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Taxation of services – including provision on taxation of fees for technical services

Secretariat Note – Recent Work of the Committee on Tax Treatment of Services

Summary

This note is an historical perspective on where the discussions on taxation of services within the Committee currently stand. It is a summary of discussions in the Committee since 2008, intended to give an overall picture, especially to the new members of the Committee. The summary reviews the discussions on the current treatment through different Articles and the potential inconsistencies that exist. This note complements separate notes by Mr. Brian Arnold (E/C.18/2013/CRP.5) and Mr. Tizhong Liao (E/C.18/2013/CRP.16).

Secretariat Note – Recent Work of the Committee on Tax Treatment of Services

Introduction

Tax treatment of services has been a priority of the UN Committee of Experts on International Cooperation in Tax Matters (the Committee) for a number of years. The issue arose during the early years of the Committee, especially during the discussions of the revision of article 5 and its Commentary - because of the special provision in article 5(3)(b) for so-called "services permanent establishments."

Fourth Session of the Committee (2008) – A Subcommittee on Article 14 and Services

At its fourth session in October 2008 the Committee established a Subcommittee on Article 14 and the Tax Treatment of Services. With Article 14 retained in the UN Model (and abolition only being an option) and given that there was a recognition that there were some issues with its current drafting, the Subcommittee was asked to examine in more detail those issues and possible solutions. The services issues were seen as related.

Fifth Session of the Committee (2009) – A Subcommittee Dedicated to Services

A new Subcommittee on Taxation of Services was formed at the fifth session in 2009, alongside a distinct Subcommittee on Article 14, recognising the overlapping but distinct nature of the issues involved. These Subcommittees both had as Coordinator Ms. Liselott Kana. At the fifth annual session, paper E/C.18/2009/CRP.4 was presented as the conclusions of the original Subcommittee on Article 14 and Services. It noted some initial consideration of the issues with Article 14 including coverage of activities other than the furnishing of professional services

Ms. Kana noted that there were many diverging interpretations and approaches on the subject of taxation of services and that there should be a broad accommodation by putting together different options in the main text or in the commentaries, and carefully explaining their implications, in order to reflect the reality of different countries and make the United Nations Model Convention as practically useful and relevant as possible.

The specific mandate of the new Subcommittee on Services was: "to address the issue of the taxation treatment of services in general in a broad way including related aspects and issues. The issue of taxation of fees for technical services should also be addressed… the Subcommittee should present at the next annual session of the Committee an initial evaluation, some possible building blocks and potential ways to go forward."

First Reports by Mr. Arnold – Treatment of Services in the UN Model

Subsequently the Secretariat, at the request of the Subcommittee on Taxation of Services, (the Subcommittee) obtained the services of Mr. Brian Arnold to write a consultant's report on the tax treatment of services within the UN Model Convention (also drawing some comparisons with the OECD Model where possible) to better inform the Committee. Mr. Arnold presented his findings in two papers to the sixth session of the Committee in 2010 (E/C.18/2010/CRP.7 and E/C.18/2010/CRP.7/Add.1).

In his detailed analysis, Mr. Arnold noted the various articles in the UN Model (as well as in the OECD Model) that potentially deal with the taxation of services: Articles 5 and 7, 8, 14, 15, 16, 17, 18, 19 and 21. He noted a lack of consistency in the way those articles applied, which was reflected in a table in his first paper as follows:

Table: Conditions for Source Country Tax

Type of Income from Services	**Conditions for Source Country Tax**
Business profits	• permanent establishment and income attributable to PE services performed in the source country for 183 days or more for the same or a connected project
Construction and related services	• construction project at a fixed place in the source country that lasts more than 6 months
Insurance	• collection of premiums or insurance of risks in the source country other than through independent agents
Shipping and transportation	• more than casual activities in the source country
Independent personal services	• fixed base and income attributable to the fixed base services performed in the country if person stays in the country for 183 days or longer
Dependent personal services	• employment exercised in the source country if the individual stays for more than 183 days or is paid by a resident of the source country or a nonresident with a PE or fixed base in the source country
Remuneration of directors and top-level managers	• residence of the paying company in the source country
Entertainers and sportspersons	• activities in the source country
Social security payments	• payment by the source country
Private pension payments	• payer resident in the source country or PE in the source country
Government service	• payment by the source country unless services rendered in other country by a resident and national of that country
Other income	• income derived in source country

