E/C.18/2024/CRP.13

Distr.: General
DD MM YYYY

Original: English

Committee of Experts on International Cooperation in Tax Matters
Twenty-eighth session
New York, 19-22 March 2024
Item 3(c) of the provisional agenda
Issues related to the United Nations Model Double Taxation Convention between Developed and Developing Countries

Co-Coordinators' Report: The treatment of income from cross-border insurance activities

Summary

This note is provided to the Committee for ***discussion*** at its Twenty-eighth Session.

At its Twenty-fourth Session, the Committee approved the Subcommittee's work program, which included an item on the treatment of income from cross-border insurance activities. At its Twenty-seventh Session, the Committee considered E/C.18/2023/CRP.46, which set out the Subcommittee's proposal to delete paragraph 6 of Article 5 (which creates a deemed permanent establishment) and introduce a new paragraph 6 of Article 7 (which would allow taxation of the relevant premiums on a gross basis). The note also included a draft of a proposed Commentary on both Articles 5 and 7 to explain the changes. At the Twenty-seventh Session, there was general support for the substance of the change, but several Members supporting such a change noted that they would prefer that the new rule be reflected in a stand-alone article rather than in a new paragraph in Article 7. In that regard, it was noted that such a new provision should provide guidance regarding the source of premium income in the case of reinsurance and with respect to direct insurance that covers multiple entities and/or countries.

This note therefore includes the text of a new Article 12C and an updated Commentary explaining the changes should the Committee decide to adopt the Subcommittee's proposal. The Committee is asked to consider and give guidance on the following issues:

(a) whether it supports inclusion of the new Article 12C;

(b) whether the definition of insurance in paragraph 3 of Article 12C provides sufficient clarity regarding the scope of the article;

(c) whether additional guidance on beneficial ownership, particularly in the case of reinsurance, would be helpful and, if yes, what specific situations could be addressed; and

(d) whether the proposed Commentary on Articles 5 and 12C set out in paragraphs 29 and 30 adequately explain the proposed changes and whether there is additional guidance that would be helpful.

I. Introduction

1. The United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model) includes a special rule regarding insurance in the permanent establishment article. Under this provision, an enterprise of one Contracting State will 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." This provision does not, however, apply to reinsurance transactions. As described in Section III, some countries, both developed and developing, choose not to include this provision, but include other provisions in their treaties to allow expanded source State taxation. Both the United Nations and the OECD have considered proposals to change the treatment of insurance in various ways.

2. Section II of this note provides background regarding how insurance companies operate and are structured, which give rise to tax concerns for many countries. Section III describes the history of provisions intended to address these concerns. Section IV describes the Subcommittee's proposed approach, while Section V provides proposed Commentary changes explaining the changes proposed in Section IV. Section VI includes questions for the Committee.

II. The Operation and Structure of Insurance Companies (including Reinsurance Companies)

3. The fundamental business of an insurance company is underwriting, the process of receiving remuneration for the willingness to take on a potential risk by promising to pay a customer if a loss from that risk is realized. The insurance company generally will employ "underwriters", professionals who evaluate and analyze the risks involved in insuring people and assets. Insurance underwriters establish pricing for accepted insurable risks.

4. From the perspective of the purchaser, insurance performs the function of protecting against the financial cost of an unexpected loss. Expanding access to insurance in developing countries therefore is connected to SDG 1, eradicating poverty, as an uninsured loss of a primary breadwinner, a home or a crop can plunge an entire family (back) into poverty. Therefore, life insurance, property and casualty insurance, agricultural insurance and other types of insurance perform an important societal function. Insurance companies are highly regulated because governments need to ensure that an insurance company will have sufficient assets to pay any claims that may arise.

5. Although the insurance company will establish the terms on which insurance may be sold, the policies will be sold either through the insurance company's own employee salespeople or through a network of brokers. These brokers may be dependent or independent agents within the meaning of Article 5 of tax treaties (at least before changes made to the UN Model and the OECD Model in 2017). Most countries require insurance companies selling to retail customers to do so through local subsidiaries or branches that are subject to local regulation. Reinsurance and some more specialized insurance (such as surplus lines, relating to potential losses too big for normal insurance companies) may not require such a physical presence.

6. Insurance generally involves both "risk shifting" and "risk distribution". Risk shifting is transferring the risk of loss from one party to another, such as from the insured to the insurer, and is sometimes an issue when considering captive insurance companies. Risk distribution is the pooling of independent risks of unrelated parties. An insurer can further reduce its overall risks by diversification, such as by writing homeowners' insurance in multiple markets. An insurer can also shift part of its risk through reinsurance, which effectively is insurance for insurers. Reinsurance therefore performs an important business function by further distributing risk, allowing insurance companies to underwrite more risks and reducing costs.

7. Reinsurance can take several forms. First, a reinsurer may take on only specific risks (or a block of risks) from an insurer, through what is called "facultative" reinsurance, or may take on all risks incurred by the insurer during a specified period of time, pursuant to a "reinsurance treaty". In either case, the coverage may be "proportional" or "non-proportional". In the former case, the reinsurer may accept a certain percentage of all losses incurred by the insurance company. For example, a quota share treaty is a form of pro-rata reinsurance contract in which the insurer and reinsurer share premiums and losses according to a fixed percentage. In the latter case, the reinsurer will only be liable if the insurance company's losses exceed a certain amount. One common form of non-proportional insurance is "excess-of-loss" insurance, in which the reinsurer will pay the entire amount of the insurer's loss in excess of the agreed threshold. However, it is also possible for a reinsurer to take only a specific "slice" of losses or for different reinsurers to take different slices.

Example: Proportional vs. Excess of Loss

Insurance Company is a resident of Country A. It has entered into a "quota share" reinsurance treaty with Reinsurer, a resident of Country B, with respect to 25% of insurance written by Insurance Company during 2023 in exchange for a premium roughly equal to 25% of the insurance premiums received by Insurance Company. The reinsurance is recognized by Company A's insurance regulators and therefore reduces the amount of capital and reserves that Insurance Company is required to maintain, reducing Insurance Company's costs. Insurance Company's customers have claims of $5000x with respect to 2023, $1250 of which are reimbursed by Reinsurer.

In 2024, Insurance Company instead enters into an excess-of-loss reinsurance treaty with Reinsurer, under which Reinsurer agrees to reimburse Insurance Company for all losses in excess of $4000x. In 2024, claims against Insurance Company again equal $5000. Under the excess-of-loss reinsurance treaty, Reinsurer pays only $1000x.

In 2025, Insurance Company enters into a non-proportional reinsurance treaty with Reinsurer A, under which Reinsurer A will pay all losses above $4000x and below $5000x. Insurance Company also enters into an excess-of-loss reinsurance treaty with Reinsurer B with respect to any losses that exceed $5000x. The claims against Insurance Company again equal $5000x. Reinsurer A will pay $1000x to Insurance Company. Reinsurer B will not be required to make any payment.

