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NOTE ON THE TAXATION OF SERVICES UNDER THE UNITED NATIONS MODEL TAX CONVENTION*

Summary

This note has been prepared by a consultant, Mr Brian Arnold, for the Secretariat on behalf of the Subcommittee on Services, in accordance with the mandate given to that Subcommittee by the Fifth Session of the Committee of Experts on International Cooperation in Tax Matters in the report of its meeting in Geneva from 19 to 23 October 2009. The mandate of the Subcommittee on Services is as follows:

> "The Subcommittee is mandated 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. This is the initiation of this extensive work and 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."

This note surveys the provisions of the UN Model dealing with services and attempts to identify the principles underlying those provisions. The note evaluates the principles underlying the current provisions of the UN Model and suggests possible principles to guide any revisions of the Model. More specifically, the note considers the appropriate treatment of fees for technical services performed by nonresidents. Finally, the note makes some recommendations for further work on possible amendments to the provisions of the UN Model and Commentary dealing with services.

* This report should not be taken as necessarily representing the views of the United Nations.

NOTE ON THE TAXATION OF SERVICES UNDER THE UNITED NATIONS MODEL TAX CONVENTION

1. INTRODUCTION

1. This note has been prepared for the Subcommittee on Services as mandated by the Fifth Session of the Committee of Experts on International Cooperation in Tax Matters in the report of its meeting in Geneva from 19 to 23 October 2009. The mandate of the Subcommittee on Services is as follows:

> The Subcommittee is mandated 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. This is the initiation of this extensive work and 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.

2. This note represents the first step in the Subcommittee's work. It surveys the provisions of the UN Model dealing with services and attempts to identify the principles underlying those provisions. The note evaluates the principles underlying the current provisions of the UN Model and suggests possible principles to guide any revisions of the Model. More specifically, the note considers the appropriate treatment of fees for technical services performed by nonresidents. Finally, the note makes some recommendations for further work on possible amendments to the provisions of the UN Model and Commentary dealing with services.

2. THE DEFINITION OF SERVICES

3. There is no definition in the UN or OECD Models of the word "services." The *Oxford English Dictionary* defines service broadly as "the action of helping or doing work for someone." This definition is inappropriately broad for purposes of tax treaties because it includes voluntary or charitable services. The definition in *Black's Law Dictionary* is perhaps more appropriate: "the act of doing something useful for a person or company for a fee." This is the definition that is used for the purposes of this note.

4. It is probably not necessary to define the term "services" for purposes of the UN Model. However, the existing provisions of the UN Model make it necessary to identify specific types of services, such as professional and independent services and artistic and sports activities, because these activities are subject to special rules. Similarly, if a special provision is adopted to deal with technical services, it would be necessary to define such

activities. Defining specific types of services is a difficult task that can be addressed, if necessary, at a later stage of the Subcommittee's work.

3. OVERVIEW OF THE EXISTING PROVISIONS OF THE UN MODEL DEALING WITH SERVICES

5. This part of the note provides a brief description of all of the provisions of the Model that deal with income derived from services. This survey is intended to be as comprehensive as possible. It is also intended to identify the allocation of the right to tax between the residence country and the source country with respect to various types of services. In the next section of the note the provisions dealing with services will be analyzed in more detail to determine the conditions under which source countries are entitled to tax income from services and the limitations, if any, on source country taxation.

3.1 Articles 5 and 7 – Business Profits

6. Under Article 7, income from services rendered in a contracting state (the source country) by an enterprise resident in the other contracting state may be taxed in the source country only if the enterprise carries on business in the source country through a permanent establishment (PE) in the source country. If the enterprise carries on business through a PE in the source country only the profits that are attributable to the PE or attributable to other similar activities carried on through the PE (a limited force of attraction rule) are taxable by the source country. It is generally accepted that the source country tax under Article 7 is limited to tax on the net profits of the nonresident enterprise.

7. A PE is defined in Article 5 to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. Also, a dependent agent is deemed to be a PE of a nonresident enterprise if the agent has and habitually exercises an authority to conclude contracts on behalf of the nonresident enterprise. The term PE "also encompasses" a building site, construction, assembly or installation project or supervisory activities in connection with such a site or project if the site, project or activities last more than 6 months. Construction and related services performed by a nonresident in the source country will be taxable by the source country only under these conditions. More generally, the term PE "also encompasses" the furnishing of services by a nonresident if the activities continue for more than 6 months (to be changed to 183 days or more as agreed by the UN Tax Committee in 2009) and take place with respect to the same or a connected project. A PE is also deemed to exist where a nonresident enterprise collects insurance premiums or insures risks in the source country unless such activities take place through an independent agent.

3.2 Article 8 – Shipping, Inland Waterways Transport, and Air Transport

8. Under Article 8, profits from international shipping and air transportation and inland waterways transport are taxable exclusively by the country in which the enterprise has its place of effective management. However, as an alternative, profits from international shipping activities in a country may be taxed in that country if the activities are more than casual. In this case Article 8(2) (alternative B) provides special rules for the allocation of the profits between the source and residence countries and the calculation of the source country tax.

3.3 Article 14 – Independent Personal Services

9. Under Article 14, income from professional services or independent activities derived by a resident of one state is subject to tax by the other state in two circumstances:

1. if the resident has a fixed base in the other state that is regularly available to the resident for the purpose of performing the activities. In this case, which is similar to Article 7, only the income attributable to the fixed base is taxable by the source country.

2. if the resident's stay in the source country lasts for 183 days or longer in the aggregate in any 12 month period. In this case only the income from activities performed in the source country are taxable by the source country.

3.4 Article 15 – Dependent Personal Services

10. Under Article 15, income from employment (dependent personal services) derived by a resident of one state from employment exercised in the other state may be taxed in that other state (the source country). Such income may also be taxed by the country in which the employee is resident but the residence country must provide relief for the source country tax in accordance with Article 23. However, employment income is exempt from tax in the source country if

1. the employee is present in the source country for periods not exceeding in the aggregate 183 days in any 12 month period, and

2. the remuneration is not paid by an employer resident in the source country or borne by a PE or fixed base that a nonresident employer has in the source country.

11. The conditions for exemption from source country tax in Article 15(2) demonstrate a concern about tax base erosion. If the remuneration paid by the employer is deductible in computing income for purposes of the source country's tax base (either because the employer is a resident of the source country or because the employer is a nonresident with a PE or a fixed base in the source country), the remuneration derived by the employee is taxable by the source country even if the employee is present in the

source country for only a very short period. In these situations the only condition for source country tax is the exercise of employment activities in the source country.

3.5 Article 16 – Director's Fees and Remuneration of Top-Level Managerial Officials

12. Under Article 16, fees derived by nonresident directors and salary, wages, and other remuneration derived by nonresident senior managers of a company resident in the source country may be taxed by that country. Such income may also be taxed by the country in which the directors or managers are resident but that country must provide relief for the source country tax in accordance with Article 23. The only condition for source country tax under Article 16 is the residence of the company. It is not necessary for the fees or remuneration to be derived from activities performed in the source country by the directors or managers.

3.6 Article 17 – Artistes and Sportspersons

13. Under Article 17, income derived from personal activities as an entertainer or sportsperson exercised in a country may be taxed by that country. This right to tax extends to situations where the income from such activities accrues to a person other than the entertainer or sportsperson. The country in which the entertainer or sportsperson is resident is also entitled to tax such income but it is under an obligation to provide relief for the source country tax in accordance with the provisions of Article 23.