In the two papers, Mr. Arnold identified several factors that are used to determine under what conditions, and how, a source country is entitled to tax such income. The factors identified were as follows:

- the allocation of jurisdiction to tax income from services between the residence and source countries;
- the types of services;
- threshold requirements for source country taxation;
- income from services subject to source country taxation;
- the method of source country taxation permitted;
- the legal capacity in which the services are performed; and
- the identity of the client or person to whom the services are rendered.

Mr. Arnold raised a number of key points which he considered any future work in harmonizing the treatment of services for tax purposes would need to address issues of:

- consistency;
- non-discrimination;
- the source principle;
- the threshold principle – the appropriate threshold requirement for source country taxation;
- the base erosion principle;
- the enforcement principle; and
- the net basis taxation principle.

Mr. Arnold also addressed the particular issues related of payments made by the residents of a country to foreign residents for the provision of services supplied to the former – so-called "fees for technical services". He noted (at paragraph 89) that:

> The erosion of the source country's tax base by payments for such technical services has led some countries to add specific provisions to their treaties to allow them to tax technical fees on a gross basis. Alternatively, some countries may take the position based on their domestic law that income from technical and other similar services is not income from carrying on business or income from professional or independent personal services; as a result, such income is "other income" that is taxable by a source country if the income arises in the source country in accordance with Article 21(3). There is no limit on source country taxation of other income under Article 21 so that such tax may be imposed as a flat rate withholding tax on the gross amount of the payment. In effect, there is no threshold requirement for source country taxation of other income under Article 21.
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> Mr. Arnold indicated that, while there seems to be widespread recognition that source countries should be entitled to tax interest, royalties, and technical fees that constitute business profits even in the absence of a PE, the concern is that the source country should tax these amounts on a net basis. If a non-resident derives interest, royalties, technical fees or other similar amounts that do *not* form part of the non-resident's business profits, it is appropriate, he considered, for the source country to tax the

amounts up to a ceiling, as established in Articles 11 and 12 of the UN Model. Source country tax in these situations can be justified by reference to the base erosion principle. Mr. Arnold discussed how such a result could be achieved by possible amendments to the UN Model. At paragraphs 99-100 of E/C.18/2010/CRP.7, he noted policy changes and minor drafting changes that might in his view improve the Mode, though they did not constitute firm recommendations. The suggestions were:

A. Policy changes

1) Article 5(3)(b) and Article 14(1)(b) should be replaced with a provision similar to, but broader than, the alternative services PE provision contained in the Commentary on Article 5 of the OECD Model. For those countries that decide to delete Article 14 from their treaties, the alternative services PE provision would replace Article 5(3)(b). For those countries that choose to retain Article 14, fundamental changes to that Article are the subject of a separate note prepared for the Subcommittee on Article 14. That note recommended, in substance, that Article 5(3)(b) should be moved to Article 14 and the fixed-base requirement should be deleted. Even if those recommendations are accepted, Article 14 should be further revised along the lines of the OECD alternative services provision, with modifications in accordance with other recommendations in this note (for example, the deletion of the same or a connected project requirement).

2) The adoption of a combined threshold based on both days of presence and days of work in the source country for purposes of Articles 5(3)(b), 14(1)(b), and 15(2) should be studied.

3) The adoption of a shorter time threshold (90 or 120 days) for purposes of Articles 5(3)(b), 14(1)(b), and 15(2) should be considered.

