United Nations Practical Portfolio

Protecting the Tax Base

of Developing Countries against Base Erosion: **Income from Services**

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of Developing Countries against Base Erosion: **Income from Services**

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Part 1
Introduction

1.1 Background

In 2012, the Organisation for Economic Co-operation and Development (OECD) began working on the problem of base erosion and profit shifting (BEPS). The work on BEPS was a natural outgrowth of the OECD work on exchange of information as a means of countering international tax avoidance and evasion. In their June 2012 meeting, the G20 finance ministers emphasized "the need to prevent base erosion and profit shifting". In February 2013, in response to the G20, the OECD issued a short report on *Addressing Base Erosion and Profit Shifting*[1] that identified several areas for action and deadlines for the implementation of those actions. On 19 July 2013 the OECD released an *Action Plan on Base Erosion and Profit Shifting.*[2] This action plan set out an ambitious agenda with 15 specific action items, some of which were completed in September 2014 and the rest in October 2015. The Final Reports on BEPS were issued in November 2015.

Early in the BEPS Project, the OECD recognized the importance of involving developing countries, since their tax systems are probably more susceptible to BEPS than those of developed countries. In general, revenue from corporate taxes forms a larger part of the total tax revenues of developing countries than that of developed countries, and the tax authorities of developing countries generally have fewer administrative resources than developed countries to combat international tax avoidance and evasion and prevent BEPS.

The United Nations has been active in assisting developing countries in protecting their tax bases against BEPS. Some of these actions predate the OECD/G20 BEPS Project. In 2013, the United Nations Committee of Experts on International Cooperation in

[1] Organisation for Economic Co-operation and Development (OECD), *Addressing Base Erosion and Profit Shifting* (Paris: OECD, 2013), available from http://www.oecd.org/tax/beps-reports.htm.

[2] OECD, *Action Plan on Base Erosion and Profit Shifting* (Paris: OECD, 2013), available from http://www.oecd.org/ctp/BEPSActionPlan.pdf.

Tax Matters established a Subcommittee on Base Erosion and Profit Shifting for Developing Countries with a mandate to consider the implications of BEPS for developing countries and to recommend changes to the United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention)[3] to deal with BEPS. In addition, the Subcommittee on Transfer Pricing is engaged in work with respect to the effects of the transfer pricing aspects of BEPS on developing countries.

In early 2014, the Capacity Development Unit of the United Nations Financing for Development Office launched a project to assist developing countries in identifying the major risks of BEPS in their domestic tax laws and tax treaties. This project resulted in a book of 10 chapters dealing with six of the OECD/G20 BEPS action items (other than transfer pricing) that are considered to be most important by developing countries — hybrid entities and instruments, the avoidance of permanent establishment (PE) status, interest and other financing expenses, the digital economy, treaty abuse, and disclosure of aggressive international tax planning — and three additional chapters dealing with tax incentives, income from services and capital gains, plus an introductory overview.[4]

Part 2 of the September 2014 Report to the G20 Development Working Group (DWG) on the Impact of BEPS on Low Income Countries requested the OECD, the International Monetary Fund (IMF), the United Nations, the World Bank Group (WBG) and regional organizations to assess how practical toolkits could be developed to assist developing countries in implementing rules to deal with base-eroding payments between multinational enterprises. The DWG Report suggests that such a toolkit could consist of:

- An explanatory note to identify the risks of base-eroding payments

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[4] See United Nations, Department of Economic and Social Affairs, *United Nations Handbook on Selected Issues in Protecting the Tax Base of Developing Countries* (New York: United Nations, 2015), available from http://www.un.org/esa/ffd/wp-content/uploads/2015/07/handbook-tb.pdf.

- A paper on tax policy considerations related to countermeasures to such base-eroding payments
- An analysis of the advantages and disadvantages of the various options to deal with base-eroding payments
- Model legislation and explanatory notes
- Administrative guidance and practical auditing techniques
- Training materials

In response to the recommendation of the DWG Report, the Capacity Development Unit of the Financing for Development Office embarked on a project to produce a series of practical portfolios to assist developing countries in protecting their domestic tax bases against BEPS. The present *Portfolio,* dealing with income from services, is the first in a series of similar portfolios providing practical guidance to developing countries to assist them in combating various aspects of base erosion, such as base-eroding payments involving interest, royalties, capital gains and tax incentives.

This *Portfolio* is intended for the use of tax officials from developing countries. It is intended to assist these tax officials in identifying the risks of BEPS with respect to income from services, understanding the causes of such BEPS and assessing the options for countering it. The material in the present *Portfolio* is not aimed at any particular country, but is intended for use by a wide range of developing countries with different tax systems and at different levels of economic development. Therefore, the guidance provided in this *Portfolio* must be adapted to the particular needs and circumstances of each country.

The *Portfolio* focuses on the tax treatment of income from services under a developing country's domestic law and its tax treaties from the perspective of potential BEPS; it does not provide a comprehensive examination of the tax policy aspects of income from services. Therefore, any decisions by a particular country about the adoption of measures to counter BEPS with respect to income from services should take into account many aspects of the taxation of income from services that are not dealt with in this *Portfolio*. For example, some measures may be effective in countering BEPS but may have the effect of discouraging non-residents from providing services in developing countries or to residents of developing countries. Further, some countermeasures may be difficult for tax officials in developing countries to administer and enforce.

It is worth emphasizing that any country concerned about BEPS should first review the provisions of its domestic tax system to determine whether it is imposing tax on non-residents earning income from services in all of the situations in which the country considers that it wants to impose tax and is able to do so effectively. Second, the country must review the operation of the rules of its tax system to determine whether those rules are operating as intended or are allowing or facilitating BEPS. Third, if the existing rules are allowing or facilitating BEPS in certain circumstances, the country must consider what types of action it might take to prevent it.

The present *Portfolio* contains four parts, including this introduction. Part 2 comprises a Tax Policy Assessment Manual consisting of:

- An analysis of the provisions of the domestic law and tax treaties of developing countries dealing with the taxation of income from services
- An analysis of the provisions of the tax treaties of developing countries dealing with the taxation of income from services
- A description of the information that is necessary or desirable for the tax officials of developing countries to gather in order to formulate tax policy with respect to income from services appropriately
- The identification of the risks of BEPS with respect to income from services and the options for countering such risks, and
- A checklist of the tax policy considerations that should be taken into account by tax officials of developing countries in adopting provisions of domestic law and negotiating provisions of tax treaties dealing with income from services

This Tax Policy Assessment Manual does not deal with the domestic laws or tax treaties of particular countries. Instead, it deals with the basic patterns of taxation of income from services that are commonly found in the domestic laws and tax treaties of most developing countries. Tax officials from developing countries will find it necessary to adapt the material in the Manual to the particular situation in their countries.

Part 3 of the present *Portfolio* provides guidance for tax officials from developing countries in designing and drafting domestic legislation to counter BEPS and in negotiating tax treaties to counter BEPS with respect to income from services. Part 4 comprises a Tax Administration Manual, which provides guidance concerning the administrative aspects of the provisions of the domestic laws and tax treaties of developing countries dealing with income from services.

1.2 How to use the *Portfolio*

Tax officials from developing countries can use this *Portfolio* in a variety of ways. First, it can be used to obtain a general understanding of the tax treatment of income from services under domestic law and tax treaties. If this is the goal, tax officials may wish to focus their attention primarily on chapter 2 (Analysis of the provisions of a country's tax treaties and model tax treaties dealing with income from services) and chapter 3 (Information gathering for tax policy analysis) of part 2. Second, this *Portfolio* can be used as a guide to analysing the provisions of a country's domestic law and tax treaties dealing with income from services. In this case, tax officials may wish to read chapters 2 and 3 carefully and think about how their country's rules compare with the general patterns of taxation of income from services that are commonly used worldwide, and how the provisions of their country's tax treaties dealing with income from services compare with the equivalent provisions of the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital (OECD Model Convention).[5] Third, if readers are primarily interested in the treatment of a particular type of service, they can go to the sections of parts 2, 3 and 4 dealing with that type of service. The detailed table of contents will be useful for this purpose. Fourth, readers who have a good understanding of their country's rules and tax treaties for taxing income from services and are primarily concerned about the risks of base erosion should go directly to chapter 4 of part 2 dealing with the risks of base erosion.

[5] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

Part 2

Tax Policy Assessment Manual

Chapter 1

Tax policy analysis of the provisions of a country's domestic law dealing with the taxation of income from services from the perspective of base erosion

1.1 Introduction

How is income from services taxed under a country's domestic tax law? That is the general question with which this chapter deals. In particular, the chapter discusses how a country's tax base might be reduced or eroded with respect to income from services, including employment services and business services generally. The chapter is divided into two sections. The first section deals with income derived by residents of a country from services performed or consumed outside the country. The second section, which is more important from the perspective of base erosion, deals with non-residents who earn income from services in a country.

In general, a country's tax base may be eroded with respect to income from services if the country does not tax certain income from services; or if it allows a deduction for payments for services against its tax base but does not tax those payments; or if the tax on the payments is less than the tax saving resulting from the deduction of the payments.

This chapter identifies the basic patterns that countries use to tax income from services. It may be useful for tax officials of a particular country to consider how their country's taxation of income from services compares with these basic patterns.

1.2 Types of services in general

Somewhat surprisingly, most countries do not have a definition of "services" for purposes of their domestic law. Similarly, there is no definition of the word "services" in the United Nations Model Double Taxation Convention between Developed and Developing Countries[1] or the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention on Income and on Capital,[2] or in the General Agreement on Trade in Services (GATS).[3] For those countries that do not tax income from services differently from other types of income, it is unnecessary to distinguish between services and other activities. However, many countries tax certain types of income from services differently from other amounts, including other types of income from services. It is necessary for these countries to identify the income from services that they tax differently from other income. Similarly, under both the United Nations and OECD Model Conventions, it is necessary to identify specific types of services, such as professional and independent services and artistic and sports activities, because these activities are subject to special rules. In general, the United Nations and OECD Model Conventions do not provide definitions of these special types of services (the definition of "professional services" in Article 14 (2) of the United Nations Model Convention is an exception), although the Commentaries often provide helpful guidance for purposes of determining the type of services covered by particular articles.

In general, for purposes of both domestic law and tax treaties, the meaning of services should be considered to be quite broad and to include a wide range of activities performed by one person for the benefit of another person in consideration for a fee. For the purposes of this *Portfolio*, the term services is considered to have a broad meaning that covers all types of services, including employment and business services.

Under the domestic laws and tax treaties of many countries, it is often necessary to distinguish between payments for services and other types of payments, such as royalties, payments for leasing of industrial,

[1] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

[2] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[3] General Agreement on Trade in Services, 15 April 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, available from http://www.wto.org/english/docs_e/legal_e/26-gats.pdf.

commercial or scientific equipment and payments for know-how. These distinctions are especially difficult to make where services and other transfers are made under so-called mixed contracts and where services are provided as an ancillary and subsidiary aspect of a transfer of intellectual property, lease of equipment or supply of know-how.

Countries take different positions with respect to whether certain payments are treated as services, royalties or other income. Some countries take the position that services must involve activities performed by individuals; therefore, they consider automated activities, such as the provision of access to a database, online gaming or gambling and communications, not to be services. However, other countries do not consider intervention by individuals to be necessary in order for income to be characterized as income from services.

1.3 Residents earning foreign source income from services

The opportunities for base erosion with respect to residents of a country earning income from services performed outside the country depend on whether the country taxes on a worldwide or territorial basis. In general, worldwide taxation means that a country taxes all or most of the income earned by its residents irrespective of whether the income is derived in that country or outside that country (that is, in other countries), whereas territorial taxation[4] means that a country taxes only income sourced in or derived from its territory irrespective of whether the income is earned by a resident or a non-resident. In effect, under territorial taxation, foreign source income is exempt from tax. In other words, the exemption of certain foreign source income from services earned by residents is the equivalent of taxing that income on a territorial basis.

If a country taxes its residents on their worldwide income, including income from services performed outside the country, the

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[4] The term "territorial taxation" or "territoriality" is used loosely to mean different things. Sometimes it is used to describe an exemption for dividends from foreign corporations in which resident corporations own a minimum percentage of the shares. In the present *Portfolio*, the term is used to mean a tax system under which all or almost all foreign source income earned by residents of the country is exempt from tax.

opportunities for base erosion are more limited than if it taxes on a territorial basis. If a country does not tax its residents on income from services performed outside the country, those residents have an incentive to earn income outside the country if the foreign tax on such income is less than what the residence country's tax would be, assuming that the income was earned in the residence country. In these circumstances, the choice to exempt foreign source income generally from domestic taxation, either as a matter of tax policy or as a mechanism to relieve double taxation, results in significant opportunities for base erosion.

Thus, there are two basic patterns for taxing income from services earned by residents of a country:

(a) Worldwide taxation, under which residents are generally taxable on their income from services wherever those services are earned or performed; and

(b) Territorial taxation, under which a country taxes income from services generally only if the income is earned or derived from the country, so that residents are not taxable on income from services earned outside the country.

It is not necessary for a country to tax all income from services in accordance with one of these basic patterns. For example, a country that generally taxes on a worldwide basis may decide to exempt certain foreign source income from services, such as income from services performed through a foreign permanent establishment (PE). Therefore, it is necessary to consider whether income from services of a particular type conforms to either worldwide or territorial taxation.

1.3.1 Worldwide taxation

If a country taxes income from services derived by its residents on a worldwide basis, the opportunities for base erosion are quite limited because any income from services is subject to tax by the country. Nevertheless, there are some risks of base erosion.

First, if a country taxes on a worldwide basis, the income derived by its residents will often be subject to double taxation — once by the residence country and again by the country in which the services are performed. It is generally accepted that the country of residence has the obligation to eliminate the double taxation and must do so by providing a credit against its own tax for the tax paid to the foreign country, or by exempting the income earned in the foreign country. It should be noted that if a country provides relief from double taxation by exempting the foreign source income from tax, in effect, it is taxing that income on a territorial basis (see the discussion of territorial taxation in section 1.3.2 below).

Second, if a country uses a foreign tax credit to eliminate double taxation, the credit will usually be limited to the amount of the country's tax on the foreign source income. Therefore, for purposes of determining the limitation on the credit, it is necessary to calculate the amount of the foreign source income, and in particular, to determine which expenses are allocated to the foreign source income from services. If the proper amount of expenses is not allocated to the foreign source income for this purpose, in effect, the expenses will be deductible against the country's domestic source income. This result is inappropriate and can be viewed as a form of base erosion. In addition, depending on the type of limitation used for purposes of the foreign tax credit (overall, per country or item-by-item), residents of the country may be able to obtain credit for foreign taxes on income from foreign services that are higher than the residence country's tax on such income by averaging those foreign taxes with lower foreign taxes on other income.

The determination of the source of income from services is critically important whether a country provides relief from double taxation by exempting the foreign source income or by allowing a credit against the country's tax for the foreign tax on the income. If a country exempts income from foreign services from tax, its rules for determining the source of income from services (that is to say, which services are considered to be foreign services) will decide whether the income is subject to tax—because it is domestic source income—or not subject to tax (exempt)—because it is foreign source income. Similarly, if a country uses a foreign tax credit system to eliminate double taxation, it will limit the amount of the credit to the domestic tax on the foreign source income. Thus, if income from services is considered to be domestic source income, no foreign tax credit will be provided for any foreign taxes on such income. As discussed further in section 1.3.2 below, for purposes of relief from international double taxation, many countries consider that income from services earned by residents is foreign source income if the person performing the services is physically present and performing the services outside the residence country.

Third, even if a country taxes on a worldwide basis, it will not usually tax the income, including income from services, derived by a foreign corporation that is owned or controlled by residents of the country. Thus, residents of a country that provide services outside the country on which they are subject to tax by the country may form foreign corporations that they control to provide those services. This use of a controlled foreign corporation (CFC) is a relatively simple way for residents of a country to avoid paying tax on their worldwide income. Moreover, such CFCs can be used to provide services in the country in which the controlling shareholders of the CFCs are resident. In this situation, a country's rules for the taxation of income from services performed by non-residents become relevant. (These rules are discussed in section 1.4 below.) If a country does not tax income from services derived by non-residents in certain circumstances, there is a risk that CFCs may be used by its residents to avoid that country's tax on income from services provided in the country.

1.3.2 Territorial taxation

If a country taxes on a territorial basis (that is, it does not tax income from services performed outside the country), the critical issue with respect to the taxation of income from services, for both residents of the country and non-residents, is how the country determines the source of income from services. In general, income from services is considered to be earned for tax purposes where the persons performing the services are present and performing the services. However, as discussed in section 1.4 below, dealing with the taxation of income from services derived by non-residents, some countries consider that income from services is domestic source income subject to domestic tax if the services are performed in their country or if the services are used or consumed by persons in their country. Some countries use the place of performance of services rule exclusively and other countries use both rules.

If a country uses the place of performance of services as the source of income from services, it will not impose tax on any income from services performed outside the country by persons — employees or independent contractors — present outside the country. Therefore, residents of the country will have an incentive to earn income from services by performing services outside that country rather than inside that country if the foreign tax on the income is less than the residence country's tax.

1.4 Non-residents earning domestic source income from services

The opportunities for base erosion with respect to services performed by non-residents of a country depend on how the country taxes non-resident service providers. In general, whether a country taxes its residents on their worldwide income or only on their domestic source income, it will tax non-residents on their income from services earned in the country. The critical question in this regard is: How does a country determine the source of income from services derived by a non-resident of the country? Virtually all countries tax income from services derived by non-residents if the non-residents are physically present and perform the services in their territories. Some countries also impose tax on income from services derived by non-residents if the services are consumed or used by persons in their territories. These countries may also tax certain payments to non-residents for services if the payments are deductible against the countries' tax bases (that is to say, if the payments are made by a resident of the country or a non-resident with a PE or fixed base in the country).

If a country uses the place of consumption or use as the source of services, it will impose tax on amounts paid by residents of the country for services performed outside the country but used or consumed in the country. For example, if a resident of the country pays an engineer or architect who is resident in another country for plans for the construction of a building in the country, the services of the engineer or architect might be performed substantially or totally outside the country but would be used in the country. In many situations, the customer or client in the country who pays for the services will deduct the amount paid to the non-resident for the services in computing its income subject to tax by the country; such deductions will reduce the country's tax base.

Since a non-resident service provider may not have any presence in a country, the only effective way to tax the non-resident is to impose a withholding tax on the gross amount of the payments, or perhaps deny the payer a deduction for the payments. Whether there is a net reduction of a country's tax depends on a comparison of the tax saving from the deduction of the payments and the amount of any withholding tax on the payments. For example, if a payer is subject to tax on its income by a country at a rate of 40 per cent and the amount of the payment for the services is 1,000, the deduction of the payments will result in a tax saving for the payer of 400. If the withholding tax rate applicable to the payment for the services is 15 per cent or 150, the country's tax base will be eroded by (400 − 150 = 250). This does not mean, however, that the country should impose withholding tax at a rate of 40 per cent, since the withholding tax should be a proxy for tax at the applicable rate on the non-resident's net income.

If a country taxes only income derived by non-residents from services performed in the country, the basic patterns of taxation of those services are as follows:

(a) Taxation of income from all such services (that is to say, there is no condition for taxing such services, such as a threshold or connection with the jurisdiction, other than the performance of services); in this case, the income may be taxed on a net basis (that is, with deductions allowed for the expenses incurred in earning the income) or on a gross basis through a withholding tax (that is to say, the person who pays for the services is obligated to withhold the tax from the amount paid for the services);

(b) Taxation of income from such services if a threshold is met (for example, the services are performed through a PE or fixed base in the country); in this case, the income is usually taxed on a net basis;

(c) Taxation of income from such services if the non-resident service provider is present in the country or provides services in the country for a minimum period of time in any 12-month period; in this case, the income may be taxed on a net basis or on a gross basis through a withholding tax.

Income from services earned by non-resident service providers from services performed outside the country is not subject to tax by that country.

If a country also taxes income derived by non-residents from services consumed or used in the country, the basic patterns of taxation of those services are as follows:

(a) All payments by residents of the country for services provided by non-residents are subject to a gross basis withholding tax; such a broad tax is difficult to enforce, especially where the payments are made by individuals;

(b) Payments by residents of the country for services provided by non-residents are subject to a gross basis withholding tax if the payments are deductible by the residents in computing their income subject to tax;

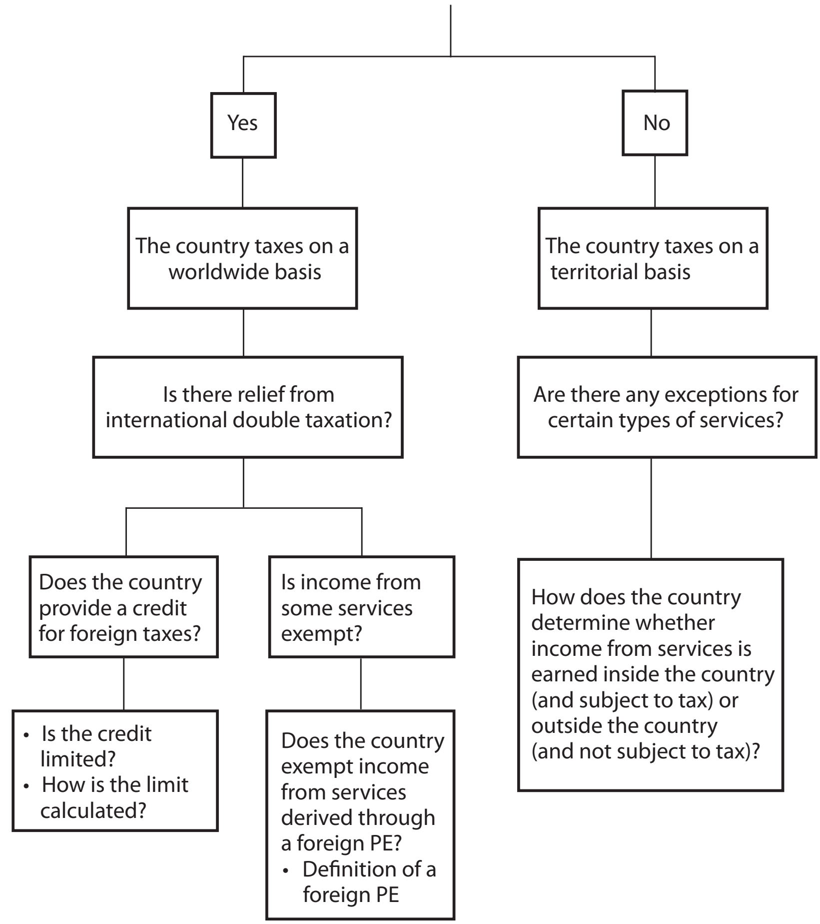
(c) Payments by non-residents with a PE or fixed base in the country are subject to a gross basis withholding tax if the payments are deductible by the non-residents in computing their income subject to tax by that country (that is, their income attributable to the PE or fixed base).