8. Customers of an insurance company may, of course, pay premiums for years before an event giving rise to an insured loss occurs. Accordingly, another important source of income for an insurance company is investment income earned by investing premiums until such a loss occurs.[1] This investment income generally will be subject to tax at the time it is earned, even though it eventually may be used to pay out losses. This timing mismatch may be alleviated through the allowance of deductions for increases to reserves, but the rules for "reserving" vary considerably from country to country. If reserves are not allowed, then the insurance company is in effect taxable on "phantom income". One effect of entering into reinsurance contracts is that not only the risk, but also some of the cash that produces such investment income, is transferred to the reinsurance company through the payment of reinsurance premiums. For that reason, reinsurance companies usually are located in jurisdictions that do not impose income taxes or that have extremely generous reserving policies.

[1] It is not uncommon for a profitable insurance company to pay out losses that exceed the amount of the premiums it receives, with the shortfall more than made up through the insurance company's investment income.

III. Provisions in Model and Bilateral Treaties to Address the Problem of Insurance

9. The first version of the UN Model, published in 1980, included the following provision relating to insurance in Article 5:

> 6. Notwithstanding the preceding provisions of this article, 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.

10. The reasons for the initial inclusion of this paragraph are described in the following paragraphs from the Commentary on Article 5 of the 1980 UN Model:

> This paragraph does not correspond to any provision of the OECD Model Convention. It was included because it was the common feeling of the Group that the OECD definition of permanent establishment was not adequate to deal with certain aspects of the insurance business. Members from developing countries pointed out that if an insurance agent was independent, the profits would not be taxable in accordance with the provisions suggested in article 5, paragraph 7, of the United Nations Model Convention (based on article 5, paragraph 6, of the OECD Model Convention); and if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions suggested in subparagraph 5 (a) (based on article 5, paragraph 5, of the OECD Model Convention). Those members expressed the view that taxation of insurance profits in the country where the premiums were being paid was desirable and should take place independently of the status of the agent. They therefore suggested that the United Nations Model Convention should include a special provision relating to insurance business. However, such taxation is based on the assumption that the person (employee or representative) through whom premiums are collected and risk insured, is present in the country where the risk is located.
>
> Once agreement had been reached on the principle of including a special provision on insurance, the discussion in the Group focused mainly on cases involving representation through "an independent agent". Members from developing countries felt it would be desirable to provide that a permanent establishment existed in such cases because of the nature of the insurance business, the fact that the risks were situated within the country claiming tax jurisdiction, and the facility 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. Members from developed countries, on the other hand, stressed that in cases involving independent agents, insurance business should not be treated differently from such activities as the sale of tangible commodities. Those members also drew attention to the difficulties involved in ascertaining the total amount of business done when the insurance was handled by a number of independent agents within the same country. In view of the difference in approach, the group agreed that the case of representation through independent agents should be 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.

These paragraphs were unchanged in the Commentary on paragraph 6 of Article 5 of the 2001 UN Model.

11. Some participants in the Subcommittee noted that it is also important to consider how much net profit might be reported by a permanent establishment deemed to exist by application of Article 5(6). The Commentary to Article 7 of the UN Model does not provide guidance regarding the determination of the profits of a permanent establishment that is deemed to exist by reason of paragraph 6. The UN Model retains Article 7(4), allowing for an apportionment of the total profits of an enterprise, a provision that sometimes is used with respect to insurance companies.[2] Moreover, in the example set out in the box above, the profits of Insurance Company would be reduced by the premiums paid to Reinsurer, but Country A would not have been able to tax Reinsurer on those premiums. This would also be true if Insurance Company were a resident of another country, operating through a branch in Country A. Therefore, depending on their domestic law, some countries may find that the inclusion of paragraph 6 of Article 5 in their bilateral treaties does not result in retention of significant tax revenues.

12. Although the OECD Model does not include a provision similar to paragraph 6 of Article 5, the Commentary acknowledged the problem presented by the use of agents by insurance companies in paragraph 21 of the Commentary on paragraph 5 of Article 5 of the 1963 OECD Draft Double Taxation Convention on Income and on Capital, which stated:

> The special problems which can arise in the case of insurance companies dealing by means of intermediaries or variously qualified representatives shall be further studied.

The Commentary on paragraph 5 of Article 5 of the 1977 OECD Model Double Taxation Convention on Income and on Capital included a more extensive analysis of the issue:

> 38. 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 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. 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.

13. In 2011, the Commentary on the UN Model relating to insurance companies was modified to include the paragraph quoted in paragraph 11 from the OECD Commentary (now re-numbered paragraph 114), along with the following explanatory introduction:

[2] See paragraph 27 of the Commentary on Article 7 of the UN Model, quoting paragraph 54 of the Commentary on Article 7 of the 2008 OECD Model.

> 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…

Accordingly, to this point, the issue identified related solely to the problem of conducting business through agents.

14. The OECD also returned to the issue of when an agent of an insurance enterprise will cause the enterprise to have a permanent establishment in 2011. In the public discussion draft, *Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention,* the issue was described as follows:

> **25. Activities of insurance agents**
>
> ***Description of the issue***
>
> 135. To what extent do activities of local insurance agents who refer contracts for final approval by the foreign insurance company create a permanent establishment?
>
> 136. The issue is illustrated by the following example developed in the course of the preparation of the branch reports and general report on the topic "Is there a Permanent Establishment?' for the IFA 2009 Congress:
>
> ***Insurance agents***
>
> ICO is a life insurance company resident in State R. It sells life insurance in State S through agents. All the agents work out of their private homes and thus do not need separate offices. Some minor paperwork is done at home. None of the agents are employed by ICO but they work solely for ICO. The agents offer insurance policies on behalf of ICO, receive the applications from the clients and send them over to ICO in State R. The insurance policy is not in force until ICO has received and reviewed the medical information related to each client. In the meantime, a temporary life insurance policy is in force. This policy is automatically terminated when the draft policy is approved or rejected by ICO. Over time, ICO rejects some 10 per cent of the policies submitted by the agents.
>
> ***Recommendation of the Working Group***
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> 137. The Working Group concluded that this issue was basically a policy question: whether the conclusion expressed in paragraph 39 of the Commentary that "it did not seem advisable to insert a special provision for insurance agents"– was still shared by the member States. Since few countries included such a special provision in their treaties, it was agreed that no changes should be made to the Commentary with respect to this issue.

This example appears to be based on *Canada vs Knights of Columbus*[3] in which the taxpayer, a U.S. fraternal organization with hundreds of agents selling insurance in Canada, was found not to have a permanent establishment in Canada.

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[3] May 2008, Tax Court, Case No. 2008TCC307.

