E/C.18/2020/CRP.7

Distr.: General
8 May 2020

Original: English

Committee of Experts on International Cooperation in Tax Matters
Twentieth session

[Dates and location of the session TBC]

Item 3 (b) of the provisional agenda

Update of the UN Model Double Taxation Convention between Developed and Developing Countries – Article 7 and EPC Contracts

Note by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries

Summary

Note E/C.18/2019/CRP.27, which was presented but not discussed at the nineteenth session of the Committee (Geneva, 15-18 October 2019), dealt with a technical issue raised by Xiong Yan in relation to the application of the limited force of attraction rule of Art. 7(1) UN Model to engineering, procurement and construction (EPC) contracts.

Section 1 of this note describes the issue. Section 2 includes the analysis of the application of Article 7 to EPC contract. Section 3 includes the revised Commentary changes that were finalized by the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries at its meeting of 14-16 February 2020.

At its twentieth session, the Committee is invited to discuss and approve the proposals included in section 3 of this note.

Article 7 and EPC Contracts

Table of Contents

1. Description of the issue

1. Note E/C.18/2019/CRP.27, which was presented but not discussed at the nineteenth session of the Committee (Geneva, 15-18 October 2019), dealt with the following technical issue that was initially raised by Xiong Yan in relation to the application of the limited force of attraction rule of Art. 7(1) UN Model to engineering, procurement and construction (EPC) contracts:

> 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 of 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. Analysis and proposed Commentary changes presented in October 2019

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 (*b*) and (*c*) are together commonly referred to as the so-called "limited 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. Paragraph 6 of the Commentary 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 Xiong Yan, 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 Art. 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 Art. 7(1)(*a*), because the profits are not "attributable to that permanent establishment". Art. 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 Art. 7(1)(*b*) is not relevant, because that subparagraph refers to profits from sales activities.

8. Finally, it also seems clear that Art. 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 Art. 7(1)(*c*), the existing Commentary to Art. 7(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. At its October 2019 meeting, the Subcommittee on the UN Model Tax Convention between Developed and Developing Countries discussed the draft new Commentary paragraphs proposed in note E/C.18/2019/CRP.27 in order to provide further guidance on the application of Art. 7(1)(*a*) and to make explicit the point above regarding the limited force of attraction rule. After discussing written comments sent by a member of the Committee in advance of the meeting, the Subcommittee decided that the draft Commentary paragraphs should be amended to reflect the fact that functions might be performed through the permanent establishment in relation to the acquisition of goods and services provided by the head office. It was also suggested that the draft Commentary changes should take account of the existing paragraphs 9 to 11 of the Commentary on Article 7 of the UN Model, which address similar issues in relation to turnkey contracts.

3. Revised Commentary changes proposed by the Subcommittee

11. In accordance with the decision taken at its October 2019 meeting, the Subcommittee revised and finalised the following draft Commentary changes at its February 2020 meeting. In doing so, the Subcommittee decided that paragraphs 9-11 of the Commentary on Article 7, which address the issue of turnkey contracts from the perspective of the application of Art. 7(2), should be modified and incorporated in the new Commentary as suggested below in order to avoid duplication and inconsistent statements (all the changes made to the proposal that appeared in paragraph 10 of note E/C.18/2019/CRP.27 appear in redline in the Annex).

12. It is proposed to add the following new paragraphs 6.1 to 6.7 to the Commentary on Article 7 of the UN Model:

6.1 *[amended existing paragraph 9 of the Commentary]* Problems may arise with respect to application of paragraphs 1 and 2 with regard to turnkey contracts as well as engineering, procurement and construction (EPC) contracts. Under a turnkey contract a contractor agrees to construct a factory or similar facility and make it ready for operation; when the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. Under an EPC contract, the home office of an enterprise of a Contracting State undertakes the provision of goods and services through engineering and procurement activities conducted in the home country while construction, assembly or installation activities in connection with such goods and services are performed through a permanent establishment of the enterprise in the other Contracting State. Under both types of contracts, activities such as the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance are sometimes completed before construction activities actually start (and hence, before the creation of a permanent establishment) and are often performed outside the country in which the permanent establishment is situated.

6.2 *[amended existing paragraph 10 of the Commentary]* The question thus arises how much of the total profits from these contracts is properly taxable in the country in which the permanent establishment is situated under the rules of paragraphs 1 and 2. A member from a developed country said that there were instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was this member's view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.

6.3 *[existing paragraph 10 of the Commentary]*The Committee recognized that such cases involved many interrelated treaty issues, such as the source of income rules, the potential application of other Articles (such as Article 12A), the application of the definition of permanent establishment and the concept of profits of an enterprise.

6.4 Nevertheless, as regards the application of subparagraph 1(*a*) and paragraph 2 in relation to such contracts, the Committee considers that the following part of the Commentary on Article 7 of the 2008 OECD Model Convention, with the minor changes appearing between square brackets, is applicable:

> 24. […] 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 that permanent establishment.
>
> 25. For example, where such goods are supplied by the other parts of the enterprise, the profits arising 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 the 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.

6.5 Where, however, functions are performed through the permanent establishment in relation to the acquisition of goods supplied, or services performed, by other parts of the enterprise, profits may be attributable to the permanent establishment with respect to the performance of these functions.