Income from services provided by a non-resident outside the country and used or consumed outside the country would not be subject to tax by that country.

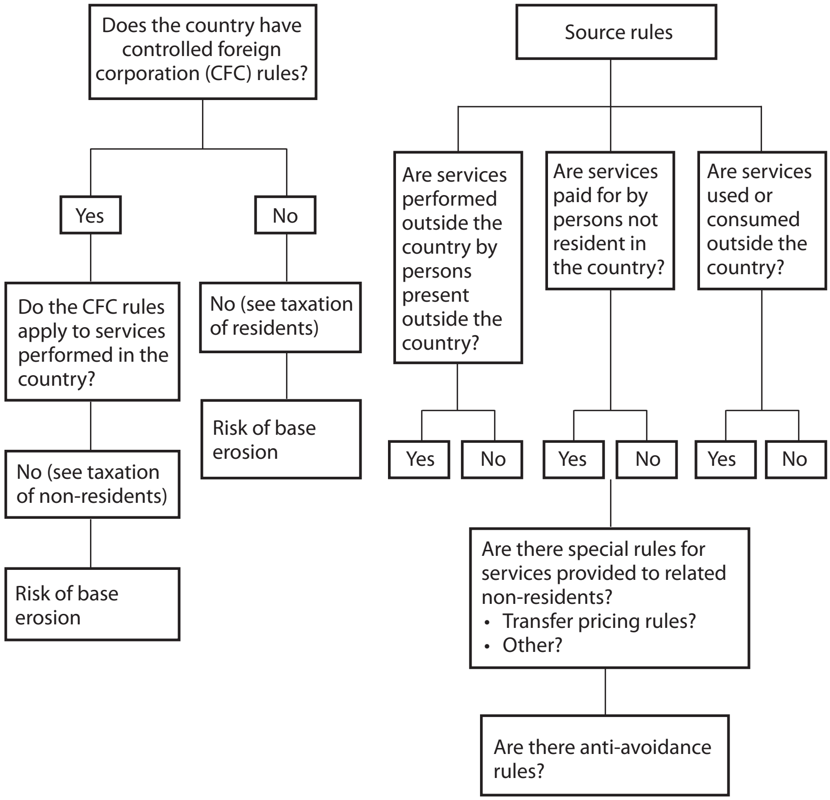
Some services performed by non-residents may be subject to tax by a country irrespective of where the services are performed or used or consumed if the payments for the services are made by a resident of the country or a non-resident with a PE or fixed base in the country. Alternatively, the country may deny the payer any deduction for the payments to the non-resident service provider. This form of taxation is usually restricted to payments for managerial, technical and consulting services. For example, assume that R Co, a resident of Country R, provides management services to its wholly owned subsidiary, S Co, resident in Country S. The services are performed by officers and employees of R Co who work exclusively in Country R. In this situation, S Co will likely deduct the payments to R Co for the management services in computing its income subject to tax in Country S. As a result, Country S may impose a withholding tax on those payments despite the fact that the services are performed outside Country S.

Flow chart 1
Taxation of residents

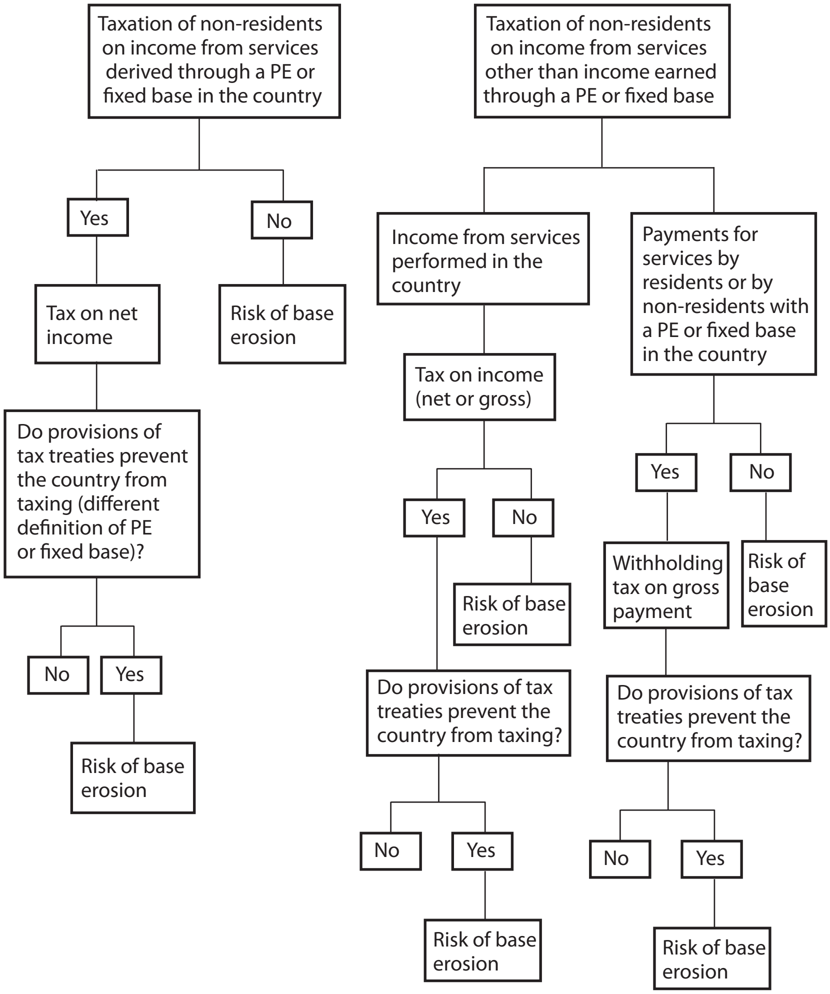
Does the country tax residents on income from services that they earn from any source outside the country?



Flow chart 1
(cont'd)



Flow chart 2
Taxation of non-residents



Chapter 2

Analysis of the provisions of a country's tax treaties and model tax treaties dealing with income from services

2.1 Introduction

In general, tax treaties place restrictions on the taxes imposed by the contracting States under their domestic laws. How do tax treaties restrict the taxes imposed by a country on income from services—especially income from services derived by non-residents—since tax treaties do not generally restrict the taxes imposed by a country on its own residents?

The previous chapter examined how countries tax income from services in order to acquire a foundation for determining the extent to which their tax bases can be eroded. Since tax treaties restrict a country's ability to tax under its domestic law, the provisions of a country's tax treaties dealing with income from services may create risks of base erosion that do not exist under domestic law. In this chapter, the provisions of tax treaties dealing with income from services are examined in order to acquire a foundation for determining the extent to which a country's tax base can be eroded through the use of tax treaties.

First, some basic questions are posed about a country's tax treaty network and the most important provisions of its tax treaties dealing with income from services. Then the provisions of the United Nations and Organisation for Economic Co-operation and Development (OECD) Model Conventions[5] dealing with income from services are

[5] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Eco-

examined. These model treaties provide a convenient basis for comparison with each country's tax treaties. Finally, the most common variations from the provisions of the United Nations and OECD Model Conventions dealing with income from services that countries include in their bilateral tax treaties are discussed.

In considering the provisions of tax treaties dealing with income from services, it is important to keep in mind the relationship between a country's domestic law and its tax treaties. In general, in most countries the provisions of the country's tax treaties take precedence over domestic law in the event of a conflict, although the tax authorities and the courts of some countries strive to avoid such conflicts through the interpretation of tax treaties. Further, some countries have enacted domestic laws, such as anti-avoidance rules, which expressly prevail over the provisions of their tax treaties (so-called treaty overrides). For other countries, tax treaties represent the highest form of law in the hierarchy of sources of law and cannot be overridden by ordinary domestic laws. For a detailed discussion of the relationship between domestic law and tax treaties, see the introductory chapter in *United Nations Handbook on Selected Issues in the Administration of Double Tax Treaties for Developing Countries.*[6]

2.2 Tax treaty network

How many tax treaties does a country have? With what countries does the country have tax treaties? For example, does the country have tax treaties with developed or developing countries, or both? With its major trading partners? With countries that are geographically close? With low-tax countries or tax havens?

Are the country's tax treaties primarily based on the United Nations Model Convention or the OECD Model Convention? What, if

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nomic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[6] Brian J. Arnold, "An overview of the issues involved in the application of double tax treaties", in *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), chapter 1, section 2, available from http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Handbook_DTT_Admin.pdf.

any, variations from the United Nations or OECD Model Conventions do the country's tax treaties contain with respect to income from services? In particular, each country's tax treaties should be considered with respect to:

(a) Income from employment
   (i) General rules under Article 15
   (ii) Directors' fees and remuneration of top-level managers under Article 16
   (iii) Pensions under Article 18
   (iv) Government service under Article 19
(b) Income from professional and other independent services under Article 14
(c) Income from business services under Articles 5 and 7
   (i) Does the definition of permanent establishment (PE) (Article 5) contain special provisions with respect to construction and insurance?
   (ii) Does the definition of PE contain Article 5 (3) (b)?
(d) Income from entertainment and sports activities under Article 17

Does the country have special provisions in its tax treaties dealing with fees for technical services? Are these provisions contained in Article 12 dealing with royalties, or in a separate article?

2.3 Provisions of the United Nations and OECD Model Conventions dealing with income from services

2.3.1 Restrictions on the taxation of income from services derived by residents of a country

As noted above, the provisions of tax treaties, including both the United Nations and OECD Model Conventions, do not generally limit the ability of the contracting States to tax their own residents. However, residence countries are prevented from taxing in the following situations:

(a) Under Article 8 of both the United Nations and OECD Model Conventions, profits derived from the operation of ships and aircraft in international traffic and boats in inland waterways transport are taxable only in the country in which the enterprise has its place of effective management; thus, neither the country in which the enterprise is resident nor the country in which any of the profits are earned is entitled to tax the profits. However, under Article 8 (alternative B) of the United Nations Model Convention, a country is entitled to tax profits from international shipping if the operations in the country are more than casual.

(b) Under Article 18 (alternative A) and (alternative B) of the United Nations Model Convention, social security pensions paid by the Government of a country are taxable only by that country. The country in which the recipient of the pension payments is resident cannot tax those payments. In contrast, under Article 18 of the OECD Model Convention, pensions are taxable only by the country in which the recipient of the pension is resident.

(c) Under Article 19 of both Models, remuneration and pensions paid by the Government of a contracting State to an individual for services rendered to that Government are taxable only by that State; however, if the individual is a resident and a national of the other contracting State and the services are rendered in that State, the remuneration and pensions are taxable only by that State.

These restrictions on the taxing rights of the residence country do not appear to present any serious risks of base erosion.

2.3.2 Restrictions on the taxation of income from services derived by non-residents of a country

This section examines the provisions of the United Nations and OECD Model Conventions that prevent a country from taxing income from services derived by a resident of the other contracting State even where the income is subject to tax under the country's domestic law. If the income is not taxable under the country's domestic law, then the only effect of the restriction in the treaty is to prevent the country from taxing the income if it changes its domestic law in the future to tax the income.

2.3.2.1 Employment income

In general, under Article 15 of both Models, the country in which employment is exercised is entitled to tax the income from such employment unless the employee is employed by a non-resident without a PE or fixed base in the country and is not present in the country for 183 days or more in any 12-month period beginning or ending in the relevant taxation year. (Since Article 14 dealing with professional and other independent services has been deleted from the OECD Model Convention, the reference to fixed base is relevant only for purposes of the United Nations Model Convention.) In other words, the provisions of Article 15 of both the United Nations and OECD Model Conventions prevent a country in which employment services are exercised from taxing the income from such services unless the employee:

- Is employed by a resident of that country, or
- Is employed by a non-resident with a PE or fixed base in that country and the employment income is deductible in computing the profits attributable to the PE or fixed base, or
- Is present in that country for more than 183 days in any 12-month period beginning or ending in the relevant fiscal period

If employment services are exercised by a resident of one contracting State outside the other contracting State, the income from such employment is taxable only by the State in which the employee is resident, even if the employer is a resident of the other contracting State or a non-resident with a PE or fixed base in the other contracting State. For example, assume that A, an individual resident of Country R, is employed by S Co, a company resident in Country S, and performs his employment services for S Co exclusively in Country R. Assuming further that Country R and Country S have entered into a tax treaty with a provision similar to Article 15 of the United Nations and OECD Model Conventions, the income derived by A would not taxable by Country S despite the fact that the remuneration of A is deductible in computing the income of S Co subject to tax by Country S.

Exceptions

The general rule for the tax treatment of income from employment described above does not apply to all employment income. The following specific types of employment income are subject to special rules:

(a) Under Article 16 of the United Nations and OECD Model Conventions, directors' fees are taxable by the country in which the company paying the fees is resident; Article 16 of the United Nations Model Convention also extends to remuneration of top-level managerial officials. Such fees and remuneration are taxable by the country in which the company paying the fees and remuneration is resident, irrespective of where the directors or managers perform their services (that is to say, inside or outside the country in which the company is resident).

(b) Under Article 19 of both Models, remuneration and pensions paid by the Government of one contracting State to an employee resident in the other contracting State are taxable by the Government paying the remuneration or pension. It does not matter for the purpose of this rule whether the employment services are performed inside or outside the country paying the amount. However, as noted above, this rule does not apply if the employee is a resident and national of the other State and the employment services are performed in the other State.

(c) Under Article 17 of both Models, income from entertainment and athletic activities performed in a country by an individual as an employee may be taxed by that country. The only condition for taxation is that the entertainment or athletic activities must take place in the country. There is no minimum threshold for taxation. Income from entertainment and athletic services are discussed in more detail in section 2.3.2.2 below.

(d) Under Article 18 of the OECD Model Convention, pensions (and other similar remuneration) are taxable only by the country in which the recipient is a resident. Under Article 18 of the United Nations Model Convention, however, pensions paid by the Government of a country as part of its social security system are taxable by that country. Also, under Article 18 (alternative B) a country is entitled to tax pension payments if the payer is a resident or a non-resident with a PE in that country.

2.3.2.2 Entertainment and athletic activities

Under Article 17 of both Models, a country is entitled to tax income from any entertainment or athletic activities that take place in the country. There is no minimum threshold for tax by the source country. Article 17 also contains an anti-avoidance rule that allows the country in which the activities take place to tax the income from those activities even if they accrue to a person other than the entertainer or athlete.

2.3.2.3 Income from professional and other independent services

Under Article 14 of the United Nations Model Convention, income from professional and other independent services performed by a resident of one contracting State is taxable by the other contracting State if the resident has a fixed base regularly available in the other State or stays in the other State for 183 days or more in any 12-month period beginning or ending in the relevant fiscal period. Where the services are performed through a fixed base, only the income attributable to the fixed base is subject to tax. Such income may include income from services performed outside the country in which the fixed base is located if the income is attributable to the fixed base. However, in most situations, income attributable to a fixed base will be limited to income from activities performed in the country in which the fixed base is situated. Where the services are not performed through a fixed base but the service provider stays in the country for 183 days or more, only income from activities performed in that country are subject to tax under Article 14.

Therefore, income from professional and other independent services performed by a resident of one contracting State in the other State is not taxable by the other State in which the services are performed if the service provider does not have a fixed base in that country or does not stay in that country for 183 days or more. In general, a fixed base is the same as a PE. As a result, taxpayers resident in one country can earn income from professional and other independent services performed in another country and avoid paying tax on that income in the other country by not establishing a fixed base in that country and not staying in that country for 183 days or more.

2.3.2.4 Income from other business services

Under Article 7 of both Models, income from services, other than income covered by other Articles, derived by a resident of one contracting State is taxable by the other contracting State only if the resident carries on business through a PE in the other country and only to the extent that the profits are attributable to the PE. A PE is defined in Article 5 of both Models to include a fixed place of business that lasts for a minimum period of six months. Under Article 5 (3) (b) of the United Nations Model Convention, a PE is deemed to exist if a resident of one contracting State furnishes services in the other contracting State for 183 days or more in any 12-month period in connection with the same or a connected project.

Profits attributable to a PE may include profits earned from services performed outside the country in which the PE is located. For example, if employees whose salaries are borne by the PE perform services outside the country in which the PE is located, any profits from the services performed by the employees should be attributed to the PE. However, in most situations the profits attributable to a PE will be limited to profits from services performed in the country in which the PE is located.

Profits from services performed by a resident of one contracting State in the other State are not taxable by that State unless the services are performed through a fixed place of business in the other State or, in the case of the United Nations Model Convention, are performed for a period of 183 days or more in any 12-month period for the same or a connected project. Therefore, taxpayers resident in one State can avoid tax by the country in which the services are performed by ensuring that they do not establish a PE in that country. Taxpayers can avoid having a PE in several ways: for example, by not having a fixed place of business in the country, limiting the performance of services in the country to less than 183 days, or fragmenting projects among related parties.

Construction services

Under the United Nations and OECD Model Conventions, a construction, assembly or installation project or a building site is a PE only if it lasts more than 6 months or 12 months, respectively. Although it is not completely clear under the United Nations Model Convention, a construction PE must be a fixed place of business and also meet the time threshold. Thus, taxpayers can avoid having a construction PE by carrying out projects that take less than 6 or 12 months or that take place in different locations, or by fragmenting projects among related parties.

Insurance

Under Article 5 (6) of the United Nations Model Convention, a resident of one contracting State is deemed to have a PE in the other contracting State if it collects insurance premiums or insures risks in the other State (other than through an independent agent). In contrast, under the OECD Model Convention, a resident of one contracting State carrying on an insurance business in the other contracting State is subject to tax in that State only if it has a PE in that other State. Thus, under the OECD Model Convention, it is relatively easy for an insurance company resident in one State to avoid tax on insurance profits derived from the other State by not establishing a fixed place of business in the other State and not doing business through agents with authority to regularly conclude contracts. However, it is difficult to avoid tax on insurance profits earned in another country under Article 5 (6) of the United Nations Model Convention.

2.3.2.5 Income from technical services

The United Nations Committee of Experts on International Cooperation in Tax Matters, at its eleventh session in October 2015, approved the addition of a new Article to the United Nations Model Convention dealing with fees for technical services. Under this new Article, a country will be entitled to tax fees for technical services paid by its residents or non-residents with a PE or fixed base in the country to residents of the other country for technical services on the gross amount of the fees. If, however, the recipient of the fees is a resident of the other country and the beneficial owner of the fees, the tax on the fees is limited to a rate agreed through the negotiations of the treaty partners. Under the new Article, it is not necessary for the technical services to be performed in the country; nor is it necessary for the non-resident service provider to have a PE or fixed base in the country. A country is entitled to impose a gross withholding tax on fees for technical services if the fees "arise" in the country and are paid to a resident of the other country. For this purpose, technical fees would arise in a country if the fees are paid by a resident of the country or a non-resident with a PE or fixed base in the country. Fees for technical services are defined to be fees for services of a management, technical or consultancy nature and generally include services that require the exercise of specialized skills, knowledge or experience. Employment services and services for the personal use of an individual are expressly excluded from the provision.

Table 1
Summary of the provisions of the United Nations and OECD Model Conventions dealing with income from services

Type of income from services	Conditions for source country tax

Business profits (Arts. 5 and 7)	▪ PE and income attributable to PE
	▪ United Nations Model Convention:
	  ▫ Services performed in the source country for 183 days or more for the same or a connected project
	▪ OECD Model Convention:
	  ▫ Alternative services PE rule

Construction and related services (Art. 5 (3))	▪ Construction project in the source country that lasts more than 6 months (United Nations) or 12 months (OECD)
Insurance (Art. 5 (6))	▪ United Nations Model Convention only: ▫ Collection of premiums or insurance of risks in the source country other than through independent agents
Shipping and air transportation (Art. 8)	▪ No source country tax except under United Nations Model Convention alternative B rule if international shipping activities in the source country are more than casual

Independent personal services (Art. 14)	▪ If business profits, see "Business profits" above
	▪ United Nations Model Convention only:
	  ▫ Fixed base and income attributable to the fixed base
	  ▫ Services performed in the country if the person stays in the country for 183 days or longer

Table 1 (cont'd)

Type of income from services	**Conditions for source country tax**
Dependent personal services (Art. 15)	▪ Employment exercised in the source country if the individual stays for more than 183 days or is paid by a resident of the source country or a non-resident with a PE or fixed base (United Nations Model Convention only) in the source country
Remuneration of directors (Art. 16)	▪ Residence of the paying company in the source country
Remuneration of top-level managers (Art. 16)	▪ United Nations Model Convention only: ▫ Residence of the paying company in the source country
Entertainers and athletes (Art. 17)	▪ Activities in the source country
Social security payments (Art. 18)	▪ United Nations Model Convention only: ▫ Payment by the source country
Private pension payments (Art. 18)	▪ Payer resident in the source country or PE in the source country
Government service (Art. 19)	▪ Payment by the source country unless services provided in the other country by a resident and national of that country
Other income (Art. 21)	▪ United Nations Model Convention only: ▫ Income derived in the source country

Chapter 3

Information gathering for tax policy analysis

3.1 Introduction

For purposes of applying tax policy analysis to a country's tax system with respect to income from services, the following information would be useful. Ideally, the information should be collected on a country-by-country basis.