15. In the 2014 public discussion draft on *BEPS Action 7: Preventing the Artificial Avoidance of PE Status*, there is a discussion not only of the problem of when the activities of an agent will cause an insurance enterprise to have a permanent establishment, but also a short mention of the problem of reinsurance:

> 38. A provision dealing exclusively with the situation of dependent agents who do not formally conclude insurance contracts would likely address cases where a large network of exclusive agents is used to sell insurance for a foreign insurer.
>
> 39. Existing tax treaties include a few examples of provisions dealing with insurance. A number of treaties include provisions similar to those found in the UN Model, sometimes without a specific exception for re-insurance. Other provisions exclude any form of insurance of local risks (other than life insurance) from any limitation imposed by Art. 7 and, therefore, allow source taxation of insurance profits from insuring such local risks regardless of whether or not the profits are attributable to a PE. Such provisions may be subject to a standstill clause or may limit the tax to a certain percentage (e.g. 10%) of the gross premiums if the profits are not attributable to a PE.
>
> 40. Insurance (including re-insurance) raises difficult issues as regards the question of where profits that represent the remuneration of risk should be taxed. As recognised in Actions 4 and 9 of the Action Plan, BEPS issues arise in relation to the transfer of risk within a multinational group, including through insurance and re-insurance.
>
> 41. Since the PE threshold relates to activities carried on in a State, a change to the PE threshold would not address cases where the remuneration of risk is shifted through the payment of insurance or re-insurance premiums to an associated enterprise that performs no functions in a State. It might therefore be more appropriate to address the BEPS concerns related to such cases through the adjustment of the profits of the local enterprise from which the risk-remuneration is being shifted. This could be done through transfer pricing or special measures (e.g. addressing the deductibility of insurance or re-insurance premiums paid to related parties), as contemplated under Actions 4 and 9 of the Action Plan. In the case of transfer of risk to an independent party that can be done through bona fide insurance or re-insurance, the most significant BEPS concern seems to be related to the possibility that an insurance enterprise could actively sell insurance or re-insurance in a country through the use of exclusive agents without having a PE in that State.
>
> 42. Based on this analysis, the Focus Group concluded that the following two alternative approaches could be adopted in order to deal with BEPS concerns related to the artificial avoidance of the PE threshold in relation to insurance activities…

The two alternatives were to include a provision such as paragraph 6 of Article 5 of the UN Model, or not to include any provision specific to insurance but to rely instead on other changes made to Article 5 as part of the BEPS project.

16. Public comments on the Action 7 discussion draft made several points in arguing against the addition to the OECD Model of a provision such as paragraph 6 of Article 5 of the UN Model. In particular, many of those commenting pointed out that the collection of insurance premiums does not constitute a "key entrepreneurial risk-taking function" (KERT), as described in Part IV of the *Report on the Attribution of Profits to Permanent Establishments*. As a result, they argued, the creation of a permanent establishment would increase administrative burdens on insurance companies but be unlikely to result in increased revenue to the host State. Of course, the Committee of Experts rejected the Authorised OECD Approach to

Article 7 some years ago so that argument is not dispositive with respect to the equivalent paragraph in the UN Model. Some commenters pointed out that many countries, particularly in Europe, have insurance premium taxes that apply whenever an insured risk is located in that country. One or two pointed out that there is no difference between insurance and reinsurance – reinsurance is the means by which insurance companies shift risk to other companies to achieve risk diversification – effectively insuring themselves against excessive loss.

17. Most stakeholders argued that there was no need or justification for including a special rule for insurance companies. However, in many cases those comments went on to argue against different versions of the dependent agent provision on the grounds that those provisions could result in permanent establishments for insurance enterprises that had entered into "quota share" reinsurance treaties with insurance companies located in a host State or had outstanding "delegated underwriting authority" with agents therein. The existence of these common types of arrangements in the insurance industry might reasonably have been seen as justification for a different approach to the industry. Nevertheless, the Action 7 Final Report rejected a specific rule applicable to insurance companies with the following explanation:

> ***2. Strategies for selling insurance in a State without having a PE therein***
>
> 18. As part of the work on Action 7, BEPS concerns related to situations where a large network of exclusive agents is used to sell insurance for a foreign insurer were also examined. It was ultimately concluded, however, that it would be inappropriate to try to address these concerns through a PE rule that would treat insurance differently from other types of businesses and that BEPS concerns that may arise in cases where a large network of exclusive agents is used to sell insurance for a foreign insurer should be addressed through the more general changes to Art. 5(5) and 5(6) in section A of this report.

Thus, the OECD final report once again focused on the agency issue and not on the risk of reducing the tax base through reinsurance.

18. In connection with its own work on BEPS, the Committee of Experts considered a proposal to expand the existing provision to include reinsurance as well as direct insurance, "[d]ue to the Committee's concerns that Article 5(6) can be abused and avoided in relation to re-insurance."[4] If this change had been adopted, it would have allowed the host State to treat the reinsurance enterprise as having a permanent establishment, but would not have addressed the problem described in the public comments regarding the determination of the profits of the permanent establishment.

19. The arguments for and against the deletion of the exception for reinsurance are described in E/C.18/2016/CRP.10, the report of the Coordinator of the Subcommittee on Base Erosion and Profit Shifting, in what was proposed to be the Commentary explaining this change:

> 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

[4] E/C.18/2016/CRP.10.

> 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.

20. A related proposal considered by the Committee of Experts would have added an alternative provision to the Commentary on Article 5 which would allow taxation by the source State of profits derived from the insurance business even in the absence of a permanent establishment. The relevant paragraph would have read as follows:

> 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. Some 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.

It should be noted that this provision does not include the words "through a person", which appears in paragraph 6 of Article 5 of the UN Model; some participants in the Subcommittee have indicated that the meaning of those words is somewhat unclear to them.

21. The proposal to include in the Commentary the alternative provision set out in paragraph 20 was approved at the 13th session of the Committee.[5] However, at its 14th Session, the Committee agreed to make no changes to the insurance provisions of the 2017 version of the UN Model but to add the issue of insurance to the agenda for the next meeting of the Committee.[6] The 2017-2021 membership of the Committee did not take up work on the issue "[d]ue to other priorities,"[7] but continued to include it in the list of issues that might be taken up by the next (this) membership of the Committee.

22. At its meeting in June 2023, the Subcommittee considered the drafting of a provision similar to that in paragraph 20. It noted that the paragraph effectively included two thresholds – "profits" and "premiums", while other provisions that allow for gross basis taxation do not consider whether the recipient is in a profit or loss position.

23. Finally, as noted in the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, "Some countries take a broader approach and simply exclude the profits of insurance enterprises from the application of the treaty, leaving these profits to be taxed in accordance with domestic law." Such a provision can be found in paragraph 6 of the protocol to the 2003 treaty between Chile and New Zealand, which reads:

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[5] Paragraph 68 of E/2016/45-E/C.18/2016/7.
[6] Paragraph 54 of E/2017/45-E/C.18/2017/3.
[7] Paragraph 37 of E/C.18/2020/CRP.37

> Income, premiums or profits from any kind of insurance may be taxed in accordance with the laws of either Contracting State.

IV. Proposed Approach

24. The preceding description of various attempts to address the allocation of taxing rights from insurance activities demonstrates that many countries have significant concerns about what is a highly mobile industry. At the same time, there is a legitimate concern among stakeholders that changes to the UN Model should not affect legitimate business transactions, such as reinsurance contracts with unrelated parties that serve to shift and distribute risk to the benefit of the entire insurance industry.