The only condition for source country tax under Article 17 is that the activities producing the income must take place in the source country.

3.7 Article 18 – Pensions and Social Security Payments

14. Under Article 18, social security payments (public pensions) are taxable exclusively by the country making the payment. However, Article 18 provides alternative provisions for the taxation of private pensions. Under one alternative such pensions are taxable exclusively by the country in which the recipient is resident. Under the other alternative private pensions may also be taxed by the country in which the payer of the pension is resident or has a PE. Like Article 15, the second alternative shows a concern about the erosion of the tax base of the source country. If contributions to the pension plan were deductible in computing the income subject to tax by the source country (in the case of a PE, only if the contributions are effectively connected with the PE), that country is given the right to tax the recipient of the payment. In this situation the residence country is also entitled to tax the pension but would be obligated to provide relief from double taxation in accordance with Article 23.

3.8 Article 19 – Government Service

15. Under Article 19, the right to tax salary, wages and other remuneration and pensions in respect of government service is allocated exclusively to one of the Contracting States. In most cases that right is given to the state paying the amount. However, if the government employee is a resident and a national of the other state and the services are rendered in that state, the salary etc. is taxable exclusively by that state. Similarly, pension payments by a Contracting State are taxable exclusively by the other State if the recipient individual is a resident and a national of the other state. Article 19 does not apply to salaries and pensions paid by a Contracting State in connection with a business carried on by it.

3.9 Article 20 – Students

16. Article 20 is restricted to payments for maintenance, education or training. Therefore, it cannot apply to income from services and is not discussed further in this note.

3.10 Article 21 – Other Income

17. Under Article 21(3), a source country is entitled to tax items of income derived by a resident of the other state if those items of income are not dealt with in another Article of the Convention and arise (have their source) in the source country. Thus, the only condition for source country taxation of other income under Article 21 is that the income must have its source in the source country. No rules are provided for determining the source of income. The potential application of Article 21 to income from services depends on whether such income is dealt with in another Article of the UN Model. In some circumstances the scope of application of the other provisions of the Model depends on the domestic laws of the source country. As a result, it cannot be concluded that Article 21 is irrelevant to income from services in all cases.

3.11 Summary

18. The types of income from services dealt with in the UN Model and the conditions under which the source country can tax such income are summarized in the following table.

TABLE

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 more than 6 months (to be changed to 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

4. ASSESSMENT OF THE PROVISIONS OF THE UN MODEL DEALING WITH INCOME FROM SERVICES

19. Based on the review of the various provisions of the UN Model dealing with services in the previous section, this section contains an assessment of these provisions in accordance with several factors. The purpose of this assessment is to identify the underlying principles for the taxation of income from services under the UN Model.

4.1 Types of services covered

20. The provisions of the UN Model deal comprehensively with all types of services. However, the treatment accorded to different types of services varies enormously. Several specific types of services, such as government service, employment, pensions, shipping and air transportation, are given special treatment in separate articles of the Model. In contrast, Article 7 deals with business profits generally and includes income from services in certain circumstances.

21. The different treatment of various types of income from services under the UN Model raises difficult issues of qualification. For example, if services are considered to constitute the carrying on of a business, the source country is authorized to tax the income from such services only if, in general, the business is carried on through a PE or a fixed base in the source country. On the other hand, if the services are performed by an employee or an entertainer or sportsperson, the source country is entitled to tax the income from such services simply if the activities take place in the source country.

22. In general, it would be desirable to minimize the qualification issues arising from the different treatment of various types of services. This objective can be achieved by reducing the number of types of income from services dealt with in the UN Model or by minimizing the differences in treatment among the various types of services. It must be recognized, however, that the different treatment of different types of services may be justified. The Subcommittee's work provides an opportunity to ensure that the special treatment of any particular type of income from services is clearly justified.

4.2 Allocation of jurisdiction to tax income from services

23. The fundamental purpose of all of the provisions of the UN Model dealing with services is to allocate the right to tax the income from such services between the residence country and the source country. Three basic allocation patterns are discernible:

1. the right to tax can be allocated exclusively to the residence country (for example, income from international shipping and air transportation is taxable exclusively by the country in which the enterprise has its place of effective management).

2. The right to tax can be allocated exclusively to the source country (for example, social security payments are taxable exclusively by the country making the payment).

3. The right to tax can be shared by both countries. In this situation, the residence country is obligated under Article 23 to provide relief for the tax imposed by the source country by exempting the income earned in the source country or by providing a credit against residence country tax for the tax paid to the source country. If the right to tax is shared by both countries, the source country's right to tax can either be limited or unlimited. Under the existing provisions of the UN Model, the source country's right to tax income from services is always unlimited. Source country taxation is typically limited with respect to dividends, interest, and royalties.

24. The key issue with respect to the allocation of the right to tax income from services is identifying the circumstances in which a source country is entitled to tax such income. When should a country be entitled to tax income from services performed in the country by a resident of the other contracting state? Conversely, when should the source country be denied the right to tax income from services performed in the country by a resident of the other contracting state, with the result that the income is taxable only in the country of residence? The answers to these questions involve difficult judgments about an allocation of taxing rights that should facilitate cross-border trade and investment, should be fair to both the country of source and the country of residence (in this context developing countries are usually in the position of source countries receiving investment from other countries), and should not impose unreasonably onerous compliance burdens on taxpayers. Any taxing rights allocated to a source country should be capable of being enforced effectively although developing countries should not be penalized for having weaker tax administrations than developed countries.

25. Once it has been determined that a source country should be entitled to tax income from services, it is necessary to consider whether that right to tax should be limited or unlimited. Under Article 7, and arguably under Article 14, source country tax is limited to tax on the net income derived. It is appropriate to consider whether unlimited source country taxation with respect to other services is appropriate. More specifically, should a source country be entitled to tax income from services on a gross basis (i.e., at a fixed percentage of the gross amount)?

4.3 Threshold requirement

26. In several circumstances, a source country's right to tax income from services under the provisions of the UN Model is conditional on the satisfaction of a threshold requirement. This threshold is typically based on a quantitative and/or qualitative evaluation of a nonresident's connections with the source country, in particular, the nonresident's involvement in the economic and commercial life of the source country. In some circumstances, the threshold for the taxation of income from services by a source country is very low. For example, for income from employment where the nonresident

employee is paid by an employer resident in the source country or by a nonresident employer with a PE in the source country, the threshold is the performance of any duties of employment in the source country. It does not matter how long the employee is present in the source country, how long this employment is exercised in the source country, or how much income is derived from the employment in the source country. Similarly, the performance of any entertainment or sports activities in the source country is sufficient to give the source country the right to tax the income from such activities. On the other hand, with respect to certain other types of services, the threshold for source country tax is very high. For example, for independent personal services, the nonresident service provider must have a fixed base regularly available to him in the source country or must stay in the source country for 183 days or more. Similarly, for income from services that are business profits, the nonresident service provider must have a PE in the source country or furnish services in the source country for the same or a connected project for more than 6 months.

27. The determination of an appropriate threshold requirement for source country taxation of income from services is a key issue. Together with the treaty rules establishing the income subject to tax by the source country (discussed below), the threshold requirement is the means by which the allocation of taxing rights between the source and residence countries is implemented. The lower that threshold is, more income from services will be taxable by the source country; the higher the threshold, less income will be taxable by the source country and more income will be taxable by the residence country.

