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Taxation of Services

Taxation of Services

Report of the Coordinator (Ms. Liselott Kana)

The Subcommittee on Tax Treatment of Services met from 18-19 May 2016 in Bern, Switzerland. The Subcommittee is grateful to the Swiss Government and in particular its State Secretariat for International Financial Matters (SIF) for hosting that meeting, and to the European Commission, particularly its Directorate-General for International Cooperation and Development (DG DEVCO), for its assistance, especially in ensuring sufficient developing country participation at the meeting.

The Subcommittee's mandate is as follows:

> The Subcommittee is mandated to address the issue of the taxation treatment of services in general in a broad way.
>
> The particular issue of taxation of fees for technical services will be addressed by presenting wording, including different options, for the text of the Article on Technical Services at the tenth annual session in 2014.
>
> Recognizing the extensive work that is required, the Subcommittee will report at the tenth and subsequent annual sessions.

The Members of the Subcommittee (serving in their personal capacity) are: Ms. Liselott Kana (Coordinator, Chile); Mr. Andrew Dawson (UK); Mr. El Hadji Ibrahima Diop (Senegal); Mr. Henry John Louie (USA); Mr. Eric Nii Yarboi Mensah (Ghana); Ms. Pragya S. Saksena (India); Mr. Christoph Schelling (Switzerland); Mr. Stig B. Sollund (Norway); Mr. Mohammed Baina (Morocco) Ms. Ingela Willfors (Sweden); Mr. Ignatius Kawaza Mvula (Zambia).

The assistance of others in helping the Subcommittee meet its mandate is also gratefully recalled. The key involvement of Professor Brian Arnold over several years in drafting work on Technical Services is especially acknowledged.

The Committee approved the text of a new Fees for Technical Services Article as extracted at **Annex 1**, at its eleventh session in 2015. The Subcommittee proposes that it be included in the next Update of the UN Model as Article 16, a placement that seems most appropriate to the nature of the Article.

The Draft Commentary at **Annex 2** is provided for approval by the Committee at its twelfth session, subject to non-substantive editing that may be required for inclusion in the next Model update. It is based upon discussions prior to and at the eleventh session of the Committee as well as the meeting of the Subcommittee in Berne.

A draft of proposed wording to the Commentary on Article 12 to address Fees for Technical Services in the context of that Article, rather than as a separate Article, is at **Annex 3** for approval of the Committee.

Finally, wording is proposed addressing consequential changes to current Articles 23 A(2) and 24(4) (expected to be renumbered as Articles 24 A(2) and 25(4), subject to other changes to the Model. The proposed changes for inclusion in the relevant Commentaries to those Articles are provided at **Annex 4** for approval by the Committee.

Annex 1: Agreed Text for New Article [16] as of 21 October 2015

Article [16] –

Fees for Technical Services

1. Fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, notwithstanding the provisions of Article 14 and subject to the provisions of Articles 8, 16 and 17, fees for technical services arising in a Contracting State may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the fees is a resident of the other Contracting State, the tax so charged shall not exceed ___ percent of the gross amount of the fees [the percentage to be established through bilateral negotiations].

3. The term "fees for technical services" as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is made:

(a) to an employee of the person making the payment;

(b) for teaching in an educational institution or for teaching by an educational institution; or

(c) by an individual for services for the personal use of an individual.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of fees for technical services, being a resident of a Contracting State, carries on business in the other Contracting State in which the fees for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent

personal services from a fixed base situated in that other State, and the fees for technical services are effectively connected with

a) such permanent establishment or fixed base, or

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

In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. For the purposes of this Article, subject to paragraph 6, fees for technical services shall be deemed to arise in a Contracting State if the payer is a resident of that State or if the person paying the fees, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the obligation to pay the fees was incurred, and such fees are borne by the permanent establishment or fixed base.

6. For the purposes of this Article, fees for technical services shall be deemed not to arise in a Contracting State if the payer is a resident of that State and carries on business in the other Contracting State or a third State through a permanent establishment situated in that other State or the third State, or performs independent personal services through a fixed base situated in that other State or the third State and such fees are borne by that permanent establishment or fixed base.

7. Where, by reason of a special relationship between the payer and the beneficial owner of the fees for technical services or between both of them and some other person, the amount of the fees, having regard to the services for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the fees shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Annex 2: Draft Commentary: Article [16] Fees for Technical Services

Article [16]

FEES FOR TECHNICAL SERVICES

A. General Considerations

1. Article [16] was added to the United Nations Model Convention in 2017 to allow a Contracting State to tax fees for certain technical services made to a resident of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States. Under this Article, a Contracting State is entitled to tax fees for technical services if the fees are paid by a resident of that State or by a non-resident with a permanent establishment or fixed base in that State and the fees are borne by the permanent establishment or fixed base; it is not necessary for the technical services to be performed in that State. Fees for technical services are defined to mean payments for services of a managerial, technical or consultancy nature.

2. Until the addition of Article [16], income from services derived by an enterprise of a Contracting State was taxable exclusively by the State in which the enterprise was resident unless the enterprise carried on business through a permanent establishment in the other State (the source State) or provided professional or independent personal services through a fixed base in the source State. With the rapid changes in modern economies, particularly with respect to cross-border services, it is now possible for an enterprise resident in one State to be substantially involved in another State's economy

without a permanent establishment or fixed base in that State and without any substantial physical presence in that State. In particular, with the advancements in means of communication and information technology, an enterprise of one Contracting State can provide substantial services to customers in the other Contracting State and therefore maintain a significant economic presence in that State without having any fixed place of business in that State and without being present in that State for any substantial period. The OECD/G20 Base Erosion and Profit Shifting Project, Action 1: Final Report "Addressing the Tax Challenges of the Digital Economy" (2015) illustrates the difficulties faced by tax policy makers and tax administrations in dealing with the new digital business models made available through the digital economy. The Report did not recommend, for the time being, a withholding tax on digital transactions (which include digital cross border services); nor did it recommend a new nexus for taxation in the form of a significant economic presence test. However, it was recognized that countries were free to include such provisions in their tax treaties, among other additional safeguards against BEPS.

3. Before the introduction of Article [16], countries were faced with more restrictive rules of application when technical services were provided cross border. In general, the rules under Article 7, together with Article 5, and Article 14 of the United Nations Model Convention give limited scope for taxing such services, in particular without a fixed base or permanent establishment in the State of source. As noted in these Commentaries, countries have different interpretations of those rules, which can make their application difficult for all parties.

4. Furthermore, under Article 12 of the United Nations Model Convention, fees for technical services paid by a resident of one Contracting State to a resident of the other Contracting State cannot generally be taxed as royalties by the State in which the payer is resident. However, some countries take the view that the expression "information

concerning industrial, commercial or scientific experience" includes certain technical services, as noted in paragraph 5 below. Article 12 permits a Contracting State in which royalties arise to tax the gross amount of the royalty payments at a rate to be negotiated between the Contracting States. Royalties are defined in Article 12, paragraph 3 to mean payments for the use of, or the right to use, any copyright, patent, trademark, design, plan, secret formula or process, any industrial, commercial or scientific equipment, or information concerning industrial, commercial or scientific experience. In other words, royalties are payments for the use of, or the right to use, intellectual property, equipment or know-how (information concerning industrial, commercial or scientific experience). Thus, royalties involve the transfer of the use of, or the right to use, property or know-how. In contrast, when an enterprise provides services to a customer, it does not typically transfer its property or know-how or experience to the customer; instead, the enterprise simply performs work for the customer. Under a so-called "mixed contract," an enterprise may provide both services and the right to use property or know-how to a customer. In such situations, in accordance with paragraph 12 of the Commentary on Article 12 (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention), the payments under the contract must be disaggregated into separate elements of payments for services and royalties unless one element is only ancillary and largely unimportant. The negotiation of a rate of tax for fees for technical services under Article [16] that is the same as the rate for royalties in Article 12 may help to alleviate difficulties with mixed contracts, may be useful for developing countries with scarce administrative resources and may also reduce potential conflicts in applying the article.

5. In addition, countries have different interpretations of the meaning of the expression "information concerning industrial, commercial or scientific experience" in Article 12, paragraph 3 of the United Nations Model Convention (the same wording is contained in

Article 12, paragraph 2 of the OECD Model Convention). Some countries take the position that the provision of brain-work and technical services are covered by this phrase, and therefore payments for such services are in general taxable under Article 12. (See paragraphs 14 and 16 of the Commentary on Article 12.)

6. The uncertainty concerning the treatment of fees for technical and other similar services under the provisions of the United Nations Model Convention as it read before 2017 was undesirable for both taxpayers and tax authorities. It may also have resulted in difficult disputes, both for taxpayers and administrations, consuming scarce resources, as well as causing unrelieved double taxation or double non-taxation.

7. Fees for technical services may also result in the erosion of the tax base of countries that are prevented from taxing such fees by the provisions of the United Nations Model Convention. Fees for technical services are usually deductible against a country's tax base if the payer is a resident of the country or a non-resident with a permanent establishment or fixed base in the country. The reduction or erosion of a country's tax base by deductible fees for technical services is not generally objectionable. If the payer is an enterprise, the payments are legitimate expenses incurred by the payer for the purpose of earning income and should be deductible (assuming, of course, that the amount of the payments is reasonable). If the country is entitled to tax the non-resident service provider on the fees earned for the technical services, the reduction of the country's tax base by the deductible payments is offset by the country's tax on those fees.

8. Where technical services are provided by an enterprise of one Contracting State to an associated enterprise in the other Contracting State, there is the possibility that the payments may be more or less than the arm's length price of the services. Within a multinational group, fees for technical services may sometimes be used to shift profits

from a profitable group company resident and operating in one country to another group company resident in a low-tax country. Assume, for example, that Company B, an enterprise resident in Country B, a low-tax country, provides managerial, technical or consultancy services to Company A, an associated enterprise resident in Country A, a high-tax country. Assuming that the tax treaty between Country A and Country B contains provisions following those of the United Nations Model Convention, Company B can avoid having a permanent establishment in Country A by not establishing a fixed place of business in Country A and by not furnishing services in Country A for more than 183 days in any 12-month period. Thus, before the adoption of Article 16, even if Company B was subject to tax on its income from services provided to Company A under the domestic tax law of Country A, the income would not have been taxable by Country A as a result of the tax treaty between Country A and Country B. If, for whatever reason, Company B is not taxable by Country B on that income, or is subject to a low rate of tax on such income, the multinational enterprise will have effectively shifted profits from a relatively high-tax country (Country A) to a relatively low-tax country (Country B).