4) The same or a connected project requirement should be deleted from Article 5(3)(b).

5) The 6-month time frame threshold for construction and related activities should be changed to 183 days, and possibly be reduced to 90 or 120 days, or left up to bilateral negotiations. The possible deletion of the requirement to treat each project separately should be considered, especially if the same or a connected project requirement in Article 5(3)(b) is deleted. It might be useful to survey the provisions of existing treaties to determine how many treaties already use a threshold of less than 6 months or 183 days for construction and other activities.

6) Several changes to the provisions of Article 17 dealing with entertainment and sports activities should be considered:

    a) Article 17 could be revised to apply only to entertainment and sports activities engaged in by independent individuals or enterprises. As a result, income from such activities derived by employees would be dealt with under Article 15.

b) The scope of Article 17 could be expanded to include other high-value services.
c) A monetary threshold could be added to Article 17 in order to exclude from source country taxation taxpayers earning relatively small amounts from entertainment or sports activities performed in the source country.
d) Article 17 could be revised to require source country taxation on a net basis or, if taxation on a gross basis continues to be allowed, to limit source country tax to a fixed percentage (to be agreed on through bilateral negotiations) of the gross revenue derived from the source country.

7) The provisions of the UN Model or Commentary should be revised to permit source country taxation of income from technical and other similar services provided in the source country, especially if those services are provided by a nonresident to an associated enterprise in the source country. A first step in the work on this issue might be to canvass the existing provisions of bilateral treaties dealing explicitly with technical services. This work might be followed by a survey of country positions on various options (four of which are identified in this note) for the taxation of income from technical and other similar services.

8) If a source country is authorized by the provisions of the UN Model to tax income from services performed in the source country, that country should be required to tax the income on a net basis or, if taxation on a gross basis is allowed, the source country's tax should be limited to a fixed percentage (to be agreed on through bilateral negotiations) of the gross revenue derived. However, unlimited gross-basis taxation by a source country should be permitted in situations in which the expenses incurred in earning the income from services are negligible.

9) The Commentary on Article 18 should be revised to add alternative provisions for the source country taxation of pension payments. B. Minor changes in the wording of the existing provisions. Currently, there are several unnecessary inconsistencies in the wording of the provisions of the UN Model dealing with services. These inconsistencies should be eliminated. For example:

1. All threshold requirements based on time should be measured in days rather than months.

2. Various terms are used to refer to the performance of services: a) Article 5(3)(b) – "furnishing" b) Article 14(1) – "performing" or "performed" c) Article 19 – "rendered". All of these provisions, except perhaps Article 15, should be revised to refer to "performing" services or the "performance of" services. If the UN Model is changed in this way, the Commentary should state that the changes are not intended to alter the meaning of the provisions.

3. Article 14(1)(b) refers to a taxpayer's "stay" in the other Contracting State, whereas Article 15(2)(a) refers to the recipient's "presence" in the other

state. Article 14(1)(b) should be revised to read "If he is present in the other Contracting State …"

Sixth Session of the Committee (2010)

During the discussions that followed in the sixth annual session of the Committee in 2010 it was noted that the growing importance of the services sector as a percentage of the volume on international trade in the world economy or as a percentage the GDP in most countries' economies meant the issue of taxation of services deserved more attention from the Committee. One member of the Committee also noted that tax revenues from services, in particular technical assistance services, could be a substantial source of revenue for developing countries; the best collection strategy could be withholding taxes at source, but that was often resisted by service-providing countries. Another member expressed the view that the concept of where the service was consumed for tax purposes was a useful one for consideration in that context.

In conclusion, it was agreed that the Subcommittee on taxation of services would draw upon Mr. Arnold's work, and other sources, in its work of examining taxation of services, including fees for technical services.