4.4 Income subject to tax

28. Once it is established that the threshold requirement for source country tax has been satisfied, it is necessary to determine the income that is taxable by the source country. In most cases, the income taxable by the source country is the income from the services performed in the source country determined in accordance with the domestic tax law of the source country. In the case of business profits and income from independent personal services, only the income attributable to the PE or fixed base in the source country is taxable by the source country. Such attributable income does not include domestic source income that is not attributable to the PE or fixed base. However, in the case of Article 7, attributable income includes income attributable to business activities similar to those carried on through the PE. Attributable income also includes foreign source income attributable to the PE or fixed base, although many countries do not tax such foreign source income under domestic law.

29. It should be noted that under the existing provisions of the UN Model dealing with services, the source country is not generally entitled to tax income from services performed outside the source country. As a result, a source country is not entitled to tax income from services performed outside the country even if the services are consumed in the source country.[1] For example, under Article 5(3)(b) the service activities must take

1 In many situations services may be performed in one country but the services may be used or consumed in another country. For example, a consultant resident in Country X may prepare a report for a client resident in Country Y without visiting Country Y

place "within a Contracting State," under Article 15 the employment must be "exercised in the other Contracting State," and under Article 17 an artiste's or sportsperson's personal activities must be "exercised in the other Contracting State." Moreover, under Article 14(1)(b) only the income derived from a nonresident's "activities performed in that other State" are subject to tax in that state.[2] In certain limited circumstances – remuneration of directors and top-level managers and government service – a source country is entitled to tax if the payer is a resident company or the government of the source country even if the services are not performed in the source country. These provisions should be regarded as exceptions to the general principle that only income from the services performed in the source country are subject to tax by that country.[3]

4.5 Basis of source country taxation permitted

30. Once the income subject to source country taxation has been determined, the computation of the amount of income subject to tax by the source country is a matter for the domestic law of the source country. However, in certain limited circumstances the UN Model prescribes that the source country tax cannot exceed the tax on the net income derived by the nonresident. This is the case with respect to income from services taxable under Article 7 and, arguably at least, Article 14. All other types of income from services, such as employment, entertainment and sports activities, and government services, can be taxed by the source country without any limit; for example, the gross income may be subject to a final withholding tax at a fixed rate.

5. UNDERLYING PRINCIPLES FOR SOURCE COUNTRY TAXATION OF INCOME FROM SERVICES UNDER THE UN MODEL

5.1 Introduction

31. The preceding review of the provisions of the UN Model dealing with services does not reveal any clear underlying principles that might be used to guide a revision of those provisions. The provisions differ significantly depending on the type of services involved, without any apparent justification. They differ as to the threshold requirement for source country taxation, the income subject to source country taxation, and the basis of source country taxation (net or gross). Thus, the existing provisions of the UN Model appear to represent a hodgepodge of *ad hoc* rules that lack any clear rationale.

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or performing any services there. The use of the report by the client in Country Y or the payment for the consultant's services, which would ordinarily be deductible by the client in Country Y, could arguably be seen as justification for the taxation of the consultant's fee by Country Y. Both the UN and the OECD Models reject this as a basis for source country taxation.

2 Even under Article 14(1)(a) income attributable to a fixed base that a nonresident has available in a country is likely to be restricted to income derived from activities in the source country that are connected to the fixed base.

3 The treatment of income derived from insurance under Article 5(6) of the UN Model may be considered as another exception although it is unclear whether insurance services are provided in the country in which the insurer is located or the country in which the risk insured is located.

32. In this section of the note, an attempt is made to determine whether the fundamental inconsistencies in the treatment of income from the various types of services are justified, and if so, why. If the inconsistencies are not justified, they should be reduced or eliminated. If the inconsistencies are justified, then it must be determined if the rationale for the special treatment of a particular type of service should be applied to other types of services. At the conclusion of this section an attempt is made to identify the principles for the taxation of income derived from services that should be generally applicable even though exceptions to those general principles may be recognized in certain limited circumstances.

5.2 Government service

33. Article 19 is based on the principle that the country paying the salary, wages, other remuneration, or pension should have the exclusive right to tax the income. As the Commentary on Article 19 (paragraph 2) indicates, the principle of exclusive taxation by the paying country is based on international courtesy and the Vienna Conventions on Diplomatic and Consular Relations. The Vienna Conventions justify an exception for taxation by the non-paying country where the services are performed in that country by an individual who is a resident or national of that country. The special treatment of government services is generally accepted and justified. Because the underlying rationale for the exclusive source country taxation of amounts in respect of government service is based on international courtesy, the rationale is not applicable to any other types of income from services.

5.3 Pensions and social security payments

34. Article 18A(2) and 18B(2) give exclusive taxing rights to the country paying social security benefits. The rationale for this treatment is that the "payments involved are wholly or largely financed out of the tax revenues of the source country." (Paragraph 4 of the Commentary on Article 18.) This rationale for exclusive source country taxation is clearly justified.[4] It appears to be unique and is not applicable to other types of income from services.

35. Other private pensions in respect of past employment are taxable only by the country in which the recipient is resident (Article 18A(1)) or by both the residence country and the country in which the payer is resident or has a PE (Article 18B(2)). The rationale for source country taxation of pensions is not completely clear. First, it can be argued that a pension is a form of deferred compensation for employment services performed in the source country that should be taxed in the same manner as employment income. Second, for developing countries, pension payments may represent a substantial net outflow because, *vis à vis* developed countries, the flows of pension payments are unlikely to be reciprocal. These two rationales are mentioned in the Commentary on

4 As the Commentary notes, however, this rationale does not apply where the social security benefits are financed largely by private contributions.

Article 18 (paragraph 8). Third, to the extent that the source country has previously allowed a deduction for contributions to a pension plan, the taxation of the pension payments by the source country can be justified as a means of recapturing or offsetting the erosion of the tax base caused by the prior deductions. This rationale is accepted by the OECD as a justification for source country tax (see paragraph 13 of the Commentary on Article 18 of the OECD Model). This rationale is not as persuasive where the past employment services are rendered in countries other than the country from which the pension payments are made. As the OECD Commentary indicates (paragraph 19), in some situations it would be very difficult to allocate pensions to the various countries in which the past employment services were rendered. These compliance problems justify allocating the right to tax pension payments to the country in which the payer is resident or has a PE.

36. The source country taxation of pension payments is easiest to justify in cases where the employment services are rendered exclusively or primarily in the source country and the source country has allowed deductions for pension contributions. However, Article 18 of the UN Model gives the right to tax to the country in which the pension fund that makes the payments is resident. According to the OECD, treating the country in which the pension fund is established as the source country is difficult to justify (paragraph 19.1 of the Commentary on Article 18 of the OECD Model). As a result, although the Commentary on Article 18 of the OECD Model sets out four alternatives for source country taxation of pensions, it points out several arguments against these provisions.

37. The appropriate tax treatment of pensions under tax treaties is dependent on several factors, including the pension flows between the two countries and the tax treatment of pension contributions and pension receipts. As a result, in my view, there is no one treaty provision that is suitable for all countries. Although existing Article 18 of the UN Model presents two alternatives for the taxation of pensions, it seems clear that other possibilities are also defensible. Therefore, perhaps the Commentary on Article 18 should be revised to present additional alternatives for source countries to consider.

38. Because of the special problems with source country taxation of pension payments, there do not appear to be any underlying principles with respect to the treatment of pensions that can or should be applied to other types of income from services.