3.2 Income derived by residents from foreign services

3.2.1 Total amount of gross revenue from foreign services

This information is useful even if a country taxes on a territorial basis and exempts income from foreign services, because it will give the country an idea of how much tax revenue in respect of such services is forgone. In some situations, the amount of foreign income may affect the rate of tax on a resident's domestic source income (often referred to as "exemption with progression").

3.2.2 Total amount of net income from foreign services

This information is useful to show the amount of tax revenue generated from income from foreign services. Where a country allows the deduction of foreign losses, this information would indicate the extent to which the tax base is reduced by such losses. If a country does not tax income from foreign services, this information may be useful to determine whether the domestic tax base is eroded by the deduction of expenses related to exempt foreign income.

3.2.3 Income from services derived from transactions with related non-residents

This information is important for purposes of a country's transfer pricing rules. It is important to ensure that residents are charging an arm's length price for services provided to related non-residents. In this regard, it should be noted that Action 13 of the OECD/G20 BEPS Project (Transfer Pricing Documentation and Country-by-Country Reporting) proposes that multinational enterprises be required to report certain information to each jurisdiction in which it is operating (so-called country-by-country reporting). Such information would include:

- Revenue earned in the country
- Profits before tax
- Taxes paid and accrued
- Employees
- Capital
- Retained earnings
- Tangible assets

In addition, multinationals will be required to identify all entities in the group doing business in the country and the type of business they carry on. However, the information referred to above will be provided on an aggregate basis for each country and not on an entity-by-entity basis. Some developing countries would prefer also to require multinational enterprises to provide information concerning payments to related parties for interest, royalties and services.

The information available to countries pursuant to this proposed country-by-country reporting is an important source of information for the tax authorities to use in combating BEPS. Such information will likely be available only through the exchange of information provisions in bilateral tax treaties or the Multilateral Convention on Mutual Administrative Assistance in Tax Matters.[7] Developing

[7] OECD-Council of Europe, Convention on Mutual Administrative Assistance in Tax Matters, 2011, available from http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

countries that do not have an extensive network of bilateral tax treaties may wish to consider ratifying the Multilateral Convention on Mutual Administrative Assistance.

3.3 Income derived by non-residents from services

3.3.1 Types of services

What are the major types of services performed by non-residents in a country, or for residents of a country, or for non-residents carrying on business in the country? This information is useful if the tax treatment is different for income from various types of services under a country's domestic law or under the provisions of its tax treaties. For example, many countries have special provisions for taxing non-resident entertainers and athletes; therefore, it would be useful to have a system to identify performances in a country by non-resident entertainers and athletes.

3.3.2 Total amounts paid by residents to non-residents for services

It would be important to know the total amounts paid by residents to non-residents for services:

- Performed in a country
- Performed through a permanent establishment (PE) or fixed base in a country
- Performed outside a country

This information is important to determine to what extent a country's tax base is reduced by payments for services to non-residents.

3.3.3 Total amount of net income from services performed by non-residents and total amount of tax collected on such income

3.3.4 Total amount of withholding tax collected on gross amounts paid to non-residents

3.3.5 Residence of non-resident service providers

It is useful to know to what extent amounts are paid to non-resident service providers who are resident in low-tax or no-tax countries or who are resident in countries with which a country has a tax treaty.

3.3.6 Income from services derived from transactions with related non-residents

This information is important for purposes of a country's transfer pricing rules. It is important to ensure that residents are charging an arm's length price for services provided to related non-residents. In this regard, as noted in section 3.2.3 above, the country-by-country reporting proposed as part of the BEPS project will be an important source of information for the tax authorities of developing countries. However, as it currently stands, the proposals will not require multinationals to report related-party payments for interest, royalties or services.

Chapter 4

Identification of the risks of the erosion of the tax base of developing countries through the provision of services, and possible responses

4.1 Introduction

This chapter of the Tax Policy Assessment Manual identifies the risks of base erosion with respect to income from services. It is divided into two sections:

- Income from services derived by residents of a country, and
- Income from services derived by non-residents of the country

For developing countries generally, the risks of base erosion are greater with respect to income from services provided by non-residents. With respect to income from services derived by non-residents, the risks of base erosion are identified for employment services, entertainment and sports activities and business services (including professional and independent services).

Further, the risks of base erosion are also greater with respect to services provided by non-resident persons related to persons resident or carrying on business in a country. For example, for a multinational enterprise with a subsidiary resident in a country, it may not matter to the enterprise from an economic or commercial perspective whether payments are received from the subsidiary in the form of dividends, interest, royalties, rents or payments for services such as management, technical or consulting services. However, if the tax consequences in the country of the various payments differ, the multinational enterprise is likely to choose the method of payment that results in minimizing the amount of tax payable in the country.

Still further, the risks of base erosion are greater with respect to certain types of services provided by related parties. For example, a multinational enterprise may incur large expenses with respect to services provided to it by third parties, such as telecommunications companies. These expenses represent legitimate expenses. The issue for the country is whether the amount of the enterprise's total expenses allocated to the subsidiary is reasonable. The amount charged to the enterprise by the telecommunications companies are expenses incurred at arm's length. In contrast, where the expenses are for services provided to the subsidiary in the country by another group company, such as technical or management services or head office services, the amounts charged must be checked to ensure that they do not exceed arm's length amounts.

Even if arm's length services are provided to persons carrying on business in a country, the country may have concerns where the service providers are resident in low-tax countries. In such circumstances, the non-resident service providers may have a competitive advantage over residents of the country providing the same or similar services.

One very important point to keep in mind in examining the question of base erosion is that any identification of the risks of the erosion of a country's tax base involves an assumption about what the country's tax base is or should be. For the purposes of this Tax Policy Assessment Manual, it is assumed that a country's tax base is comprehensive (that is to say, that all income from services derived by residents and all income derived by non-residents from services having its source in the country is subject to tax). Therefore, each country must assess the risks of tax base erosion from the perspective of its own tax system, as suggested in the introduction to the present *Portfolio.*

The major factors that should be considered in identifying and evaluating the risks of base erosion are as follows:

- What income from services does the country not tax?
- What income, if any, does the country tax at a lower rate than the country's normal tax rate applicable to individuals and corporations?
- Which payments for services are deductible against the country's tax base?

- The taxes imposed on the income from services in the country in which the service provider is resident
- The limitations on the country's taxation of income from services imposed by the country's tax treaties
- Payments for services to related parties

4.2 Employment income

4.2.1 Residents

If a country taxes on a territorial basis, income from employment services performed by its residents outside the country may not be subject to tax by the country. On the other hand, if a country taxes its residents on their worldwide income, foreign source employment income earned by its residents will be taxable by the country, but its tax will usually be reduced by a credit for any foreign taxes paid by its residents on their foreign employment income. The amount of tax in the country that is forgone depends on the tax rates in the foreign country compared with the country's tax rates.

If this situation — residents earning employment income abroad — is considered to be a serious problem, the only solution is to tax resident employees on their foreign source employment income. If taxing resident employees on their foreign source income is not feasible, countries should at least ensure that any expenses incurred by such employees in earning their foreign source income are not deductible.

4.2.2 Non-residents

Usually income from employment services derived by non-residents is subject to tax by a country if the employee is present and performing the duties of employment in the country irrespective of:

- The residence of the employer
- Whether a non-resident employer has a permanent establishment (PE) or fixed base in the country
- The amount of income
- Whether the remuneration is deductible against the country's tax base

Most countries impose tax on an employee's gross income from employment, permitting no or only limited deductions in computing income. Also, they collect tax on income from employment derived by non-residents by imposing an obligation on employers to withhold tax on account of the employees.

The major risks of base erosion with respect to income from employment derived by non-residents are discussed immediately below. For a detailed discussion of the issues involved in the secondment of employees by a non-resident company to a related resident company or to a PE of the non-resident company, see section 5.3 below.

If non-residents are employed by a non-resident employer that has a PE or fixed base in a country, is the employment income subject to tax under the country's domestic law?

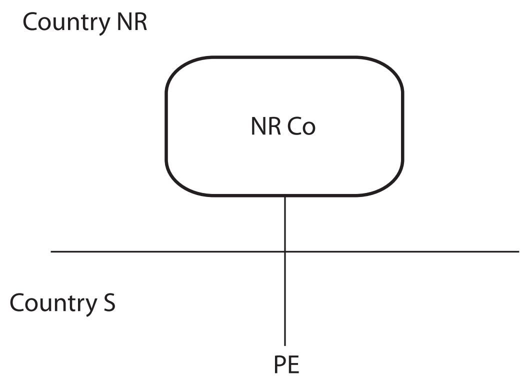
The remuneration paid by the non-resident employer to non-resident employees who are employed in connection with a PE or fixed base that the non-resident has in a country will usually be deductible in computing the income attributable to the PE or fixed base that is taxable by that country. Thus, if the employees' income is not taxable but the employer claims a deduction, the country's tax base will be eroded by the deduction.

The solution for this type of base erosion is to subject the employment income to tax under domestic law and to impose an obligation on the non-resident employer with a PE or fixed base in a country to withhold the tax on that income. Since the non-resident employer has a PE or fixed base in the country, the obligation to withhold is generally enforceable. It is also possible to make the deduction of remuneration paid to non-resident employees conditional upon the employer's withholding the tax on such amounts. In other words, unless the employer withholds the appropriate amount of tax, the salary and wages paid to the non-resident employee would not be deductible.

Example 1

NR Co, a resident of Country NR, carries on business in Country S through a PE there. Several individuals resident in Country NR are employed by NR Co at the PE in Country S. NR Co deducts the remuneration paid to these employees in computing the income attributable to its PE.

If Country S does not tax the salary and wages received by the employees of NR Company, the tax base of Country S will be reduced by the deductions claimed by NR Co for the salary and wages paid to the employees.



- Employees resident in Country NR working for PE
- Salaries and wages deductible by NR Co
- Tax on salaries and wages under the domestic law of Country S
- Obligation on NR Co to withhold tax

However, it should be noted that the provisions of a country's tax treaties may prevent the country from discriminating against a non-resident employer with a PE in the country compared to a resident of the country in the same circumstances (Article 24 (3) of the United Nations Model Convention[8]). Therefore, for example, a country would not be allowed to require such a non-resident employer to withhold tax from the salary and wages of non-resident employees unless resident employers were also required to withhold. Also, a country would not be allowed to deny the non-resident employer the right to claim a deduction for the salary and wages paid to non-resident employees in computing the profits attributable to the PE if resident employers in the same circumstances are entitled to deduct such amounts.

[8] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

If non-residents are employed by a non-resident employer that does not have a PE or fixed base (or is not otherwise taxable) in a country, is the employment income subject to tax under the country's domestic law?

If a country does not impose tax under its domestic law on employment income earned by non-resident employees from employment services performed in the country for a non-resident employer unless the employer has a PE or fixed base in the country, non-resident employers may try to avoid having a PE or fixed base in the country in order to avoid paying tax to the country on any profits derived from that country and on any employment income derived from that country by their employees. Some of the common methods for avoiding a PE or fixed base include:

(a) Commissionaire arrangements (under the law of many civil law countries, the commissionaire has no legal authority to bind the principal on whose behalf the commissionaire works; therefore, a commissionaire arrangement cannot result in an agency PE);

b) Moving the location of business activities from place to place within a country; and

(c) Having activities carried on in the country by related or associated non-residents.

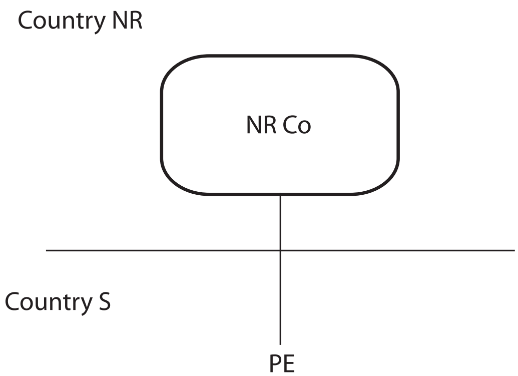
These strategies and proposals to counteract them are discussed in Action 7 of the OECD/G20 BEPS Project (Prevent the artificial avoidance of PE status).

Example 2

NR Co has been carrying on business through a PE in Country S for several years. Several individuals resident in Country NR are employed by NR Co at the PE in Country S. NR Co subsequently reorganizes its business operations in Country S so that it no longer has a PE in Country S. The individuals resident in Country NR continue to work in Country S but none of them spends 183 days or more in Country S.

Are the individuals resident in Country NR subject to tax by Country S on their income from employment derived from Country S under its domestic law? Do the tax treaties of Country S contain provisions similar to

Article 15 (2) (Dependent personal services) of the United Nations Model Convention that would prevent Country S from taxing the employment income? Does the domestic law or tax treaties of Country S contain anti-avoidance rules to prevent non-residents from artificially avoiding PE or fixed base status?



- Employees resident in Country NR working in Country S for less than 183 days
- Country S cannot tax employees

The solution for this risk of base erosion is to ensure that a country's domestic law contains anti-avoidance rules to prevent non-residents from avoiding having a PE or fixed base through artificial means. If the anti-avoidance rules are contained in domestic law, it is important that the provisions of the countries' tax treaties do not prevent the application of the anti-avoidance rules.

Even if non-resident employees are taxable under a country's domestic law where the non-resident employer does not have a PE or fixed base in the country, the employment income will escape tax to the extent that the country has entered into tax treaties with a provision similar to Article 15 (2) of the United Nations Model Convention

Article 15 (2) on dependent personal services prevents a source country from taxing employees resident in the other contracting State if they are employed by a non-resident employer without a PE or fixed base in the country unless the employee is present in the country for 183 days or more.

The solution for this risk of base erosion is to ensure that a country's domestic law and tax treaties contain anti-avoidance rules to prevent non-residents from artificially avoiding having a PE or fixed base in the country.

If services are provided by a non-resident individual to a resident of a country or to a PE or fixed base that a non-resident has in a country and the individual is not an employee but an independent contractor, is the income derived from the country by the independent contractor subject to tax under the country's domestic law? Do the provisions of the country's tax treaties prevent the country from taxing a non-resident independent contractor on income from services earned in the country unless the independent contractor has a PE or fixed base in the country?

Under the domestic law and tax treaties of many countries, income earned by non-resident independent contractors is treated differently from income earned by non-resident employees. Therefore, the legal relationship between non-resident service providers and their clients may be manipulated in order to avoid the imposition of tax by a country.

The solution for this type of base erosion is to ensure that the provisions of a country's domestic law allow the legal relationship between non-resident service providers and their clients to be determined on the basis of the substance of the relationship, and not just on its legal form.[9]

Example 3

NR Co has been carrying on business through a PE in Country S for several years. Several individuals resident in Country NR are employed by NR Co at its PE in Country S. NR Co subsequently reorganizes its business operations in Country S so that some of the individual employees become independent contractors providing services to the PE. The

[9] See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1 – 8.28 of the Commentary on Article 15 of the OECD Model Convention.

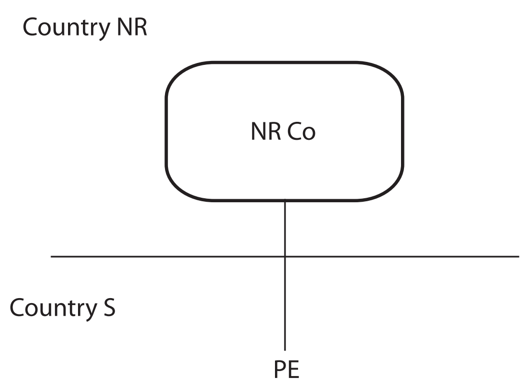
individuals resident in Country NR continue to work in Country S for the PE, but none of them spends 183 days or more in Country S and none of them has a PE or fixed base in Country S.

Are the individuals resident in Country NR subject to tax in Country S on their income from services performed in Country S for the PE of NR Co? Do the provisions of the tax treaties of Country S prevent it from taxing the individuals resident in Country NR on their income from services performed in Country S for the PE of NR Co?

Example 4

An individual, Ms. NR, resident in Country NR, is employed by R Co, a company resident in Country S. Ms. NR is subject to tax in Country S on her salary from R Co. Also, Article 15 (2) of the tax treaty between Country S and Country NR allows Country S to tax the salary of Ms. NR. Subsequently, Ms. NR and R Co enter into a new contract under which Ms. NR becomes an independent contractor. Ms. NR does not spend 183 days or more in Country S and does not have a PE or fixed base in Country S.

Is Ms. NR subject to tax in Country S on her income from R Co as an independent contractor? If Ms. NR performs the same activities for R Co as an independent contractor as she did previously as an employee, is she treated as an employee under the domestic law of Country S?



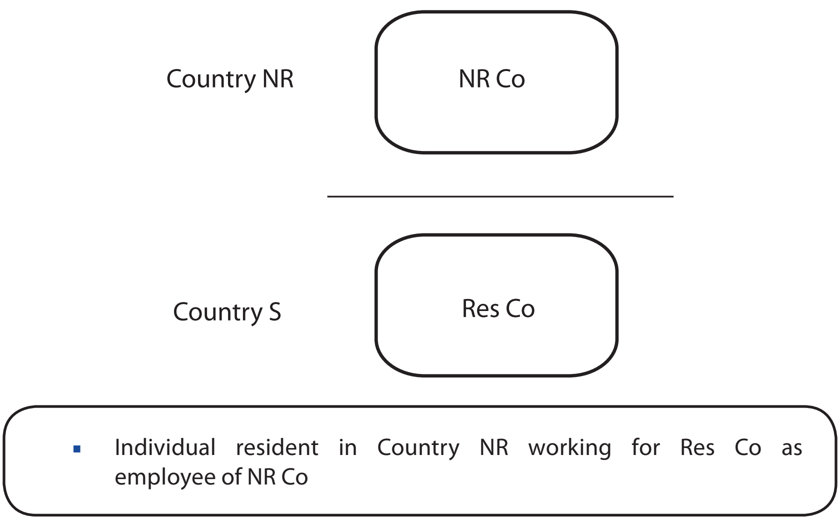
- Individual resident in Country NR performing services for the PE of NR Co as an independent contractor
- Country S cannot tax an individual unless there is a PE or fixed base

If services are provided by an individual resident of Country NR as an employee of a company resident in Country NR to a resident of Country S, the salary earned by the individual may not be subject to tax in Country S unless the individual stays in Country S for a substantial period of time; even if Country S taxes the individual's salary, its tax treaties may prevent it from taxing the salary unless the individual is present in Country S for 183 days or more

These rules of domestic law or tax treaties may be exploited if a company resident in Country NR engages in the business of providing personnel to companies resident in Country S.

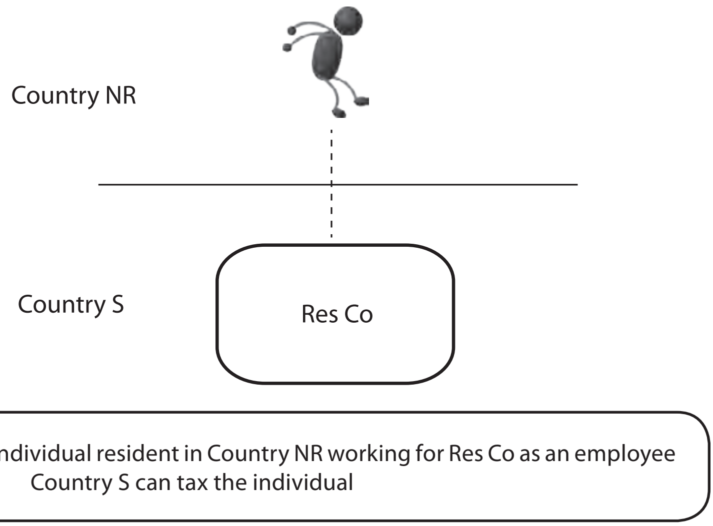
Example 5

The company resident in Country S may enter into a contract with a non-resident company for the services of an individual who is legally an employee of the non-resident company, instead of hiring an employee directly.



Example 6

The non-resident individual may, however, work for the company resident in Country S under the same terms and conditions that apply to the company's other employees.



The solution to this type of base erosion is for each country to have domestic anti-avoidance rules to prevent this type of tax avoidance and to ensure that the provisions of its tax treaties are interpreted and applied to deny treaty benefits in these circumstances.

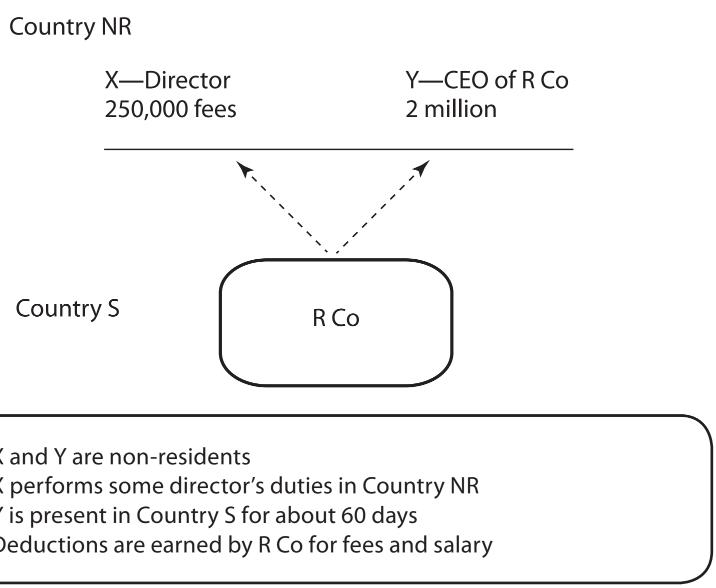
If a country does not tax the fees and remuneration earned by directors and top-level managers of companies resident in the country, the country's tax base will be eroded, since the fees and remuneration will be deductible by the resident companies

Directors and top-level managers can earn substantial amounts. The solution for this risk of base erosion is for a country to ensure that the provisions of its domestic law impose tax in these circumstances and that any tax treaties that it enters into contain a provision comparable to Article 16 of the United Nations Model Convention. Domestic tax imposed on directors' fees and the remuneration of top-level managers can be effectively collected by requiring the resident companies to withhold the tax from the fees and remuneration. Article 16 allows the country in which the paying company is resident to tax the fees and remuneration irrespective of where the services are performed by the directors or top-level managers. If a country imposes tax on directors' fees and remuneration of top-level managers that are derived from services performed outside the country, there is a risk of double taxation, since the country in which the directors or managers are resident will probably also tax the income, and, in the absence of a tax treaty with provisions similar to those of the United Nations Model Convention, that country would be under no obligation to provide relief for the tax imposed by the country in which the company is resident.