9. In addition, ordinarily the fees paid by Company A to Company B for the services would be deductible by Company A in computing its income subject to tax by Country A. This deduction reduces the tax base of Country A and, before the adoption of Article 16, Country A would not have been able to impose tax on the payments by Company A to Company B, as discussed in paragraph 8, to offset the effect of the deduction. However, under Article [16], if the fees for technical services were paid to a resident of Country A or a non-resident of Country A with a permanent establishment or fixed base in Country A, Country A would be entitled to tax those fees.

10. The base erosion and profit shifting illustrated in the example above raise serious concerns for both developed and developing countries. However, the problem is

especially serious from the perspective of developing countries, because they are disproportionately importers of technical services and often lack the administrative capacity to control or limit such base erosion and profit shifting through anti-avoidance rules in their domestic law and tax treaties.

11. The inability of countries to tax fees for technical services provided by non-resident service providers under the provisions of the United Nations Model Convention before the addition of Article [16] may have given non-resident service providers, in certain circumstances, a tax advantage over domestic service providers. Fees for technical services provided by domestic service providers are subject to domestic tax at the ordinary rate applicable to business profits. In contrast, as indicated above, non-resident service providers would not have been subject to any domestic tax if they did not have a permanent establishment or fixed base in that country, and they might have been subject only to low taxes (or no tax at all) on the fees earned in their country of residence.

12. As a result of these considerations, the United Nations Committee of Experts identified fees for technical services as a matter of priority to be dealt with as part of its larger project on the taxation of income from services under the United Nations Model Convention. After considerable study and debate, having due regard to all the arguments for and against the expansion of taxing rights with regards to services, the Committee decided to add a new article to the United Nations Model Convention expanding the taxing rights for States from which fees for technical services are paid.

13. The majority of the Committee of Experts therefore rejected the position that a State should be entitled to tax income from services derived by a resident of the other Contracting State only if the services are performed in the first State. In particular, they rejected the argument that the residence of a payer of fees for technical services in a Contracting State and the deduction of those fees against that State´s tax base do not

provide sufficient nexus to that State to justify that State taxing those fees. In the view of those members of the Committee, base erosion is a sufficient justification for the taxation of income from employment under Article 15 and directors' fees and remuneration of top-level managerial officials under Article [17]. Although taxation of employment income under Article 15 is limited to employment exercised in a country, Article [16] allows a Contracting State to tax an individual resident in the other Contracting State on fees derived by the individual as a director or remuneration derived as a top-level managerial official of a company resident in the first State, irrespective of whether the services are rendered inside or outside the first State. Moreover, under Articles 7 and 14, a country is entitled to tax income derived outside the country as long as the income is attributable to a permanent establishment or fixed base in that country.

14. Article [16] may result in some non-resident service providers grossing up the cost of technical services provided to residents of a Contracting State. Countries should be aware of this possibility in the same way that they should be aware of the possibility of similar grossing up with respect to interest and royalties under Articles 11 and 12 respectively. The possibility that fees for technical services may be grossed up is a factor to be taken into account in this regard, along with many other factors. It is also a factor to be taken into account in establishing the maximum rate of tax imposed by a Contracting State on fees for technical services under Article [16], paragraph 2.

15. The taxation of fees for technical services on a gross basis under Article [16] may result in excessive or double taxation. However, the possibility that fees for technical services may be subject to excessive or double taxation is reduced or eliminated under Article 24 (Methods for the Elimination of Double Taxation)]. In addition, the possibility of excessive or double taxation can be taken into account in establishing the maximum rate of tax imposed by a Contracting State on fees for technical services under Article

[16], paragraph 2, and depending on the negotiated rate, the risk of an excessive tax may be completely eliminated.

16. Despite the inclusion of Article [16] into the United Nations Model Convention, a significant minority of the members of the Committee did not agree with the policy justifications set forth above for the Article. Fundamentally, these members did not agree with the justifications set forth in paragraphs 2 and 5 above that rapid changes in modern economies, particularly with respect to cross-border services, enable non-resident service providers to be substantially involved in another State's economy without a physical presence. Rather, these members were of the view that in cases of payments for technical services that are not performed in the payer's State, there is no nexus to that State that warrants taxation by that State on the payment.

17. In the view of these members of the Committee, as a policy matter, taxation of fees for technical services is warranted only when the service provider has a sufficient nexus to the payer's State, which typically is in the form of a fixed base or a permanent establishment. In other words, to justify taxation of technical services in a State, the services should be performed in that State with the degree of nexus required by Articles 5 (Permanent Establishment), 7 (Business Profits) and 14 (Independent Personal Services).

18. The other argument advanced for the inclusion of Article [16] is that the payment for the service is deductible and hence erodes the tax base of the payer's State. However, in the view of the members opposed to Article [16], mere deductibility of a commercially justified payment cannot be equated to harmful base erosion, and is therefore not a sufficient reason for taxing that payment in the same State.

19. Those members of the Committee that did not agree with the inclusion of Article [16] in bilateral tax treaties were also concerned that the term "technical services" as used in

the Article is not adequately defined. These members were therefore concerned that the application of the Article would result in increased uncertainty, inconsistent treatment, and lengthy disputes between taxpayers and tax authorities.

20. In the view of those members of the Committee that did not agree with the inclusion of Article [16], a further problem with taxation of fees for technical services on a gross basis is that it can lead to double taxation. The imposition of a tax on a gross basis denies the taxpayer the ability to take into account expenses that were incurred in connection with the provision of the services, which would be deductible if tax were imposed on a net basis. Thus, it is possible that the residence State's remedies for relieving double taxation may not be adequate to fully relieve the gross-basis taxation imposed by the other State.

21. As a matter of broader economic policy, those members that opposed the inclusion of Article [16] were concerned that, as a result of the Article, consumers of technical services in the source State may encounter higher prices for those services, because foreign service providers could pass added tax costs onto the consumer through means such as so-called "gross-up" clauses in contracts. Typically, a gross-up clause will specify a net amount that the provider will receive, effectively passing the burden of any withholding tax onto the consumer of the services. The use of gross-up clauses could result in the tax being shifted onto the consumer and make it more expensive to purchase the services. This can put the foreign service provider at a competitive disadvantage, effectively foreclosing access to a market that imposes such a withholding tax and restricting the consumer's legitimate choice of suppliers,

22. These members were also concerned that the inclusion of Article [16] would lead to trade distortions as the taxation of goods and services would operate on a different basis. The reason for this is that the profits of an exporter of goods are taxable only in

its State of residence, whereas, under Article [16], what is in effect an import tariff would be applied to technical services.

23. In summary, these members did not accept the analysis in paragraphs 2 to 15 above, and regarded any expanded taxing jurisdiction on fees for technical services as an unjustified shift of the balance of taxation from the place where services are performed to the place where services are consumed. Countries sharing these concerns may wish not to include Article [16] in their bilateral tax treaties.

24. Alternatively, countries, which wish to obtain additional taxing rights on fees for technical services, but are concerned with the broad scope of Article [16], may consider agreeing to amend Article 12 (Royalties) to permit taxation of certain "fees for included services," an approach that is found in a number of bilateral tax treaties between developing and developed countries. The underlying policy rationale for this narrower approach is that, in order to justify taxation by the State from which the payment is made even in cases when the services are not performed in that State, fees for services must be directly related to the enjoyment of property for which a royalty as otherwise defined in Article 12 is paid. Wording for this narrower alternative approach is set forth in paragraphs 25 and 26 of the Commentary on Article 12.

25 However, a majority of the members of the Committee of Experts was of the view that the alternative referred to in paragraph 24 is not an acceptable alternative to Article [16] for developing countries because, in essence, they considered that there is no principled justification for restricting the taxation of fees for technical services to services directly related to property producing royalties. Moreover, they took the view that the alternative supported by a minority of the members of the Committee contains many vague terms of uncertain meaning, which may lead to frequent disputes about the interpretation of that provision.

26. Instead, countries concerned about the scope of Article [16] and the uncertainty associated with the definition of "fees for technical services" in Article [16], paragraph 3 might consider an alternative version of Article [16] under which Article [16] would apply to all fees for services performed in a Contracting State, but only to fees for services performed outside that State by related persons. Under this alternative provision, paragraphs 1, 2, 3, 4, and 7 of Article [16] would remain unchanged except that the term "fees for technical services" in those paragraphs would be replaced by the term "fees for services." However, paragraphs 5 and 6 would be replaced by the following paragraphs:

5. For the purposes of this Article, fees for services shall be deemed to arise in a Contracting State if:

(a) the services are performed in that State; or

(b) the payer is a resident of that State and the fees are paid to a closely related person unless the payer carries on business in the other Contracting State or a third State through a permanent establishment situated in that State, or performs independent personal services through a fixed base situated in the other Contracting State or a third State and such fees are borne by that permanent establishment or fixed base; or

(c) the payer has in that State a permanent establishment or a fixed base in connection with which the obligation to pay the fees for services was incurred and such fees are borne by that permanent establishment or fixed base.

6. For the purposes of this Article, a person is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises. In any case, a person shall be considered to be

closely related to an enterprise if one possesses directly or indirectly more than 50 per cent of the beneficial interest in the other (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) or if another person possesses directly or indirectly more than 50 per cent of the beneficial interest (or, in the case of a company, more than 50 per cent of the aggregate vote and value of the company's shares or of the beneficial equity interest in the company) in the person and the enterprise. [For the purposes of this Article, an individual shall be connected to another individual if the individual is related to that other individual by blood relationship, marriage or adoption.]

27. Under this alternative, a country would be entitled to impose tax under Article [16], paragraph 2 up to the maximum agreed rate on fees for services paid by a resident of that country or by a non-resident with a permanent establishment or fixed base in that country to a resident of the other Contracting State if the fees for services arise in the first country. Fees for services would be deemed to arise in a country in accordance with paragraph 5 if:

1. the services are performed in that country, or
2. the services are performed outside that country by a person who is closely related to the payer of the fees.

Thus, this alternative provision would eliminate any disputes about whether the relevant services are within the definition of "fees for technical services" in Article [16], paragraph 3 because it applies to all services. Under this alternative provision, a Contracting State would not be entitled to tax fees for services paid to service providers resident in the other Contracting State that are not closely related to the payer for services performed outside the first State. In contrast, under Article [16], fees for technical services paid to non-closely related service providers resident in the other Contracting State for services performed outside the first State would be taxable by the first State. However, under the alternative provision, a Contracting State would be entitled to tax fees for services performed outside that State if the services are

performed by persons closely related to the payer. In many cases, such closely-related party services present the most serious risk of eroding a country's tax base.

28. Article [16] allows fees for technical services to be taxed by a Contracting State on a gross basis. Many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income from services derived by non-residents. A withholding tax imposed on the gross amount of payments made by residents of a country, or non-residents with a permanent establishment or fixed base in the country, is well established as an effective method of collecting tax imposed on non-residents. Such a method of taxation may also simplify compliance for enterprises providing services in another State since they would not be required to compute their net profits or file tax returns.