25. The general changes made to Article 5 in both the OECD Model and the UN Model in response to the BEPS project may have addressed the specific issue of the network of exclusive agents presented in the *Knights of Columbus* case. However, the other issues discussed above have not been addressed.[8]

26. The Subcommittee also identified an additional issue, which is that the different ways that insurance premiums are taxed in different countries may result in unintentional asymmetries in tax treaties. Some countries impose taxes on insurance premiums in the form of an income tax, which usually is collected through a withholding tax; in many countries, a general withholding tax on all payments made by their residents or borne by permanent establishments situated therein would apply also to insurance premiums. Other countries impose excise taxes or other indirect taxes on insurance premiums[9] or policies.[10] In the case of a bilateral tax treaty entered into between two countries with different systems, it is possible that the taxing rights of a country that imposes a withholding tax could be limited while those of a country that imposes an excise tax would not be.

27. For example, if State W imposes an income tax, in the form of a withholding tax, on insurance premiums and State X an excise tax, then one option is to include both taxes as covered taxes in Article 2. In that case, if the treaty included paragraph 6 of Article 5, then an insurance company that is a resident of State X would be subject to tax on the profits attributable to the deemed permanent establishment in State W. An insurance company that is a resident of State W would be subject to the State X excise tax because it is deemed to have a permanent establishment, allowing the imposition of the tax. Alternatively, if both taxes are covered taxes but the treaty includes a provision such as in paragraph 20, the negotiated rate would apply to amounts paid to each insurance company. Finally, if the treaty excluded both taxes from Article 2, then each of State W and State X could apply its domestic law without limit. The Committee agreed that this is an issue that should be addressed in the Commentary.

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[8] For example, some years ago U.S.-based insurance companies complained that U.S. subsidiaries of foreign insurance companies were entering into quota share reinsurance contracts that resulted in substantial amounts of profits being shifted to low-tax jurisdictions. Under these “reinsurance treaties”, a specified percentage of each risk underwritten by the U.S. affiliate would automatically be reinsured with the non-U.S. affiliate. In many cases, the U.S. affiliates had large local staffs that would interact with customers, performing most of the insurance functions. However, the reinsurance treaties often provided for very large “quotas” (sometimes as high as 75%) being reinsured in the low-tax affiliates, which usually had quite small staffs. It is worth noting that, although it is not certain whether the quota share reinsurance treaty will result in profits or losses in any particular year, over time most insurance companies generate profits. This loophole, identified in the late 1990s, appears finally to have been addressed in the United States by the enactment of the Base Erosion and Anti-abuse Tax in 2017. It also is possible that some provisions of Pillar Two developed by the Inclusive Framework on BEPS, if adopted widely, might also address the problem in other countries.

[9] In Europe, these frequently are referred to simply as “insurance premium taxes”.

[10] See Section 4371 of the U.S. Internal Revenue Code (Policies Issued by Foreign Insurers).

28. At its Twenty-seventh Session, most of the Members supporting the proposed change also supported the development of a stand-alone article to address the treatment of insurance instead of adding a paragraph to Article 7 as the Subcommittee had proposed. Such an article could read:

Article 12C
Insurance Premiums

1. Insurance premiums arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, insurance premiums arising in a Contracting State may also be taxed in that State and according to the laws of that State, but if the beneficial owner of the insurance premium is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent [the percentage is to be established through bilateral negotiations] of the gross amount of the insurance premiums. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "insurance premiums" as used in this Article means amounts paid to an insurance enterprise pursuant to a contract (policy) in which the insurance enterprise indemnifies another person against losses from specific contingencies, perils or risks. The term includes amounts paid to secure reinsurance from a reinsurance enterprise.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the insurance premiums, being a resident of a Contracting State, carries on business in the other Contracting State in which the insurance premiums arise, through a permanent establishment situated therein, and the policy in respect of which the insurance premium is paid is effectively connected with

(a) such permanent establishment, or with

(b) business activities referred to in (c) of paragraph 1 of Article 7.

In such cases the provisions of Article 7 shall apply.

5. Insurance premiums shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the insurance premiums, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the premiums was incurred, and such premiums are borne by such permanent establishment or fixed base, then such premiums shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the insurance premium, having regard to the policy for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to

the laws of each Contracting State, due regard being had to the other provisions of this Convention.

29. The inclusion of Article 12C would require some consequential changes:

a. Paragraph 6 of Article 5 would be deleted from the text of the UN Model but would be included as an alternative provision (without the exemption for reinsurance) in the Commentary to Article 5.

b. Paragraph 2 of Article 23 A would be amended to include a reference to Article 12C.

V. Draft Commentary

30. The changes described in paragraph 28 would require some consequential changes to the Commentary on Article 5. The Subcommittee therefore proposes the following changes to the Commentary on Article 5:

Insurance Activities

71. ***Until [202-], t***~~T~~his ***article contained a paragraph intended*** ~~paragraph of the United Nations Model Tax Convention does not correspond to any provision in Article 5 of the OECD Model Tax Convention and is included~~ to deal with certain aspects of the insurance business. ***The prior paragraph read:***

> ***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.***

This paragraph was included because of concerns that insurance companies could do large-scale business in a State without being taxed in that State in the absence of a fixed place of business. This is ~~Paragraph 114 of the Commentary on Article 5 of the 2017 OECD Model Tax Convention nevertheless discusses the possibility of including such a provision in bilateral tax treaties in the following terms:~~

> ~~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.~~

~~72. Paragraph 6 of the United Nations Model Tax Convention, which achieves the aim quoted above, is necessary~~ because insurance agents ~~generally have no~~ ***may be seen as not having*** authority to conclude contracts; ~~thus~~***if that is the case***, the conditions of paragraph 5(*a*) ~~would~~***might*** not be fulfilled. ***Moreover, i***~~I~~f an insurance agent is independent~~,~~ ~~however~~, the profits of the insurance company ~~attributable to his activities~~ ***arising from the activities of that agent*** are not taxable in the source State because the provisions of paragraph 7 of Article 5 would be fulfilled and the enterprise would not be deemed to have a permanent establishment.

7***2***~~3~~. ***The prior paragraph was included in Article 5 because s***~~S~~ome ***members of the Ad Hoc Group that first drafted the UN Model*** ~~countries, however,~~ favour***ed*** extending the provision to allow taxation even where there is representation by such an independent agent. They ~~take~~***believed*** this approach ***was appropriate*** 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 ***members of that Ad Hoc Group saw*** ~~countries see~~ no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. ***In [2025], Members of the Committee agreeing with this latter point*** ~~They~~ also ***noted that the changes to paragraphs 5 and 6 made in 2017 have addressed some of the concerns that such a provision is intended to address.*** ~~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.~~

73. Some Members of the Committee have concerns that go beyond the agency questions set out above. They believe that it is also important to consider how much profit might be reported by a permanent establishment deemed to exist by application of Article 5(6). The Commentary to Article 7 of the UN Model does not provide guidance regarding the determination of the profits of a permanent establishment that is deemed to exist by reason of paragraph 6. The UN Model retains Article 7(4), allowing for an apportionment of the total profits of an enterprise, a provision that may be used with respect to insurance companies if the conditions of that paragraph are met.[11] These Members also note that, if a resident insurance company reinsures its risk with a reinsurance company in the other country, the profits of that insurance company will be reduced by the premiums paid to the reinsurance company, but under the prior paragraph 6, the source country would not have been able to tax the reinsurance company on those premiums. This would also be true if the insurance company were a resident of another country, operating through a branch in the source State. Therefore, depending on their domestic law, some countries may find that the inclusion of the prior paragraph 6 of Article 5 in their bilateral treaties does not result in significantly increased tax revenues.