Example 7

X is a resident of NR Co and a director of R Co, a company resident in Country S. Y is a resident of Country NR and the Chief Executive Officer of R Co. X receives 250,000 for attending board meetings and chairing the audit committee. The board meetings are usually held in Country S but are occasionally held in Country NR. Y works full time on R Co business, but spends an average of only 5 days per month in Country S. Y receives a salary of 2 million annually.

Are X and Y subject to tax by Country S? If so, are they taxable on the total amount received from R Co or only on the portion attributable to the time they spend in Country S?



To the extent that employment income is paid by the Government of a country to non-residents, the amounts paid will reduce the country's treasury as well as its tax base

The solution to this problem is for a country to impose tax under its domestic law on any remuneration paid by its Government to non-resident employees irrespective of whether the duties of employment are performed inside or outside the country. In addition, any tax treaties entered into by the country should contain a provision similar to Article 19 of the United Nations Model Convention (Government services), which permits the Government that pays the remuneration to tax it. Each country should ensure that its taxes on such employment income are not avoided by non-residents inappropriately structuring their legal relationship with the Government as independent contractors rather than employees (see above).

> **Example 8**
>
> The Government of Country S employs persons who are resident in Country NR. Does Country S impose tax on the employment income earned by the non-resident employees? If not, the revenues of Country S are reduced by the forgone tax.

A country's tax base may be eroded by pensions paid to non-residents if the non-residents are not subject to tax by the country and the employers claim deductions for the payments (or for prior contributions to the pension plan) against the country's tax base

The solution for this base erosion is for each country to ensure that pensions paid to non-residents by resident employers, by non-resident employers with a PE or fixed base in the country, and by the Government are subject to domestic tax. Moreover, any tax treaties that the country enters into should not limit its ability to tax such pensions (that is to say, the treaties should contain Article 18 (alternative B) of the United Nations Model Convention (Pensions and social security payments)).

> **Example 9**
>
> R Co, a company resident in Country R, pays pensions to its employees. Some of the employees are resident in Country NR. The contributions to

the pension plan made by the employees and by R Co on their behalf were deductible by the employees and R Co in computing their income for purposes of the Country R tax.

If Country R does not tax the pension payments made to the employees resident in Country NR, the tax base of Country R will be eroded by the prior deductions for the contributions to the pension plan.

4.3 Income from entertainment and athletic services

Some entertainers and athletes can make large sums of money in a short period. They may be self-employed, employees of an entity such as a team or orchestra, or employees of an entity that they control or own. There is a possibility that the income derived by non-resident entertainers and athletes may not be taxable under a country's domestic law because, for example, the country taxes income of non-residents only if they have a PE or fixed base in the country or spend a minimum amount of time in the country.

The solution is for each country to ensure that it imposes tax on all income derived by entertainers and athletes from activities performed in the country, irrespective of whether the income is earned from employment or independent services. In addition, any tax treaties entered into by the country should not limit its right to tax income from entertainment and athletic activities performed in the country by non-residents (in other words, the tax treaties should contain provisions similar to Article 17 of the United Nations Model Convention).

Non-resident entertainers and athletes may attempt to avoid a country's tax by, for example, assigning some or all of their income earned in the country to another person (for example, a corporation controlled by the entertainer or athlete). Each country should ensure that the provisions of its domestic law allow it to tax any income derived from employment or athletic activities performed in the country, irrespective of whether the income is derived by the entertainer or athlete or by some other person, such as a related entity. In addition, any tax treaties entered into by the country should contain a provision comparable to Article 17 (2) of the United Nations Model Convention.

Example 10

Mud is a popular rap artist who is a resident of Country NR. Mud comes to Country S to perform a series of four concerts over 8 days. The contract for the concerts is entered into between a promoter resident in Country S and Mud Enterprises, a company resident in Country NR. Mud owns all of the shares of Mud Enterprises and performs the concerts as an employee of Mud Enterprises. Mud's salary for the four concerts is 10,000; Mud Enterprises earns a fee of 1 million for the four concerts.

Are Mud and Mud Enterprises subject to tax on their income earned from the concerts in Country S? If only Mud, as an entertainer, is subject to tax, that tax is easy to avoid by having most of the income earned by a company that Mud controls or diverting the income to a related person.

4.4 Income from professional and independent services

Non-resident professionals and other individuals performing services in a country may not be taxable under its domestic law unless they spend a minimum amount of time in the country or provide the services through a PE or fixed base in the country

If this type of base erosion is considered to be unacceptable, the solution is for the country to impose tax on all income from services performed in the country by non-resident individuals. Such a tax may be difficult to enforce, especially where an individual is in a country temporarily. The tax can be effectively enforced through a withholding obligation on residents of the country or non-residents carrying on business in the country. However, even these types of withholding tax may be difficult to enforce to the extent that they are imposed on individuals. A country may also consider denying a deduction by the person paying the non-resident for the services. This provision will be effective only for persons in the country that are otherwise entitled to claim a deduction for such service payments.

Even if a country taxes all income from services performed by non-resident individuals in the country, any tax treaties entered into by the country with provisions similar to Article 14 or 7 of the United Nations Model Convention will prevent the country

from taxing the income unless the individuals spend a minimum amount of time in the country or provide the services through a PE or fixed base in the country

This limitation on a country's taxing rights can be avoided if the country does not enter into tax treaties. It would not be sufficient for Article 14 (Independent personal services) to be omitted from its tax treaties, because in that event Article 7 (Business profits) would likely apply. It might also be possible for a country to attempt to negotiate a shorter minimum amount of time (such as 90 or 120 days) than the 183 days specified in Article 14 of the United Nations Model Convention.

Example 11

X is an architect who is a resident of Country NR. X gets a contract to design a building located in Country S for a company resident in Country S. In a given year, X visits Country S on numerous occasions and spends in total 160 days during that year in Country S.

Is X subject to tax by Country S on the fees received for the design of the building and the supervision of construction? If Country S has a tax treaty with Country NR, would the provisions of that treaty (Article 14) prevent Country S from taxing the fees of X? What if X has contracts to design two buildings at two different locations in Country S and spends 120 days at one location and 100 days at the other location during that year?

Non-resident professionals and other individuals may perform services outside a country for clients resident in or carrying on business in the country; in these circumstances, the clients will likely deduct the payments for the services in computing their income for purposes of the country's tax. These deductions will reduce the country's tax base

The solution for the above type of base erosion is for each country to impose a withholding tax on payments for services (or certain services) made to non-residents or to deny the deduction of such amounts by clients resident or carrying on business in the country. This explains why some countries have adopted statutory rules to impose withholding tax on payments for management, technical and consulting services provided by non-resident individuals and entities.

Example 12

NR Co is a company resident in Country NR. NR Co carries on business in Country S and uses space in the premises of a wholly owned subsidiary in Country S. NR Co employs 24 employees who travel throughout Country S but report to a manager located at the subsidiary's premises. All of these employees are residents of Country NR.

Does NR Co have a PE in Country S? If NR Co has a PE in Country S, are the salary and wages paid to its employees deductible in computing the profits attributable to the PE? Are such salary and wages subject to tax by Country S under its domestic law? If NR Co does not have a PE in Country S, are the salary and wages of its employees working in Country S subject to tax by Country S under its domestic law? Do the tax treaties of Country S prevent it from taxing the salary and wages of the non-resident employees?

Even if a country taxes income from services performed by non-resident individuals outside the country, any tax treaties entered into by that country with provisions similar to those of the United Nations Model Convention will prevent the country from imposing such a tax

The solution here is for each country to negotiate the inclusion of special provisions in its tax treaties to allow the imposition of tax on payments by its residents or persons carrying on business in the country to non-resident individuals or entities for managerial, technical or consulting services.

Example 13

Klaus is a professional engineer who is a resident of Country NR. Klaus is hired by a company resident in Country S to provide an engineering report on the structural integrity of several buildings in Country S as a result of a recent earthquake. Klaus visits Country S and spends a week at each building site inspecting the properties. He returns to Country NR, where he carries out a variety of tests on models of the buildings at a sophisticated wind tunnel at a local university and prepares his report. In total, Klaus spends 5 weeks in Country S during the year and an additional 6 months in Country NR doing tests and preparing his report. Klaus receives fees of 2 million for his work.

Under the domestic tax law of Country S, is Klaus subject to tax on the total professional fees he earns for his report? Is he taxable on the fees attributable to the time he spends working in Country S? Even if Klaus is taxable under the domestic law of Country S, to the extent that Country S has entered into tax treaties with provisions similar to Article 14 of the United Nations Model Convention, Country S will not be entitled to tax the professional fees that Klaus earns. Klaus does not have a fixed base in Country S and he does not spend more than 183 days in the year in Country S; therefore, Country S would not be allowed to impose tax under Article 14. Note also that even if Klaus had a fixed base in Country S or spent more than 183 days in Country S, Country S would be allowed to tax only the fees attributable to the fixed base or earned by Klaus from services performed in Country S.

4.5 Income from other business services

Non-resident entities and individuals performing services in a country may not be taxable under the country's domestic law unless they spend a minimum amount of time in the country or provide the services through a PE in the country

If this type of base erosion is considered to be unacceptable, the solution is for each country to impose tax on all income from services performed in the country by non-resident individuals or entities. Such a tax may be difficult to enforce, especially where the non-resident is in the country temporarily, and it may discourage non-residents from performing services in that country. The tax can be effectively enforced through a withholding obligation on payers resident in or carrying on business in the country. However, even such a withholding tax may be difficult to enforce to the extent that it is imposed on individuals. To the extent that the payments for the services provided by non-residents are deductible by payers in the country, the country may consider denying deductions for the payments or allowing deductions only if the payers withhold the appropriate amount of tax.

Even if a country taxes all income from services performed in the country by non-resident entities and individuals, any tax treaties entered into by the country with provisions similar to Articles

5 and 7 of the United Nations Model Convention will prevent the country from taxing the income unless the income is earned through a PE in the country

The above limitation on a country's taxing rights can be avoided if the country does not enter into tax treaties. Alternatively, a country might attempt to negotiate a shorter minimum time period for a services PE under Article 5 (3) (b) (Permanent establishment) than the 183-day minimum in the United Nations Model Convention.

Where non-resident service providers are taxable by a country only if (under its domestic law or tax treaties) they have a PE in the country, they may try through various artificial means to avoid having a PE in the country

The solution to this problem is for a country to have anti-avoidance rules in either its domestic law or its tax treaties, or both, to prevent artificial avoidance of PE status. The OECD BEPS Action 7 (Prevent the artificial avoidance of PE status) deals in detail with the artificial avoidance of PE status and makes several proposals for combating such avoidance. In addition, a country might consider attempting to negotiate tax treaties that do not contain the "same or connected project" requirement in Article 5 (3) (b).

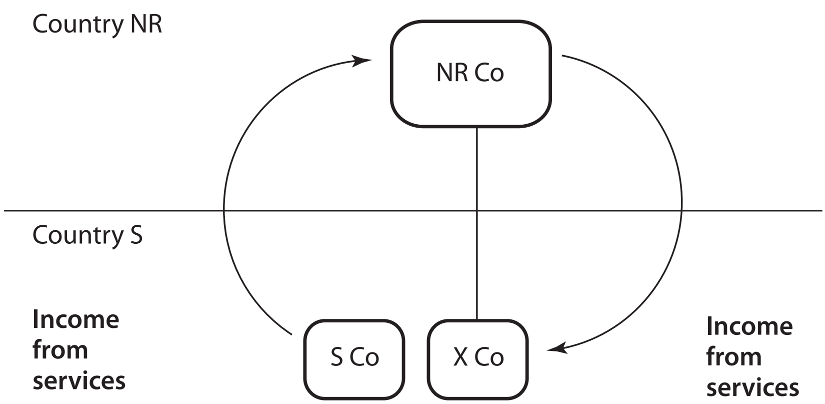
Non-resident entities and individuals may perform services outside a country to clients resident in or carrying on business in the country; in these circumstances, the clients will likely deduct the payments for the services in computing their income for purposes of the country's tax—these deductions will reduce the country's tax base

The solution for this type of base erosion is for a country to impose a withholding tax on payments for services (or certain services) made to non-residents or to deny the deduction of such amounts by clients resident or carrying on business in the country. This explains why some countries have adopted statutory rules to impose withholding tax on payments for management, technical and consulting services provided by non-resident individuals and entities.

Example 14

NR Co is a company resident in Country NR. NR Co provides substantial consulting and management services in Country NR to its wholly owned subsidiary S Co, resident in Country S. NR Co also provides services to X Co, an unrelated company resident in Country S. NR Co does not have a PE in Country S and does not send any employees to work in Country S.

Are the payments by X Co and S Co for the services provided by NR Co deductible in computing the income of S Co and X Co? Are the payments by S Co subject to the transfer pricing rules of Country S? Are the payments by S Co and X Co subject to withholding tax by Country S?



Example 15

R Co is a multinational company with subsidiaries in many countries all over the world. R Co has a subsidiary, S Co, which is resident in Country S. R Co also has a wholly owned subsidiary, TH Co, resident in Country TH, which imposes tax at low rates. TH Co provides management services to S Co in consideration for fees of 4 million. Although employees of TH Co occasionally visit S Co in Country S, the management services are performed primarily in Country TH. TH Co does not have a PE in Country S.

Is TH Co subject to tax in Country S on the fees it earns from S Co from services performed in Country S and from services performed outside Country S?

Non-resident entities and individuals may perform services for related individuals or entities resident in or carrying on business in a country; as noted in subsection immediately above, the amounts paid for the services will likely be deductible against that country's tax base; in addition, because the payer and non-resident service provider are related, there is a risk that the payer will pay more or less for the services than their fair market value

The solution for this type of base erosion is for countries to have robust transfer pricing rules that can be applied to ensure that the amounts charged in cross-border related-party transactions are the same as the amounts that would be charged by parties dealing at arm's length.

Even if a country taxes income from services performed outside the country by non-resident entities and individuals, any tax treaties entered into by the country with provisions similar to those of the United Nations Model Convention will prevent the country from imposing such a withholding tax

The solution here is for countries to negotiate the inclusion of special provisions in their country's tax treaties to allow the imposition of tax on payments by residents or persons carrying on business in their countries to non-resident individuals or entities for managerial, technical or consulting services, as proposed by the United Nations Committee of Experts on International Cooperation in Tax Matters.

Example 16

Based on the facts of the previous example, assume that under the domestic tax law of Country S, TH Co is subject to a withholding tax of 10 per cent on the fees it earns from services performed in Country S and on the fees it earns from the services provided in Country TH. Thus, S Co will be required to withhold 400,000 from the fees and remit that amount to the tax authorities of Country S. However, if Country S and Country TH have entered into a tax treaty with terms identical to those of the United Nations Model Convention, TH Co will not have a PE in Country S and Country S will not be entitled to tax the business profits of TH Co earned inside or outside Country S.

If the treaty between Country S and Country TH has a provision similar to the one that the United Nations Committee of Experts has proposed to add to the United Nations Model Convention, Country S would be entitled to tax any managerial, technical or consulting fees derived by TH Co from persons resident or carrying on business in Country S through a PE or fixed base, irrespective of whether TH Co has a PE or fixed base in Country S or whether the services are performed in Country S.

Non-resident insurance companies may not be taxable by a country because they do not carry on business through a PE in the country; nevertheless, they may engage in substantial business in the country

This type of base erosion can be countered if each country imposes tax on non-resident insurance companies that collect premiums in the country or insure risks located in the country.

Even if a country imposes tax on non-resident insurance companies that collect premiums or insure risks in the country, any tax treaties entered into by the country will prevent the country from imposing that tax unless they contain a provision similar to Article 5 (6) of the United Nations Model Convention

Non-resident construction companies may not be taxable by a country unless the construction project requires them to spend a minimum amount of time in that country

If a non-resident construction company provides construction services to a resident of another country, the payments will likely be deductible against the tax base of the country in which the payer is resident. Therefore, unless the country can tax the non-resident construction company, its tax base will be eroded. This base erosion can be dealt with if the country imposes tax on all income derived by non-residents from construction projects in the country. However, the imposition of such a tax may discourage non-residents from doing construction business in that country.

Even if a country imposes tax on all income derived by non-residents from construction activities in the country, any tax treaties entered into by the country (based on the United Nations

Model Convention) will prevent that country from imposing that tax unless the construction project lasts for at least six months

A country can avoid the limitations imposed by tax treaties by not entering into tax treaties or by attempting to negotiate a shorter minimum time period for a construction site PE. In addition, a country might consider attempting to negotiate a provision in its tax treaties dealing with construction site PEs that does not require the construction activities to occur at a single fixed place of business.

Example 17

R Co is a construction company resident in Country R. R Co gets a contract from a company resident in Country S to construct two shopping centres in two different cities. It takes R Co four months to complete construction on each shopping centre.

Assuming that Country S has a tax treaty with Country R with a provision identical to Article 5 (3) (a) of the United Nations Model Convention, Country S will not be allowed to tax R Co on its profits from the construction project in Country S unless it lasts more than six months. However, arguably, each shopping centre will be considered to be a separate site for purposes of Article 5 (3) (a), so that neither site will be deemed to be a PE. In other words, the two construction sites cannot be aggregated for purposes of applying the six-month minimum time threshold, despite the fact that both shopping centres are owned by the same entity and both projects are covered by a single contract.

If Country S wants to be able to impose tax on non-resident construction companies in these circumstances, it should not enter into treaties with provisions similar to Article 5 (3) (a), or it should negotiate special provisions in its treaties that allow construction projects at different locations in Country S to be aggregated, especially if they are performed for the same owner.

4.6 Summary: key risks of base erosion

This chapter contains a comprehensive list of the potential risks for the erosion of a country's tax system as a result of non-residents performing services. Many of the risks described in this chapter are relatively insignificant and it may not be worthwhile for a country to take any action to eliminate these risks. From a risk management perspective, each country will wish to target the base-erosion risks that pose the greatest threat to its tax base. Each country must identify the most serious risks of tax base erosion based on its particular situation. However, in general, the following situations are likely to present the most serious risks of base erosion:

(a) Income from employment:
- Non-resident employees working for a PE or fixed base of a non-resident
- Non-resident employees who are in substance employees of a resident employer but who are legally employed by a non-resident employer (international hiring-out of labour)
- Non-residents who are in substance employees of a resident employer but are legally independent contractors

(b) Income from entertainment and sports activities:
- Taxation of income from all entertainment and sports activities of non-residents taking place in a country if the non-residents earn substantial amounts

(c) Professional and other independent services:
- Non-residents performing substantial services in a country without having a PE or fixed base in the country, especially where the non-residents artificially avoid having a PE or fixed base
- Non-residents performing substantial services outside a country to clients who are resident or carrying on business in the country, especially where the payers claim deductions for the payments to the non-resident service providers

(d) Other business services:
- Services provided by a non-resident to a related person resident in a country
- Non-residents performing substantial services in a country without having a PE in the country, especially where the non-residents artificially avoid having a PE or fixed base

- Non-residents performing substantial services outside a country to clients who are resident or carrying on business in the country, especially where the clients claim deductions for the payments to the non-resident service provider

Chart
Risks of base erosion with respect to income from services and the options for dealing with such risks

Risks of base erosion	Options for dealing with the risks of base erosion
Employment income — residents	
▪ Services performed by residents outside a country if the country taxes on a territorial basis ▪ Exemption of income from services performed through a foreign PE ▪ Use of a controlled foreign corporation (CFC) by residents of a country to perform services in that country	▪ Tax residents earning employment income on a worldwide basis ▪ Ensure that exemption is not available in inappropriate circumstances ▪ Consider whether tax is imposed by the foreign country ▪ Adopt CFC rules or limit base erosion by non-residents (see below)
Employment income — non-residents	
▪ Services performed by non-residents in a country	▪ Ensure that income from such services is subject to tax under a country's domestic law ▪ Impose a withholding obligation on resident employers and non-resident employers with a PE or fixed base in the country ▪ Deny a deduction if there is no withholding
▪ Amounts paid to non-resident employees by residents of a country or non-residents with a PE or fixed base in the country for services performed outside the country (deductible against the country's tax base)	▪ Ensure income from such services is subject to tax under a country's domestic law ▪ Impose a withholding obligation on resident employers and non-resident employers with a PE or fixed base in the country

Risks of base erosion	**Options for dealing with the risks of base erosion**
	▪ Deny a deduction if there is no withholding (Tax treaties may prevent a country from taxing)
▪ Services performed by non-resident employees of a non-resident employer without a PE or fixed base in a country (no deduction against the country's tax base) ▫ If taxable in the country, provisions similar to Art. 15 (2) of the United Nations Model Convention in the country's treaties will prevent that country from taxing employees	▪ Ensure in domestic law or tax treaties that non-residents cannot artificially avoid having a PE or fixed base
▪ Remuneration of non-resident directors and top-level managers of companies resident in a country	▪ Ensure that tax on such income is imposed under domestic law and there is an obligation on the resident company to withhold tax ▪ Ensure that any tax treaties contain provisions similar to Art. 16 of the United Nations Model Convention
▪ Non-resident individual's legal status as independent contractor rather than employee may prevent a country from taxing, either because of domestic law or tax treaties (including international hiring-out of labour—formal employer is non-resident but resident is employer in substance)	▪ Ensure that domestic law contains anti-abuse rules to prevent artificial manipulation of legal relationships, including international hiring-out of labour
▪ Non-resident employers providing employment services to the Government of a country	▪ Impose tax on amounts paid by the Government to non-resident employers and ensure that any tax treaties contain provisions similar to Art. 19 of the United Nations Model Convention

