OECD commentary, one member of the subcommittee is of the opinion that the title of the sub-chapter “Electronic commerce” is not adequate, as one of its core principles, i.e., the absence of personnel in the source country, also applies to other industries (see para. 42.6, last sentence). By the same token, that member also considers the relationship between paragraph 10 (which requires local personnel, although their activities may sometimes be limited to setting up and maintenance etc.) and paragraph 42.6 to be contradictory. Other members of the subcommittee underline the general principle mentioned above, namely that human presence is not required to constitute a permanent establishment.

27. Paragraph 42.3 of the OECD commentary draws a distinction between a contract with an Internet service provider and a place of business at the disposal of the enterprise. The subcommittee recognizes that some businesses could seek to avoid creating a permanent establishment by managing the contractual terms in cases where the circumstances would justify the permanent establishment conclusion instead. For that reason, the subcommittee suggests the inclusion in the sub-chapter on e-commerce of a statement to the effect that substance overrides form.

28. Article 5(4)(f) deals with situations of “fragmentation”, that is to say, situations in which establishment of the enterprise is such that any activities mentioned in article 5(4)(a)-5(4)(e) are split up so as not to be covered under article 5(4)(f). In the context of anti-abuse, paragraph 27.1 was added in to the OECD commentary in 2003 to clarify that places of business are not “separated organizationally” where they each perform complementary functions in a contracting State. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is engaged in merely a preparatory or auxiliary activity. Fragmentation is also referred to under article 5(3), paragraph 20, third sentence, of the OECD commentary. It can thus be said that fragmentation is deemed a danger for tax revenue and should be carefully considered.

29. In 2005, changes were made to paragraph 41.1 of the OECD commentary to such an extent that the multiple permanent establishment approach was rejected. In the opinion of the subcommittee, this should be subject to safeguards against abusive arrangements where this situation is brought about by purely artificial structures. In such a situation, a rule that substance overrides form should apply.

VII. Conclusions

30. The subcommittee has put forward above a number of substantive proposals to the Committee on amendments to the commentaries to article 5 of the United Nations Model Convention. On certain other points deemed by the subcommittee to fall outside its mandate, it suggests to the Committee that further study be conducted subject to the deliberations and decision of the Committee.