[11] See paragraph 27 of the Commentary on Article 7 of the UN Model, quoting paragraph 54 of the Commentary on Article 7 of the 2008 OECD Model.

74. One approach that deals only with the reinsurance question set out in paragraph 73 would be to include the provision from the prior paragraph 6 without the exception for re-insurance. Such a provision would read:

> *6. Notwithstanding the preceding provisions of this Article but subject to the provisions of paragraph 7, an insurance enterprise of a Contracting State shall 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.*

75. However, the Committee viewed this approach as only a partial solution to the problem of taxing insurance companies as it would not resolve any of the difficult issues regarding the determination of the profits to be taxed under Article 7. Accordingly, in 202[-], a new Article 12C was added to the UN Model to allow source State taxation of insurance, including reinsurance, premiums without regard to whether the relevant insurance or reinsurance company has a permanent establishment in that State. The alternative provisions set out in paragraph 71 and 74, which create a deemed permanent establishment, should not be included in a bilateral treaty that includes Article 12C.

76. In deciding on the best approach to insurance enterprises, countries may want to consider an additional issue, which is that the different ways that insurance premiums are taxed in different countries may result in unintentional asymmetries in tax treaties. The prior paragraph 6 of Article 5 would restrict the source State's right to tax only in cases where the tax imposed with respect to the premiums is a covered tax under Article 2. This is likely to be the case if a Contracting State imposes taxes on insurance premiums in the form of an income tax, such as a gross-basis withholding tax. However, many countries impose excise taxes or other indirect taxes on insurance premiums or policies. In the case of a bilateral tax treaty entered into between two countries with different domestic law systems for taxing insurance premiums, it is possible that the taxing rights of a country that imposes a withholding tax could be limited while those of a country that imposes an excise tax would not be. Countries may want to consider these differences while drafting Article 2 in order to avoid inadvertent asymmetric treatment under their treaties.

77. For example, if State W imposes an income tax, in the form of a withholding tax, on insurance premiums and State X imposes an excise tax, then one option is to include both taxes as covered taxes in Article 2. In that case, if the treaty included paragraph 6 of Article 5, then an insurance company that is a resident of State X would be subject to tax on the profits attributable to the deemed permanent establishment in State W. An insurance company that is a resident of State W would be subject to the State X excise tax because it is deemed to have a permanent establishment, allowing the imposition of the tax. Alternatively, if the treaty excluded both taxes from Article 2, then each of State W and State X could apply its domestic law without limit.

31. The Subcommittee proposes the following Commentary on new Article 12C:

Article 12C

A. General Considerations

1. This article of the United Nations Model Tax Convention was added to the UN Model in 202[ ] to replace paragraph 6 of Article 5 of previous versions of the UN Model. Paragraph 6 of Article 5 had provided an expanded definition of permanent establishment that would have allowed taxation of certain profits from insurance activities in the host State even in the absence of a fixed base or a dependent agent. A special provision addressing the taxation of insurance premiums was included because of concerns that insurance companies could do large-scale business in a State without being taxed in that State on their profits arising from such business. Paragraph 6 of Article 5 did not, however, apply to reinsurance premiums.

2. Over the years, the Committee had discussed various problems with paragraph 6 of Article 5.[12] Because paragraph 6 of Article 5 created a deemed permanent establishment, it generally required taxation of the relevant insurance company on a net basis (if such net basis taxation was available to domestic insurance companies). Determining those taxable profits could be difficult. The Commentary to Article 7 of the UN Model does not provide guidance regarding the determination of the profits of a permanent establishment that is deemed to exist by reason of paragraph 6. The UN Model retains Article 7(4), allowing for an apportionment of the total profits of an enterprise, a provision that may be used with respect to insurance companies if the conditions of that paragraph are met. In addition, if a resident insurance company reinsures its risk with a reinsurance company in the other country, the profits of that insurance company will be reduced by the premiums paid to the reinsurance company, but under the prior paragraph 6, the source country would not have been able to tax the reinsurance company on those premiums. This would also be true if the insurance company were a resident of another country, operating through a branch in the source State. Therefore, depending on their domestic law, some countries could find that the inclusion of the prior paragraph 6 of Article 5 in their bilateral treaties did not result in retention of significant tax revenues. The difficulties in determining the taxable profits of the deemed permanent establishment reinforced, in the case of insurance premiums, the general preference expressed by many developing countries for the simplicity of treaty provisions that allow them to continue collecting tax on non-residents through their domestic withholding taxes.

3. For these reasons, the Committee decided to replace paragraph 6 of Article 5 with Article 12C to avoid the need to determine the profits of a deemed permanent establishment in those circumstances. Article 12C allows certain premium payments paid to insurance or reinsurance companies to be taxed by a Contracting State on a gross basis and does not require any threshold, such as a permanent establishment or fixed base, as a condition for the taxation of such payments. Article 12C therefore serves the same function with respect to insurance and reinsurance premiums as other articles do with respect to dividends, interest, royalties, fees for technical services and payments underlying income from automated digital services.

[12] See E/C.18/2024/CRP.[ ] for the history of those discussions.

4. [A XX minority] of the Committee did not support the adoption of Article 12C. In general, those Members prefer taxation on a net basis to taxation on a gross basis. Several expressed concerns about the potential tax burden if tax is imposed each time that the same risk is reinsured.

B. Commentary on the Paragraphs of Article 12C

Paragraph 1

5. This paragraph establishes that premiums arising in a Contracting State for insurance or reinsurance and paid to a resident of the other Contracting State may be taxed in the latter State. It does not, however, provide that such premiums are taxable exclusively by that State. Such premiums may also be taxed in the State in which such premiums arise.

6. The article applies if the insurance premiums arising in a Contracting State are "paid" to a resident of the other Contracting State. The term "paid" has a broad meaning. As indicated in paragraph 3 of the Commentary on Article 10 (quoting paragraph 7 of the Commentary on Article 10 of the 2017 OECD Model Tax Convention) and paragraph 6 of the Commentary on Article 11(quoting paragraph 5 of the Commentary on Article 11 of the 2017 OECD Model Tax Convention), the concept of payment means the fulfilment of the obligation to put funds at the disposal of the insurance enterprise in the manner required by contract or custom.

7. Article 12C deals only with insurance premiums arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to insurance premiums arising in a third State. Paragraph 5 specifies when insurance premiums are deemed to arise in a Contracting State.

Paragraph 2

8. This paragraph establishes the principle that the Contracting State in which the insurance premiums arise may tax such premiums in accordance with the provisions of its domestic law. However, if the beneficial owner of the premiums is an enterprise of the other Contracting State, the amount of tax imposed by the other State may not exceed a maximum percentage, to be established through bilateral negotiations, of the gross amount of the premiums.