Risks of base erosion	Options for dealing with the risks of base erosion
▪ Pensions paid to non-residents	▪ Impose tax on pensions paid to non-residents by resident employers, non-resident employers with a PE or fixed base, or the Government, and ensure that any tax treaties contain provisions similar to Art. 18 (alternative B) of the United Nations Model Convention
Income from entertainment and athletic activities	
▪ Income derived by a non-resident entertainer or athlete from activities in a country for a short time may not be taxable	▪ Impose tax on any income from entertainment or athletic activities performed in the country irrespective of whether the non-resident has a PE or fixed base in the country or spends a minimum period of time in the country ▪ Ensure that any tax treaties contain provisions similar to Art. 17 of the United Nations Model Convention
▪ Non-resident entertainers and athletes may assign income to another person who is not taxable by a country	▪ Ensure that domestic law contains anti-avoidance rules to prevent non-resident entertainers and athletes from assigning income to another person ▪ Ensure that any tax treaties contain provisions similar to Art. 17 (2) of the United Nations Model Convention
Business, professional and other independent services	
▪ If a country taxes income from business services only if a non-resident has a PE or fixed base in the country, the non-resident may structure its affairs to avoid PE or fixed base by:	▪ Ensure in domestic law and/or tax treaties that non-residents cannot artificially avoid having a PE or fixed base

Risks of base erosion	Options for dealing with the risks of base erosion
▫ Providing services at various locations ▫ Fragmenting services among related entities ▫ Using related entities to carry on connected projects	
▪ Amounts paid to non-residents by residents of a country or non-residents with a PE or fixed base in the country for services performed outside the country, that is to say, services provided outside the country but consumed or used in the country (deductible against the country's tax base)	▪ Ensure that payments for such services are subject to tax under domestic law ▪ Impose a withholding obligation on resident payers and non-resident payers with PE or fixed in the country ▪ Deny a deduction if there is no withholding ▪ Ensure that tax treaties do not prevent the country from taxing
Construction	
▪ If construction activities are taxable only if they last for a minimum period, non-residents can avoid tax by fragmenting a construction project into multiple projects with shorter time periods ▪ Tax treaties may provide that income from construction is taxable by a country only if the non-resident has a PE	▪ Adopt a shorter minimum time period for construction projects in domestic law and in tax treaties ▪ Adopt anti-avoidance rules in domestic law and/or tax treaties ▪ Ensure that non-residents cannot avoid PE status artificially
Insurance	
▪ Non-resident insurance companies can carry on substantial business activities in a country without a PE	▪ Ensure that a PE is not necessary for the country to tax income from insurance businesses ▪ Ensure that tax treaties contain provisions similar to Art. 5 (6) of United Nations Model Convention

Risks of base erosion	Options for dealing with the risks of base erosion
International shipping and air transportation	
▪ If payments for shipping and air transportation services are deductible against a country's tax base and payments are not taxable, the country's tax base will be eroded	▪ Impose a domestic withholding tax on payments for shipping and air transport of goods or persons taken on board in the country
▪ Difficult to tax to the extent that activities occur outside any country's territory	▪ Ensure that tax treaties do not contain provisions similar to Art. 8 (alternative A or B) of United Nations Model Convention
▪ Art. 8 (alternative A) prevents any tax on such services ▪ Art. 8 (alternative B) prevents any tax except on more than casual shipping activities in the country	
Fees for technical services	
▪ If payments for managerial, technical and consulting services provided by non-residents are deductible against a country's tax base and are not taxable, or are taxable at a lower rate, the country's tax base will be eroded	▪ Impose withholding tax on payments by residents and non-residents with a PE or fixed base in the country to non-residents for technical, among other, services, irrespective of where services are rendered ▪ Ensure that tax treaties do not prevent imposition of withholding tax on gross payments (the existing United Nations Model Convention would prevent such withholding tax—see new Article for the United Nations Model Convention dealing with fees for technical services)

Chapter 5
Special topics

5.1 Introduction

This chapter deals briefly with a number of special topics related to the risks of base erosion with respect to services. Section 5.2 discusses the risks of base erosion in connection with value added taxes (VAT) on supply of services by non-residents. Sections 5.3 and 5.4 deal, respectively, with the secondment of employees and the performance of services by one company in a multilateral group to or for the benefit of another company in the group. Although they are beyond the scope of the present *Portfolio*, these two topics raise serious transfer pricing concerns, which the tax authorities of countries should be aware of. Section 5.5 deals with the special problems caused by mixed contracts under which an enterprise provides the use of intangible property and also technical assistance to a client.

5.2 Value added tax (VAT) on services performed by non-residents

Although the present *Portfolio* deals with income taxes imposed on income from services, it is worthwhile mentioning briefly the imposition of indirect or consumption taxes on services rendered by non-residents to residents of a country. With respect to VAT on such cross-border services, most countries adhere to the destination principle, under which exports of services are not subject to VAT by a country but imports are taxable. However, two different approaches are used to determine the place where services are taxable. Some countries impose VAT on supplies of services by persons resident or established in those countries even if the services are rendered to non-resident consumers and provide refunds to taxable businesses. Other countries impose their VAT on supplies of services to resident consumers; non-resident suppliers must register for VAT purposes and collect tax on supplies of services. Some countries use a "reverse charge" mechanism to collect VAT on supplies of services by non-resident suppliers. Instead of the non-resident service supplier collecting the tax, business consumers who are registered for VAT are required to collect the tax. In most cases they will be entitled to claim that tax as an input tax credit against the tax payable on the taxable supplies they provide. This is the approach recommended by the OECD *International VAT/GST Guidelines*.[10]

Although the reverse-charge mechanism works reasonably well for services rendered to businesses (so-called B2B supplies), it is not suitable for services rendered to consumers (so-called B2C supplies) because individual consumers are unlikely to self-assess VAT on services purchased from non-residents. For this reason, many countries limit the exemption for exports of services to B2B supplies (a place of origin approach). However, some countries have attempted to extend the destination approach to B2C supplies by requiring non-resident service suppliers to register and collect VAT on supplies to individual consumers.

To avoid opportunities for base erosion with respect to B2B supplies, countries should require all business consumers to self-assess VAT on taxable supplies from non-resident suppliers. Although taxable businesses will be able to claim input credits for the self-assessed VAT, exempt businesses will not and the VAT will be collected. The imposition of VAT in these situations eliminates any competitive advantage for non-resident service suppliers.

The threshold for the application of VAT to non-resident service suppliers is similar to the (permanent establishment) PE threshold for the imposition of income tax; taxpayers can arrange their affairs to avoid having to register for VAT in the same ways that they can avoid having a PE in a country for income tax purposes. In particular, digital services can be provided to consumers and businesses resident in a country by non-resident enterprises without the need for

[10] OECD, *International VAT/GST Guidelines* (Paris: OECD, 2014), available from http://www.oecd.org/tax/consumption/international-vat-gst-guide lines.pdf.

any substantial presence in the country, so that they are not subject to income tax or VAT. As discussed above, business consumers can be required to self-assess services received from non-residents; however, it is extremely difficult for the tax authorities to expect individual consumers to self-assess VAT. In response to the OECD/G20 *Action 1: 2015 Final Report: Addressing the Tax Challenges of the Digital Economy*,[11] several countries have adopted a new threshold for the imposition of VAT with respect to services provided to resident consumers. Under these new thresholds, non-resident enterprises are required to register for VAT if they make sales in the country in excess of a minimum monetary amount. Although some non-resident enterprises may refuse to register, but continue to provide services to resident consumers, large multinational enterprises are unlikely to blatantly ignore the legal and tax requirements of the countries in which they do business. Therefore, it may be sufficient for countries to rely on voluntary compliance by large public enterprises with respect to VAT imposed on remote services and digital products. The alternative to voluntary compliance by non-resident service providers is a withholding tax imposed on resident consumers, which raises significant compliance and enforcement concerns.

5.3 Secondment of employees

A multinational enterprise often sends employees who are resident in one country to another country to work for a subsidiary company resident in that country. In this situation, there should be legal documentation in place with respect to the terms and conditions under which the employees work for the subsidiary. On the other hand, if employees of the parent company or a related company visit the subsidiary to work on behalf of the parent or related company (for example, performing quality control functions), the benefits of the services performed by the employees are derived by the parent or related company, not the subsidiary, and the salaries of those employees are properly paid by the parent or related company. In certain situations, it may be difficult to determine whether an employee's activities are carried out for the benefit of the employer or a related company.

[11] Available from http://www.oecd.org/ctp/addressing-the-tax-challenges-of-the-digital-economy-action-1-2015-final-report-9789264241046-en.htm.

If the employees of the non-resident parent company become residents of the country in which the subsidiary is resident, they will be taxable as residents under the domestic law of that country. However, if that country has entered into a tax treaty with the country in which the parent company is resident with a provision similar to the tie-breaker rule in Article 4 (Resident) of the United Nations Model Convention,[12] the employees will likely be considered to be residents of the country in which the parent company is resident for purposes of the treaty (because the employees have their permanent homes or their centre of vital interests in that country). Even if the tie-breaker rule applies to make employees resident in the country in which their employer is resident, the country in which the subsidiary is resident is entitled to tax the income from employment derived by the employees under Article 15 (Dependent personal services) of the treaty to the extent that they are employed by a resident of that country and the employment activities are exercised in that country.

Whether or not employees of the parent company or related company become residents of the country in which the subsidiary is resident, they may become employees of the subsidiary or remain employees of the parent company.

If the employees cease to be employees of the non-resident parent company or other related company and become employees of the subsidiary, their employment income will usually be taxable by the country in which the subsidiary is resident and deductible in computing the profits of the subsidiary under the domestic law of that country. In addition, if that country has any tax treaties with a provision similar to Article 15 of the United Nations Model Convention, those treaties will not prevent that country from taxing the income of the non-resident employees from employment exercised in that country in accordance with its domestic law.

If the employees remain employees of the parent or related company, which will often be the case because of complications with respect to their continuing participation in pension and other deferred

[12] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

compensation plans, the subsidiary should be expected to compensate the parent or other related company for providing the services of their employees. The amount paid by the subsidiary will be deductible in computing its profits subject to tax by its country of residence; however, that country will not be entitled to tax the income derived by the employees unless they are present in that country for more than 183 days in any 12-month period or the non-resident parent or related company has a PE or fixed base in the country and the remuneration of the employees is borne by that PE or fixed base.

The provision of services by one company to a related company through the secondment of employees of the first company to the related company is a transaction between non-arm's length parties that should be subject to transfer pricing rules (see *United Nations Practical Manual on Transfer Pricing for Developing Countries*[13]). The country in which the subsidiary is resident should ensure that it does not allow the subsidiary to deduct an amount in excess of the arm's length price of the employment services provided by the parent or related company. The issue that often arises in this regard is whether the arm's length price for the provision of employees by a related enterprise is simply the salaries and other remuneration of the employees for the period during which they provide services for the subsidiary, or that amount plus a markup. Where the subsidiary can obtain the services by hiring its own employees for an amount equal to or less than the remuneration paid to the seconded employees by their employer, the country in which the subsidiary is resident should not allow the deduction of any markup on the remuneration; only reimbursement of the actual expenses incurred by the parent or related company with respect to the seconded employees should be deductible.

Where employees of a non-resident enterprise work on behalf of a PE or fixed base located in the source country, the source country will be entitled to tax the employment income derived by those employees under Article 15 of any applicable tax treaty. In addition, the source country will usually be required by Article 7 (Business profits) or 14

[13] United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf.

(Independent personal services) of any applicable tax treaty to allow a deduction in computing the profits of the PE or fixed base for the remuneration of those employees to the extent that their employment activities are attributable to the PE or fixed base. The question that often arises in this regard is whether the source country must allow a deduction for the actual costs incurred in remunerating those employees or the actual costs plus a markup. The allowance of a markup is based on the proposition that a PE is deemed to be a separate entity dealing at arm's length with the other parts of the enterprise, and that such a separate enterprise would expect to make a profit from providing services through its employees to other enterprises.

The Commentary on Article 7 of the United Nations Model Convention[14] indicates that a markup should be allowed only if part of the business of the enterprise involves providing services to arm's length third parties. Therefore, if an enterprise provides services through employees to a PE, but does not provide similar services to third parties, only the actual costs incurred by the enterprise in providing the employees to the PE should be deductible in computing the profits of the PE.

See section 4.2 above for a discussion of the risks of base erosion with respect to employment income.

5.4 Intra-group services

In multinational groups, it is common for a wide range of services to be provided by one member of the group to another member or members of the group. For example, the parent company of a multinational group may provide legal and accounting services to all of the members of the group, or one member of the group may be responsible for the training of employees or the purchasing of certain goods and services for the benefit of all the members of the group. Since amounts paid by an enterprise resident in one country to a related service provider resident in another country are deductible in computing the taxable profits of the first enterprise, those payments erode the tax base of the country in which the payer is resident.

[14] Paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraphs 35–38 of the Commentary on Article 7 of the 2010 OECD Model Convention.

Intra-group services raise difficult transfer pricing issues. The country in which the payer is resident must ensure that the amount paid for services provided by a related non-resident service provider does not exceed the arm's length price of those services.[15] Before a country applies its domestic transfer pricing rules or the provisions of Article 9 (Associated enterprises) of an applicable tax treaty, it must determine whether, as a question of fact, intra-group services have been rendered to or by a resident member of a multinational group. This factual question may be relatively easy to determine where one member of the group provides services for the benefit of another member of the group because if the service recipient is an independent enterprise, it would be required to contract with a third party for those services or perform them in-house itself. The question is more difficult where one member of the group provides services for several members of the group or for the group as a whole.

In some situations, it may be appropriate to consider that no services have been provided to a group company. For example, activities performed by one group company, say the parent, that relate to its ownership of the shares of other group companies (sometimes referred to as shareholder activities), such as the cost of meetings of the parent's shareholder, should not be considered to involve services provided to the other group companies because independent enterprises in similar circumstances would not be willing to pay for such services, since they derive no benefits from them. On the other hand, one group company may provide management and other related services (often referred to as stewardship activities) to other group companies. These services provide benefits to the group companies receiving them and arm's length charges for such services are justified. Difficult issues may be encountered where one group member pays standby fees (in addition

[15] With respect to the transfer pricing of intra-group services, see United Nations, Department of Economic and Social Affairs, *Practical Manual on Transfer Pricing for Developing Countries* (New York: United Nations, 2013), at 19-20, available from http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf; and OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010), chapter VII, available from http://www.oecd.org/publications/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm.

to the fees for the services actually performed) with respect to services to be provided by another group company. Such fees should be allowed only if it would be reasonable for an independent enterprise in similar circumstances to incur similar standby fees.

It is important with respect to all intra-group services for the tax authorities to carefully examine the terms and conditions of the contractual arrangements between the group members, and also the actual services performed.

5.5 Mixed contracts

In some circumstances, goods or intangible property may be sold or licensed together with services. For example, goods or equipment may be sold with the seller agreeing to provide after-sales services, which could include training of the employees of the buyer with respect to the operation of the goods or equipment or repair services under a limited warranty. Another frequently encountered example is the licensing of intangible property together with technical assistance. Such mixed contracts present difficulties for tax administrations.

If property and services are sold together in a mixed contract between associated enterprises, the tax authorities must determine for the purpose of transfer pricing rules whether the rules should be applied to the combined transaction, or whether the combined transaction should be disaggregated into its separate components and the transfer pricing rules applied to each component.[16] Mixed contracts often involve payments for both services and royalties. Such contracts must be disaggregated into their different elements if royalties and services are taxed differently under a country's domestic law (for example, if different rates of withholding tax are applied to royalties and services) or if a tax treaty with provisions similar to those of the United Nations Model Convention applies. Under Article 7 or 14 of the United Nations Model Convention, income from services is taxable

[16] See OECD, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris: OECD, 2010), paragraphs 1.42–1.44, available from http://www.oecd.org/publications/oecd-transfer-pricing-guidelines-for-multinational-enterprises-and-tax-administrations-20769717.htm.

by a country only if the income is earned by a resident of the other contracting State through a PE or fixed base located in the country and only to the extent that the income is attributable to the PE or fixed base. Moreover, the income covered by Article 7 or 14 will usually be taxed on a net basis. Under the new Article on fees for technical services (see section 2.3.2.5 above), a contracting State will be entitled to tax fees for technical services derived by a resident of the other contracting State on a gross basis at a rate to be negotiated.

In contrast to the treatment of income from services, under Article 12 (Royalties), a contracting State in which royalties arise is entitled 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 (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 general, royalties mean 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, typically when an enterprise provides services to a customer, the enterprise does not transfer its property or know-how or experience; instead, the enterprise simply performs work for the customer.

Where an enterprise provides both services and the right to use property or know-how to a customer, the Commentary on the United Nations Model Convention provides that 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.[17] If a developing country includes the new Article on technical services in its treaties, the negotiation of a rate of tax for fees for technical services that is the same as the rate for royalties in Article 12 may help to alleviate the difficulties with mixed contracts and, in particular, may be useful for developing countries with scarce administrative resources.

[17] Paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention.

As with intra-group services, it is important with respect to mixed contracts for the tax authorities to carefully examine the terms and conditions of the contractual arrangements between the parties, as well as the actual facts concerning the use of property and services provided. This is especially important where the parties are not dealing at arm's length.

Chapter 6

Checklist

6.1 Residents of a country earning income from services performed outside that country

1. Does the country tax its residents generally on income earned outside that country?
2. Does the country tax its residents on income from services performed outside the country? If not, has the country considered whether this provides opportunities for its residents to avoid tax?
3. Even if a country taxes its residents on their worldwide income, does it exempt from tax certain income from services performed outside the country?
4. How does the country provide relief from international double taxation of income from services?
5. If a country provides a credit against its tax for foreign taxes on income from services earned by a resident of the country outside the country, is the credit limited to the country's tax on the foreign income? If so, how is the limitation determined?
6. Does the country have controlled foreign corporation (CFC) rules that apply to income earned by a CFC from services performed in the country?

6.2 Non-residents of a country earning income from services in the country

1. Does the country tax non-residents on income from services performed in the country or consumed or used in the country, or both? If so, under what circumstances?

2. How much tax revenue, if any, does the country raise from taxing income from services earned by non-residents?
3. Consider whether the country's rules for taxing non-residents on income from services discourages non-residents from rendering services in the country or to residents of the country.
4. Consider whether the country discriminates against non-residents compared to residents or vice versa.
5. Are the provisions of the country's domestic law for taxing non-residents on income from services relatively easy for that country's tax administration to enforce?
6. If a country imposes or is considering whether to impose a gross withholding tax on certain payments to non-resident services providers, consider whether the tax will be passed on to the payers resident in the country.
7. Does the country have robust transfer pricing rules to prevent related parties from charging more or less than the arm's length price for cross-border services?

Part 3

Designing and drafting domestic legislation and negotiation of tax treaties to prevent base erosion with respect to the taxation of income from services

Chapter 1

Introduction

Part 3 of the present *Portfolio* on services deals with the designing and drafting of legislative and treaty provisions to prevent base erosion and profit shifting (BEPS) with respect to income from services. Chapter 2 provides a general analysis of the major structural features of domestic legislation to combat base erosion with respect to various types of income from services. Chapter 3 provides some sample legislative provisions designed in accordance with the structural features discussed in chapter 2, along with explanatory notes describing the purpose of the provisions and providing guidance for their interpretation and application. Chapter 4 deals with the negotiation of the provisions of tax treaties dealing with the prevention of base erosion related to income from services.

It is worth emphasizing that the purpose of this part of the *Portfolio* is not to provide legislative or treaty provisions that developing countries can enact as part of their domestic law or include in their treaties. Each country has its own drafting style and an existing income tax system into which any new provisions dealing with base erosion must be incorporated. Indeed, in many cases a country's existing tax system may deal adequately with some of the risks of base erosion identified in the present *Portfolio*. Therefore, the sample legislative and treaty provisions set out in part 3 are included as suggestions or models that might be referred to for guidance when a country is drafting its tax legislation or negotiating its tax treaties, in order to ensure that adequate consideration is given to the risks of base erosion. A comparison of the samples and a country's existing legislation and treaties may suggest possible changes that might be made. Further, the sample provisions should not be treated as recommendations for the inclusion of such provisions, even in modified form, in a country's tax system or its tax treaties. Each country must decide for itself whether, and to what extent, it is concerned about the risks of base erosion with respect to income from services identified in chapter 4 of part 2 and, if so, how best to deal with those risks. This *Portfolio* is intended to provide the tax officials of developing countries with guidance in this regard.

Chapter 2

The major design elements in drafting domestic legislation to counter base erosion with respect to income from services

2.1 Introduction

This chapter analyses the major design elements or structural features of domestic legislation for taxing income from services to eliminate the risks of base erosion that were identified in chapter 4 of part 2. The chapter has three components, dealing with:

(a) The taxation of residents of a country earning foreign income from services (section 2.2);

(b) Non-residents earning income from services taxable by a country on a net basis (section 2.3.2); and

(c) Non-residents earning income from services taxable by a country on a gross basis through a withholding tax (section 2.3.3).