29. Article [16] does not require any threshold, such as a permanent establishment, fixed base or minimum period of presence in a Contracting State as a condition for the taxation of fees for technical services. In this regard, Article [16] is significantly different from Article 7 and Article 14. However, in the case of technical services, modern methods for the delivery of services allow non-residents to perform substantial services for customers in the other country with little or no presence in that country. This ability to derive income from a country with little or no presence there, combined with concerns about the base-erosion and profit-shifting aspects of technical services, is considered by a majority of the members of the Committee to justify the absence of any threshold requirement as a condition for a country to tax fees for technical services.

30. Where fees for technical services are dealt with in both Article [16] and Article 7, paragraph 6 of Article 7 provides that the provisions of Article [16] prevail. However, this priority for Article [16] does not apply if the beneficial owner of the fees for technical services carries on business through a permanent establishment in the

Contracting State in which the fees for technical services arise, and those services are effectively connected with the permanent establishment or business activities referred to in (c) of paragraph 1 of Article 7. In this situation, paragraph 4 of Article [16] provides that the provisions of Article 7 apply instead of Article [16].

31. Similarly, where fees for technical services are dealt with in both Article [16] and Article 14, Article [16], paragraph 2 indicates expressly that Article [16] applies notwithstanding the application of Article 14. However, this priority for Article [16] over Article 14 does not apply if the beneficial owner of the fees performs independent personal services in the Contracting State in which the fees for technical services arise through a fixed base situated in that State and the technical services are effectively connected with the fixed base. In this situation, Article [16], paragraph 4 provides that the provisions of Article 14 apply instead of Article [16].

32. There is no overlap between Article [16] and Articles 15, [19] and [20] dealing with income from employment, pensions and government services respectively because the definition of "fees for technical services" in Article [16], paragraph 3 expressly excludes payments to employees. Thus, for example, payments received by an employee from an employer resident in a country for employment services exercised outside that country would not be taxable by that country under Article [16], paragraph 2 even if the payments are fees for technical services.

33. Since paragraph 2 of Article [16] is subject to the provisions of Articles 8 (Shipping, Inland Waterways Transport and Air Transport), [17 (Directors' Fees and Remuneration of Top-Level Managerial Officials)] and [18 (Pensions and Social Security Payments)], Article [16] does not apply to fees for technical services to which the provisions of those Articles apply. In general, the taxing rights of a country under Article 8, [17] or [18] are unlimited, whereas the taxing rights under Article [16],

paragraph 2 are limited to the maximum percentage of the gross fees for technical services agreed to in that provision. The relationship between Article [16], paragraph 2 and Articles 8, [17] and [18] is discussed further in the Commentary on paragraph 2.

B. Commentary on the Paragraphs of Article [16]

Paragraph 1

34. This paragraph establishes that fees for technical services arising in one Contracting State and paid to a resident of the other Contracting State may be taxed in the other Contracting State. It does not, however, provide that such fees are taxable exclusively by the State of residence.

35. In most cases, the person who provides technical services will receive fees for those services. If the person who receives the fees for technical services is not the person who provides those services, it is a matter of domestic law as to who is the proper taxpayer with respect to those fees. If fees for technical services are paid to a person, other than the person who provides the services, Article [16] applies to the fees as long as the recipient is a resident of the other Contracting State.

36. The expression "fees for technical services" is defined in paragraph 3 to mean any "payment" for managerial, technical or consulting services. The term "payment" has a broad meaning consistent with the meaning of the related term "paid" in Articles 10 and 11. As indicated in paragraph 3 of the Commentary on Article 10 (quoting paragraph 7 of the Commentary on Article 10 of the OECD Model Convention) and paragraph 6 of the Commentary on Article 11 (quoting paragraph 5 of the Commentary on Article 11 of the OECD Model Convention), the concept of payment means the fulfillment of the obligation to put funds at the disposal of the service provider in the manner required by contract or custom.

37. Article [16] deals only with fees for technical services arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to fees for technical services arising in a third State. Paragraph 5 and paragraph 6 specify when fees for technical services are deemed to arise in a Contracting State and deemed not to arise in a Contracting State, respectively. However, unlike Articles 10 and 11, which do not apply to dividends paid by a company resident in a third State or interest arising in a third State, Article [16] applies to fees for technical services paid by a resident of a Contracting State or a third State that are borne by a permanent establishment or fixed base that the resident has in the other Contracting State.

Paragraph 2

38. This paragraph lays down the principle that the Contracting State in which fees for technical services arise may tax those payments in accordance with the provisions of its domestic law. However, if the beneficial owner of the fees is a resident of the other Contracting State, the amount of tax imposed by the State in which the fees for technical services arise may not exceed a maximum percentage, to be established through bilateral negotiations, of the gross amount of the payments

39. When considered in conjunction with Article [24 (Methods for the Elimination of Double Taxation)], paragraph 2 establishes the primary right of the country in which fees for technical services arise to tax those payments in accordance with its domestic law (subject to the limitation on the maximum rate of tax if the beneficial owner of the fees is a resident of the other Contracting State). Accordingly, the country in which the recipient of the fees is resident is obligated to prevent double taxation of those fees. Under Article [24] A or [24] B, the residence country is required to provide relief from double taxation through the exemption from tax of the fees for technical services or the granting of a credit against tax payable to the residence country on the fees for technical

services for any tax imposed on those fees by the other Contracting State in accordance with Article [16].

40. The decision not to recommend a maximum rate of tax on fees for technical services is consistent with Articles 10, 11 and 12 of the United Nations Model Convention dealing with dividends, interest and royalties, respectively. This decision can be justified under current treaty practice. The withholding rates on fees for technical services adopted in bilateral tax treaties between developed and developing countries vary widely. Thus, the maximum rate of tax on fees for technical services is to be established through the bilateral negotiations of the Contracting States.

41. A precise level of withholding tax on fees for technical services should take into account several factors, including the following:

- the possibility that a high rate of withholding tax imposed by a country might cause non-resident service providers to pass on the cost of the tax to customers in the country, which would mean that the country would increase its revenue at the expense of its own residents rather than the non-resident service providers;
- the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment;
- the possibility that some non-resident service providers may incur high costs in providing technical services, so that a high rate of withholding tax on the gross fees may result in an excessive effective tax rate on the net income derived from the services;
- the potential benefit of applying the same rate of withholding tax to both royalties under Article 12 and fees for technical services under Article [16] (see Example 6, paragraphs [92] and [93]).

- the fact that a reduction of the withholding rate has revenue and foreign-exchange consequences for the country imposing withholding tax; and
- the relative flows of fees for technical services (e.g., from developing to developed countries).

42. Paragraph 2 applies notwithstanding the provisions of Article 14. Under Article 14, income from the performance of professional or other independent personal services by a person who is a resident of a Contracting State is taxable by the other Contracting State only if the services are performed through a fixed base in the other Contracting State that is regularly available to the person or if the person stays in that State for 183 days or more in any twelve-month period commencing or ending in the relevant fiscal period.

43. Since paragraph 2 applies notwithstanding the provisions of Article 14, the conditions for the taxation of income from professional or other independent personal services under Article 14 do not apply to the taxation of fees for technical services under paragraph 2. Thus, fees for technical services are taxable by a Contracting State in accordance with the provisions of paragraph 2 if the fees arise in that State, irrespective of whether the person who performs the services has a fixed base in that State, stays in that State for any particular length of time, or performs the technical services in that State. However, by virtue of paragraph 4, if a resident of one Contracting State performs independent personal services (that are technical services) in the other Contracting State through a fixed base that is regularly available to the resident, or stays in the other Contracting State for 183 days or more and receives fees for technical services within the meaning of Article [16], paragraph 3, Article 14 will apply to those payments in priority to Article [16].

44. Paragraph 2 applies in priority to Article 7 as a result of Article 7, paragraph 6. Thus, the conditions for the taxation of the business profits of an enterprise under Article 7 do not apply to fees for technical services covered by paragraph 2. Fees for technical services are taxable by a Contracting State under paragraph 2 if the fees arise in that State irrespective of whether the enterprise providing the services has a permanent establishment in that State, provides services that are similar to those effected through the permanent establishment or provides the technical services in that State. However, by virtue of paragraph 4, if an enterprise of one Contracting State provides technical services through a permanent establishment in the other Contracting State and receives fees for those technical services within the meaning of paragraph 3, Article 7 will apply to those payments in priority to Article [16], paragraph 2.

45. The application of paragraph 2 is expressly subject to the provisions of Article 8. Certain payments for international shipping, air transportation or inland waterways transport under Article 8 could be within the definition of "fees for technical services" in paragraph 3. This might be the case with respect to auxiliary activities that are closely connected to the direct operation of ships and aircraft, as discussed in paragraph 11 of the Commentary on Article 8. To eliminate any uncertainty in this regard, paragraph 2 explicitly provides that in any situation in which both Article [16] and Article 8 apply to the same services, the provisions of Article 8 prevail. Thus, any fees for technical services that result from the operation of ships or aircraft in international traffic, or the operation of boats in inland waterways, or auxiliary activities, are taxable exclusively in accordance with Article 8 of the United Nations Model Convention.

46. Similarly, paragraph 2 is subject to the provisions of Article [17] dealing with directors' fees and the remuneration of top-level managerial officials. Therefore, under Article [17] where directors' fees or remuneration of top-level managerial officials are taxable by the Contracting State in which the company paying the fees or remuneration is

resident, Article [16] cannot apply to the fees or remuneration because paragraph 2 is expressly subject to the provisions of Article [17]. The taxing rights of a Contracting State under Article [17] are unlimited, whereas the taxing rights under Article [16] are limited to the maximum rate of tax agreed to in paragraph 2. If, however, the payments are outside the scope of Article [17] (because, for example, the payments are made with respect to services provided by the individual in a capacity, other than that of a director or top-level managerial official of the company, such as an independent contractor), the other State is entitled to tax the payments in accordance with paragraph 2.

47. Similarly, paragraph 2 is expressly subject to the provisions of Article [18] dealing with entertainment or sports activities. Although it may be unlikely that such activities would be within the definition of "fees for technical services" in paragraph 3, it is important to provide certainty in this regard. Therefore, if an overlap between the provisions of paragraph 2 and Article [18] does occur, Article [18] takes precedence over Article [16]. If, however, an artiste or sportsperson resident in one Contracting State receives fees for technical services from a person resident in the other Contracting State and those fees are outside the scope of Article [18] (because, for example, although the fees are in consideration for personal activities as an artiste or sportsperson, those activities take place outside the country in which the payer is resident), the first Contracting State is entitled to tax the fees under paragraph 2.