5.4 Director’s fees and remuneration of top-level managerial officials

39. Fees and remuneration paid by a company resident in a country to directors or top-level managers resident in the other contracting state in their capacity as directors or top-level managers are taxable by the country in which the company is resident. Such income is also taxable by the country in which the directors or managers are resident, but that country must provide relief for the source country tax in accordance with Article 23.

40. The principle underlying Article 16 is not articulated in the Commentary of either the OECD Model or the UN Model. The principle is obviously not the location of the performance of the services by the directors or managers because there is no requirement in Article 16 that the services must be performed in the country in which the company paying the amounts is resident. As a practical matter, it might be difficult to determine where the services of directors or top-level managers are performed and it is probably reasonable to assume that ordinarily such services would be performed primarily in the country in which the paying company is resident. Further, the company paying the fees or remuneration is likely to claim a deduction for such amounts in computing its income tax liability in its country of residence. Since the tax base of the country in which the paying company is resident is eroded by the deduction of the payments, that country should be entitled to tax the payments. This base-erosion rationale for Article 16 is more convincing than the justification set out above, viz., that the country in which the paying company is resident to tax the fees or remuneration is a proxy for the place where the services are rendered. The base-erosion principle applies whether the services are performed in the country in which the paying company is resident or elsewhere.

5.5 Entertainment and sports services

41. Article 17 authorizes unlimited source country taxation of artistes and sportspersons if their activities are exercised in the source country. In this situation, there is no threshold for source country tax. Income from even isolated temporary activities in the source country is taxable. In other words, there is no requirement for a minimum number of days of performance or presence in the source country as there is for other services under Articles 7 and 14. Nor is there any requirement for a minimum amount of revenue or net income. Even small amounts derived by an artiste or sportsperson from activities in the source country are taxable by that country.[5]

42. Therefore, the only requirement for source country taxation of income from artistic and sports activities is that the activities take place in the source country. With respect to other services, however, the source country is not entitled to tax the income simply because the services are performed in the source country. As discussed below with respect to income from services generally, the service provider must have an PE or fixed base in the source country or spend a substantial period working or being present in the source country in order for that country to have the right to tax the income.

43. Therefore, the key issue is what justifies the expanded scope of source country taxation of income from artistic and sports activities compared to income from other services. In my opinion, there is no principled justification for the different treatment of income from entertainment and athletic activities. From a practical perspective, it is understandable why, despite the enforcement difficulties, a country would want to tax nonresident entertainers and athletes who derive large sums from short-term performances in the source country. If taxation of such services is justified then, despite

5 Prior to 2001, Article 14 of the UN Model contained a monetary threshold for professional and other independent services. Very few countries included such a threshold in their bilateral treaties.

the enforcement difficulties, taxation by a source country of any high-value services performed in the source country (or possibly all services performed in the source country) can also be justified.

44. There are several options for revising the provisions of the UN Model to reduce or eliminate the discrepancy between the treatment of artistic and sports activities on the one hand and other services on the other hand. First, Article 17 could be removed, with the result that income from artistic and sports services would be dealt with under Article 7, 14, or 15 depending on the circumstances. This would shift jurisdiction to tax such income from source countries to residence countries and is likely to be unacceptable. Second, income from artistic and sports activities performed as an employee could be removed from Article 17 and dealt with under Article 15. Income from artistic and sports activities derived by non-employees would continue to be dealt with under Article 17. This change would also involve some shifting of jurisdiction to tax from source countries to residence countries although the extent of that shifting would be less than under the first option.[6] Third, the scope of Article 17 could be expanded to deal with more types of high-value services (i.e., situations in which taxpayers other than artistes or sportspersons can earn substantial amounts in a short time in a source country).

45. The major difficulty with this option is defining the types of services to be covered.[7] Potentially many types of services can produce large amounts of income from only short-term activities in a country. However, it may be possible to identify certain service providers who are more likely to be able to earn large amounts in a short period. For example, consultants, speakers (former politicians, former athletes, etc.), broadcast journalists, and movie directors are not significantly different from entertainers and athletes in any relevant way. Fourth, consideration might be given to the introduction of a monetary threshold for source country taxation so that nonresidents earning relatively small amounts of income in the source country are not faced with compliance issues that are disproportionate to the amount of income derived. Otherwise, such compliance problems could discourage cross-border activities, contrary to the fundamental purpose of tax treaties. Although there are some difficulties with a monetary threshold (setting the limit where two currencies are involved, dealing with inflation, etc.), these difficulties are not insurmountable. Despite the elimination of a monetary limit from Article 14 of the UN Model in 2001, in my opinion, such a limit is justifiable as a means of alleviating the compliance burden on nonresident entertainers and sportspersons earning small amounts of income and encouraging cross-border entertainment and sports activities.

5.6 Employment services

46. Source country taxation of income from employment is dependent on three factors:

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6 Employees who are engaged in entertainment or athletic activities would continue to be subject to source country taxation if they are employed by a resident of the source country, by a nonresident with a PE in the source country, or by a nonresident without any PE in the source country if the employees are present in the source country for 183 days or more.

7 A similar difficulty applies to the adoption of special provisions for fees for technical services, as discussed below.

- Where the employment is exercised;
- The period of physical presence of the employee in the source country; and
- Who pays or bears the cost of the employee's remuneration.

47. If the employee is paid by a resident of the source country or the employee's remuneration is borne by a permanent establishment or fixed base of the employer in the source country, the source country is entitled to tax the employment income. In this regard, Article 15 is similar to Article 16. The underlying principle that justifies source country tax is the erosion of the source country's tax base as a result of the deduction of the employee's remuneration by the employer. As a result, the source country is entitled to tax the employment income irrespective of how much the income is or how long the employee spends working in the source country. Although there are compliance problems for nonresidents who are employees in a country for short periods (the necessity to file returns in the source country and claim foreign tax credits in the residence country), these problems are not considered to be sufficient to outweigh the source country's claim to tax.[8] In this situation, the enforcement of source country tax on employment income is handled by requiring the resident employer or nonresident employer with a PE or fixed base in the source country to withhold from the remuneration paid to the employee.

48. If the employee is paid by a nonresident employer and the remuneration is not borne by the employer's PE or fixed base, if any, in the source country, the base-erosion principle does not apply. Instead, the source country is entitled to tax only if the employee is present in the source country for more than 183 days in any 12-month period beginning or ending in the fiscal year. This threshold requirement is based exclusively on the physical presence of the employee in the source country. The fundamental idea seems to be that if the employee spends more than half of the year in the source country, that country is entitled to tax. If, however, the employee spends half or less than half of the year in the source country, only the residence country is entitled to tax the employment income. The primary advantage of this physical presence test is its simplicity. It is relatively easy to determine whether a person is present in a country or not.

49. The threshold for source country taxation of employment income could be framed differently. For example, the source country could be entitled to tax any employment income derived from employment exercised in the source country. In effect, all employment income would be taxed like employment income derived from resident employers or nonresident employers with a PE or fixed base in the source country. This approach would present serious enforcement difficulties where there is no resident employer to withhold the tax from the employment income. Another approach would involve using a threshold based on days of employment rather than days of presence. It would be somewhat more difficult to determine the days of employment. Also, there does not appear to be any clear advantage to adopting a threshold based on the days of employment, in light of the fact that the presence test is well accepted and applied in a

8 It is notable that, to my knowledge, very few countries have *de minimis* exemptions for nonresident employees in their domestic law.

consistent manner by most countries. Arguments can be made that a days-of-employment threshold is more appropriate than a days-of-presence threshold because presence in the source country by an employee for a purpose unrelated to employment is not relevant to a source country's right to tax income from employment. Moreover, a days-of-employment threshold would be consistent with the threshold for income from services under Article 5(3)(b). It would be inconsistent, however, with the days-of-presence threshold in Article 14(1)(b). Overall, in my opinion, the case for changing to a days-of-employment threshold is not convincing especially for developing countries.