Seventh Session of the Committee (2011) – IBFD Study and a Work Program with an Initial Focus on Fees for Technical Services

During the seventh session of the Committee in 2011, the discussions on the issue of taxation of services benefited from a study by Mr. Wim Wijnen and Mr. Jan de Goede (both of the International Bureau for Fiscal Documentation) prepared at the request of the Committee and entitled "The Tax Treatment of Services in Tax Treaties"[1]. The authors analysed over 1,500 tax treaties to determine what kinds of provisions countries used when dealing with services. One conclusion was that countries in principle preferred to follow the standard provisions of the UN, OECD or other models, without deviation. Only if those were not adequate did they adopt more detailed criteria, which could obscure the distinction between various treaty provisions, e.g., provisions on professional services and dependent personal services. When no standard provisions were available, as was the case with autonomous provisions on services and on services linked with royalty contracts, countries developed their own policy, resulting in a great number of diverse provisions that made the application of treaties challenging.

Another conclusion was that countries appeared to have a strong preference for taxation of net services income rather than withholding tax on gross income. Discussions at the seventh annual session in 2011 focused on ways of taking forward the work on services, drawing upon a short options paper (E/C.18/2011/CRP.7). Some members called for a comprehensive approach to reviewing the treatment of services under the United Nations Model Convention, namely, an article-by-article review of all the provisions of the Convention dealing with services, paying special attention to fees for technical services and permanent establishment

[1] Published as: W.Wijnen, J. de Goede & A. Alessi, *The Treatment of Services in Tax Treaties*, 66 Bull. Intl. Taxn. 1 (2012), Journals IBFD.

issues. Others were of the view that if that approach were followed, it would not be possible to achieve concrete results within a reasonable period of time.

It was ultimately agreed that the Committee would start with work on "fees for technical assistance" with a view to achieving concrete results for the next annual session, but it would also have a longer-term plan of work with a view to a comprehensive review of services issues for the United Nations Model Convention.

Eighth Session of the Committee (2012) – A Decision on Fees for Technical Services

At the eighth session of the Committee in 2012 the taxation of services was discussed based on a new more detailed options paper by Mr. Arnold (E/C.18/2012/4), a paper that explored in detail the specific option of adding a new article and commentary dealing expressly with the taxation of income from technical and other services (E/C.18/2012/CRP.4) and a paper from El Hadji Ibrahima Diop, a Member of the Committee addressing some of the issues in E/C/2012/CRP.4 from another perspective (E/C.18/2012/CRP.4/Add.1).

Mr. Arnold indicated in E/C.18/2012/CRP.4 that his overall findings on treatment of services, as indicated in his earlier papers for previous annual sessions (E/C.18/2010/CRP.7 and E/C.18/2011/CRP.7) revealed that there is no coherence or consistency on the topic in either the United Nations Model Convention or the OECD Model Convention. Before describing how technical services are handled through different articles in the United Nations Model, he pointed out the inherent difficulty in seeking to define the term "technical services", a term sometimes used for managerial, consultancy or administrative services.

In the United Nations Model Convention, he continued, no specific article deals comprehensively with taxation of income from technical services. It is currently dealt with in several articles, mainly article 7 and article 14, except for specialized services, for example construction and insurance. Under article 7, he said, income or business profits from technical services can be taxed by the source country only if the non-resident taxpayer has a fixed place of business in the source country and the income is attributable to the permanent establishment. According to article 5(3)(b) an establishment is considered to be a permanent establishment if the non-resident furnishes services in the source country for more than 183 days in any 12-month period in connection with the same or connected project. This would result in the source country being able to tax the income from those services.

With regard to article 14, if a non-resident has a fixed base regularly available in the source country then income from any profession and independent services attributable to that fixed base is taxable by the source country. In addition, if the non-resident stays in the source country for at least 183 days and furnishes services there, then the income derived from those services is taxable by the source country.