6.6 While they apply in different circumstances, subparagraphs (*b*) and (*c*) of paragraph 1 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 subparagraph (*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 establishment is situated, and profits from any sales that take place outside of that State may not be taxed by that State.

6.7 Similarly, in the case of subparagraph (*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.

13. It is proposed to replace existing paragraphs 9 to 11 of the Commentary on Article 7 of the UN Model by the following:

9. This paragraph reproduces Article 7, paragraph 2, of the 2008 OECD Model Convention. *[rest of paragraph 9 as well as paragraphs 10-11 are moved to paragraphs 6.1 to 6.3 above]*

ANNEX

Changes made to the proposal included in paragraph 10 of note E/C.18/2019/CRP.27

It is proposed to add the following new paragraphs 6.1 to 6.7 to the Commentary on Article 7 of the UN Model:

6.1 *[existing paragraph 9 of the Commentary]* ~~9. When last considered by the former Group of Experts a member from a developed country pointed out that his country was having some p~~Problems may arise with respect to application of paragraphs 1 and 2 ~~inconsistent determination of the profits properly attributable to a permanent establishment, especially~~ with regard to ~~"~~turnkey~~"~~ contracts as well as engineering, procurement and construction (EPC) contracts. Under a turnkey contract a contractor agrees to construct a factory or similar facility and make it ready for operation; when the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. Under an EPC contract, the home office of an enterprise of a Contracting State undertakes the provision of goods and services through engineering and procurement activities conducted in the home country while construction, assembly or installation activities in connection with such goods and services are performed through a permanent establishment of the enterprise in the other Contracting State. Under both types of contracts, ~~The international tax problems occur when the facility is to be constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constitute a permanent establishment within that country if of sufficiently long duration. Turnkey contracts, however, often involve components~~ activities ~~other than normal construction activities, including~~ such as the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance ~~. Those latter items, it was explained,~~ are sometimes completed before construction activities actually start (and hence, before the creation of a permanent establishment ~~at the construction site~~) and are often performed outside the country in which the ~~construction site/~~permanent establishment is situated.

6.2 *[existing paragraph 10 of the Commentary]* ~~10.~~ The question thus ari~~o~~ses how much of the total profits from~~of~~ these ~~turnkey~~ contracts is properly ~~attributable to the permanent establishment and~~ taxable in the country in which the permanent establishment ~~it~~ is situated under the rules of paragraphs 1 and 2. A member from a developed country said that there were ~~he knew of~~ instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was this member's ~~his~~ view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.

6.3 *[existing paragraph 10 of the Commentary]* ~~11.~~ The ~~Group~~ Committee recognized that ~~the problem was a complex and potentially controversial one involving~~ such cases involved many interrelated treaty issues, such as the source of income rules, the potential application of other Articles (such as Articles 12A) ~~and~~ , the application of the definition of permanent establishment

and the concept of profits of an enterprise. ~~The Group acknowledged that the problem might be considered in the course of bilateral negotiations, but it agreed upon no amendment to address it.~~

6.4 Nevertheless, as regards the application of subparagraph 1(*a*) and paragraph 2 in relation to such contracts, the Committee considers that the following part of the Commentary on Article 7 of the 2008 OECD Model Convention, with the minor changes appearing between square brackets, is applicable:

> 24. […]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 that permanent establishment.
>
> 25. For example, where such goods are supplied by the other parts of the enterprise, the profits arising 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 the 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.

6.5 Where, however, functions are performed through the permanent establishment in relation to the acquisition of goods supplied, or services performed, by other parts of the enterprise, profits may be attributable to the permanent establishment with respect to the performance of these functions.

~~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~~3 While they apply in different circumstances, ~~clause~~subparagraphs (*b*) and (*c*) of paragraph 1 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~~subparagraph (*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 establishment is situated, and profits from any sales that take place outside of that State may not be taxed by that State.

6.74 Similarly, in the case of ~~clause~~subparagraph (*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.

It is proposed to replace existing paragraphs 9 to 11 of the Commentary on Article 7 of the UN Model by the following:

9. This paragraph reproduces Article 7, paragraph 2, of the 2008 OECD Model Convention. *[rest of paragraph 9 as well as paragraphs 10-11 are moved to paragraphs 6.1 to 6.3 above]* ~~When last considered by the former Group of Experts a member from a developed country pointed out that his country was having some problems with inconsistent determination of the profits properly attributable to a permanent establishment, especially with regard to "turnkey" contracts. Under a turnkey contract a contractor agrees to construct a factory or similar facility and make it ready for operation; when the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. The international tax problems occur when the facility is to be constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constitute a permanent establishment within that country if of sufficiently long duration. Turnkey contracts, however, often involve components other than normal construction activities, including the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, are sometimes completed before construction activities actually start (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment is situated.~~

~~10. The question thus arose how much of the total profits of the turnkey contract is properly attributable to the permanent establishment and taxable in the country in which it is situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.~~

~~11. The Group recognized that the problem was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definition of permanent establishment and the concept of profits of an enterprise. The Group acknowledged that the problem might be considered in the course of bilateral negotiations, but it agreed upon no amendment to address it.~~