50. Consideration could be given to introducing into Article 15(2) an alternative threshold based on the days of employment in the source country. The exemption in Article 15(2) would apply only if the employee was present in the source country for 183 days or less and performed the duties of employment in the source country for less than a certain number of days (for example, 90 days which, assuming a 5-day work week, would represent approximately 4 ½ months). Such a combined threshold makes sense only if a similar combined threshold is adopted for purposes of Article 5(3)(b) and Article 14(1)(b). Such a combined threshold would obviously impose additional administrative burdens on the tax authorities and for this reason cannot be recommended.

51. Another issue with respect to the threshold for employment income is whether the period of presence should be reduced to 120 days or 90 days. There is no clear justification for any particular number of days. The period should be based on a balancing of the source country's right to tax income arising in or having its source in its territory and the compliance and administrative difficulties in collecting the tax. The administrative difficulties in collecting the tax appear to be the same whether the period is 183 days or some shorter period. Obviously, a shorter period would give increased taxing rights over employment income to source countries. If the period of presence for purposes of Article 15 is reduced, the threshold periods for purposes of Articles 5(3)(b) and 14(1)(b) should be reduced in parallel fashion to maintain some measure of consistency. The thresholds for Articles 5(3)(b) and 14(1)(b) are discussed below.

5.7 Service businesses

52. The two general provisions of the UN Model dealing with income derived from services are Article 7 dealing with business profits and Article 14 dealing with professional and independent personal services. Such income is taxable by the source country only if:

1. The taxpayer has a PE or fixed base in the source country and the income is attributable to the PE or fixed base;

2. In the case of professional and independent personal services, the taxpayer "stays" (i.e., is present) in the source country for 183 days or more in any 12-month period beginning or ending in the year and the income is derived from services performed in the source country;

3. In the case of business profits, the taxpayer furnishes services in the source country for the same or a connected project for more than 183 days.

53. In my view, the fixed-place-of-business threshold (i.e., PE or fixed base) that applies to the source country taxation of business profits generally is clearly inappropriate for income from services. That threshold was adopted at a time when most cross-border business activity involved the manufacture or production and sale of goods. In the modern economy cross-border services are much more important. Such services can usually be performed without the need for any fixed place of business and certainly without the need for a permanent (more than 6 months) fixed place of business. If a resident of one country provides services in the other country through a fixed place of business in the other country that exists for more than 6 months, that country should clearly have the right to tax the income. However, the country in which services are performed should also have the right to tax where the services are not performed through a fixed place of business that exists for at least 6 months.

54. Articles 5(3)(b) and 14(1)(b) of the UN Model provide two alternative threshold requirements. Article 14(1)(b) is a days-of-presence threshold similar to that in Article 15(2). Article 5(3)(b) is a days-of-work threshold. The length of time for both thresholds, 183 days or 6 months, is superficially similar; however, assuming a 5-day work week, 183 days of presence represents approximately 130 days of work, and 183 days of work represents approximately 255 days of presence.

55. As discussed in connection with the treatment of employment income, the choice between a days-of-presence and a days-of-work threshold is not an easy one. Each has advantages and disadvantages. However, whatever threshold is adopted, it should apply to all types of services unless there are compelling reasons for some different threshold. If the thresholds used for Articles 7, 14, and 15 are consistent, it will be easier for taxpayers and tax officials to apply the provisions of the treaty. For countries that wish to delete Article 14 from their treaties, one consequence would be that the same threshold would be applied to both professional and other independent services and to other business services. For countries that wish to retain Article 14, the threshold for source country taxation of services dealt with under both Articles 7 and 14 should be the same. In my view, there is no justification for different thresholds to be used for independent personal services under Article 14 and for other business services under Article 7. Furthermore, the threshold for source country taxation of employment income under Article 15 should be consistent with the thresholds under Articles 7 and 14.

56. One option, raised above in connection with employment income, which avoids the necessity of choosing between a days-of-presence threshold and a days-of-work threshold would be to use a combined days-of-presence and days-of-work threshold for purposes of Articles 7, 14, and 15. Under this option, the source country would be entitled to tax income from services performed in the source country if the taxpayer was present in the source country for a specified number of days or worked in the source country for a specified number of days. Another option would be to revise the

Commentary to give countries the choice of using a days-of-presence or a days-of-work threshold.[9]

57. In any case, the key issue is whether the existing thresholds – 183 days of presence or 183 days of work — are still appropriate or whether they should be reduced. According to the Commentary on Article 7 of the OECD Convention at paragraph 9 and noted at paragraph 9 of the Commentary on Article 7 of the UN Model, "it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights." Therefore, the fundamental policy issue is, at what point can an enterprise of one state be considered to be participating sufficiently in the commercial and economic life of another state to justify taxation of the enterprise by that other state. A threshold of 183 days of either presence or work can be argued to be appropriate because it is consistent with the 6-month minimum time requirement for a PE.

58. On the other hand, where nonresident service providers are paid by residents of a country or nonresidents with a PE in the country, base erosion considerations would seem to justify a lower or no threshold for source country tax, as is the case for employment income and income from entertainment or sports activities. Compliance and administrative enforcement considerations would not appear to be significantly greater for independent service providers than for employees. Many countries impose an obligation to withhold on residents and nonresidents with a PE in the country making payments to nonresidents for services rendered.

59. In summary, there is no compelling reason to reduce the threshold for source country taxation of services to less than 183 days. By the same token, there is no compelling reason not to reduce that threshold to 90 or 120 days. In my view, if a resident of one country spends 90 days working in another country, the resident is participating sufficiently in the economic life of that other country to justify that country exercising its jurisdiction to tax the income derived from the services performed in its territory. Perhaps the 183-day threshold should be left unchanged in Articles 5, 14, and 15, but the Commentary could be revised to allow countries to agree to a lower threshold in their bilateral treaties in appropriate circumstances. For example, for countries for which the flow of cross-border services is reciprocal, a higher threshold may be more appropriate than for countries for which the flow is disproportionate. Typically, the flow of cross-border services will be disproportionate between developed and developing countries.

60. The 2008 Update to the OECD Model added to the Commentary on Article 5 (paragraph 42.23) an alternative services PE rule that countries may include in their treaties. This alternative provision was included in recognition of the fact that some countries wish to exert taxing rights with respect to income from services performed in

[9] As noted above, these alternative thresholds should be reasonable approximations of one another. Therefore, it would not be appropriate to use the same time period (e.g. 183 days) for both thresholds.

their territories in circumstances where the taxpayer does not otherwise have a PE in the source country. The alternative OECD provision builds on the provision of Articles 5(3)(b) and 14(1)(b) of the UN Model and reads as follows:

> "Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State
>
> *a)* through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
>
> *b)* for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State
>
> the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual."

61. In effect, the OECD alternative provision applies in two circumstances:

- services are performed in the source country by a single individual who is present there for 183 days or more and a gross-revenue test is satisfied, or
- services are performed in the source country by one or more individuals who are present and performing services there for 183 days or more on the same or a connected project.