48. Paragraph 2 is not expressly subject to the provisions of Article [21] dealing with income from services provided by students, apprentices or business trainees. Given that Article [16] is intended to apply to specialized, high-value services, income from services derived by students, apprentices and business trainees should not fall within the definition of "fees for technical services" in paragraph 3.

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

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

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1. For example, where the trustees of a discretionary trust do not distribute fees for technical services earned during a given period, these trustees, acting in their capacity as such (or the trust, if recognised as a separate taxpayer) could constitute the beneficial owners of such fees for the purposes of Article 16 even if they are not the beneficial owners under the relevant trust law.

51. Relief or exemption in respect of an item of income is granted by a State to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is paid to a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for a State to grant relief or exemption merely on account of the status of the direct recipient of the income as a resident of the other Contracting State. The direct

recipient of the income qualifies as a resident but no potential double taxation arises as a consequence of that status, since the recipient is not treated as the owner of the income for tax purposes in the State of residence.

52. It would be equally inconsistent with the object and purpose of the Convention for a State to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the OECD's Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"[1] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has as a practical matter very narrow powers which render it in relation to the income concerned a mere fiduciary or administrator acting on account of the interested parties.

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1. Reproduced at page R(6)-1 of Volume II of the full-length version of the OECD Model Tax Convention.

53. In these various examples (agent, nominee, conduit company acting as a fiduciary or administrator), the direct recipient of the fees for technical services is not the "beneficial owner" because that recipient's right to use and enjoy the fees is constrained by a contractual or legal obligation to pass on the fees received to another person. Such an obligation will normally derive from relevant legal documents but may also be found to exist on the basis of facts and circumstances showing that, in substance, the recipient clearly does not have the right to use and enjoy the fees unconstrained by a contractual or legal obligation to pass on the fees received to another person. This type of obligation would not include contractual or legal obligations that are not dependent on the receipt of the fees by the direct recipient such as an obligation that is not dependent

on the receipt of the fees and which the direct recipient has as a debtor or as a party to financial transactions. Where the recipient of fees for technical services does have the right to use and enjoy the fees unconstrained by a contractual or legal obligation to pass on the fees received to another person, the recipient is the "beneficial owner" of those fees.

54. The fact that the recipient of fees for technical services is considered to be the beneficial owner of those fees does not mean, however, that the limitation of tax provided for by paragraph 2 must automatically be granted. This limitation of tax should not be granted in cases of abuse of this provision. As explained in the section on "Improper use of the Convention" in the Commentary on Article 1, there are many ways of addressing conduit company structures and, more generally, treaty shopping situations. These include specific anti-abuse provisions in domestic law and treaties, general anti-abuse rules in domestic law and tax treaties, judicial doctrines, such as substance-over-form or economic substance approaches, and the interpretation of tax treaty provisions. Whilst the concept of "beneficial owner" deals with some forms of tax avoidance (i.e. those involving the interposition of a recipient who is obliged to pass on fees for technical services to someone else), it does not deal with other cases of treaty shopping and must not, therefore, be considered as restricting in any way the application of other approaches to addressing such cases.

55. The above explanations concerning the meaning of "beneficial owner" make it clear that the meaning given to this term in the context of the Article must be distinguished from the different meaning that has been given to that term in the context of other instruments[1] that concern the determination of the persons (typically the individuals) that exercise ultimate control over entities or assets. That different meaning of "beneficial owner" cannot be applied in the context of the Convention. Indeed, that meaning, which refers to natural persons (i.e., individuals), cannot be reconciled with

the express wording of Article 10, subparagraph 2(a), which refers to the situation where a company is the beneficial owner of a dividend. In the context of Articles 10, 11, 12 and [16], the term "beneficial owner" is intended to address difficulties arising from the use of the words "paid to" in relation to dividends, interest, royalties and fees for technical services rather than difficulties related to the ownership of the underlying property or rights in respect of which the amounts are paid. For that reason, it would be inappropriate, in the context of these articles, to consider a meaning developed in order to refer to the individuals who exercise "ultimate effective control over a legal person or arrangement".[2]

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1. See, for example, Financial Action Task Force, International Standards on Combating Money Laundering and the Financing of Terrorism & Proliferation – The FATF Recommendations (OECD-FATF, Paris, 2012), which sets forth in detail the international anti-money laundering standard and which includes the following definition of beneficial owner (at page 109): "the natural person(s) who ultimately owns or controls a customer and/or the person on whose behalf a transaction is being conducted. It also incorporates those persons who exercise ultimate effective control over a legal person or arrangement." Similarly, the 2001 report of the OECD Steering Group on Corporate Governance, "Behind the Corporate Veil: Using Corporate Entities for Illicit Purposes" (OECD, Paris, 2001), defines beneficial ownership as follows (at page 14):

   > In this Report, "beneficial ownership" refers to ultimate beneficial ownership or interest by a natural person. In some situations, uncovering the beneficial owner may involve piercing through various intermediary entities and/or individuals until the true owner who is a natural person is found. With respect to corporations, ownership is held by shareholders or members. In partnerships, interests are held by general and limited partners. In trusts and foundations, beneficial ownership refers to beneficiaries, which may also include the settlor or founder.

2. See the Financial Action Task Force's definition quoted in the previous note.

56. Subject to other conditions imposed by the Article, the limitation of tax in a State remains applicable when an intermediary, such as an agent or nominee located in the other Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State. The text of the United Nations Model Convention was amended in 2001 and 2017 (following amendments to the OECD Model Convention in 1995 and 2014) to clarify this point.

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

Paragraph 3

58. This paragraph specifies the meaning of the phrase “fees for technical services” for purposes of Article [16]. The definition of “fees for technical services” in paragraph 3 is exhaustive. “Fees for technical services” are limited to the payments described in paragraph 3; other payments for services are not included in the definition and are not dealt with in Article [16].

59. Article 16 applies only to fees for technical services, and not to all payments for services. Paragraph 3 defines “fees for technical services” as payments for managerial, technical or consultancy services. Given the ordinary meanings of the terms “managerial,” “technical” and “consultancy,” the fundamental concept underlying the definition of fees for technical services is that the services must involve the application by the service provider of specialized knowledge, skill or expertise on behalf of a client or the transfer of knowledge, skill or

expertise to the client, other than a transfer of information covered by the definition of "royalties" in Article 12, paragraph 3. Services of a routine nature that do not involve the application of such specialized knowledge, skill or expertise are not within the scope of Article 16.

60. The ordinary meaning of the term "management" involves the application of knowledge, skill or expertise in the control or administration of the conduct of a commercial enterprise or organization. Thus, if the management of all or a significant part of an enterprise is contracted out to persons other than the directors, officers or employees of the enterprise, payments made by the enterprise for those management services would be fees for technical services within the meaning of paragraph 3. Similarly, payments made to a consultant for advice related to the management of an enterprise (or of the business of an enterprise) would be fees for technical services.

61. The ordinary meaning of the term "technical" involves the application of specialized knowledge, skill or expertise with respect to a particular art, science, profession or occupation. Therefore, fees received for services provided by regulated professions such as law, accounting, architecture, medicine, engineering and dentistry would be fees for technical services within the meaning of paragraph 3. Thus, if an individual receives payments for professional services referred to in Article 14, paragraph 2 from a resident of a Contracting State, those payments would be fees for technical services. If the payments arise in that Contracting State because they are made by a resident of that State or borne by a permanent establishment or fixed base in that State, the payments would be subject to tax by that State in accordance with paragraph 2 irrespective of the fact that the services are not performed in that State through a fixed base in that State.

62. Technical services are not limited to the professional services referred to in Article 14, paragraph 2. Services performed by other professionals, such as pharmacists, and other

occupations, such as scientists, academics, etc., may also constitute technical services if those services involve the provision of specialized knowledge, skill and expertise.

63. The ordinary meaning of "consultancy" involves the provision of advice or services of a specialized nature. Professionals usually provide advice or services that fit within the general meaning of consultancy services although, as noted in paragraphs 60 and 61, they may also constitute management or technical services.

64. The terms “management,” “technical” and “consultancy” do not have precise meanings and may overlap. Thus, for example, services of a technical nature may also be services of a consultancy nature and management services may also be considered to be services of a consultancy nature.

65. The definition of “fees for technical services” does not include a reference to the domestic law of a Contracting State. The lack of any reference to domestic law is justified because:

a) the definition generally covers most types of services that are regarded as technical services under the domestic law of the countries that tax such services;

b) such a reference would introduce a large element of uncertainty;

c) future changes in a country’s domestic law with respect to the taxation of fees for technical services could otherwise have an effect on the Convention; and

e) in the United Nations Model Convention, reference to domestic laws should be avoided as far as possible.

It would be inconsistent with the definition of “fees for technical services” for the meaning of terms used in the definition, especially the terms “management,” “technical” and “consultancy,” to be determined in accordance with the domestic law of the country applying the treaty under Article 3, paragraph 2.

66. As expressly provided in subparagraph 3(a), fees for technical services for purposes of Article [16] do not include payments of salary, wages or other remuneration to an employee of the payer. Where such payments are made by an employer resident in one Contracting State to an employee resident in the other Contracting State, they are covered by Article 15 or Article [20] (Government Service) of the Convention. In addition, since pensions arise in respect of prior employment, they are excluded from Article [16] and are dealt with by Article [19] (Pensions and Social Security Payments) even if the employment involved the provision of technical services to the employer.

67. As expressly provided in paragraph 3, the definition of fees for technical services does not include payments for teaching in an educational institution or teaching by an educational institution. Thus, if an educational institution established in one Contracting State pays for teaching services provided by an individual or an enterprise resident in the other Contracting State that are otherwise considered to be fees for technical services, the payments made by the educational institution for those teaching services are excluded from the definition of "fees for technical services" by subparagraph 3(b). Further, if an educational institution established in one Contracting State receives payments from an enterprise resident in the other Contracting State for teaching services provided by that institution to some of the enterprise's employees, the payments received by the educational institution for those teaching services (to the extent that they would otherwise be considered to be fees for technical services) would not be fees for technical services subject to Article 16 because of the specific exclusion in subparagraph 3(b). There is no definition of the term "educational institution" for purposes of subparagraph 3(b). Consequently, in accordance with Article 3, paragraph 2 of the Convention, the term would have its meaning under the law of the State applying the Convention. The meaning of the term would generally include universities, colleges and other post-secondary educational institutions. Countries in which the term

"educational institution" has a very broad or unusual meaning may wish to clarify the meaning of the term in their treaties.

68. Some countries may be concerned that the exclusion in subparagraph 3(b) is excessively broad and uncertain and may be subject to abuse. These countries may wish to omit the exclusion in subparagraph 3(b) entirely or limit that exclusion to teaching services that are provided as part of a degree program offered by an educational institution. These countries are free to do so by adding the words "as part of a degree granting program" or similar words to subparagraph 3(b). In this case, payments received by an educational institution for teaching services of a managerial, technical or consultancy nature that are not part of a degree program would be fees for technical services within the meaning of paragraph 3.