As these three sections indicate, in most countries the rules for taxing residents and non-residents differ; the distinction between residents and non-residents is therefore important. However, this chapter does not discuss a country's rules for distinguishing between residents and non-residents. It simply assumes that countries make such a distinction and that the rules for taxing residents and non-residents with respect to income from services differ. Similarly, this chapter assumes that countries tax certain income from services derived by non-residents on a net basis (that is to say, allowing the deduction of expenses incurred in earning the income) and other income from services on a gross basis through a withholding tax. The chapter does not examine how countries determine which amounts are subject to net-basis taxation and which amounts are subject to withholding tax.[1] It analyses the design features of net-basis taxation and withholding taxes in general, rather than as they might apply to particular types of income from services.

2.2 Taxation of residents on income from services

2.2.1 Introduction

As discussed in chapter 1 of part 2, the risks of base erosion with respect to income from services earned by residents of a country are dependent upon how that country taxes its residents. If it taxes its residents on their worldwide income, including their income from services performed outside the country, the risks of base erosion will be less than they would be if the country taxes residents only on their income earned in the country. The extent of base erosion is greatest where residents of a country earn income in low-tax or no-tax countries.

2.2.2 Risks of base erosion

2.2.2.1 If income from foreign services is exempt from tax in a country

If some or all income from services earned by residents outside a country is exempt from tax, there are two risks of base erosion. First, residents will have an incentive to earn foreign source income rather than domestic source income if the foreign source income is subject to tax at a rate less than the residence country's domestic rate. Second, expenses incurred by residents to earn foreign source income that is exempt from tax by the country should not be deductible against that country's tax base, but there is a risk that such deductions may in fact be claimed.

2.2.2.1.1 Incentive for residents to earn foreign source income

The incentive for residents to earn foreign source income, which is

[1] See part 2, chapter 2, section 1.4, for a discussion of how this distinction is made.

exempt from tax, rather than domestic source income, which is taxable, can be dealt with by:

(a) Taxing all foreign source income and providing a credit for any foreign taxes on the income (as discussed in section 2.2.2.2 below); or

(b) Limiting the scope of the exemption for income from foreign services.

The scope of the exemption for income from services earned outside a country could be limited to income from foreign services that is subject to foreign tax or subject to foreign tax in the source country (not in other countries) at a rate comparable to the tax rate imposed by the residence country. For example, if a country imposes tax at a rate of 40 per cent, it might limit the exemption from tax for income from foreign services to such income that is taxed at a foreign rate equal to some minimum percentage (for example, 50 or 75 per cent) of the country's domestic tax rate. If the income is subject to a foreign tax rate that is less than the minimum, the foreign source income would be subject to tax by the country, with a credit for the foreign tax on the income (as discussed in section 2.2.2.2 below). This approach would require a comparison of a country's tax on the income in question and the foreign tax on that income. To be meaningful, such a comparison requires the foreign source income to be computed in accordance with the residence country's tax rules for the computation of income. This comparison will impose compliance burdens on taxpayers and administrative burdens on the tax administration.

A possible alternative to minimize the compliance burden on taxpayers would be to provide a list of either high-tax countries (income earned in such countries would be exempt) or low-tax countries (income earned in such countries would be taxable by the residence country). This listed-country approach imposes an administrative burden on tax officials to study the tax systems of other countries to determine whether they are high-tax or low-tax countries and to monitor foreign tax systems on an ongoing basis to keep the list current.

Another alternative would be to limit the exemption to income from services earned in a foreign country that are likely to be taxed by that country because the taxpayer's connections with that country are substantial. For example, the exemption could be limited to income from services performed in a foreign country if the services are performed through a permanent establishment (PE) or fixed base in that country, or if the resident taxpayer spends a substantial amount of time (presence or time spent performing services) in the other country. This approach requires a definition of a PE and fixed base (which may already exist as part of domestic law) and a decision on the amount of time that must be spent in another country in order to obtain the exemption. It might also be necessary to have anti-avoidance rules to prevent resident taxpayers from artificially creating a PE or fixed base in another country in order to obtain the exemption. (This problem of avoidance — discussed in section 2.3.2.2 below — is the converse of the problem where a non-resident avoids tax in a source country by artificially not having a PE or fixed base in that country.) It would also be difficult for the tax authorities to verify whether a taxpayer has a PE or fixed base in another country or spends the requisite amount of time there. If the residence country has a tax treaty with that country that provides for the exchange of information, it may request the tax authorities of that country to provide the necessary information.

Another risk of base erosion with respect to an exemption for services provided outside a country is that taxpayers may attempt to change the source of income from domestic to foreign in order to obtain the exemption. This problem is similar to the problem discussed in section 2.3.2.1 below where a non-resident attempts to shift the source of income from one country to another in order to avoid tax in the first country. The problem depends on the rules in each country for determining the source of income from services. Many countries use the same source rules for providing relief from double taxation of residents as for taxing non-residents on their domestic source income. However, each country should carefully consider whether the same source rules are appropriate for both purposes.[2]

Many countries consider income from services to be sourced in the country in which the services are performed or consumed. The place of consumption or use of services may be an inappropriate source rule for purposes of taxing residents on their foreign source income.

[2] See Part 2, chapter 1, section 1.4, for further discussion of source rules for income from services.

For example, if a resident of a country performs services in the country that are consumed or used in another country, the residence country is clearly justified in deciding to tax the income because the services producing the income take place there. Therefore, each country should consider ensuring that it has clear rules as to the source of income from services and that those rules cannot be easily manipulated to change the source of income.

2.2.2.1.2 Disallowing the deduction of expenses incurred to earn exempt or low-taxed foreign source income

It is a fundamental principle of tax policy that expenses incurred in earning income that is exempt from tax should not be deductible. Therefore, if a country exempts all or certain income from services earned by its residents in a foreign country, it should not allow the deduction against its tax base of expenses incurred by residents to earn such income. A country's tax law may contain a general provision denying the deduction of expenses to earn exempt income, or it may have a more specific provision denying the deduction of expenses incurred by residents to earn foreign source income that is exempt or that is subject to low foreign tax. If it does not, the country should consider adopting such a provision.

The legislative provisions implementing this fundamental tax policy principle are likely to be straightforward. However, the provisions must be enforced, and difficult issues may arise in practice concerning the allocation of expenses to exempt foreign source income or taxable domestic source income. For example, a resident may have interest expense on debt used to finance all of the resident's business activities. To the extent that those activities involve earning income from services that is exempt from tax, the interest expense should not be deductible.

2.2.2.2 If income from foreign services is taxable in a country

2.2.2.2.1 Limiting the foreign tax credit

If a country uses the foreign tax credit method to eliminate double taxation of income from services earned by its residents, the amount of foreign tax that qualifies for credit is generally limited to the amount of the country's tax on the foreign income. If the country uses a per country or an overall limitation on the foreign tax credit, it may allow foreign taxes to be credited on income from services that are greater than the country's tax on the income. If the country uses an overall limitation on the foreign tax credit, under which the credit is limited to the country's tax on the taxpayer's total foreign source income, high foreign taxes on income from services paid to one country can be averaged with low foreign taxes on other income, especially passive income, paid to another country. If the country uses a per country limitation, under which the credit is limited to the country's tax on the income earned in each foreign country, high foreign taxes on income from services earned in a country can be averaged with lower taxes on other income imposed by that country.

If this type of averaging is considered to be problematic, a country can reduce the extent of the averaging by shifting from an overall limitation to a per country limitation or by limiting the foreign tax credit in respect of income from services to foreign taxes on such income (sometimes referred to as a per item or basket limitation). A per item limitation can be applied on an overall basis (all income from services from all countries) or a per country basis (just all income from services from each country separately).

Example 1

Boris, a resident of Country R, is a risk-management specialist. In addition to his income from Country R, Boris provides services to a client in Country X and also earns interest income from investments in Country X and Country Y. The income and tax payable in Country R, Country X and Country Y are as follows:

	Country R	Country X	Country Y
Income from services		5,000	0
Tax paid (40%)		2,000	
Interest income		1,000	1,000
Tax paid (10%)		100	100
Worldwide income	20,000		
Tax payable (30%)	6,000		

If Country R uses an overall limitation, the foreign tax credit allowed would be the lesser of the total foreign tax paid on Boris's total foreign source income (2,100) and the Country R tax on the total foreign source income (30 per cent × 7,000 = 2,100). Thus, all of the foreign tax paid would be deductible against the tax payable to Country R, resulting in tax payable of 3,900.

If Country R uses a per country limitation, the foreign tax credit allowed for Country Y would be zero, since no tax is payable on the interest earned in Country Y. For Country X, the credit would be the lesser of the tax payable to Country X (2,100) and the Country R tax on the income earned in Country X (30 per cent × 6,000 = 1,800). Thus, less than all of the tax paid to Country X is creditable. The difference between this result and the result under the overall limitation is that the high Country X tax on the income from services cannot be averaged with the absence of tax on the interest income earned in Country Y, but can be averaged only with the low-taxed interest income earned in Country X.

If Country R uses a per item limitation, the foreign tax credit for the tax paid to Country X on income from services would be limited to the lesser of the tax paid on that income (2,000) and the Country R tax on that income (30 per cent × 5,000 = 1,500); the foreign tax credit for the tax paid to Country X on the interest income would be the lesser of the tax paid on that income (100) and the Country R tax on that income (30 per cent × 1,000 = 300). Therefore, the foreign tax credit would be limited to 1,600. In effect, the per item approach does not allow the high Country X tax on income from services to be averaged with its low tax on interest income.

To the extent that the overall and per country limitations on the foreign tax credit allow more than 1,500 of the Country X tax on Boris's income from services to be credited against the Country R tax, the Country R tax on Boris's income earned in Country R is arguably reduced inappropriately.

2.2.2.2.2 Allocating expenses to foreign source income for purposes of the limitation on the foreign tax credit

If income from services provided by residents of a country outside that country is taxable by the residence country (that is to say, the country taxes its residents on their worldwide income from services), the residence country will likely provide a credit against its tax for the foreign tax imposed on that income in order to eliminate double taxation. In principle, this foreign tax credit should be limited to the amount of the residence country's tax on the foreign source income; otherwise, the credit will reduce the residence country's tax on domestic source income. Therefore, in computing the limitation on the foreign tax credit, it is important for any expenses incurred by residents in earning the income from foreign services to be deducted. This point is shown in the following example.

Example 2

Manuel, a resident of Country R, is a security consultant. His total gross billings from his business of providing services for 2015 is 14,000 and his net income is 10,000. Of Manuel's total gross billings, 2,000 is from services provided in Country NR. Manuel pays tax to Country NR of 500. Of Manuel's total expenses of 4,000, 1,000 were incurred in earning the 2,000 of income in Country NR. Country R imposes tax at a rate of 35 per cent, so that Manuel's tax payable to Country R before any foreign tax credit is 3,500 (35% × net income of 10,000). In computing the limitation on the foreign tax credit, expenses of 1,000 incurred in earning the foreign source income should be allocated to that income. Thus, the foreign tax credit should be the lesser of 500 (the foreign tax paid) and the portion of domestic tax paid (3,500) that the foreign source income is of the total income (1,000 (net foreign income)/10,000 (total net income)). The result is that the credit is limited to 350 and the tax payable to Country R is 3,150. Some countries allow the excess amount of foreign tax paid to be carried forward to other years.

Note that if Country R does not require the expenses incurred by Manuel in earning the foreign source income to reduce that income for purposes of computing the limitation on the credit, the full amount of foreign tax paid to Country NR would be credited against the tax of Country R. In this case, the limitation would be the lesser of 500 (the foreign tax paid) and the portion of domestic tax paid (3,500) on the foreign source income (2,000 (foreign income)/10,000 (total net income) = 700). The credit would be 500 and the tax payable to Country R would be 3,000. In effect, the Country R tax on Manuel's net income earned in Country R (9,000 × 35% = 3,150) would be reduced inappropriately by 150.

2.3 Taxation of non-residents on income from services

2.3.1 Introduction

As discussed in chapter 4 of part 2, the risks of base erosion with respect to non-residents performing services in a country or to residents of a country depends on whether the country taxes such non-residents on their income and, if so, whether the country taxes the income on a net or gross basis. If the country does not tax the income from services derived by non-residents, it may be because it has determined that the tax is too difficult to collect or that it would discourage non-residents from providing services to residents of the country. These are legitimate concerns for a country. The discussion that follows assumes that a country has decided that, at least in certain circumstances, non-residents performing services in or to the country should be subject to tax on the income they derive for such services. On this assumption, the following material looks at the major structural features that should be considered in designing legislative provisions to tax non-residents on income from services in order to minimize the erosion of the domestic tax base.

2.3.2 Net-based taxation of non-residents on income from services

2.3.2.1 Introduction

If a country decides to tax non-residents on their income from services on a net basis in certain circumstances, it is necessary to decide what those circumstances are. In general, non-residents are subject to taxation on a net basis only where:

- They have a substantial presence in a country
- The expenses they incur in earning the income are significant
- The tax authorities of the country have access to the necessary information to compute and verify the non-resident's net income, and
- The country can collect the tax effectively

Where these conditions are not met, a country may tax non-residents on a gross basis or, as noted above, may decide not to tax them at all.

The compliance burden imposed on non-residents that are taxable by a country on a net basis and the administrative burden on the country's tax officials is substantial. Tax returns must be filed and assessed, and the tax must be collected. Although a country may tax certain income derived by non-residents from services on a net basis, it may seek to ensure that the tax is collected effectively by imposing an obligation on payers in the country to withhold tax from the payments to non-residents. The amount withheld is treated as tax paid on account of the non-resident's tax payable as assessed on the basis of the non-resident's tax return. Non-residents earning income from services may also be required to pay instalments of tax on a periodic basis under domestic law. Provisional withholding and payments of tax instalments are useful methods of minimizing the risks of non-residents not paying taxes owed to a country as determined in their tax returns.

Typically, countries impose net-basis taxation on income from business or professional services earned by non-residents (other than income from entertainment and athletic services, which is discussed in section 2.3.3.6.5 below). Income derived by non-residents from employment is usually subject to withholding by employers, but in some circumstances the withholding may not be final. Income from employment derived by non-residents subject to withholding is dealt with below in section 2.3.3.6.1. If a country imposes net-basis taxation on certain non-resident employees, many of the considerations discussed below with respect to the net-basis taxation of business services will apply.

To the extent that a country imposes tax only on income from services derived by non-residents from the country, there is a risk that non-residents will be able to avoid the country's tax by manipulating the source of the income. Many countries consider income from services to be derived in the country in which the services are performed or the country in which the services are used or consumed. If a country has a source of income rule based on the place of performance of the services, non-residents may be able to avoid tax by performing the services outside the country. This risk of tax avoidance is reduced if the country also considers income from services to be sourced where the services are used or consumed. However, as discussed in sections 2.3.3.2 and 2.3.3.4 below, a place of use or consumption source rule also presents difficulties. In addition, as discussed in sections 4.2.7.1 and 4.2.7.5 below, in general, the current provisions of the United Nations and the Organisation for Economic Co-operation and Development (OECD) Model Conventions[3] prevent contracting States from taxing income from services that are performed outside their territories.

[3] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

2.3.2.2 Avoidance of threshold requirements

If a country taxes certain non-residents on their income from services only if they meet a minimum threshold requirement, such as having a PE or fixed base in the country or spending a minimum amount of time in the country, there is a risk of base erosion where non-residents avoid that country's tax by artificially avoiding the threshold under its domestic law. A country can minimize the risks of base erosion by eliminating any threshold requirement or by designing the threshold requirement so that it is not easy to avoid. Some of the common ways of avoiding threshold requirements are as follows:

- If the threshold is a fixed place of business or a fixed base that must be used or available for use for a minimum period of time, it is relatively easy for some non-residents to arrange their affairs so that the services are provided at different places in a country, which in the aggregate—but not separately—exceed the minimum period.
- Similarly, it is relatively easy for some non-residents to arrange their affairs so that some of the services are performed by related or associated non-residents; as a result, none of the non-resident service providers meets the threshold requirement. Therefore, services performed by related or associated non-residents should be aggregated so that threshold requirements cannot be avoided by fragmenting activities among such non-residents.
- If a fixed time threshold is used, non-residents may be able to avoid it by leaving the country for temporary periods. Therefore, any time threshold should not be based on continuous presence, but on aggregate periods of presence within a longer time frame.
- Sometimes non-residents may enter into multiple contracts with respect to the same customer or project to avoid any threshold requirement (so-called split contracts). This type of tax avoidance can be countered by aggregating all contracts with the same or related customers.

If a fixed time threshold is used, the time period should be considered carefully. It is possible for a country to impose tax on any non-resident who performs any services in the country irrespective of any minimum time. However, such a tax might be difficult to enforce and might discourage non-residents from coming to the country to perform short-term services. On the other hand, if the time threshold is too long, some non-residents will be able to avoid it simply by limiting their service activities in the country to less than the minimum. Another consideration is the relationship between the threshold adopted in a country's domestic law and the threshold in its tax treaties. For example, the time thresholds in Article 14 (1) (b) (Independent personal services) and Article 5 (3) (b) (Permanent establishment) of the United Nations Model Convention are 183 days of presence and 183 days of furnishing services, respectively. A country may wish to consider a lower threshold in domestic law so that it has a concession to make to other countries in negotiating a tax treaty with those countries.

The considerations discussed above apply equally to professional and independent services and construction activities conducted by non-residents in a country.

2.3.2.3 Insurance activities

Because of the ways in which an insurance business can be carried on, it is possible for a non-resident insurance company to engage in substantial business in a country without establishing a fixed place of business or having dependent agents in that country. Therefore, a country should consider adopting provisions in domestic law to impose tax on non-resident insurance companies if they perform certain activities in the country, such as collecting premiums or insuring risks in the country. Such a provision would be similar to Article 5 (6) of the United Nations Model Convention, although it should not exclude reinsurance. Depending on the registration requirements for non-resident insurance companies adopted by a country, that country might consider imposing tax on the income of any non-resident insurance company that is registered to do business in the country.

2.3.2.4 International shipping and air transportation

International shipping and air transportation activities carried on by non-residents outside a country (international traffic) are difficult to tax. Typically, tax treaties prevent countries from taxing non-residents on such income, except in the case of more than casual shipping activities under Article 8 (alternative B) of the United Nations Model Convention. If a country wishes to tax shipping and air transportation activities of non-residents to the extent that they take place in the country (so-called cabotage), it will need provisions in domestic law to impose tax where a non-resident enterprise picks up or drops off cargo or passengers in the country. In these circumstances, it is difficult to determine the amount of income that is earned in and taxable by the country. Therefore, if a country wishes to tax in these circumstances, it will probably be necessary to do so through a withholding tax, as discussed in section 2.3.3.6.6 below.

Because of the difficulties involved in taxing shipping and air transport income derived by non-residents, some countries have abandoned income taxes and adopted different types of taxes, such as tonnage taxes.

2.3.3 Gross-based taxation of non-residents on income from services

2.3.3.1 Introduction

In certain circumstances it is very difficult for countries to impose tax on the net income of non-resident service providers. For example, where non-residents perform services in a country for only short periods of time or perform services outside the country, the only feasible way for the country to impose tax on the non-resident is to impose a gross-based withholding tax on the payments made to the non-resident. In addition, where non-resident service providers do not incur significant expenses in earning income from services, some countries have imposed tax on such non-residents through a withholding tax on payments made to them. In these circumstances, the persons making payments for services to non-residents are required to withhold an amount (equal to the tax or on account of the tax) from the payment and send it to the tax authorities. Where a non-resident does not have any significant presence in a country, a withholding tax is the only feasible way for the country to impose tax on the non-resident.

If the persons paying non-residents for services claim deductions for such payments against a country's tax base, the resulting base erosion can be offset by imposing tax on the non-resident service providers or by denying the deduction of the payments by the payers. In normal circumstances, the payments to non-resident service providers represent legitimate expenses incurred by the payers in earning their income. Therefore, such expenses should ordinarily be deductible. However, it might be possible to make the imposition of withholding tax on payments for services a condition for the deduction of the payments.

Because a withholding tax is imposed on the gross amount paid to a non-resident, the amount of the tax may be excessive compared to a tax on the net income. In principle, a gross-based withholding tax is a proxy for a tax on the net income, and the rate of withholding should be established with this in mind. If the rate of withholding is excessive, the non-resident may not be able to claim a foreign tax credit in its country of residence for the full amount of the tax. (This assumes that the residence country uses the foreign tax credit method to provide relief from double taxation in these circumstances. If the residence country uses the exemption method, the withholding tax represents an absolute cost for the non-resident service provider and cannot be recovered through a credit against the non-resident service provider's residence country tax.) The resulting unrelieved double taxation may discourage non-residents from providing services to residents of the country or may result in the withholding tax being passed on to the resident payers. On the other hand, in some cases the unrelieved double taxation may encourage non-residents to establish a PE or fixed base in the country to ensure that they are taxable on a net basis.

In designing legislative provisions for the imposition of withholding taxes on payments for services, the following major factors should be considered:

- Which payments for services should be subject to tax?
- What rates of withholding tax should apply?
- On whom should the obligation to withhold be imposed?
- Should the withholding tax be a final tax, or just an interim payment on account so that the non-resident can file a return on a net basis and claim a refund of any excessive withholding?

Each of these factors is discussed below.

It is worth emphasizing at this point that if rates of withholding vary depending on the type of services performed, the compliance burden on withholding agents and the administrative burden on the tax authorities will be greater than if a uniform rate is applicable to all services. From a compliance and administrative perspective, the simplest and most efficient system is to require withholding on all payments for services irrespective of whether the payments are made to residents or non-residents, the type of services involved, and whether the services are performed inside or outside the country. Under such a system, withholding agents would not be required to determine:

- Whether the service provider is a non-resident or a resident of a treaty country, or
- Whether the service provider is an employee or an independent contractor, or
- The nature of the services

These are all difficult issues for withholding agents to determine in order to withhold properly and avoid liability. The simplicity and effectiveness of such a broad-based withholding system obviously requires withholding on a much broader range of payments for services than a system of withholding that is more limited and selective. To the extent that more payments for services are subject to withholding, the compliance burden on withholding agents will be increased.