9. When considered in conjunction with Article 23 (Methods for the elimination of double taxation), Article 12C establishes the primary right of the country in which the premiums arise to tax those payments in accordance with its domestic law (subject to the limitation on the maximum rate of tax if the beneficial owner of the premiums is an enterprise of the other Contracting State). Accordingly, the country in which the recipient of those premiums is resident is obligated to prevent double taxation of those premiums. Under Article 23 A or 23 B, the residence country is required to provide relief from double taxation through the exemption of the income or the granting of a credit against any tax payable to the residence country for any tax imposed on that income by the other Contracting State in accordance with the convention. In this regard, where a country generally applies the exemption method under Article 23 A, it is nevertheless

entitled to apply the credit method under paragraph 2 of Article 23 A with respect to items of income taxable under Article 12C.

10. The decision not to recommend a maximum rate of tax on insurance premiums is consistent with Articles 10, 11, 12, 12A and 12B of the United Nations Model Tax Convention dealing with dividends, interest, royalties, fees for technical services and income from automated digital services, respectively. Thus, the maximum rate of tax on insurance premiums is to be established through the bilateral negotiations of the Contracting States. This decision can be justified under current treaty practice. The source State tax treatment of insurance premiums allowed in bilateral tax treaties varies although the maximum rate that can be applied by the source State frequently is set at a rate lower than that applicable to dividends and interest to reflect the fact that an insurance enterprise will pay out a significant amount of its premium income to cover losses of those that are insured. However, it is natural for an insurance enterprise's underwriting losses to be cyclical. An insurance company may collect premiums for a number of years before suffering large underwriting losses in a later year. Many, but not all, countries allow deductions for additions to reserves so that the company's results show a more realistic and steady profit. It is therefore appropriate to consider the industry's profits over a number of years in setting an appropriate rate. Another factor favouring a low rate is the possibility that the same risk will be reinsured multiple times, with a withholding tax imposed on each reinsurance premium.

11. Paragraph 2 will restrict the source State's right to tax only in cases where the tax imposed with respect to the premiums is a covered tax under Article 2. This is likely to be the case if a Contracting State imposes taxes on insurance premiums in the form of an income tax, such as a gross-basis withholding tax. However, many countries impose excise taxes or other indirect taxes on insurance premiums or policies. In the case of a bilateral tax treaty entered into between two countries with different domestic law systems for taxing insurance premiums, it is possible that the taxing rights of a country that imposes a withholding tax could be limited while those of a country that imposes an excise tax would not be. Countries may want to consider these differences while drafting Article 2 in order to avoid inadvertent asymmetric treatment under their treaties.

12. For example, if State W imposes an income tax, in the form of a withholding tax, on insurance premiums and State X an excise tax, then one option is to include both taxes as covered taxes in Article 2. In that case, under paragraph 2 of Article 12C, the negotiated rate would apply to premiums arising in each Contracting State. Alternatively, if the treaty excluded both taxes from Article 2, then each of State W and State X could apply its domestic law without limit.

13. Paragraph 2 applies in priority to Article 7 as a result of paragraph 6 of Article 7. Thus, the conditions for the taxation of the business profits of an enterprise under Article 7 do not apply to insurance premiums covered by paragraph 2. Insurance premiums are taxable by a Contracting State under paragraph 2 if the premiums arise in that State irrespective of whether the relevant insurance enterprise has a permanent establishment in that State or conducts business activities in that State that are similar to those effected through the permanent establishment. However, by virtue of paragraph 4, if an insurance enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment in that other State and receives insurance premiums in connection with those business activities, Article 7 will apply to those payments in priority to paragraph 2 of Article 12C.

14. The requirement of beneficial owner is included in paragraph 2 to clarify the meaning of the words "paid to a resident" as they are used in paragraph 1 of the Article. It clarifies that a Contracting State is not obliged to give up taxing rights over insurance premiums merely because those premiums were paid directly to a resident of another State with which the first State had concluded a convention.

15. Since the term "beneficial owner" is included in paragraph 2 to address potential difficulties arising from the use of the words "paid to a resident" in paragraph 1, it is intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country. The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries[13]), rather, it should be understood in its context, in particular in relation to the words "paid to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

16. Relief or exemption in respect of an item of income is granted by a State to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for a State to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct recipient of the income qualifies as a resident but no potential double taxation arises as a consequence of that status, since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

17. It would be equally inconsistent with the object and purpose of the Convention for a State to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the OECD's Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[14] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has as a practical matter very narrow powers which render it in relation to the income concerned a mere fiduciary or administrator acting on account of the interested parties.

18. In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the insurance premiums is not the "beneficial owner" because that recipient's right to use and enjoy the premiums is constrained by a contractual or legal obligation to pass on the premiums received to another person. Such an obligation will normally derive from relevant legal documents but may also be found

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[[13] For example, where the trustees of a discretionary trust do not distribute insurance premiums earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer) could constitute the beneficial owners of such premiums for the purposes of Article 12C even if they are not the beneficial owners under the relevant trust law.]

[14] Reproduced at page R(6)-1 of Volume II of the full-length version of the 2017 OECD Model Tax Convention, available at https://read.oecdilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-2017-full-version_g2g972ee-en#page1833, accessed on 10 May 2021.

to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the insurance premiums unconstrained by a contractual or legal obligation to pass on the premiums received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the premiums by the direct recipient such as an obligation that is not dependent on the receipt of the premiums and which the direct recipient has as a debtor or as a party to financial transactions. Where the recipient of insurance premiums does have the right to use and enjoy the premiums unconstrained by a contractual or legal obligation to pass on the premiums received to another person, the recipient is the "beneficial owner" of those premiums.

19. Whether entering into a reinsurance contract affects an insurance enterprise's status as a beneficial owner of the insurance premiums it receives depends on the terms of that contract. Reinsurance can take several forms. First, a reinsurer may take on only specific risks (or a block of risks) from an insurer, through what is called "facultative" reinsurance, or may take on all risks incurred by the insurer during a specified period of time, pursuant to a "reinsurance treaty". In either case, the coverage may be "proportional" or "non-proportional". In the case of proportional reinsurance, the reinsurer may accept a certain percentage of all losses incurred by the insurance company. For example, a quota share treaty is a form of pro-rata reinsurance contract in which the insurer and reinsurer share premiums and losses according to a fixed percentage. In the case of non-proportional reinsurance, the reinsurer will only be liable if the insurance company's losses exceed a certain amount. One common form of non-proportional insurance is "excess-of-loss" insurance, in which the reinsurer will pay the entire amount of the insurer's loss in excess of the agreed threshold. However, it is also possible for a reinsurer to take only a specific "slice" of losses or for different reinsurers to take different slices.