Mr. Arnold noted how easy it could be for a non-resident enterprise to earn substantial income in a source country without being subjected to tax in that country. That problem is even more apparent when a resident is paying a non-resident for such services, as such a payment is often tax deductible in the source country. Such an erosion of the tax base, he said, is often more accentuated in the case of intra-group dealings involving multinationals, where such business practices can be used to reduce taxable income from a source country. Mr. Arnold then outlined a number of options to address taxation of services in a more consistent manner. The

choice of which option was most appropriate, however, was left to the Committee to decide as Mr. Arnold did not put forward any preference. The options he outlined were as follows:

(a) Revision of the commentary in the United Nations Model Convention to provide a neutral discussion, with no recommendations, of the arguments for and against any special provision for technical services;

(b) Adding to the first option a number of cases in which specific provisions dealing with technical services have been included in actual bilateral treaties, but without any recommendation;

(c) Revision of the commentary to add a neutral discussion and provide an alternative provision or provisions, which countries would be encouraged to adopt if they decided to include special treatment of technical services in their treaties;

(d) Reduction of the time thresholds in article 5(3)(b) and in article 14(1)(b) to less than the current 183 days. The new threshold would apply either to all services or solely to technical services;

(e) Revision of article 12 to include technical services related or connected to the transfer of intellectual property. The change could also be included in the commentary to article 12 only, as an alternative provision;

(f) Revision of article 14 to include the base erosion conditions of article 15(2). The source country would be entitled to tax payments for professional and independent services if payments were made by a resident of the source country or borne by a permanent establishment or fixed base of a non-resident in the source country. This could be limited to technical and other similar services;

(g) Revision of article 21(3), in which income from technical services could be defined as “other income” to fit the purpose of article 21(3). Currently there is no limitation on source country tax under article 21(3) but this could be added;

(h) Adding a new article and commentary dealing with income from technical services. While pointing out that some bilateral treaties include such a provision, Mr. Arnold raised a number of questions that may need to be answered before going forward with this option: what are the conditions for source country tax?; how is the source country going to tax (gross or net basis)?; and how are technical services to be defined? An alternative is to include such provisions in the commentary as an alternative, which is being done by OECD for the provision of technical services related to permanent establishment; or

(i) Deeming a subsidiary to be a permanent establishment of its non-resident parent, therefore any income derived by the parent from services rendered to the subsidiary would be attributable to the permanent establishment and subject to tax by the source country. This would deal with intra-group services and could be extended to different kinds of services, not just technical services, but should not apply to “arm’s length” services. In this particular case, it would also be necessary to decide on services provided by related entities.

Mr. Arnold concluded this list of options to deal with fees for technical services by noting the preference of a majority of the members of the Subcommittee for a different and specific article in the United Nations Model Convention to deal with technical services. He also noted that a clear definition of technical services was needed if the Committee chose to draft a new article.

After the presentation, a number of participants took the floor to express their views on how to proceed, whether through the drafting of a new article or the revision of existing ones. Those who did not support the idea of a new article argued that there were other ways to address the shortcomings raised by Mr. Arnold without resorting prematurely to the drafting of a new article. They pointed out that the issue of tax base erosion is neither limited to technical services nor to services in general. As for the issue of a large amount of income that can be earned in a very short period of time in dealing with services, they suggested that the issue be addressed through the revision of article 5. They considered that the problem was not limited to technical services, and that the best way to solve the problem was to lower the requirements related to the existence of a permanent establishment.

Concerning taxation of gross income instead of net income, they observed that technical services are generally highly skilled services involving large amounts of remuneration paid to employees or subcontractors, and that taxation on a gross basis has the potential to result in double taxation. They considered that it should be avoided or that the rate should be kept reasonably low.