69. As expressly provided in subparagraph 3(c), the definition of "fees for technical services" does not include payments by individuals for services for personal use. Such payments would not normally be deductible by those individuals for tax purposes, and therefore the payments would not cause any erosion of the tax base of the State in which the fees for technical services arise. Moreover, the imposition of withholding tax obligations on such payments by individuals under domestic law would be difficult to enforce and might cause serious compliance problems for individuals utilizing technical services supplied remotely by non-residents.

70. The definition of "fees for technical services" in paragraph 3 does not exclude profits from international shipping, inland waterways transport and international air transport, directors' fees, remuneration of top-level managerial officials or income from entertainment and sports activities. However, such income (even if it is within the definition of "fees for technical services") is not subject to tax by a country under paragraph 2 if it is taxable under Article 8, [17] (Directors' Fess and Remuneration of

Top-Level Managerial Officials) or [18] (Artistes and Sportspersons), as the case might be, because paragraph 2 is expressly subject to the provisions of Article 8, [17] and [18].

71. The treatment of reimbursements of expenses for purposes of the definition of "fees for technical services" in paragraph 3 poses special difficulties. As an initial matter, it is important to distinguish between an allowance for expenses and the reimbursement of expenses. An allowance is an amount usually established in advance for which the recipient of the allowance is not obligated to account; a *per diem* allowance for meals and accommodation is an example of a typical allowance. Since the recipient of an allowance does not have to account for the actual expenses incurred, any allowance received by a person for technical services is included within the meaning of "fees for technical services" under paragraph 3.

72. The reimbursement of expenses is different from an allowance because the person must account for the actual expenses incurred, and only those actual expenses qualify for reimbursement. The issue is whether payments received in reimbursement of actual expenses incurred in connection with the provision of technical services should be included in the definition of "fees for technical services".

73. First, a person may be reimbursed for expenses incurred in connection with providing technical services, but may not receive any fee for those services. For example, an individual resident in one Contracting State might be invited to speak at a conference or participate in a meeting in the other Contracting State and might be reimbursed for his or her travel expenses, but not receive any fee. In these circumstances, it seems difficult to justify the application of withholding tax to the reimbursement. However, unless reimbursements are explicitly excluded from the definition of "fees for technical

services", paragraph 2 would permit the State in which the fees arise to impose withholding tax on the reimbursement at the rate specified in the treaty.

74. Second, a non-resident service provider may be paid a fee and separately reimbursed for all the expenses incurred in providing the services. In these circumstances, if reimbursements are excluded from the definition of fees for technical services, the tax imposed by the State in which the fees arise would be limited to the amount of the fee. On these facts, the fee represents the non-resident's entire net profit from the performance of the technical services. However, the maximum limit on the tax imposed under paragraph 2 is based on the gross amount of the payments, and the rate of withholding tax specified in Article [16] may have been established on the assumption that the fees represent the non-resident's gross revenue. As a result, if reimbursements are excluded from the definition of fees for technical services, the rate of withholding agreed to by the Contracting States may be too low. Moreover, the exclusion of reimbursements from the definition of fees for technical services might lead to abuses. For example, in order to reduce the source country's withholding tax, non-resident service providers might receive payments labeled as reimbursements that are actually fees, or might be reimbursed for expenses for which they would not ordinarily be reimbursed. Preventing these types of abuses would impose a significant administrative burden on the tax authorities.

75. Third, a non-resident service provider might not be reimbursed for any of the expenses incurred in providing the services. The maximum rate of withholding tax in paragraph 2 may have been agreed to on the assumption that some of a non-resident's expenses would be reimbursed. Therefore, if reimbursements are excluded from the definition of "fees for technical services", the rate established in the treaty might be too high for a non-resident service provider that receives no reimbursement for expenses.

76. It appears to be extremely difficult to predict to what extent, on average, non-resident service providers are reimbursed for their expenses. As a result, any single rule for the treatment of reimbursements will operate improperly in some situations. On the one hand, if reimbursements are excluded from the definition of "fees for technical services", the rate agreed to in the treaty might be too low where most or all of a non-resident's expenses are reimbursed, but too high where none of the expenses are reimbursed. Also, taxpayers might try to disguise part of their fees as reimbursements of expenses and it might be difficult for the tax authorities to detect such abuses. On the other hand, if reimbursements are not excluded, the rate agreed to in the treaty might be too high where a non-resident's expenses are reimbursed, but too low where they are not reimbursed.

77. As a result of the difficulties described in the foregoing paragraphs, the solution that has been adopted is to omit any reference to the reimbursement of expenses in the definition of "fees for technical services" in Article [16], paragraph 3. However, countries are encouraged to deal with the problem in their domestic laws and to take the issue into account in establishing the maximum rate of tax under Article [16], paragraph 2.

78. Although paragraph 3 defines the phrase "fees for technical services," it does not provide a definition of the term "services." Similarly, other articles of the United Nations Model Convention dealing with various types of services do not contain any definition of the term "services." Neither Article 14, which deals with professional and other independent personal services, nor Article [20], which deals with services rendered to the government of a Contracting State, provides a definition of the term "services." Similarly, the General Agreement on Trade in Services does not contain any definition of the term "services."

79. Although the term “services” in the phrase “fees for technical services” is undefined in the context of Article [16], it should be understood to have a broad meaning in accordance with ordinary usage to generally include activities carried on by one person for the benefit of another person in consideration for a fee. Such activities can be carried out in a wide variety of ways and the manner in which such services are provided does not alter their character for the purpose of Article [16], to the extent that such services fall within the definition of “fees for technical services” in paragraph 3.

80. It is often necessary to distinguish between fees for services, including fees for technical services, and royalties in order to determine whether Article 12 or another Article of the Convention (Article [16] in the case of “fees for technical services”) is applicable. The distinction between fees for services and royalties is clear in principle. Under Article 12, paragraph 3, royalties are payments for the use, or the right to use, certain types of property or information concerning industrial, commercial or scientific experience (so-called know-how). In contrast, the performance of services does not involve any transfer of the use of, or the right to use, property. However, in practice it is often difficult to distinguish between royalties and fees for services, including technical services, especially with respect to so-called mixed contracts. Guidance with respect to the distinction between fees for services and royalties is provided in paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, which reproduces paragraphs 11.2 – 11.6 of the Commentary on Article 12 of the OECD Model Convention.

81. The following examples illustrate the application of the definition of “fees for technical services” in paragraph 3.

82. Example 1: X is a resident of State R and a skilled heart surgeon. X’s practice is carried on primarily in State R, although X occasionally travels to other countries to perform complicated

heart surgery. X performs surgery in State R on an individual resident in State S. The tax treaty between State R and State S contains a provision identical to Article [16] of the United Nations Model Convention. Although the payments made by the patient, a resident of State S, to X would be considered to be fees for technical services that arise in State S, they are explicitly excluded from the definition by subparagraph (c) of paragraph 3. As a result, the payments would not be taxable by State S in accordance with Article [16], paragraph 2.

83. The result in Example 1 would be the same if X travelled to State S and performed the surgery in State S unless X performed the services through a fixed base regularly available to X in State S, in which case Article 14 would apply.

84. Example 2: X is a resident of State R and a skilled heart surgeon. X's practice is carried on primarily in State R, although X occasionally travels to other countries to perform complicated heart surgery. X enters into a contract with a health services corporation resident in State S under which X agrees to perform heart surgery on patients referred to him by the health services corporation. X is not an employee of the health services corporation. The surgeries are performed both in State S and in State R. The tax treaty between State R and State S contains a provision identical to Article [16] of the United Nations Model Convention. Under Article [16], paragraph 3, the payments made by the health services corporation, a resident of State S, to X would be considered to be fees for technical services that arise in State S, irrespective of whether the surgery is performed in State S, State R or a third State. As a result, the payments would be taxable by State S in accordance with paragraph 2. If X were an employee of the health services corporation, the payments to X would be excluded from the definition of "fees for technical services" by subparagraph 3(a).

85. Example 3: R Company is a resident of State R. R Company's business is the collection, organization and maintenance of various databases. R Company sells access to these databases to its clients. One of R Company's clients is Company S, a resident of State S. State R and State

S have entered into a tax treaty that contains a provision identical to Article [16] of the United Nations Model Convention. The payments that R Company receives from S Company for access to its databases would not be fees for technical services within the meaning of paragraph 3. Although R Company used its knowledge, skill and expertise in creating the database, the services that R Company provides to S Company – access to the database – are routine services that do not involve the application of R Company's knowledge, skill and expertise for the benefit of S Company. Accordingly, Article [16] would not apply to the payments.

86. If, however, S Company entered into a contract with R Company under which R Company created a specialized database customized for S Company's use from information supplied by S Company or collected by R Company, the payments by S Company to R Company would be "fees for technical services" under paragraph 3. In this situation, R Company would be applying its knowledge, skill and expertise for the benefit of S Company. As a result, the payments would be taxable by State S in accordance with paragraph 2. It would not matter whether R Company performed all or any part of the services of creating the database in State S.

87. Example 4: R Company, a resident of State R, is engaged in the insurance business in both State R and State S. R Company provides insurance against a wide variety of risks. State R and State S have a tax treaty that is the same as the United Nations Model Convention, including Articles 5, 7 and [16]. R Company would be deemed to have a permanent establishment in State S under Article 5, paragraph 6 to the extent that it collects premiums or insures risks in State S other than through an agent of independent status. Therefore, by virtue of paragraph 4, R Company's insurance activities in State S would be taxable by State S in accordance with Article 7, and Article [16] would not apply.

88. In Example 4, even if R Company is not deemed to have a permanent establishment in State S under Article 5, Article [16] would not apply because the insurance premiums received by R Company cannot be considered to be fees for technical services within the meaning of

paragraph 3. Although R Company uses its knowledge, skill and expertise to develop its various insurance products that are sold to its clients, R Company is not applying its knowledge, skill and expertise directly for the benefit of each particular client.

89. Example 5: R Company is a financial institution resident in State R. R Company provides a wide variety of financial services to its customers, including acceptance of deposits, extension of credit, credit and debit cards, payment and transmission services, banker's drafts, guarantees, foreign exchange, negotiable instruments, derivative products, investment research and advisory services. R Company's business is conducted primarily in State R, but it also has clients in other countries, including State S. State R and State S have a tax treaty that is identical to the United Nations Model Convention, including Article [16].

90. Whether the payments received for services provided by a financial institution constitute fees for technical services within the meaning of paragraph 3 depends on the nature of the particular services. Many services provided by financial institutions do not involve the application of any specialized knowledge, skill and expertise on behalf of a particular client. Instead, the financial institution uses its knowledge, skill and expertise to develop general products, services or practices that are made available to its clients routinely in consideration for fees. This would be the case, for example, with respect to payment and transmission services, banker's drafts, foreign exchange, debt and credit card services and negotiable instruments.