20. The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of "beneficial owner" cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e. individuals), cannot be reconciled with the express wording of paragraph2(a) of Article 10 which refers to the situation where a company is the beneficial owner of a dividend. In the context of Articles 10, 11, 12, 12A, 12B and 12C, the term "beneficial owner" is intended to address difficulties arising from the use of the words "paid to" in relation to dividends, interest, royalties, fees for technical services, income from automated digital services and premiums rather than difficulties related to the ownership of the underlying property or rights in respect of which the amounts are paid. For that reason, it would be inappropriate, in the context of these articles, to consider a meaning developed in order to refer to the individuals who exercise "ultimate effective control over a legal person or arrangement".

21. The fact that the recipient of insurance premiums is considered to be the beneficial owner of those premiums does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision. As explained in the section on "Improper use of the Convention" in the Commentary on Article 1, there are many ways of addressing conduit company structures and, more generally, treaty shopping situations. These

include specific anti-abuse provisions in domestic law and treaties, general anti-abuse rules in domestic law and tax treaties, judicial doctrines, such as substance-over-form or economic substance approaches, and the interpretation of tax treaty provisions. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on insurance premiums to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

22. Subject to other conditions imposed by the Article, the limitation of tax in a State remains applicable when an intermediary, such as an agent or nominee located in the other Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State.

23. The paragraph lays down nothing about the mode of taxation in the State in which the insurance premiums arise. Therefore, it leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or individual assessment. As with other provisions of the United Nations Model Tax Convention, procedural questions are not dealt with in the Article. Each State is able to apply the procedure provided in domestic law.

Paragraph 3

24. Paragraph 3 specifies the meaning to be attached to the term "insurance premiums" for the application of the taxation treatment defined by the Article. The term means amounts paid to an insurance enterprise pursuant to a contract (policy) in which the insurance enterprise indemnifies another person against losses from specific contingencies or perils (risks). Thus, for example, the definition would apply to premiums paid by a corporation to ensure the life of a senior executive ("key person" insurance).

25. Insurance generally involves both "risk shifting" and "risk distribution". Risk shifting is transferring the risk of loss from one party to another, such as from the insured to the insurer, and is sometimes an issue when considering captive insurance companies. Risk distribution is the pooling of independent risks of unrelated parties. An insurer can further reduce its overall risks by diversification, such as by writing homeowners' insurance in multiple markets. An insurer can also shift part of its risk through reinsurance, which effectively is insurance for insurers. Reinsurance therefore performs an important business function by further distributing risk, allowing insurance companies to underwrite more risks and reducing costs.

26. The definition in paragraph 3 also includes payments made by an insurance enterprise to secure reinsurance from a reinsurance enterprise. Some Members of the Committee were concerned that including reinsurance in the definition could result in tax being imposed multiple times with respect to the same risks. Other Members did not view such a result as multiple taxation as they viewed each reinsurance policy as a separate transaction giving rise to independent tax consequences. In their bilateral negotiations, countries might want to set a relatively low rate in paragraph 2 to take into account the common practice of entering into reinsurance contracts.

27. Another Member was concerned that imposing a tax on reinsurance premiums paid to an unrelated third party reinsurer could impact the local market and increase the cost of insurance. Reinsurance companies are located in very few countries and payments to a non-resident third party reinsurer are legitimate business transactions and represent a real shifting of the risk. This Member was of the view that the gross tax should only apply to reinsurance premiums paid to related non-residents, including back-to-back arrangements. Countries sharing these concerns could redraft the definition to include such a limitation.

28. The definition is restricted to payments made to an "insurance enterprise". This limitation is included to help distinguish insurance contracts from certain financial instruments such as credit default swaps and catastrophe bonds. Countries that wish to cover all such instruments are free to delete the reference to "insurance enterprise" in their bilateral agreements.

29. Country practice differs with respect to "captive insurance." In a captive insurance transaction, an entity or small group of taxpayers create an affiliated entity (frequently in a no- or low-tax jurisdiction) in order to "insure" their risks. Some countries may take the position that such captive companies do not provide the risk shifting and/or risk distribution that are hallmarks of insurance. The transaction therefore may be seen as essentially establishing a reserve for future contingent liabilities, contributions to which may or may not be deductible under that country's domestic law. Other countries may recognize the transaction as insurance, but use transfer pricing rules to ensure that any profits from the transaction are reflected in the accounts of the company being insured, not the captive insurance company. If a captive insurance company is not viewed as issuing "insurance" under a country's domestic law, it generally would not constitute an "insurance enterprise" for purposes of the definition of insurance in paragraph 3. Accordingly, if a payment made to a captive insurance company is respected as an insurance premium under the domestic law of the Contracting State from which such payment is made, then Article 12C generally will apply to the payment.

Paragraph 4

30. This paragraph provides that paragraphs 1 and 2 do not apply to insurance premiums if the relevant insurance enterprise has a permanent establishment in the State in which the premiums arise and the premiums are effectively connected with that permanent establishment. In this regard, paragraph 4 is similar to paragraph 4 of Articles 10, 11, 12 and 12A as well as paragraph 8 of Article 12B. Thus, if an insurance enterprise of one Contracting State enters into insurance policies through a permanent establishment located in the other Contracting State, the premiums received with respect to those policies will be taxable by the State in which the permanent establishment is located in accordance with Article 7, rather than in accordance with Article 12C.

31. Since Article 7 of the United Nations Model Tax Convention adopts a limited force-of-attraction rule, which expands the range of income that may be taxed as business profits, paragraph 4 also makes paragraphs 1 and 2 inapplicable if the insurance premiums are effectively connected with business activities in the State in which the premiums arise that are of the same or similar kind as those effected through the permanent establishment.

32. The paragraph does not define the meaning of the expression "effectively connected." As a result, whether insurance premiums are effectively connected with a permanent establishment or business activities similar to those carried on through a permanent establishment must be determined on the basis of all the relevant facts and circumstances of each case. In general, insurance premiums would be considered to be effectively connected with a permanent establishment if the insurance premiums are closely related to or connected with the business activities carried on through the permanent establishment. Also, insurance premiums would be effectively connected with business activities referred to in paragraph 1(c) of Article 7 where the insurance policies are entered into by an insurance enterprise as part of that enterprise's business activities carried on in a Contracting State where a permanent establishment of that enterprise is situated and these activities are of the same or similar kind as the business activities performed through that permanent establishment.

33. Where paragraph 4 applies, insurance premiums are taxable by the State in which the premiums arise as part of the profits of the permanent establishment in accordance with Article 7. Thus, paragraph 4 relieves the State in which the insurance premiums arise from the limitations on its taxing rights imposed by paragraph 2 of Article 12C. Where Article 7 applies as a result of the application of paragraph 4, most countries consider that the State in which the permanent establishment is located is allowed to tax only the net profits from the insurance activities. Article 7 does not preclude taxation of business profits attributable to a permanent establishment on a gross basis, but a Contracting State must not discriminate against residents of the other State in violation of paragraph 3 of Article 24 (Non-discrimination).

Paragraph 5

34. Subparagraph 5 lays down the principle that insurance premiums arise in a Contracting State when the payer is a resident of that State or if the person paying the insurance premiums has in the Contracting State a permanent establishment or a fixed base in connection with which the obligation to make the payment was incurred, and such payments are borne by the permanent establishment or fixed base. This rule is consistent with the domestic law rules of many developing countries, which impose a withholding tax on all payments made from their country.