Withholding taxes are typically imposed on payments to non-residents. In the absence of a payment, there is nothing from which a payer can withhold. However, there are certain circumstances in which it may be necessary for countries to impose withholding taxes on deemed payments in order to prevent tax avoidance. First, the most obvious situation is where withholding tax on deemed payments involves payments for services by a resident to a related non-resident (transfer pricing). In this situation, the related parties may attempt to obtain tax benefits by paying more or less than the fair market value of the services. If an amount less than the fair market value (the arm's length amount) is paid for the services, the withholding tax payable will be less than it would be if the fair market value were paid. Therefore, if the price of the services is adjusted to their fair market value under a country's transfer pricing rules, the withholding tax should be imposed on the fair market value of the services (that is to say, the amount deemed to be paid for the services). Conversely, if the amount paid for the services is more than the fair market value of the services, the withholding tax paid will be more than it should be, although the amount of the deduction claimed for the services will also be more than it should be. If a country's transfer pricing rules apply to adjust the amount paid for the services, both the deduction and the amount of the withholding tax should be reduced.

Second, if withholding taxes are imposed only on actual payments, there may be a mismatch between the timing of the deduction of the expenses incurred in respect of the services and the withholding tax. If expenses are deductible under a country's domestic law when they are incurred, rather than when they are paid, the expenses in respect of the services will ordinarily be deductible on an accrual basis (generally when the liability to pay is incurred). However, withholding tax is not usually imposed until the payment is made. Therefore, where a taxpayer claims a deduction for payments for services to a non-resident service provider, but does not actually pay for the services so there is no withholding tax, the result is inappropriate. This can be prevented if the country deems the payment to be made when the expense is incurred or makes the deduction of the expense conditional upon the payment of withholding tax by the payer.

2.3.3.2 Which payments for services should be subject to withholding tax?

As discussed in section 2.3.3.1 above, although it might be possible for a country to impose a withholding tax on all payments for services made to non-residents and residents, typically withholding taxes are imposed only on payments for certain types of services rendered by non-residents. These services include employment, entertainment and athletic services, and technical, management and consulting services (collectively referred to here as "technical services"). In general, a withholding tax is imposed where it is impossible or very difficult for a country to collect tax from non-residents in any other way.

Where a non-resident has a substantial presence in a country through dependent agents, one or more fixed places of business or physical presence (in the case of individuals), the country may be able to enforce any tax imposed on the non-resident through its access to the non-resident's assets in the country or through the non-resident personally. Therefore, in these situations the country may choose to impose tax on the non-resident on a net basis in the ordinary manner applied to residents. However, where a non-resident does not have a substantial and continuing presence in a country, it is often difficult to impose tax effectively by requiring the non-resident to file a return. In these circumstances, the country may impose a withholding tax on payments made to the non-resident.

Even where a non-resident has a substantial presence in a country, provisional withholding on payments to non-residents for services is an effective method of collecting tax. The provisional withholding is remitted to the tax authorities on account of the non-resident's tax liability as ultimately determined by the assessment of the non-resident's tax return. To the extent that the tax assessed is greater than the amount withheld on behalf of the non-resident, the non-resident is liable to pay the excess. Conversely, to the extent that the amount withheld exceeds the tax assessed, the non-resident is entitled to a refund of the excess.

The domestic legislation imposing withholding tax on payments to non-residents should clearly describe the payments for services that are covered so that the withholding agents can meet their obligations, as discussed below. In general, based on the withholding taxes levied in many developed and developing countries, withholding taxes are imposed on payments to non-resident entertainers and athletes and remuneration paid to non-resident employees, including directors and officers of resident companies. Several developing countries also impose withholding taxes on payments to non-residents for technical services. As mentioned above in section 2.3.3.1, the compliance burden on withholding agents may be significantly increased if only certain types of services are subject to withholding, and therefore they are required to determine whether the services they are paying for are subject to withholding.

One of the important and controversial issues that developing countries must decide upon with respect to the application of withholding taxes on payments for services is whether the withholding tax is imposed only if the services are rendered in the particular developing country or whether it is imposed irrespective of where the services are rendered. Where the services are performed in a country, the non-resident's connection to the country is clear and the country is clearly justified in imposing tax. However, where the services are provided outside the country but are consumed or used in the country (for example, by a resident of the country), the justification for that country to impose tax is less clear. Considering the analogy to sales of goods, the international consensus appears to be that countries are not entitled to impose income taxes on non-residents who simply sell goods to persons in the country. Such a tax would be considered to be a tariff on the importation of the goods.

An argument can be made that a similar analysis applies to taxes on services provided by non-residents outside a country to persons in the country where the non-residents have no other connection to the country. Nevertheless, if payments for services made to non-residents are deductible against the country's tax base, the base erosion provides some justification for the country to tax the payments or deny any deduction for the payments. In any event, several developing countries impose gross-based withholding taxes on payments to non-residents for technical services where the services are performed — or allegedly performed — outside the country. Such technical services represent a relatively easy way for multinational enterprises to erode the tax base of a developing country. The only effective way to prevent such base erosion may be to impose withholding tax or deny a deduction for the payments. However, if the country has concluded tax treaties that contain the equivalent of Article 24 (4) (Non-discrimination) of the United Nations Model Convention, that provision may prohibit the country from denying the deduction of payments to non-residents for technical services if similar payments to residents are deductible.

All deductible payments for services to non-residents inevitably erode a country's tax base. However, deductible payments made to related non-residents pose special risks of base erosion, especially where the related non-resident is resident in a low-tax country. Most countries have transfer pricing rules to ensure that payments to a related non-resident for services do not exceed the amounts that would be paid to an arm's length third-party service provider. However, transfer pricing rules are difficult to apply, especially if the tax authorities do not have adequate administrative capacity and resources. Therefore, to reduce the opportunities for base erosion, some countries may consider imposing a withholding tax on payments by their residents to related non-residents for technical services.

Every country should carefully consider whether it wants to impose a gross-based withholding tax on payments for technical services to non-residents where the services are performed outside the country. In this regard, every country should carefully consider whether such a withholding tax would constitute a violation of its obligations under the General Agreement on Trade in Services (GATS).

2.3.3.3 Which rates of withholding tax should be applied?

As noted above in section 2.3.3.1, in principle a withholding tax is a proxy for a tax on the net income derived by a non-resident. Where a non-resident incurs substantial expenses in earning income from services, which might be the case with respect to certain services, a high rate of withholding tax may be excessive and result in double taxation because the non-resident cannot claim the full amount of the withholding tax against the tax payable by the non-resident in its country of residence.

Example 3

Ingrid is an engineer resident in Country NR who provides services to a company resident in Country S in consideration for gross fees of 10,000. Ingrid incurs expenses, including travel, office expenses and salaries, totalling 6,000 to earn the income. Accordingly, Ingrid's net income derived from Country S is 4,000. Country S levies a withholding tax of 25 per cent (2,500) on the gross fees paid to Ingrid. Ingrid pays tax on her net income in Country NR at a rate of 30 per cent (30% × 4,000 = 1,200). Ingrid will be entitled to a credit for the withholding tax paid to Country S, but the credit will be limited to 1,200 (as explained in section 2.2.2.2 above). Thus, Ingrid will pay tax of 2,500 to Country S on her net income from Country S of 4,000, which is equivalent to a tax rate of 62.5 per cent.

Therefore, it is important for each country to carefully consider the rate of withholding tax imposed on services provided by non-residents, especially where the non-resident service provider is likely to incur significant expenses. It may be appropriate to consider imposing different rates of withholding depending on the services involved. Alternatively, some countries impose withholding tax not on the gross amount of the payments for services, but on a portion of that amount that reflects an allowance for the expenses incurred by the non-resident.

The allowance may vary depending on the type of services involved. However, as noted in section 2.3.3.1 above, the compliance burden on withholding agents may be increased if there are different rates of withholding for different types of services.

2.3.3.4 What persons are required to withhold?

Although withholding taxes on non-residents are legally imposed on the non-resident person receiving the payment, such taxes are collected by requiring the person making the payment to withhold an amount from the payment—usually equal to the amount of the tax—and remit it to the tax authorities on behalf of the non-resident. Typically, a country imposes an obligation to withhold on residents and non-residents carrying on business through a PE or fixed base in the country. With respect to payments to non-resident service providers, it may be difficult to effectively impose an obligation to withhold on individual consumers resident in the country. Such individuals may be unwilling to comply, and it may be difficult for the tax authorities to obtain the necessary information to identify the payers and the payments in order to make them comply. Moreover, in many situations these individual consumers will not be claiming deductions for the payments. In summary, although the obligation to withhold can be imposed on all persons that are subject to a country's jurisdiction, it probably makes sense to impose an obligation to withhold only where the country has the ability to enforce that obligation effectively.

One common way to enforce the obligation to withhold is to make the withholding agent liable for the tax payable by the non-resident if the payer fails to withhold the required amount. Thus, if the payer fails to withhold, the tax authorities can collect the tax either from the non-resident recipient of the payment or from the payer (or partly from both). Another way is to deny any deduction claimed by the payer for the payment to a non-resident if the payer is obligated to withhold from the payment and fails to do so.

2.3.3.5 Interim or final withholding tax?

Withholding taxes may be levied as final taxes or as interim or provisional payments on account of the final tax. If a final withholding tax is imposed, the amount of tax withheld is the only tax payable and the non-resident taxpayer is not usually required to file any tax return. However, if the withholding tax is an interim payment on account of tax, the non-resident taxpayer is required or permitted to file a tax return and compute the amount of tax payable; the amount withheld is treated as a payment on account of the tax ultimately determined. If the amount of tax payable as determined in the tax return for the period is less than the amount withheld, the non-resident taxpayer is entitled to claim a refund for the excess; but if the amount of tax payable is greater than the amount withheld, the non-resident is liable to pay the difference. An interim withholding tax is arguably fairer than a gross-based withholding tax because the non-resident is entitled to claim deductions for the actual expenses incurred in earning the income and to obtain a refund for any excess tax withheld. However, an interim withholding tax involves considerably greater compliance costs for taxpayers and administrative costs for the tax authorities than a final withholding tax.

If a country uses interim withholding, it may be onerous to require residents and non-residents with a PE or fixed base in the country to withhold tax from payments to non-residents in all circumstances. Thus, for example, if it is reasonably clear that a non-resident is not taxable by the country because of expenses or losses, it may be more efficient to allow the withholding agent or non-resident to apply for a waiver of the obligation to withhold rather than have the non-resident file a return and claim a refund of the excess withholding tax.

2.3.3.6 Types of payments for services subject to withholding tax

2.3.3.6.1 Employment income

Where non-resident employees perform services in a country and receive payments from an employer resident in the country, the country's tax base will be eroded by the deductions claimed by the employer. This risk of base erosion is usually dealt with by imposing a withholding tax on the payments. The withholding tax can be modelled on the system for withholding (usually on an interim basis) applied to resident employees of resident employers.

Since employees do not usually incur significant expenses in earning their income, the rate of withholding tax can be similar to the tax rate imposed on resident employees (which is usually higher than the rate of withholding tax applied to payments of dividends, interest and royalties).

Withholding tax should also be applied to payments by non-resident employers who have a PE or fixed base in a country, since that country's tax base is eroded to the extent that they claim deductions for the salary and wages paid to any resident or non-resident employees. This withholding should apply irrespective of whether the employment is exercised inside or outside the country. As discussed in section 2.3.2.2 above, countries should consider adopting rules to prevent non-resident employers from artificially avoiding having a PE or fixed base in their country.

If withholding agents fail to withhold, a country could consider denying a deduction for the amounts paid to non-resident employees that are subject to withholding, in addition to other penalties.

Non-residents may attempt to avoid a country's tax on their employment income by converting their legal status from employment (a contract "of" service) to independent contractor (a contract "for" service). If the conditions for taxing non-resident employees and non-resident independent contractors differ, countries should consider adopting anti-avoidance rules to prevent non-resident employees from artificially converting their legal status from employment to independent contractor.[4]

2.3.3.6.2 Directors' fees and remuneration of managerial officials

Where companies resident in a country pay fees to their non-resident directors or remuneration to their non-resident officers, the amounts paid will likely be deductible by those companies, resulting in the erosion of the country's tax base. This base erosion can be effectively dealt with by imposing withholding taxes on non-resident directors and managerial officials of companies resident in the country in the same way that non-residents employed by resident employers are subject to tax on their employment income.

[4] See part 2, chapter 4, section 4.2.2, for a discussion of this issue.

The withholding taxes on non-resident directors and managerial officials of companies resident in a country can be imposed on the fees and remuneration from services performed in the country or on the total amounts that are paid irrespective of where the services are rendered. If a country taxes fees for services rendered outside the country (for example, in the country in which the directors or officials are resident), there is a substantial risk of double taxation, since the country in which the services are rendered is also likely to tax the income. Nevertheless, if a country has entered into tax treaties based on the United Nations Model Convention, Article 16 will allow that country to impose tax on non-resident directors and managerial officials of resident companies irrespective of where the services are performed.

2.3.3.6.3 Income from government service

Any amounts paid by the Government of a country to non-resident employees may be subject to withholding tax.

2.3.3.6.4 Pensions

Any pensions paid to non-residents by the Government of a country, resident employers or non-resident employers with a PE or fixed base in the country should be subject to withholding tax, especially if the pension payments are deductible against that country's tax base or the contributions to the pension plan were deductible against that country's tax base.

2.3.3.6.5 Income from entertainment and athletic activities

In accordance with international practice, countries should consider taxing income derived by non-residents from any entertainment and athletic activities taking place in their country, especially where large amounts are earned from such activities. Such a tax is usually imposed through a withholding obligation imposed on the resident promoter of the event or the owner of the venue of the event.

Non-resident entertainers and athletes may attempt to avoid a country's tax by assigning some of the income from the entertainment or athletic activities to other persons who are not subject to the country's tax. Countries should consider adopting anti-avoidance rules to prevent this type of tax avoidance.

2.3.3.6.6 International shipping and air transportation

If payments by residents of a country or non-residents with a PE or fixed base in the country to a non-resident for shipping or air transportation services are deductible, the country's tax base will be eroded. As a result, countries might consider imposing a withholding tax on payments for such services that involve goods or persons taken on board in their country.

2.3.3.6.7 Fees for technical services

Payments by residents of a country or non-residents with a PE or fixed base in the country to non-residents for consulting, technical and management services will erode the country's tax base to the extent that they are deductible by the payer against the country's tax base. This type of base erosion can be prevented if the country imposes a withholding tax on the payments. Such a withholding tax is not controversial to the extent that it is applied to payments for services performed in the country. However, where the services are performed outside the country, the imposition of withholding tax is considered by many developed countries to be inappropriate (as a tariff on services), as discussed in section 2.3.3.2 above. Since income from these types of services may involve substantial expenses, there is a risk that a final withholding tax on the gross payments may be excessive. Therefore, the rate of withholding must be carefully considered.[5]

[5] See part 2, chapter 2, section 2.3.2.5, for a discussion of the new Article on fees for technical services in the United Nations Model Convention.

Chapter 3

Sample legislative provisions with explanatory notes

3.1 Introduction

This section provides some sample legislative provisions dealing with the taxation of income from services that are designed to reduce the risks of base erosion. The sample provisions presented here deal exclusively with non-residents earning income from services performed in a country or for persons in the country, and deal only with situations in which the risks of base erosion are considered to be most serious. In addition, this section presents sample provisions only with respect to those provisions that deal exclusively with services, rather than to provisions that deal with income generally (including services).

THE SAMPLE PROVISIONS IN THIS SECTION ARE NOT INTENDED TO BE INCLUDED IN ANY COUNTRY'S DOMESTIC LAW AS IS. THEY ARE PROVIDED FOR GUIDANCE ONLY.

3.2 Sample withholding tax provision

1. *Any person not resident in Country X shall pay tax of __ per cent of the following amounts that a person resident in Country X pays or credits, or is deemed by the provisions of this Act to pay or credit, to the non-resident person as, on account of, or in lieu of:*

    (a) *Services performed by the non-resident person;*

    [1 (a) (alternative A) Consulting, technical or management services performed by the non-resident person;]

    [1 (a) (alternative B) Services performed by the non-resident

person if the payments are deductible in computing the income of the resident payer;]

(b) Fees for activities of an entertainment or athletic nature performed in Country X;

(c) Fees for shipping or air transportation services that involve the carriage or goods or persons that are taken on board in Country X;

(d) Salary, wages or other remuneration in respect of employment exercised in Country X except directors' fees and remuneration of managerial officials paid by a company resident in Country X, as described in paragraph __ [see section 3.5 below];

(e) Pensions except to the extent that the payment is attributable to employment services rendered by the non-resident person outside Country X in a taxation year during which the non-resident person was not resident in Country X at any time;

(f) …

2. *A person resident in Country X that pays any amount described in paragraph 1 above to a non-resident person shall withhold tax on behalf of such non-resident person at the rate of __ per cent of the gross amount paid and remit that amount to ________.*
3. *If a person resident in Country X fails to withhold tax as required by paragraph 2 above on an amount paid to a non-resident person, that person shall be liable, together with that non-resident person, for the tax payable by the non-resident person under paragraph 1 above.*
4. *If a person resident in Country X fails to withhold tax as required by paragraph 2 above, that person shall not be entitled to deduct the amount paid to the non-resident person in computing the person's income subject to tax under this Act.*
5. *For the purposes of paragraph 1 above, if a person not resident in Country X (referred to in this paragraph as the "first person") pays or credits an amount to another person not resident in Country X, the first person is deemed to be a person resident in Country X to the extent that the amount paid or*

credited is deductible in computing the first person's income subject to tax in Country X under this Act.

6. *For the purposes of paragraph 1 above, if a partnership in which a person resident in Country X is a partner pays or credits an amount to a person not resident in Country X, the partnership shall be deemed to be a person resident in Country X.*
7. *For purposes of paragraph 1 above, if a partnership in which a non-resident person is a partner receives an amount described in paragraph 1 above that is paid or credited by a person resident in Country X, the partnership shall be deemed to be a person not resident in Country X.*
8. *For purposes of subparagraph 1 (a) above, consulting, technical and management fees means (or includes) …*

3.2.1 Explanatory notes

Paragraph 1 imposes tax on amounts paid by residents of Country X to non-residents in consideration for certain services. The tax is imposed on the gross amount paid without any deductions for expenses incurred by the non-resident recipient in earning the payments. The tax imposed under paragraph 1 is intended to apply broadly to amounts paid or credited to a non-resident as, on account of, or in lieu of, fees for any of the services listed in paragraph 1.

With the exception of fees for consulting, technical and managerial services, only fees for services performed in Country X are taxable under paragraph 1. In general, services are considered to be performed in Country X if the individuals performing the services are physically present and performing services in Country X, whether as employees or independent contractors of another enterprise or in their individual capacity.

However, in the case of consulting, technical and managerial services, paragraph 1 applies irrespective of where the services are performed. [Where services are performed outside Country X and are used or consumed outside Country X by a resident of Country X, it may be difficult for Country X to enforce any tax imposed on payments for such services. Consequently, some countries may prefer to limit the tax under paragraph 1 to fees for consulting, technical or managerial services:

- Used or consumed in Country X, or
- Performed in Country X.]

Consulting, technical and managerial services are defined in paragraph 8 to mean or include … [Some countries may prefer to define consulting, technical and managerial services in an exclusive fashion so that only the specified services are included. Alternatively, some countries may prefer to use an inclusive definition so that the expression "consulting, technical and managerial" would have its ordinary meaning, plus any services that are specifically mentioned. Some countries may choose to leave the expression "consulting, technical and managerial" undefined; as a result, it would be the responsibility of the tax authorities and, ultimately, the courts to interpret and apply the expression to particular types of services. Some guidance as to the meaning of consulting, technical and managerial services may be found in the draft commentary on the new Article dealing with technical fees in the United Nations Model Convention.]

Subparagraph 1 (a) (alternative A) provides an alternative to taxing consulting, technical and management fees under which a country could impose a withholding tax on all payments made by residents to non-residents for services to the extent that the payments are deductible by the resident payers in computing their income. Under this alternative provision, it is unnecessary to define consulting, technical and management services, as is the case under subparagraph (1) (a). In addition, this alternative provision responds directly to the risks of base erosion with respect to services provided by non-residents, since it applies only where payments to non-residents for services are deductible against a country's tax base.

Where a country imposes tax under subparagraph (1) (a) or 1 (a) (alternative A), it should consider the relationship between that tax and the provisions of any tax treaties that it enters into. Under the existing provisions of the United Nations and Organisation for Economic Cooperation and Development (OECD) Model Conventions,[6] a

[6] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Develop-*

contracting State is not entitled to impose tax on fees for business, professional and other independent services derived by a resident of the other contracting State unless the resident of the other contracting State has a PE or fixed base or stays in the first State for more than 183 days. Thus, if a country enters into tax treaties with provisions similar to those of the United Nations or OECD Model Conventions, the country will be prevented from imposing withholding tax on payments for services by its residents to non-residents. See section 4.2.7 below for a discussion of treaty provisions dealing with fees for business, professional and other independent services. As discussed in section 4.2.7.5 below, the United Nations Committee of Experts on International Cooperation in Tax Matters, at its eleventh session in October 2015, agreed on a new Article to be included in the United Nations Model Convention to allow a contracting State to impose a withholding tax on fees for consulting, technical and management services paid to a resident of the other contracting State.

Paragraph 2 imposes an obligation on any resident person that pays an amount described in paragraph 1 to a non-resident person to withhold the amount of the tax from such payments and remit it to the tax authorities on behalf of the non-resident. The amount withheld pursuant to paragraph 2 is considered to be tax paid by the non-resident person and to satisfy the non-resident's obligation to pay tax under paragraph 1.