91. However, where a financial institution uses its knowledge, skill and expertise to provide research, analysis or advice to a specific client related to that client's particular circumstances, the payments received by the financial institution for those services could be fees for technical services within the meaning of paragraph 3. This would be the case, for example, if, in Example 5, R Company provides advice to S Company, resident in State S, with respect to a potential merger or acquisition involving S Company. As a result, the payments for such advice would be fees for technical services taxable by State S in accordance with paragraph 2. If, however, R

Company provides the services through a permanent establishment located in State S, the fees received for those services would be taxable by State S in accordance with Article 7 rather than Article [16] by virtue of paragraph 4 (see paragraph 87).

92. Example 6: S Company, an enterprise resident in State S, enters into a contractual arrangement with R Company, an enterprise resident in State R, for the right to use a patented chemical formula owned by R Company for the production of an industrial substance. The contract also requires R Company to use its specialized knowledge and expertise to assist S Company to produce the industrial substance in accordance with specifications set out in the contract. In particular, R Company will perform the following services for S Company:

- provide the production procedures and assist S Company in carrying out those procedures; and
- provide specifications concerning the necessary materials, tools, containers used in the production process.

R Company also agrees to use its best efforts to ensure that S Company is able to produce the industrial substance in the quantities and with the characteristics that S Company expects. State S and State R have entered into a tax treaty with provisions identical to those of the United Nations Model Convention, including Article [16].

93. In Example 6, the payments by S Company to R Company for the right to use the patented formula would be a royalty within the meaning of Article 12, paragraph 3. However, the payments for the services provided by R Company to S Company would not be royalties because R Company is not transferring its specialized knowledge, skill or experience to S Company. On the facts of Example 6, R Company is using its specialized knowledge, skill and experience on behalf of S Company and guaranteeing the result of S Company's use of the patented chemical formula. Consequently, the payments made by S Company to R Company for the services are fees for technical

services within the meaning of paragraph 3 and State S would be entitled to impose tax on those fees under paragraph 2.

94. As noted in paragraphs 4 and 5 above, under the United Nations Model Convention as it read before 2017, it was difficult, but important, to determine if certain payments were royalties or fees for services. If the payments were royalties, they would have been taxable by the Contracting State in which they arose in accordance with Article 12 subject to the limitation on the rate of tax in paragraph 2 of Article 12. On the other hand, if the payments were fees for services, they would have been taxable by a Contracting State only if the service provider had a permanent establishment or fixed base in that State and the payments were deductible in computing the profits attributable to that permanent establishment or fixed base in accordance with Article 7 or Article 14. Thus, the tax consequences varied significantly depending on whether payments were characterized as royalties or fees for services. The determination of the nature of payments as royalties or fees for services was especially difficult with respect to mixed contracts involving the transfer of the use of or the right to use information concerning industrial, commercial or scientific experience and the performance of services.

95. The addition of Article [16] to the United Nations Model Convention in 2017 has had the potential effect of reducing the significance of the distinction between royalties and fees for technical services if the limits on the rate of tax in paragraph 2 of Article 12 and paragraph 2 of Article [16] are the same. If these rates of tax are the same, it will not matter whether payments under mixed contracts are considered to be royalties for the transfer of know-how or fees for technical services. However, if the maximum rates of tax in the two articles are different, it will be important to determine if a particular payment is a royalty taxable in accordance with Article 12, fees for technical services under Article [16], or some other type of payment.

96. The following example illustrates the distinction between payments for the transfer of know-how and fees for technical services. The considerations to be taken into account in making this distinction are discussed in paragraph 12 of the Commentary on Article 12.

97. Example 7: S Company, an enterprise resident in Country S, enters into a contractual arrangement with R Company, an enterprise resident in Country R, to acquire the use of a secret formula or process developed by R Company. The contract requires R Company to provide the information to S Company subject to strict confidentiality conditions and to use its specialized and expertise to train employees of S Company with respect to the use of the secret formula or process. State R and State S have entered into a tax treaty with provisions identical to those of the United Nations Model Convention, including Articles 12 and [16].

98. In Example 7 the payments made by S Company to R Company for the right to use the secret formula or process would be a payment for "information concerning industrial, commercial or scientific experience" within the meaning of the definition of "royalty" in paragraph 3 of Article 12. This would be the case even if the information represents know-how that is not patented or otherwise protected by intellectual property laws. Similarly, the payments made by S Company to R Company for the training of S Company's employees would also be a payment for "information concerning industrial, commercial or scientific experience" within the meaning of the definition of "royalty" in paragraph 3 of Article 12 since the training is necessary to transfer R Company's know-how to S Company. Therefore, irrespective of whether the payments for the training are provided for separately from the payments for the secret formula or process or whether the contract provides for a single payment for both, the payments for the training would be considered royalties under Article 12 rather than fees for technical services under Article [16]. However, if the training provided by R Company was not necessary to transfer the secret formula or process to S Company and S Company could obtain such

training from other sources, the training would not be considered to be a transfer of know-how and the payments for the services would be considered fees for technical services assuming that they fit within the definition of "fees for technical services" in paragraph 3 of Article [16].

Paragraph 4

99. This paragraph provides that paragraphs 1 and 2 do not apply to fees for technical services if the person who provides the services has a permanent establishment or fixed base in the State in which the fees arise and the fees are effectively connected with that permanent establishment or fixed base. In this regard, paragraph 4 is similar to Article 10, paragraph 4, Article 11, paragraph 4 and Article 12, paragraph 4. Thus, if a resident of one Contracting State provides technical services through a permanent establishment or fixed base located in the other Contracting State, the fees received for those services will be taxable by the State in which the permanent establishment or fixed base is located in accordance with Article 7 or Article 14, rather than in accordance with Article [16].

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

101. The paragraph does not define the meaning of the expression "effectively connected." As a result, whether fees for technical services are effectively connected with a permanent establishment, fixed base or business activities similar to those carried on through a permanent establishment must be determined on the basis of all the relevant

facts and circumstances of each case. In general, fees for technical services would be considered to be effectively connected with a permanent establishment or fixed base if the technical services are closely related to or connected with the permanent establishment or fixed base or if the business activities are similar to those carried out through the permanent establishment. This will be the case where the remuneration paid to the person providing the services is borne by the permanent establishment or fixed base in the State in which the fees arise.

102. Where paragraph 4 applies, fees for technical services are taxable by the State in which the fees arise as part of the profits attributable to the permanent establishment in accordance with Article 7 or the income attributable to the fixed base in accordance with Article 14. Thus, paragraph 4 relieves the State in which the fees for technical services arise from the limitations on its taxing rights imposed by Article [16]. Where Article 7 applies as a result of the application of paragraph 4, most countries consider that the State in which the permanent establishment is located is allowed to tax only the net profits from the technical services attributable to the permanent establishment. Article 7 does not preclude taxation of business profits attributable to a permanent establishment on a gross basis, but a Contracting State must not discriminate against residents of the other State in violation of paragraph 3 of Article [25] (Nondiscrimination). Similarly, where Article 14 applies, most countries consider that the State in which the fixed base is located is allowed to tax only the net income derived from the technical services. However, it may be useful for countries to clarify these issues during the negotiation of the treaty (see paragraphs 9 and 10 of the Commentary on Article 14).

Paragraphs 5 and 6

103. Paragraph 5 lays down the principle that the State in which fees for technical services arise for purposes of Article [16] is the State of which the payer of the fees is a resident or the State in which the payer has a permanent establishment or fixed base if the fees for technical services are borne by the permanent establishment or fixed base. It is not necessary for the services to be performed in the Contracting State in which the payer is resident or has a permanent establishment or fixed base. Whether a person is a resident of a Contracting State for purposes of Article [16] is determined in accordance with the provisions of Article 4 of the Convention.

104. Where there is an obvious economic link between technical services and the permanent establishment or fixed base of the payer for the services, the fees for technical services are considered to arise in the State in which the permanent establishment or fixed base is situated. This result applies irrespective of the residence of the owner of the permanent establishment or fixed base, even where the owner resides in a third State.

105. Where there is no economic link between the technical services and the permanent establishment or fixed base, the payments for technical services are considered to arise in the Contracting State in which the payer is resident. If the payer of fees for technical services is not a resident of a Contracting State, Article [16] does not apply to the fees for technical services unless the payer has a permanent establishment or fixed base in the Contracting State and there is a clear economic link between the technical services and the permanent establishment or fixed base. Otherwise there would be, in effect, a force-of-attraction principle for fees for technical services, which would be inconsistent with other provisions of the United Nations Model Convention.

106. Paragraph 5 is subject to paragraph 6, which provides an exception to the source rule in paragraph 5. Paragraph 6 deems fees for technical services made by a resident of a

Contracting State not to arise in that State where that resident (the payer) carries on business through a permanent establishment in the other Contracting State or in a third State, or performs independent personal services through a fixed base in the other Contracting State or in a third State and the fees for technical services are borne by that permanent establishment or fixed base. As a result, in these circumstances, the Contracting State in which the payer is resident is not allowed to tax the payments for technical services under paragraph 2.

107. The phrase "borne by" must be interpreted in the light of the underlying purpose of paragraphs 5 and 6, which is to provide source rules for fees for technical services. A Contracting State is entitled to tax fees for technical services under paragraph 2 only if the fees arise in that State. The basic source rule in paragraph 5 is that fees for technical services arise in a Contracting State if the payer is a resident of that State or the payer has a permanent establishment or fixed base in a Contracting State and the fees for technical services are borne by that permanent establishment or fixed base. However, the basic rule is limited by the deeming rule in paragraph 6 where the payer is a resident of a Contracting State but the fees for technical services are borne by a permanent establishment or fixed base that the payer has in the other Contracting State or in a third State.

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

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

110.The application of paragraphs 5 and 6 can be illustrated by the following examples.

111.Example 7: R Enterprise is carried on by a resident of State R. R Enterprise provides technical services to S Company, a resident of State S. The tax treaty between State R and State S is identical to the United Nations Model Convention, including Article XX. S Company carries on business in State S and in State R (or a third State) through a permanent establishment situated there. However, the technical services provided by R Enterprise to S Company are related to S Company's business carried on in State S, not to the business carried on through the permanent establishment in State R (or a third State).

112.In Example 7, since the payments are made by S Company, a resident of State S, and are not borne by a permanent establishment of S Company outside State S, the fees for technical services would be considered to arise in State S in accordance with paragraph 5. Therefore, State S would be entitled to tax the fees for technical services under paragraph 2.

113.Example 8: The facts are the same as in Example 7, except that the fees for technical services are borne by S Company's permanent establishment in State R or in a third State.