If either of these tests is satisfied, the enterprise is deemed to have a PE in the source country unless the services are limited to preparatory or auxiliary activities.

62. The gross-revenue test is intended to deal with situations where an individual provides services in the source country on behalf of a corporation, partnership, or sole proprietorship. In the absence of this rule, the source country would be entitled to tax the employment income derived by the employee, but not the income from the services provided by the employer (corporation, partnership, or sole proprietorship) because the employer would not have a PE in the source country. This type of avoidance of source

country tax is possible under Articles 5(3)(b) (assuming that otherwise there is no PE) and 14(1)(b) of the UN Model.[10] The gross-revenue test is somewhat similar in effect to Article 17(2), which allows a source country to tax income from artistic and sports activities occurring in the country even though the income accrues to someone other than the performer. Although the gross-revenue test imposes an additional administrative burden on the tax authorities because of the need to determine the worldwide revenue of the enterprise in question, it is an anti-avoidance rule that in many cases may operate on a prophylactic basis.

63. In certain limited respects, the OECD alternative services PE rule represents an improvement on Articles 5(3)(b) and 14(1)(b) of the UN Model. The provisions of Articles 5(3)(b) and 14(1)(b) of the UN Model dealing with services should be revised to incorporate the improvements reflected in the OECD alternative services PE provision. However, not all aspects of the OECD alternative services PE provision should be incorporated into the provisions of the UN Model. The OECD alternative services PE provision contains certain restrictions on source country taxation of income from services that are, arguably at least, inappropriate in the context of the UN Model, although they may be appropriate in treaties between OECD member countries.[11]

64. A complete discussion of the OECD alternative services PE provision is beyond the scope of this note. As part of its ongoing work, the Subcommittee should conduct a detailed study of the OECD alternative services PE provision with a view to making recommendations for the incorporation of various aspects of that provision into the UN Model and Commentary.

5.8 Construction

65. Construction and related activities are deemed to be a permanent establishment if the building site, construction, assembly or installation project, or supervisory activities last more than 6 months. The 6-month period applies to each site or project (paragraph 10 of the Commentary on Article 5). In my view, there is no clear, principled basis for treating construction and related activities differently from service activities generally.

66. In general, the 6-month threshold for source country taxation of construction and related activities is the same as the time threshold for other service activities under Article 5(3)(b) (although originally the time threshold for a fixed place of business PE under Article 5(1) was probably 12 months). In addition, both thresholds probably apply on a project-by-project basis.[12]

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10 Under Article 7(1)(c) of the UN Model the country in which a PE is situated is entitled to tax profits attributable to business activities carried on in that country "of the same or similar kind as those effected through that permanent establishment." Although Article 7(1)(c) would not apply in this situation because the enterprise that derives the income and the enterprise that has the PE are different, it presents the possibility of dealing with the problem through a force of attraction rule.

11 For example, the administration of a gross revenue test may be difficult for developing countries. As a result, alternatives to the gross revenue test should be explored.

12 It is arguable that building sites, construction, assembly and installation projects under Article 5(3)(a) must meet the requirements of Article 5(1). If so, Article 5(3)(a) would apply on a place-by-place rather than a project-by-project basis.

67. The justification for the 6-month period is set out in the Commentary on Article 5:

> … the goal of the treaty is to promote international trade and development, and the idea behind the time limit is that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the latter State, so as to facilitate a more permanent and larger commitment at a later stage.

68. This rationale is not very persuasive since it assumes that short-term projects will lead to longer-term projects. An alternative would be to delete the threshold entirely so that a country would be entitled to tax the income derived from any construction or related activities taking place in its territory. In other words, income from construction and related activities would be treated the same as income from entertainment and sports activities. In principle, this result appears reasonable as long as the source country imposes tax on the net income from the activities. It would, however, create some compliance problems for taxpayers and discourage cross-border construction activities to a certain extent. It might also present some enforcement problems for the tax authorities of the source country.

69. A possible compromise between the existing 6-month threshold and the elimination of the threshold entirely is to reduce the threshold for source country tax to 90 or 120 days[13] and to eliminate the requirement for each project or site to be treated separately. Similarly, the "same or a connected project" requirement for services generally would be eliminated. Such a reduced threshold represents a reasonable balance between the interests of source countries in taxing income-earning activities occurring in their territories and the need to facilitate cross-border trade and investment. However, it is difficult to justify, in principle, a lower threshold for construction services that for other services.

70. The application of the time threshold on a project-by-project basis is justified in the Commentary (paragraph 12 of the Commentary on Article 5) as follows:

> … it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of three months' duration and another with two unrelated projects, each of three months' duration, one following the other.

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13 Such a reduced threshold is currently used in several bilateral treaties.

71. This justification is not convincing. The fact that projects are not connected does not reduce in any way the extent of an enterprise's involvement in the economic life of the source country. Also, the project-by-project approach causes, rather than reduces, uncertainty because it necessitates a difficult determination of whether two or more projects are part of the same project or are connected. A provision that counts any day during which an enterprise engages in construction activities in the source country appears to be easier for taxpayers to comply with, less susceptible to manipulation, and easier for the tax authorities of the source country, especially the tax authorities of developing countries with limited resources, to apply. Even this approach, however, creates an undesirable distinction between an enterprise with simultaneous projects that last for less than the time threshold and an enterprise with consecutive projects that considered separately do not exceed the threshold but that taken together exceed the threshold. The effects of this distinction would likely be reduced if the time threshold were reduced to 90 or 120 days.

5.9 Insurance

72. Article 5(6) of the UN Model authorizes source country taxation of income from insurance if an enterprise collects insurance premiums or insures risks located in the source country. This provision represents a special exception to the dependent-agent rule. In the case of an insurance business, source country taxation is not conditional on a dependent agent having authority to conclude contracts on behalf of the enterprise and habitually exercising such authority. All that is required is the performance of certain activities – collecting premiums or insuring risks – taking place in the source country. An exception is made if the activities in the source country are carried out by an independent agent.

73. Article 5(6) is similar to Article 17 and Article 15 insofar as it applies to employees paid by a resident employer or a nonresident employer with a PE or fixed base in the source country. There is no time or other threshold for source country tax. If certain activities that are key to the business of providing insurance coverage – collecting premiums or insuring risks – occur in a source country, it has the right to tax. Article 5(6) can be justified on the basis that, in the absence of special rules, the nature of the insurance business would allow extensive insurance business to be carried on in a country by a nonresident enterprise without any fixed place of business and without dependent agents with authority to conclude contracts. In principle, if an enterprise carries on extensive business activities in a country for an extended period, even if the activities are not carried out through a PE or fixed base, that country should be entitled to impose tax on the income derived from the activities in its territory.