Some of the reasons given for recommending a new article were: (a) recent changes in the global economy whereby services now represent a bigger share in the GDP of most countries — thus warranting a new article to deal with that reality, not only for technical services but for services more generally; (b) developing countries are among the most disadvantaged by the present situation as some multinationals have used intra-group services to shift profits resulting in the declaration of losses by subsidiaries in the source countries. Such situations have led to serious erosion of tax bases in developing countries at a time when they most need revenue to deal with development challenges; (c) the Southern African Development Community has taken the lead and introduced a new article dealing with technical services in their Model Tax Agreement and have proposed taxation on gross income with a relatively low rate, which is easier to administer given the scarcity of human resources, while not overtaxing economic activity.

Another group of Committee members and observers noted that it would be risky to base any decision on the fact that there are a few treaties that already have a new article on technical services since this does not necessarily mean that both signatories of such a bilateral treaty supported the new article — it could perhaps simply be a compromise to obtain other concessions. They also pointed out that the full economic impact of shifting the tax burden has to be investigated further, and the exact meaning of technical services and their economic relevance to countries determined. In conclusion they recommended that a further study should be undertaken to answer those questions before making a decision on whether to have a new article on technical services or to address the issue otherwise.

After extensive discussions it was agreed by a majority of members and observers that there would be a new provision dealing with technical services. Some of the issues to be addressed in that provision will be:

(a) A definition or a framework of what could qualify as "technical services";

(b) Consideration of the modality of how the service is performed, including whether there is a need for physical presence in the source country. If that is the case, the threshold time for such presence must be determined;

(c) Consideration of whether the fact that the payment for services is simply borne by a resident of the source country or a permanent establishment situated therein should warrant the allocation of taxing rights to the source country.

Ninth Session of the Committee (2013) – Re-constitution of the Subcommittee?

At the Ninth Annual Session from 21-25 October the Committee will have to decide whether to re-constitute the Subcommittee, and should it decide to do so the Committee will also need to decide on its composition, leadership and mandate/ work programme.

Draft Provisions on Fees for Technical Services with Notes

As to the technical issues for consideration, paper E/C.18/2013/CPR.5 for the ninth session of the Committee in 2013 is a note by consultant Mr. Brian Arnold on possible drafts of a fees for technical services article, with an outline of some of the issues raised by each draft, as well as the broad issues raised whichever draft was chosen – such as the definition of "fees for technical services".

Additional Study by Mr. Tizhong Liao

It was also agreed at the eighth session that a more complete study should be carried out with respect to services and its taxation. Jacques Sasseville, Head of the OECD Tax Treaty Unit, and Tizhong Liao, a member of the Committee, agreed to establish liaison in order to undertake this extensive work. As a result, Tizhong Liao has presented a paper for consideration at the ninth session of the Committee in 2013 (E/C.18/2013/CPR.16).That paper gives some insights on the current difficulties that tax administrations face and will continue to face as the international trade in services and other intangibles continue to evolve. In particular the paper notes that: "There is no universal set of source rules that can readily be applied to every circumstance to determine the source or locality of profits. The growth in international trade, supported by the development of e-commerce, prompts a consideration of the adequacy of current tax laws. This is particularly evident where multinationals are increasingly able to structure their finances and conduct their affairs without being constrained by geography or national boundaries. The modern global economy differs from the environment within which many of our traditional sourcing rules were developed in many respects:…"

In light of this assessment, E/C.18/2013/CPR.16 makes some recommendations for a fairer taxation of revenues from services performed in the source states. The changes proposed concerns a range of articles in the UN Model Tax Convention. They include deemed permanent establishment treatment, providing that, for example, half of the gross income from sale of goods is considered to be attributable to production activity services in the foreign state

and the other half is treated as attributable to sales activities (services) in the source state; threshold changes in Article 5(3)(b) and Article 14(1)(b) to less than the current 183 days; the revision of the Other Income Article (Article 21(3)) to include technical services in the definition of “other income”, the revision of the Royalties Article (Article 12) to include technical services related to or connected with the transfer of intellectual property; a new technical services article or a new general services article. The note also proposes a new concept for sharing taxation rights based on a “mixed service supplies” concept inspired by the United States approach on the issue.

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