114. In Example 8, since the fees for technical services are borne by a permanent establishment of S Company situated outside State S, paragraph 6 applies to deem the fees for technical services not to arise in State S. Consequently, the fees for technical services are not taxable by State S under paragraph 2 but are taxable exclusively by State R under Article [16].

115.In Example 8, Article [16] of the Convention denies State S the right to tax the fees for technical services despite the fact that the fees are paid by a resident of State S. This result is justified because the fees relate to a business carried on by a resident of State S outside State S, either in the other Contracting State – State R – or in a third State. In such a situation, where fees for technical services are deductible in computing the profits of a business attributable to a permanent establishment situated in another country or in computing the income from independent personal services furnished through a fixed base situated in another country, those payments have a closer economic connection to the activities carried on in that other country than to State S.

116.If there is a bilateral tax treaty between State R and the third State in which S Company has a permanent establishment, and that treaty contains a provision comparable to Article [16] of the United Nations Model Convention, the fees for technical services would be considered to arise in that third State for purposes of that treaty. As a result, that treaty would allow the third State in which the permanent establishment is located to tax the fees for technical services in accordance with paragraph 2.

117.Example 9: T Enterprise is carried on by a resident of State T. T Enterprise carries on business through a permanent establishment situated in State S or provides independent

personal services through a fixed base situated in State S. T Enterprise pays R Company, a resident of State R, for technical services provided by R Company for T Enterprise in connection with its income-earning activities carried on in State S. The payments made by T Enterprise to R Company for the technical services are deductible in computing the profits attributable to the permanent establishment of T Enterprise in State S or the income attributable to the fixed base of T Enterprise in State S.

118.In Example 9, although the fees for technical services are not paid by a resident of State S, the fees are borne by the permanent establishment or fixed base that T Enterprise has in State S. In these circumstances, the fees for technical services have a close economic connection to the income-earning activities of T Enterprise carried on in State S. Thus, the fees are deemed to arise in State S in accordance with paragraph 5 and State S is entitled to tax the payments in accordance with paragraph 2.

119.In the case of interest and royalties, paragraph 21 of the Commentary on Article 11 and paragraph 19 of the Commentary on Article 12 of the United Nations Model Convention indicate that countries might substitute a rule that would identify the source of interest or royalties as the State in which the loan giving rise to the interest or the property or right giving rise to the royalties was used. A similar source rule might be substituted for purposes of Article [16]. Similarly, as suggested in the Commentary on Articles 11 and 12, where, in bilateral negotiations, the parties differ on the appropriate rule, a possible solution would be a rule that, in general, would accept the payer's place of residence as the source of fees for technical services, but where the technical services are used or consumed in a State having a place-of-use rule, the payment would be deemed to arise in that State.

120.Various other alternative source rules for fees for technical services are possible. Such alternatives include the following:

- The Contracting States might decide not to include paragraph 6. If paragraph 6 were omitted from Article [16], fees for technical services would be considered to arise in the State in which the payer is resident, even where those fees are incurred for purposes of a permanent establishment or fixed base of the payer situated outside the payer's State of residence.

- The Contracting States might decide not to include paragraph 6 and to revise paragraph 5 so that fees for technical services could be considered to arise in a Contracting State only if the payer is a resident of that State and the technical services are used or consumed by the payer in that State; or if the payer is not a resident of a Contracting State, the payer has a permanent establishment or fixed base situated in a Contracting State and the fees for technical services are borne by that permanent establishment or fixed base. In this case, technical services used or consumed by a resident of a Contracting State outside that State would not be considered to arise in that State, and that State would not be entitled to tax fees for such services under Article [16]. Paragraph 6 would be unnecessary because technical services used or consumed outside a Contracting State would include any technical services incurred for the purposes of a resident's permanent establishment or fixed base situated outside that State.

- Fees for technical services could be considered to arise in a Contracting State only if the payer is a resident of that State and the technical services are provided in that State or if the payer, not being a resident of a Contracting State, has a permanent establishment or fixed base situated in a Contracting State and the fees for technical services are borne by that permanent establishment or fixed base. In this case, a Contracting State would be entitled to tax fees for technical services paid by its residents to residents of the other Contracting State if the technical services are provided in the State. In this situation, paragraph 6 would be unnecessary.

Paragraph 7

121.The purpose of paragraph 7 is to restrict the operation of the provisions concerning the taxation of fees for technical services in cases where, by reason of a special relationship between the payer and the beneficial owner of the fees or between both of them and some other person, the amount of the fees paid exceeds the amount that would have been agreed upon by the payer and the beneficial owner if they had stipulated at arm's length. Paragraph 7 provides that in such a case the provisions of the Article apply only to the last-mentioned amount and the excess part of the fees for technical services would remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.

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

123.On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationships giving rise to the fees for technical services.

124.With regard to the taxation treatment to be applied to the excess part of the fees for technical services, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income into which it should be classified for the purposes of applying the provisions of the tax laws of the

States concerned and the provisions of the Convention. Unlike Article 11, paragraph 6, which, because of the limiting phrase "having regard to the debt-claim for which it is paid," permits only the adjustment of the rate at which interest is charged, paragraph 7 permits the reclassification of the fees for technical services in such a way as to give them a different character. This paragraph can affect not only the recipient of the fees, but also the payer of excessive fees for technical services; if the law of the State where the payer is resident or has a permanent establishment or a fixed base permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the fees for technical services, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 7, as long as they do not alter its general purport.

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

Annex 3: Proposed Addition to the Commentary on Article 12: Fees for Included Services

Add after paragraph 21 of the Commentary on Article 12:

22. As discussed in Section A. General Considerations of the Commentary on Article [16], a minority of the members of the Committee was opposed to the inclusion of Article [16] in the United Nations Model Convention. Those members of the Committee considered that it would be preferable for countries that wish to have greater taxing rights with respect to fees for technical services to include in their treaties an alternative version of Article 12 of the United Nations Model Convention that would allow Contracting States to impose tax on fees for services that are closely connected to the transfer of the use of, or the right to use, property producing royalties. This alternative version of Article 12 is set out and discussed in paragraphs 24 to 52 below.

23. However, a majority of the members of the Committee were of the view that the alternative version of Article 12 is inappropriate for most developing countries because of its limited scope and difficult and complex application. Instead, the majority of the members of the Committee suggested that countries that wish to consider an alternative to Article [16] should consider the alternative provision set out in paragraphs [30 to 32] of the Commentary on Article [16] under which a Contracting State would be entitled to tax any income from services [provided/performed] in that State and any fees for any services paid by payers in that State to closely related persons outside that State irrespective of whether those services are [provided/performed] inside or outside that State.

Fees for Included Services

24. Countries that wish to tax fees for technical services, but are concerned about the scope of Article [16] may consider an alternative version of Article 12. Under this alternative approach, the definition of “royalties” in Article 12, paragraph 3 would be

amended to include "fees for included services" and two new paragraphs would be added to Article 12.

25. Article 12, paragraph 3 would read as follows:

> 3. The term "royalties" as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial or commercial or scientific equipment or for information concerning industrial, commercial or scientific experience, and fees for included services as defined in paragraphs 4 and 5 of this Article.

26. Article 12, paragraphs 4 and 5 would read as follows:

> 4. For the purposes of this Article, "fees for included services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of technical or other personnel) if such services:
>
> (a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or
>
> (b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

5. Notwithstanding paragraph 4, "fees for included services" does not include payments:
   (a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property;
   (b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic;
   (c) for teaching in or by an educational institution;
   (d) by an individual for services for the personal use of an individual;
   (e) to an employee of the person making the payments or to any individual or individuals for professional services as defined in article 14 (Independent Personal Services).

Existing Article 12, paragraphs 4, 5 and 6 would be renumbered as paragraphs 6, 7, and 8.

27. Article 12 includes only certain technical and consultancy services. The term "technical services" in this context means services requiring expertise in a technology. Consultancy services means in this context advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

28. Under paragraph 4 of the alternative version of Article 12, technical and consultancy services are considered included services only to the extent that: (1) as described in subparagraph 4(a), they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) as described in subparagraph 4(b), they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical

design. Thus, consultancy services which are not of a technical nature cannot be included services under subparagraph 4(b).

29. Subparagraph 4(a) of the alternative version of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3 is received. Thus, subparagraph 4(a) includes technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of intangible property for which a royalty is received under a license or sale as described in paragraph 3, as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment or information concerning industrial, commercial, or scientific experience for which a royalty is received under a lease as described in paragraph 3.

30. Subparagraph 4(a) is consistent with the interpretation of the definition of “royalty” that is set forth in paragraph 12 above (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention). The inclusion of subparagraph 4(a) in the text of a bilateral treaty is particularly beneficial to countries that have concerns about relying only on the interpretation in paragraph 12 above (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention). In fact, provisions identical or substantially similar to paragraph 4(a) of the alternative provision are found in several existing bilateral tax treaties concluded by developing countries.

31. In order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3 is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the clearly predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the services are related to the application or enjoyment of the right, property, or information described in paragraph 3 and whether the clearly predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case.

Factors which may be relevant to such determination (although not necessarily controlling) include:

- the extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3;
- the extent to which such services are customarily [provided/performed] in the ordinary course of business arrangements involving royalties described in paragraph 3;
- whether the amount paid for the services (or the amount which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;
- whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and
- whether the person [provides/perform] the services is the same person as, or related to, the person receiving the royalties described in paragraph 3 (for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the services is doing so in connection with an overall arrangement which includes the payer and recipient of the royalties.

32. To the extent that services are not considered ancillary and subsidiary to the application or enjoyment of some right, property, or information for which a royalty payment under paragraph 3 is made, the fees for such services shall be considered "fees for included services" only to the extent that they are described in subparagraph 4(b) of the alternative version of Article 12.

33. The following paragraphs provide examples to clarify the types of services intended to be included within the scope of the definition of “fees for included services” and the types of services that are not intended to be included in that definition. These examples are intended to be illustrative rather than exhaustive.

34. **Example 1:**

A manufacturing company resident in State R grants rights to a company resident in State S to use manufacturing processes in which the manufacturer has exclusive rights by virtue of process patents or the protection otherwise extended by the law of State R to the owner of a process. As part of the contractual arrangement, the manufacturer agrees to [provide/perform] certain consultancy services to the State S company in order to improve the effectiveness of the latter's use of the process. Such services include, for example, the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments for these services do not form a substantial part of the total consideration payable under the contractual arrangement.

35. The payments described in Example 1 are fees for included services. They are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3 of the alternative version of Article 12, because the services are related to the application or enjoyment of the protected process and the granting of the right to use the process is the clearly predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under subparagraph 4(a) regardless of whether they are covered in subparagraph 4(b). As explained in paragraph 30 above, while this result is consistent with the interpretation of the definition of "royalty" that is set forth in paragraph 12 above (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention), countries can make this result explicit by including subparagraph 4(a) in the text of the treaty provision.