5.10 Basis of taxation

74. In contrast to other types of income from services, income from services dealt with under Articles 5 and 7 are taxable on a net basis. The source country is given the right to tax but its tax is limited to tax on the net income determined in accordance with

the rules in Article 7. One of these rules (Article 7(3)) is that deductions must be allowed for expenses incurred by the enterprise in earning income attributable to the PE. This rule can be justified by reference to common sense and principles of fairness and neutrality. In most circumstances, earning income from business activities, including services, involves substantial expenses. If the deduction of relevant and appropriate expenses is not allowed, a nonresident enterprise might be subject to excessive taxation by the source country. Such excessive taxation would seriously discourage cross-border trade and investment, contrary to the fundamental goal of tax treaties. The denial of deductions to nonresident service providers would also constitute discrimination against such nonresidents, contrary to the principle in Article 24(3).[14]

75. The requirement to tax only net income makes it more difficult for a source country to collect tax on nonresident service providers. A source country cannot collect its tax through a final gross-basis withholding tax with the obligation to withhold imposed on residents paying fees to nonresident service providers. Interim withholding on such payments can be required; but nonresidents must be entitled to file returns reporting their net income and to claim refunds for any excessive withholding. The additional administrative burden imposed on source countries in this regard is justified by the need to be fair to nonresident service providers.

76. Given the foregoing analysis, it is surprising that other provisions of the UN Model dealing with services do not require taxation on a net basis. For example, taxation on a gross basis is permitted under Articles 15, 16, 17, 18, 19, and, arguably at least, under Article 14. In my view, the taxation of professional and other independent services on a gross basis under Article 14 is very difficult to justify. There are no relevant differences between professional and other independent services and services taxable under Article 7 that can justify a different, and potentially more onerous, basis of taxation for professional and other independent services.[15] The taxation of employment income, director’s fees, remuneration of top-level managers, social security benefits, and remuneration for government service on a gross basis can be justified on the ground that, typically, few expenses are incurred in earning these types of income. Therefore, with respect to these types of income from services, the interests of the source country to collect the tax effectively and efficiently outweigh the interests of the nonresident service providers in being taxed on a net basis.

77. Taxation of artistes and sportspersons on a gross basis under Article 17 is also difficult to justify. These service providers typically incur significant expenses in earning their income. In principle, source countries should be required to tax artistes and sportspersons on a net basis. Although allowing nonresident artistes and sportspersons to file returns and claim refunds would impose administrative burdens on the tax authorities of source countries, these burdens would be no different from the administrative burdens associated with the taxation of nonresidents engaged in other business activities under

[14] Note that the provisions of Articles 7(3) and 24(3) do not require a source country to give deductions to nonresidents for expenses that are not deductible by residents of the source country in the same circumstances.

[15] For this reason, the Note on Article 14 prepared for the Subcommittee on Article 14 recommends that Article 14 should be amended to require net basis taxation.

Article 7 currently. The fact that nonresident artistes and sportspersons are present in a source country for what may be very short periods does not justify taxing such persons on a gross basis. As long as amounts paid to such persons can be subjected to withholding at source, in principle, those persons should be entitled to file returns and pay tax on a net basis.

6. SUMMARY OF GENERAL PRINCIPLES FOR THE TAXATION OF SERVICES UNDER THE UN MODEL

78. This section of the note summarizes what I consider to be the general principles that apply to the taxation of income derived from services. These general principles should guide any revisions of the provisions of the UN Model. Although these principles are generally applicable, they are subject to several exceptions for certain types of services (for example, government service and remuneration of directors and top-level managers).

6.1 Source principle

79. A source country should be limited to taxing income from services performed in the source country. Income from services performed outside the source country should not generally be taxable by the source country. To the extent that services are performed in a country there is a clear nexus between the income from those services and that country which justifies that country's right to tax the income. Moreover, the performance of services in the country will generally require the presence of individuals in the country for that purpose. The presence of those individuals will provide the source country with the opportunity to gather information and enforce its tax. Article 16 (Director's Fees and Remuneration of Top-Level Managerial Officials) and Article 18 (Pensions) constitute exceptions to this general principle. These exceptions are justified because they are limited and represent situations in which it is very difficult to determine where the services are performed or in which the services are performed in different countries.

6.2 Threshold principle

80. A source country should be entitled to tax income from services only if the nonresident service provider is present or works in the source country for a substantial period. Such a threshold facilitates cross-border trade in services by reducing the compliance burden for taxpayers whose presence and activities in the source country are limited. The threshold should be based on a days-of-presence threshold or possibly a combined days-of-presence and days-of-work threshold.

81. An exception to this threshold requirement for entertainment and sports activities is difficult to justify. Other than the amount of revenue that can be earned in a short period by big-name stars, there is no relevant difference between entertainment and sports activities and other services. If a threshold based on days-of-presence or days-of-

work is rejected, a monetary threshold should be added to Article 17. Moreover, Article 17 should be expanded to deal with more types of high-value services.

6.3 Base-erosion principle

82. The base-erosion principle supports source country taxation of income from services derived by nonresidents if the payments for the services are deductible against the tax base of the source country. This principle is the basis for the taxation of employment income by the source country if the employer is a resident of the source country or has a PE or fixed base in the source country. Theoretically, the principle could be applied much more broadly. The broader the application of this principle, however, the more it conflicts with the threshold principle described above. Thus, it is a question of which principle should prevail with respect to particular types of services. Under the existing provisions of the UN Model, the threshold principle is clearly the dominant one since the base-erosion principle applies only to certain employment income, director's fees, and remuneration of top-level managers.

6.4 Enforcement principle

83. In principle, jurisdiction to tax income from services should be allocated to a source country only if the tax can be effectively and efficiently collected. This general principle does not mean that jurisdiction to tax income from services should not be allocated to developing countries that have difficulty taxing income derived from services performed by nonresidents. It means that jurisdiction to tax such income should not be allocated to source countries if, even with efficient tax administration, the tax would be impossible or extremely difficult to collect.

6.5 Net basis taxation principle

84. In general, income should be taxed on a net basis unless the expenses incurred to earn the income are negligible or the nature of the income requires taxation on a gross basis as the only effective means of collecting the tax. Although the principle of net basis taxation is advanced here as a general principle, it is restricted to Article 7 and perhaps Article 14 of the existing provisions of the UN Model. In my opinion, net basis taxation should be extended to other types of income from services, such as income of artistes and sportspersons under Article 17. Moreover, if a special provision is adopted to allow source country taxation of technical services under special rules, the source country should be required to tax such fees on a net basis.

85. As an alternative to net basis taxation of income of artistes and sportspersons and technical fees, source countries could be allowed to impose tax on the amount of the gross payments at a flat rate, but the amount of that tax would be limited to a fixed percentage, as it is with respect to dividends, interest, and royalties under Articles 10, 11, and 12.

7. FEES FOR TECHNICAL AND OTHER SIMILAR SERVICES

86. Both the UN Model and the OECD Model make a distinction between business income and investment income. Income from services performed in a country that is taxable under Article 7 or (arguably) 14 is taxable on a net basis; any expenses incurred in earning the income are deductible in computing the amount of income subject to tax. Tax is usually levied on business profits by an assessment process whereby nonresidents file annual tax returns reporting their gross revenues and deductible expenses and tax is assessed on the reported amounts subject to verification and adjustment by the tax authorities. In contrast, the gross amount of investment income, such as dividends, interest, and royalties, derived by nonresidents from sources in a country is subject to a withholding tax that cannot exceed a specified percentage of the gross amount of the payment. The withholding tax is often a final tax that eliminates the need for nonresidents to file tax returns, but also prevents them from deducting relevant expenses and paying tax on net income.

87. This distinction between business and investment income is a fundamental part of the structure of the UN and OECD Models. Both Models provide for business profits derived by nonresidents to be taxed on a net basis and prohibit countries from imposing discriminatory taxation on nonresidents. In contrast, tax treaties usually restrict source country taxation of dividends, interest, and royalties to a fixed percentage of the gross amount of the payment.