35. Under subparagraph 5, where there is an obvious economic link between an insurance policy and the activities or assets of the permanent establishment or fixed base of the policyholder in a Contracting State, the insurance premiums are considered to arise in the State in which the permanent establishment or fixed base is situated. This result applies irrespective of the residence of the person to whom the permanent establishment or fixed base belongs, even where that person resides in a third State.

36. Where there is no economic link between the insurance policy and the permanent establishment or fixed base, the insurance premiums are considered to arise in the Contracting State of which the payer of the insurance premiums is a resident. If the payer of the insurance premiums is not a resident of either Contracting State, Article 12C does not apply to the insurance premiums unless the payer has a permanent establishment or fixed base in the Contracting State and there is a clear economic link between the insurance policy and the permanent establishment or fixed base. Otherwise, there would be, in effect, a force-of-attraction principle for insurance premiums, which

would be inconsistent with other provisions of the United Nations Model Tax Convention.

37. Where insurance premiums are incurred for the purpose of a business carried on through a permanent establishment or for the purpose of independent personal services performed through a fixed base, those payments will usually qualify for deduction in computing the profits of the permanent establishment under Article 7 or the income of the fixed base under Article 14. The deductibility of the insurance premiums provides an objective standard for determining that the payments have a close economic connection to the State in which the permanent establishment or fixed base is situated.

38. The fact that the payer has, or has not, actually claimed a deduction for the insurance premiums in computing the profits of the permanent establishment or the income of the fixed base is not necessarily conclusive, since the proper test is whether any deduction available for those payments should be taken into account in determining the profits of the permanent establishment or the income of the fixed base. For example, that test would be met even if no amount were actually deducted as a result of the permanent establishment or fixed base being exempt from tax or as a result of the payer simply deciding not to claim a deduction to which it was entitled. The test would also be met where the insurance premiums are not deductible for some reason other than the fact that such expenses should not be allocated to the permanent establishment or fixed base.

39. Some Members of the Committee were concerned that the payment rule of subparagraph 5 is, however, potentially subject to manipulation. For example, the parent company of a multinational enterprise could enter into a single insurance contract covering risk of loss in all of its subsidiaries worldwide. Because it makes a single premium payment, only the state of which the parent company is a resident would be viewed as the state in which the premiums arise, depriving the countries in which the risks are located of their right to tax the premiums. More generally, those Members believe that the jurisdiction that would have borne the cost of an uninsured loss (not the state from which payment is made) should be viewed as the source State. They therefore support renumbering the current source rule as subparagraph (a) and including the following new subparagraph 5(b):

> ***(b) Where subparagraph (a) does not operate to treat insurance premiums as arising in either Contracting State and the insurance premiums are paid to insure risks situated in a Contracting State, then such premiums shall be deemed to arise in that State to the extent that they relate to such risks.***

40. If subparagraph 5(b) is included, insurance premiums also will be deemed to arise in a Contracting State if the underlying risk is located in that State and the general rule of subparagraph (a) does not result in the premium payment being treated as arising in one of the Contracting States. For example, an insurance company resident in State I issues a property and casualty policy to another resident of State I, insuring its manufacturing facility located in State I against all perils. The State I insurance company then enters into an excess-of-loss reinsurance treaty with a reinsurance company resident in State R. That reinsurance company itself enters into a proportional reinsurance treaty with a resident of State T. Under Article 12C of the State I-State R tax treaty, the reinsurance premium paid by the State I insurer to the State R reinsurance company is treated as arising in State I. The reinsurance premium paid by the State R

reinsurer to the State T reinsurer is treated as arising in State R because paid by a State R resident. It is not treated as arising in State I, even though the risk is located in State I, because the rule of alternative subparagraph 5(b) applies only in cases where the payment rule of subparagraph 5(a) does not treat the premiums as arising in one of the Contracting States.

41. However, alternative subparagraph 5(b) of the State I-State R treaty could be relevant in other circumstances involving the same parties. For example, assume that, in the circumstances described in paragraph 40, the State I insurance enterprise enters into the excess-of-loss reinsurance treaty with the State T reinsurer, and the State T reinsurer enters into the proportional reinsurance treaty with the State R reinsurer. In that case, paragraph 5(b) would treat the payment made by the State T reinsurer to the State R insurer as arising in State I because the risk is located in State I and the payment rule of paragraph 5(a) is inapplicable to the payment made by the State T reinsurance enterprise.

42. Some Members of the Committee believe that the location rule of subparagraph 5(b) would introduce substantial complexity to a rule that was intended to simplify taxation. In that regard, they are particularly concerned about how the rule would apply in the case of reinsurance or direct insurance that covers multiple entities and/or countries. Some also argue that it is inappropriate to look through the reinsurance contract to the underlying risk, as a reinsurer relies on the underwriting prowess of the ceding insurer rather than conducting its own analysis of the underlying risks. Moreover, the withholding tax systems of many developing countries are based on place of payment, so that those countries would have difficulty applying the rule of subparagraph 5(b). Countries may want to consider these points before deciding to include subparagraph 5(b).

Paragraph 6

43. The purpose of paragraph 6 is to restrict the operation of the provisions concerning the taxation of insurance premiums in cases where, by reason of a special relationship between the payer and the beneficial owner of the income or between both of them and some other person, the amount of the premiums exceeds the amount that would have been agreed upon by the payer and the beneficial owner if they had stipulated at arm's length. Paragraph 6 provides that in such a case the provisions of the Article apply only to the last-mentioned amount and the excess part of the insurance premiums would remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.

44. It is clear from the text that in order for this paragraph to apply, the insurance premiums held to be excessive must be due to a special relationship between the payer and the beneficial owner of the income or between both of them and some other person. There may be cited, as examples of such a special relationship, cases where the insurance premiums are paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by the payer or is subordinate to a group having common interest with the payer. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

45. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationships created through the insurance policy.

46. With regard to the taxation treatment to be applied to the excess part of the insurance premium, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income into which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. Unlike paragraph 6 of Article 11, which, because of the limiting phrase "having regard to the debt claim for which it is paid," permits only the adjustment of the rate at which interest is charged, paragraph 6 permits the reclassification of the insurance premiums in such a way as to give them a different character. This paragraph can affect not only the recipient of the payments, but also the payer of excessive insurance premiums; if the law of the State where the payer is resident or has a permanent establishment or a fixed base permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the insurance premiums, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not alter its general purport.

47. Where the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess part of insurance premiums, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

VI. Issues for the Committee

32. The Committee is asked to consider and give guidance on the following issues:

(a) whether it supports inclusion of the new Article 12C;

(b) whether the definition of insurance in paragraph 3 of Article 12C provides sufficient clarity regarding the scope of the article;

(c) whether additional guidance on beneficial ownership, particularly in the case of reinsurance, would be helpful and, if yes, what specific situations could be addressed; and

(d) whether the proposed Commentary on Articles 5 and 12C set out in paragraphs 29 and 30 adequately explain the proposed changes and whether there is additional guidance that would be helpful.