36. **Example 2:**

A manufacturing company resident in State S produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial and other harmful deposits. A company resident in State R has developed a special cleaning process for removing such deposits from this type of machinery. The State R company enters into a contract with the State S manufacturing company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the State R company leases to the State S company a piece of equipment which allows the State S company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required.

37. In Example 2, the provision of cleaning services by the State R company and the lease of the monitoring equipment are related to each other. However, the predominant purpose of the arrangement is clearly the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not “ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of subparagraph 4(a) of the alternative version of Article 12.

38. Subparagraph 4(b) of the alternative version of Article 12 refers to technical or consultancy services that make available to the recipient technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. The services described in subparagraph 4(b) differ from the services described in subparagraph 4(a) of the alternative version of Article 12 in that any service that does not make technology available to the person acquiring the service is excluded. Generally speaking, technology will be considered "made available" to a person if that person is enabled to apply the technology through the [provision/performance] of the services. The fact that the provision of the service may require technical input by the person providing the service does not mean, by itself, that technical knowledge, skills, etc., are made available to the person purchasing the service. Similarly, the use of a product that embodies technology does not mean, by itself, that technology is made available to the recipient of the services.

39. Categories of services that typically involve either the development and transfer of technical plans or technical designs, or making technology available as described in subparagraph 4(b) of the alternative version of Article 12, include:

- engineering services (including the subcategories of bioengineering and
- aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);
- architectural services; and
- computer software development.

The manner through which the services are [provided/performed] is irrelevant to the characterization of the payments as fees for included services.

40. Under subparagraph 4(b) of the alternative version of Article 12, technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

- bio-technical services;
- food processing;
- environmental and ecological services;
- communication through satellite or otherwise;
- digital networking [and other digital services];
- energy conservation;
- exploration or exploitation of mineral oil or natural gas;
- geological surveys;
- scientific services; and
- technical training.

41. **Example 3:**

A manufacturing company resident in State R has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than standard wallboard products. A company resident in State S wishes to produce this product for its own use. It rents a plant in State S and contracts with the State R company to send experts to State S to show engineers employed by the State S company how to produce the more durable wallboard. The experts supplied by the State R manufacturer work with the employees of the State S firm for a few months.

42. According to the principles set out in paragraph 12 above (quoting paragraphs 11.1, 11.3 and 11.4 of the Commentary on Article 12 of the OECD Model Convention), in Example 3, payments for the use of the wallboard manufacturing process would be characterized as payments for "know-how," and thus are taxed as royalties, while the payments by the State S company to show its engineers how to produce the more durable wallboard would be characterized as business profits. However, under subparagraph 4(b) of the alternative version of Article 12, the payments for the services of the experts supplied by the State R manufacturer would be fees for included services. The services are of a technical or consultancy nature; they have elements of both types of services. The services make available to the State S company technical knowledge, skill, and processes. Therefore, the payments are fees for included services under subparagraph 4(b) of the alternative version of Article 12.

43. **Example 4:**

A manufacturing company resident in State R operates a wallboard fabrication plant outside State R. A company resident in State S enters into a contract with the State R company to produce wallboard for the State S company at that plant for a fee. The State S company provides the raw materials, and the State R manufacturer fabricates the wallboard in its plant, using advanced technology.

44. In Example 4, the payments under the contract to the State R manufacturer would not be fees for included services under the alternative version of Article 12. Although the

State R company is performing a technical service, no technical knowledge, skill, etc., is made available to the State S company, nor is there any development and transfer of a technical plan or design. The State R company is merely performing contract manufacturing services for the State S company.

45. **Example 5:**

A firm resident in State S owns inventory control software for use in its chain of retail outlets throughout State S. It expands its sales operation by employing a team of employees to travel around the countryside selling the company's wares. The company wants to modify its software to permit the sales force to access the company's central computers for information on what products are available in inventory and when they can be delivered. The State S firm enters into a contract with a State R computer programming firm resident in state R to modify its software for this purpose. In fulfilling the terms of the contract, the State R firm transfers the modified software to the State S firm.

46. According to the principles set out in paragraph 12 above (quoting paragraph 14.3 of the Commentary on Article 12 of the OECD Model Convention), in Example 5, the payments by the State S firm for the modification of computer software would be characterized as business profits. However, under subparagraph 4(b) of the alternative version of Article 12, the payments are fees for included services. The State R company [performs/provides] a technical service to the State S company, and it transfers to the State S company the technical plan (i.e., the computer program) that it develops.

47. **Example 6:**

A vegetable oil manufacturing company resident in State S wants to produce a cholesterol-free oil from a plant which produces oil containing cholesterol. A company resident in State R has developed a process for refining cholesterol out of the oil. The State S company contracts with the State R company to modify the extraction formulas which it owns and uses to eliminate the cholesterol, and to train the employees of the State S company in applying the new formulas.

48. According to the principles set out in paragraph 12 above (quoting paragraphs 11.1, 11.3 and 11.4 of the Commentary on Article 12 of the OECD Model Convention), in

Example 6, payments for the modification of the cholesterol extraction formula as well as the payments for the training in the use of the new formulas would be characterized as business profits. However, under subparagraph 4(b) of the alternative version of Article 12, both payments by the company resident in State R are fees for included services. The services are technical, and the technical knowledge is made available by the manufacturing company to the State S company through the training of its employees to apply the modified formulas.

49. **Example 7:**

A company resident in State R engaged in manufacturing vegetable oil has mastered the science of producing cholesterol-free oil and wishes to market the product worldwide. It enters into a contract with a marketing consulting firm resident in State S to do a computer simulation of the world market for such oil and to advise it on marketing strategies.

50. The payments in Example 7 would not be fees for included services under the alternative version of Article 12. The State S company is providing a consultancy service to the manufacturing enterprise in State R, which involves the use of substantial technical skill and expertise. It is not, however, making available to the State R company any technical experience, knowledge or skill, etc.; nor is it transferring a technical plan or design. The State S consulting firm is providing commercial information to the State R manufacturing company through the service contract. The fact that the consulting firm used technical skills and expertise in order to perform the services and provide the commercial information to the State R manufacturing company does not make the service a technical service within the meaning of subparagraph 4(b) of the alternative version of Article 12.

51. **Example 8:**

A hospital established in State S purchases an X-ray machine from a manufacturer resident in State R. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in the hospital, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray technology, which could improve the effectiveness of the machine, and training hospital staff in the application of these new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the X-ray machine.

52. In Example 8, the initial installation, inspection, and training services performed for the hospital in State S and the periodic services [provided/performed] during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has responsibility to service the machine during the warranty period, and the cost of the services is a relatively minor component of the contract. Therefore, under subparagraph 5(a) of the alternative version of Article 12 the payments received by the manufacturer are excluded from the definition of fees for included services, regardless of whether they would otherwise be covered by subparagraph 4(b). However, neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial sale of the X-ray machine. These payments would, absent the alternative version of Article 12, constitute business profits. However, under the alternative version of Article 12, the payments for the training of the hospital staff on the application of new developments in X-ray technology are covered by paragraph 4(b) and as such, may be taxed as fees for included services.

Annex 4: Consequential Amendments upon Inclusion of New Article [16] in the UN Model

1. to Article [23 A]

Under Article [23] A(2), a contracting state that generally provides relief of double taxation by exempting income that is taxable in the other contracting state in accordance with the provisions of the United Nations Model Convention is entitled to switch to the credit method with respect to income taxable under Article 10, 11 or 12. These provisions provide for shared taxation of dividends, interest and royalties by the residence and source countries by limiting the tax paid to the source country to an agreed percentage of the gross amount of dividends, interest or royalties.

Since new Article [16] also provides for shared taxation of fees for technical services similar to that under Articles 10, 11 and 12, the issue is whether Article [23] A(2) should be amended to refer to Article [16]. It seems to me that Article [23] A(2) should be amended in this way. Therefore, where a resident of one contracting state derives fees for technical services, which are taxable by the other contracting state in accordance with Article [16], the state of residence of the taxpayer is not required to exempt the fees from residence country tax, but is entitled to switch-over to the credit method.

If this change is made, a question arises with respect to the second sentence of Article [23] A(2). It refers to the credit being limited to the part of the tax "which is attributable to such items of income derived from that other State." In contrast, the Article [23] B(1) refers to the part of the tax, "which is attributable, . . . to the income or capital which may be taxed in that other State." The issue of interpretation that might arise under Article [23] A(2) if it is amended to add a reference to Article [16] is whether the residence country would be required to give credit for taxes paid to the other country on fees for technical services if those are provided outside that country. Article [16] allows a country to tax fees for technical services paid from that country irrespective of where the technical services are performed. Any tax imposed by a country on fees for

technical services performed outside the country are clearly taxable by that country under Article [16] so that the residence country would clearly be required to provide a credit for that tax under Article [23] B(1). However, under the different wording of Article [23] A(2), are the fees for technical services "derived from that other State?" (Note that paragraph 62 of the OECD Commentary on Article 23 B refers to "income derived from State S.")

There are two ways to clarify this issue:

1. Article [23] A(2) could be amended to conform the wording of the second sentence to the second sentence of Article [23] B(1). In other words, Article [23] A(2) would be amended to refer to the part of the tax "which is attributable to such items of income which may be taxed in that other State."
2. The Commentary on Article [23] could be revised to explain that the words "derived from that other State" mean that the income may be taxed in that other State in accordance with the provisions of the treaty.

The first alternative has the advantages of being more definitive because it is included in the treaty and of making the wording of Article [23] A and B consistent. The second alternative may be preferable because it does not require any change to United Nations Model Convention other than the addition of the reference to Article [16]. However, since Article [23] A must be amended to refer to Article [16], changing the wording of the second sentence of Article [23] A(2) does not seem to be a serious problem.

2. to Article [24](4)

Article [24](4) does not apply where the provisions of Article 9(1), Article 11(6) or Article 12(6) apply. In effect, these exceptions permit a country to deny the deduction of interest or royalties to the extent that they are excessive because of a special relationship between the payer and the recipient. Paragraph 6 of Article XX is similar to Articles 11(6) and 12 (6) in this regard. Therefore, Article [24](4) should be amended to include a reference to paragraph 6 of Article [16] as follows:

4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, paragraph 6 of Article 12, or paragraph 6 of Article [16] apply,

interest, royalties, fees for technical services and other amounts paid by an enterprise of a Contracting State . . .

It is not necessary to make any changes to the Commentary on Article [24](4), which simply quotes from the OECD Commentary on Article 24(4), because that Commentary does not refer to paragraph 6 of Article 12.