88. The distinction between business and investment income is problematic with respect to technical and other similar fees for services. If such fees are paid to a nonresident by a resident of the source country or a nonresident with a PE or fixed base in the source country, the fees will generally be deductible in computing the income of the payer and reduce the source country's tax base. If the nonresident receiving the fees does not have a PE or fixed base in the source country, the amounts will not be taxable by the source country under Article 7 or 14. If the amounts qualify as royalties under Article 12, they would be deductible but would be taxable by the source country at a flat rate (established through bilateral negotiations) on the gross amount of the payment. However, fees for technical and other services are not included in the definition of royalties in Article 12(3) because that definition is limited to payments for the use of, or the right to use, intellectual property, equipment, or information.

89. The erosion of the source country's tax base by payments for technical services and the inability of the source country to tax such payments 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.

90. This result is difficult to justify where the services provided by the nonresident constitute carrying on a business in the source country. The fundamental scheme of the UN Model is that business profits from services are taxable by a source country only if the nonresident has a PE or fixed base in the source country. Otherwise the profits are taxable exclusively by the residence country. Moreover, if the income derived by a nonresident is qualified as royalties rather than business profits, source country tax is limited to a fixed percentage of the gross amount of the royalty payments. Therefore, allowing unlimited source country taxation of fees for technical services as other income under Article 21 is inappropriate. Earning fees from the performance of technical services typically involves significant expenses. Therefore, any source country tax should be imposed on a net basis or should be limited if imposed on the gross amount of the payments.

91. In principle, business profits should be taxable on a net basis at the applicable rates imposed by the source country. If a nonresident's economic connections with a country do not meet or exceed a minimum threshold, the country should not tax the nonresident's business profits derived from the country. However, 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 nonresident derives interest, royalties, technical fees or other similar amounts that do not form part of the nonresident's business profits, it is appropriate, in my opinion, 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.

92. This result could be achieved by amending the UN Model in a variety of ways. First, Article 21 could be amended to provide that source country taxation of fees for technical and other similar services performed in the source country cannot exceed 15% (or a percentage established by bilateral negotiations) of the gross amount of the fees. The primary difficulty with this approach is that it would require a definition of technical and other similar services. Second, a new article could be added to the UN Model authorizing the source country taxation of fees derived by a resident of one state from the performance of technical and other similar services in the other state. The source country tax would be limited to 15% (or a percentage established by bilateral negotiations) of the gross amount of the fees. As with the first option, the primary difficulty with this option is the need to define the technical and other services covered by the provision. Third, the definition of "royalties" in Article 12(3) could be revised to include fees for technical and similar services. Again, the difficulty is defining the technical and other services to be treated as royalties. Fourth, a radically different solution would be to treat a domestic subsidiary as a PE of its nonresident parent corporation. Although this fourth option would not affect income from technical and other services provided by a nonresident in the source country to persons with whom the nonresident is dealing at arm's length, it would deal effectively with many intercorporate technical and related services. It seems to me that these intercorporate services are the most serious aspect of the problem. If such intercorporate services are taxable by the source country, the incentive for multinational

corporations to strip profits out of source countries through fees for non-arm's-length technical and other services will be eliminated, or at least significantly reduced.

93. Under Article 5(8) of the UN Model, a subsidiary corporation is not considered to be a PE of its nonresident parent corporation as a result, simply, of the control of the subsidiary exercised by the parent corporation. Similarly, a parent corporation is not considered to be a PE of any of its subsidiary corporations by reason of that control relationship alone. Although this rule may have implications with respect to services provided by one corporation to a related corporation, it applies more generally and therefore, it is not discussed here comprehensively.

94. Usually a nonresident corporation can carry on business in a country directly through branch operations or through a subsidiary corporation established in the country. In the case of a branch, the nonresident enterprise will be subject to source country taxation if it has a PE or fixed base in the country. If, however, it establishes a domestic subsidiary to carry on the business, the subsidiary will be subject to source country taxation on its worldwide income, or at least on its domestic source income, (depending on whether the source country taxes on a worldwide or territorial basis) without any threshold requirement. Therefore, Article 5(8) is irrelevant with respect to source country taxation of the profits of the subsidiary. The significance of Article 5(8) is that it limits source country taxation of income derived by the nonresident parent corporation from its subsidiary. Such income could take the form of dividends, interest, royalties, or income from services, such as management or technical services, provided by the parent to the subsidiary or vice versa.

95. Under the existing provisions of the UN Model, if a nonresident parent corporation provides services to its subsidiary, the income derived by the parent will often not be subject to source country taxation because the parent will not ordinarily have a PE or fixed base in the source country.[16] The payments by the subsidiary will be deductible in computing its income and will thus erode the tax base of the source country. This problem would be eliminated if the subsidiary were deemed to be PE of its nonresident parent corporation. Thus, any income derived by the parent corporation from services provided to its subsidiary would be subject to source country taxation in accordance with the rules of Article 7. Under this option, it would not appear to be necessary to define technical and other related services because all income from services provided to a subsidiary would be covered.

96. The function of a threshold requirement, such as a PE or fixed base, is to preclude source country taxation of the business profits of a resident of the other country unless that resident has substantial economic connections with the source country. The establishment or ownership of a subsidiary corporation in a country is usually indicative

[16] If a parent corporation uses the business facilities of its subsidiary to carry on its own business for the required time, the parent corporation may be considered to have a PE in the country in which the subsidiary is established. See the Commentary on Article 5, paragraph 3 of the UN Model: "the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance, where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise." It is often difficult for the tax authorities to obtain the necessary evidence to establish that a PE exists in these situations, and it is usually easy for the parent corporation to plan its affairs to avoid having a PE.

of a substantial economic connection with that country. The existence of a subsidiary provides certainty for taxpayers and the tax authorities. The compliance burden on a nonresident parent corporation does not seem to be a serious impediment to source country taxation because the subsidiary must comply with the tax laws of the source country. The existence of a domestic subsidiary provides the source country with an effective means of enforcing any tax liability on the nonresident parent corporation. The relevant payments by a subsidiary to its nonresident parent can be subject to source country withholding.

97. Treating a subsidiary corporation as a PE of its nonresident parent corporation presents a number of problems. For example, it would be necessary to define a subsidiary corporation. It would also be necessary to deal with payments to related entities rather than to the parent corporation itself. For example, if a subsidiary makes payments for services rendered by an entity related to the parent (whether the related entity is resident in the same country as the parent or in another country), the source country would not be able to tax the income from the services unless the subsidiary was considered to be a PE of the related entity. Therefore, the extension of the PE definition to include subsidiary corporations would be easy to avoid unless special rules are adopted to deal with payments to related entities.

98. In principle, whether the source country taxes on a gross or net basis, some minimum threshold requirement, other than the existence of a PE or fixed base, for source country taxation of fees for technical and similar services is desirable. However, in my opinion, an alternative threshold based on a monetary amount, days of presence, or days of work is not feasible in this context.

8. RECOMMENDATIONS

99. As this note is merely the first step in the work of the Subcommittee on Services, it is inappropriate at this stage to make firm recommendations for changes to the provisions of the UN Model dealing with services. The analysis in this note is intended to provide a platform for decisions about further work on possible changes to the UN Model. Recommendations concerning the issues that should be studied further are set out below. No attempt has been made to assign priorities to these issues. For convenience, the issues are divided into two categories: policy changes and changes in wording.

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

100. 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 …"

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