If a resident person fails to withhold as required by paragraph 2, that person is liable for the tax payable by the non-resident person under paragraph 1 to the extent that the amount of that tax is not withheld. Thus, both the non-resident person and the resident payer are liable for the same amount and the tax authorities may take collection action against either the non-resident person or the resident person, or both. Any amount collected by the tax authorities from one of the parties is considered to satisfy the liability of both parties. The tax authorities shall not collect in total more than the amount of tax payable under paragraph 1. To the extent that a resident person pays an amount under paragraph 3, that person shall have the right

ing Countries (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

to recover that amount from the non-resident person. [These ancillary issues should probably be dealt with explicitly in the legislation.]

A failure to withhold under paragraph 2 should also be subject to interest and penalties. However, such interest and penalties should apply generally to all withholding taxes, not just withholding taxes in respect of fees for services.

As an alternative or additional mechanism to enforce the obligation to withhold under paragraph 2, paragraph 4 provides that to the extent that a resident person fails to withhold as required by paragraph 2, that person will not be entitled to deduct the amounts paid to a non-resident person.

Paragraph 5 extends the tax under paragraph 1 and the obligation to withhold under paragraph 2 to non-residents of Country X who make payments for services to other non-resident persons by deeming such non-resident payers to be residents of Country X. However, non-resident payers are deemed to be residents for this purpose only to the extent that the payments are deductible in computing their income subject to tax under the tax law of Country X. In general, payments by non-residents for services described in paragraph 1 will be deductible in computing income under the tax law of Country X only if non-residents are carrying on business in Country X through a PE or fixed base. In the absence of paragraph 5, a country would not have any legal basis for imposing an obligation on non-residents to withhold tax from payments for services to non-residents because paragraph 1 applies only to payments by residents.

Paragraphs 6 and 7 extend the tax under paragraph 1 to circumstances in which a partnership pays amounts to a non-resident for services or receives amounts from a resident for services provided by the partnership. These provisions are necessary only if a partnership is treated as a transparent or flow-through entity for purposes of the country's domestic tax law. If a partnership in which a resident of the country is a partner pays an amount to a non-resident person for services described in paragraph 1, the partner resident in that country may not be considered to have paid the partner's pro rata share of the amount paid by the partnership. Thus, if the partnership is not considered to be a resident person, there would be no liability to withhold from the payment by the partnership for either the partnership or the resident partner. By deeming the partnership to be a resident of the country, paragraph 6 has the effect of making the partnership liable to withhold under paragraph 2.

Similarly, if a partnership in which a non-resident person is a partner receives an amount from a person resident in the country for services described in paragraph 1, the non-resident partner may not be considered to have received the partner's pro rata share of the amount received by the partnership. Thus, if the partnership is not considered to be a non-resident person for purposes of the country's tax law, there would be no liability to pay tax under paragraph 1 for either the partnership or the non-resident partner. By deeming the partnership to be a non-resident of the country, paragraph 7 has the effect of making the partnership liable for tax under paragraph 1 and the resident payer liable to withhold the tax under paragraph 2.

3.3 Employment status

1. *For purposes of determining whether a non-resident person is an employee of another person, the existence of a legal contract of employment between the non-resident person and the other person shall not be considered conclusive; instead, the relationship between a non-resident person and the person to whom the non-resident provides services shall be determined by reference of all the relevant facts and circumstances, including especially:*
    - (a) *Who has the responsibility or risk for the non-resident person's work;*
    - (b) *Who controls the manner in which the work is carried out by the non-resident person;*
    - (c) *Who controls the place and the time that the work is carried out by the non-resident person ;*
    - (d) *Who has the right to discipline the non-resident person with respect to the work and to terminate the contractual relationship with the non-resident person ; and*
    - (e) *Who bears the non-resident person's remuneration.*

3.3.1 Explanatory notes

Non-resident employees and non-resident independent contractors are often treated differently for purposes of domestic tax law and tax treaties. Under many countries' tax laws and their tax treaties, non-resident employees of resident employers or non-resident employers with a PE or fixed base in the country are subject to tax on their income from employment to the extent that the employment services are performed in the country, without any minimum threshold. In contrast, non-resident independent contractors are subject to tax by a country only if they meet a minimum threshold requirement, such as a PE or fixed base in the country. Therefore, non-resident employees may attempt to convert their legal relationship with the person to whom services are provided from employment to a contract of service (independent contractor).

In other circumstances, it may be advantageous for non-resident independent contractors to claim that they are employees rather than independent contractors. For example, some countries impose withholding tax on any amounts received by non-resident contractors (unless they have a PE or fixed base in the country) for services, even if the services are performed outside the country. If non-resident employees are taxable only to the extent that their employment is exercised in the country, it would be advantageous for non-resident contractors to convert their legal relationship with the person to whom the services are provided to one of employment.

Paragraph 1 is intended to prevent non-resident service providers from avoiding tax by entering into formal legal relationships with the person to whom services are provided that do not reflect the substance or real nature of those relationships. Under this provision, the formal contractual relationship is not conclusive as to the nature of the relationship for tax purposes. Instead, the real nature of the relationship between a non-resident service provider and the person to whom the non-resident provides services must be determined on the basis of all the relevant facts and circumstances. Some of the more important factors are listed in the provision. In general, employees are subject to the control and direction of their employers; they do not bear the risks associated with their work or have the opportunity for profit from their work beyond their salary and wages. In contrast, independent contractors are not usually subject to the control of their clients with respect to the manner in which the work is carried out;

moreover, as independent businesses they bear the risks and rewards of their work.

Paragraph 1 is intended to apply for purposes of domestic law and any tax treaties entered into by Country X. With respect to the application of tax treaties of Country X, this provision is intended to be consistent with paragraph 1 of the Commentary on Article 15 (Dependent personal services) of the United Nations Model Convention.[7] That Commentary provides additional explanation and examples with respect to the distinction between employees and independent contractors.

3.4 Directors' fees and remuneration of managerial officials of resident companies

1. *Where a person who is not resident in Country X is a director or a managerial official of a company resident in Country X, the non-resident person shall pay tax at a rate of __ per cent of the amount of the fees or remuneration paid by the company to the person.*
2. *A company resident in Country X that pays fees or remuneration as described in paragraph 1 above to a non-resident person who is a director or managerial official of the company shall withhold tax on behalf of such non-resident director or managerial official at the rate of __ per cent of the gross amount of such fees or remuneration and remit that amount to [the tax authorities of Country X].*
3. *If a company resident in Country X fails to withhold tax as required by paragraph 2 above, the company shall be liable, together with that non-resident person, for the tax payable by the non-resident person under paragraph 1 above.*
4. *If a company resident in Country X fails to withhold tax as required by paragraph 2 above, the company shall not be entitled to deduct the amount of the fees or remuneration paid to the non-resident person.*

[7] Paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.1 – 8.28 of the Commentary on Article 15 of the OECD Model Convention.

3.4.1 Explanatory notes

If directors and officers of companies resident in Country X are treated as independent contractors, they may be subject to tax on their remuneration from those companies only if they have a PE or fixed base in Country X or spend a substantial period of time during the year in Country X. If directors and officers of companies resident in Country X are treated as employees, they may be subject to tax on their remuneration only to the extent that their employment is exercised in Country X. Paragraph 1 alters these results by imposing tax on the fees earned by non-resident directors of resident companies and the remuneration earned by non-resident managerial officials of resident companies irrespective of their legal relationship with the resident company and irrespective of where their services are performed.

Paragraph 1 applies to all non-resident directors and managerial officials of resident companies. If employees of resident companies are taxable only to the extent that their employment is exercised in Country X, it will be necessary to identify the managerial officials who will be subject to the rule in paragraph 1. In this regard, Article 16 (Directors' fees and remuneration of top-level managerial officials) of the United Nations Model Convention applies only to "top-level managerial officials". Such officials would include the chief executive officer, the chief financial officer and the chief operating officer of a company, as well as other senior officers of the company who make important decisions concerning the affairs of the company. Thus, the scope of paragraph 1 is consistent with its purpose, which is to tax those non-resident individuals who have an important influence in managing the affairs of resident companies, but not to tax all the non-resident employees of resident companies on their remuneration irrespective of where their employment is exercised.

The tax under paragraph 1 is imposed on the gross amount of fees and remuneration paid by a resident company to a non-resident director or managerial official. No deductions are allowed. The terms "fees" and "remuneration" are intended to have a broad meaning, which includes salary, wages and fringe benefits, including stock options.

Paragraph 2 imposes an obligation on any resident company that pays directors' fees to a non-resident director or remuneration to a non-resident managerial official to withhold the amount of the tax from such payments and remit it to the tax authorities on behalf of the non-resident. Any amount withheld pursuant to paragraph 2 is considered to be tax paid by the non-resident director or managerial official and to satisfy the non-resident's obligation to pay tax under paragraph 1.

If a resident company fails to withhold as required by paragraph 2, the company is liable for the tax payable by the non-resident person under paragraph 1 to the extent that the amount of that tax is not paid. Thus, both the non-resident person and the resident company will be liable for the same amount and the tax authorities may take collection action against either the non-resident person or the resident company, or both. Any amount collected by the tax authorities from one of the parties is considered to satisfy the liability of both parties. However, the tax authorities should not be allowed to collect in total more than the amount of tax payable under paragraph 1. To the extent that a resident company pays an amount under paragraph 3, the company shall have the right to recover that amount from the non-resident director or managerial official. [These ancillary issues should probably be dealt with explicitly in the legislation.]

A failure to withhold under paragraph 2 should also be subject to interest and penalties. However, such interest and penalties should apply generally to all withholding taxes.

As an alternative or additional mechanism to enforce the obligation to withhold under paragraph 2, paragraph 4 provides that to the extent that a resident company fails to withhold as required by paragraph 2, it will not be entitled to deduct the amounts paid to a non-resident director or managerial official in computing its income.

3.5 General anti-base erosion rule

1. *Where the principal purpose (or one of the principal purposes) of a transaction or arrangement is to obtain benefits under this Act or under the provisions of an agreement between Country X and another country for the elimination of double taxation, those benefits shall be denied unless granting those benefits in the circumstances is in accordance with the object and purpose of the provisions of the Act or the agreement, as the case might be.*

2. *Paragraph 1 above shall apply notwithstanding any provisions of an agreement for the elimination of double taxation and fiscal evasion entered into between Country X and another country. [This provision may not be possible under the laws of some countries because of constitutional considerations.]*

3.5.1 Explanatory notes

Paragraph 1 is a general anti-abuse rule that is intended to prevent the erosion of a country's tax base and other types of abusive tax avoidance. The rule applies to abusive tax avoidance arrangements that are intended to take advantage of tax benefits available under domestic law or the country's tax treaties.

The general anti-abuse rule in paragraph 1 applies if two conditions are met:

(a) The principal purpose (or one of the principal purposes) of a transaction or arrangement is to obtain tax benefits (deductions, exemptions, allowances, etc.) under the provisions of the domestic tax law or tax treaties of Country X; and

(b) Granting those benefits in the circumstances would frustrate, defeat or abuse the object and purpose underlying the domestic law or treaty.

The term "arrangement" is intended to cover a series of transactions; however, this might be included explicitly in the provision.

The rule in paragraph 1 is consistent with and modelled on the guiding principle found in paragraph 25 of the Commentary on Article 1 (Persons covered) of the United Nations Model Convention. It is also consistent with the OECD/G20 proposed general anti-abuse test that will be added to the OECD Model Convention pursuant to the BEPS project.

[The explanatory note might contain examples of situations involving abusive base erosion transactions to which the rule in paragraph 1 would apply. These examples might include international hiring out of labour, fragmentation of activities among related entities to avoid PE or fixed base status, assignment of income by non-resident entertainers and athletes and manipulation of the legal status of employees and independent contractors.]

[This general anti-abuse rule is based on the assumption that a country's domestic law does not contain such a rule. If a country does have a general anti-abuse rule, that rule should be reviewed to ensure that it deals with abusive transactions that erode the country's tax base, including transactions that involve the abuse of the country's tax treaties.]

Chapter 4

Negotiation of tax treaties to prevent base erosion with respect to income from services

4.1 Introduction

Tax treaties are bilateral agreements that are the result of negotiations between the contracting States. They reflect not only the relative negotiating power of the contracting States, but also the international consensus about the provisions of tax treaties, as shown in the provisions of the United Nations and Organisation for Economic Co-operation and Development (OECD) Model Conventions.[8] Any attempt by a country to deviate significantly from the provisions of these model treaties is likely to be resisted by other countries. Therefore, although the following discussion makes several suggestions for provisions in tax treaties to limit the risks of base erosion, these provisions may not be acceptable to all countries. If a country decides that it wishes to include some of these provisions in its tax treaties, it must realize that the other contracting State may not agree, or may agree only if the country makes concessions with respect to other provisions of the treaty.

The OECD/G20 and the United Nations Committee of Experts on International Cooperation in Tax Matters are currently engaged in a project to limit base erosion and profit shifting (BEPS). This project is likely to result in changes to the United Nations and OECD Model Conventions. Therefore, a country may find that other countries are

[8] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

more willing to agree to anti-base erosion provisions if these provisions have been included in one or both of the model treaties.

Tax treaties have the effect of limiting the taxes imposed under the domestic laws of the contracting States. When a country is negotiating a tax treaty, it should be aware that the treaty may prevent it from applying the provisions of its domestic law to prevent base erosion if those provisions conflict with the provisions of the tax treaty. Therefore, in general, if a country decides to enter into tax treaties, it should carefully consider including a specific provision in its tax treaties to allow it to apply the provisions of its domestic law designed to prevent base erosion, as suggested in section 3.5 of chapter 3 above.

The following discussion examines provisions that might be included in a country's tax treaties to prevent base erosion. The discussion is organized on the basis of the various types of services dealt with in the United Nations Model Convention. It assumes that a country's tax treaties will be based on the United Nations Model Convention and that the relevant income is taxable under the country's domestic law.

4.2 Types of income from services

4.2.1 Income from employment

If a country imposes tax on non-resident employees with respect to amounts paid to them by resident employers or by non-resident employers with a permanent establishment (PE) or fixed base in the country, any treaties with a provision similar to Article 15 (Dependent personal services) of the United Nations Model Convention will prevent that country from imposing the tax on employment services provided by such employees outside the country. Therefore, if a country wishes to prevent this type of base erosion, it must get agreement on revised wording for the second sentence of Article 15 (1) and the exemption in Article 15 (2). Since almost all bilateral tax treaties contain provisions similar to Article 15 of the United Nations Model Convention, it is likely to be difficult for a country to get other countries to agree to any significant revisions to that Article.

Under Article 15 (2), non-resident employees employed by employers resident in a country or non-resident employers with a PE or fixed base in the country are taxable by that country on their income from employment exercised in the country. However, individuals that are independent contractors performing services in a country for residents of that country, or for non-residents with a PE or fixed base in that country, are taxable by the country only if they carry on business through a PE or fixed base in the country and the income is attributable to that PE or fixed base. Therefore, countries should consider protecting their domestic tax base through the following actions:

1. Adopting provisions in their domestic law that ignore the formal contracts and determine an individual's status on the basis of the nature of the services rendered and the extent to which those services are integrated into the employer's business.[9]
2. Denying the benefits of Article 15 (2) of the treaty in abusive cases.[10]
3. Including a provision in their tax treaties dealing with the international hiring-out of labour similar to the alternative provision in paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention.[11]

4.2.2 Directors' fees and remuneration of top-level managerial officials

If a country wishes to prevent base erosion with respect to fees paid to non-resident directors and remuneration paid to non-resident managerial officials of companies resident in the country — since such amounts are usually deductible in computing the income of such resident companies — it should ensure that its tax treaties contain provisions similar

[9] See chapter 3, section 3.5, above and paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 8.6, 8.7 and 8.11 – 8.28 of the Commentary on the OECD Model Convention.

[10] See chapter 3, section 3.5, above and paragraphs 8 and following of the Commentary on Article 1 of the United Nations Model Convention with respect to treaty abuse.

[11] Paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraph 8.3 of the Commentary on Article 15 of the OECD Model Convention.

to Article 16 (Directors' fees and remuneration of top-level managerial officials) of the United Nations Model Convention, which will allow the country to tax such amounts.

4.2.3 Income from government service

If a country wishes to prevent base erosion with respect to amounts paid by its Government to non-resident employees, it should ensure that its tax treaties contain provisions similar to Article 19 (Government service) of the United Nations Model Convention, which will allow the country to tax such payments.

4.2.4 Pensions

If a country wishes to prevent base erosion with respect to pensions paid to non-residents by resident employers, non-resident employers with a PE or fixed base in the country, or its Government, it should include provisions in its tax treaties similar to Article 18 (alternative B) (Pensions and social security payments) of the United Nations Model Convention, which will allow the country to tax such pensions.

4.2.5 International shipping and air transportation

If a country wishes to prevent base erosion with respect to payments made to non-residents for international shipping services that involve goods or persons taken on board in the country, it should either include Article 8 (alternative B) (Shipping, inland waterways, transport and air transport) in its treaties or exclude Article 8 from its tax treaties entirely. Since Article 8 (alternative B) allows a country to tax only shipping activities in the country that are more than casual, it will prevent the country from taxing non-resident airlines from transporting goods or persons in the country. Therefore, if that country wishes to tax income from such services, it should not include Article 8 in its tax treaties.

4.2.6 Entertainment and athletic activities

If a country wishes to tax income from entertainment and athletic activities performed in the country by non-residents, it should include

Article 17 (Artistes and sportspersons) of the United Nations Model Convention in its tax treaties.

4.2.7 Business, professional and other independent services

4.2.7.1 In general

If a country wishes to prevent base erosion with respect to business, professional and other independent services, it should ensure that non-residents providing such services cannot artificially avoid having a PE or fixed base in the country. PE and fixed base status can be avoided by fragmenting activities in a country among related entities. For example, if one non-resident entity carries on business at a fixed place in a country for five months and a related non-resident entity carries on business at the same location for an additional five months, there will be no PE in the country under Article 5 (Permanent establishment), although there would be a PE if the activities were carried on for 10 months by a single entity. Similarly, the time limits in Article 5 (3) can be avoided through the use of related entities. This type of tax avoidance can be dealt with through specific rules included in a country's tax treaties or through anti-avoidance rules in domestic law that apply to transactions that abuse the country's tax treaties. In the case of specific rules in tax treaties, it is necessary to obtain the agreement of the other contracting State to the inclusion of such rules. In the case of domestic anti-avoidance rules, it is necessary to ensure that the provisions of a country's tax treaties do not prevent the application of those rules, as discussed in section 3.5 of chapter 3 above.

If a country wishes to tax payments to non-residents for services that are performed outside the country but are consumed or used by persons in the country, it is necessary for that country to negotiate special provisions in its tax treaties to allow it to tax such payments. Other countries may be reluctant to agree to such provisions, since they involve a substantial deviation from the provisions of the United Nations and OECD Model Conventions. See the discussion of fees for technical services in section 4.2.7.5 below.

4.2.7.2 Preparatory and auxiliary activities

The exemption in Article 5 (4) of the United Nations Model Convention allows enterprises resident in one contracting State to carry on substantial preparatory and auxiliary activities in the other State without having a PE. As part of the BEPS project, the OECD/G20 is considering narrowing the scope of the activities exempted under Article 5 (4). If a country is concerned that the scope of the exemptions under Article 5 (4) is too broad, it should consider trying to negotiate a narrower version of the provision. In this regard, it should be noted that, even if some activities are excluded from the exemption under Article 5 (4) so that there is a PE in a country, there may not be any significant profits attributable to the PE. Therefore, any narrowing of the scope of the exemptions in Article 5 (4) should take into account the impact on the attribution of profits under Article 7 (Business profits).

4.2.7.3 Commissionaire and other similar arrangements

Commissionaire arrangements may be used to avoid an agency PE under Article 5 (5). As part of the BEPS project, the OECD/G20 is considering revisions to Article 5 (5) of the OECD Model Convention to ensure that commissionaire arrangements and other similar arrangements give rise to a PE. Once the OECD/G20 recommendations have been finalized, developing countries should consider including the revised version of Article 5 (5) in their tax treaties.

4.2.7.4 Insurance

If a country wishes to tax non-resident insurance companies earning income from the insurance of risks in the country, it should include provisions in its tax treaties similar to Article 5 (6) of the United Nations Model Convention, which allows taxation of non-residents that collect insurance premiums or insure risks in the country. Article 5 (6) excludes reinsurance, which allows non-resident insurance companies a relatively easy way to avoid the effect of Article 5 (6). Therefore, countries should attempt to negotiate a provision similar to Article 5 (6) of the United Nations Model Convention but excluding the words "except in regard to re-insurance".

4.2.7.5 Fees for technical services

If a country wishes to prevent base erosion through payments by residents of the country or non-residents with a PE or fixed base in the country to non-residents for consulting, technical and management services, it must include a special provision in its tax treaties allowing it to tax such payments. In the absence of a special provision, the provisions of the United Nations Model Convention, in particular Articles 7 and 14 (Independent personal services), will prevent the country from imposing tax on such payments unless the non-resident service provider has a PE or fixed base in the country.

The United Nations Committee of Experts, at its eleventh session in October 2015, agreed on a new Article to be included in the United Nations Model Convention that will allow the contracting States to tax payments for technical services made to a resident of one contracting State by a resident of the other contracting State or borne by a PE or fixed base in that State of a resident of another State. As discussed in part 2, section 2.3.2.5, the new Article will apply to allow a country to tax payments for technical services on a gross basis irrespective of whether the services are provided inside or outside the country. If the services are effectively connected with a PE or fixed base that a resident of one State has in the other State, then the income must be taxed on a net basis in accordance with the provisions of Article 7 or 14. Technical services are defined to mean consulting, technical and management services, and guidance will be provided on the meaning of these terms in the Commentary. The Commentary has not yet been finalized.

If a country wishes to tax payments to residents of the other contracting State for technical services, it probably makes sense for it to attempt to get the other contracting State to agree to a provision similar to the new Article on fees for technical services in the United Nations Model Convention. Many developed countries may be unwilling to agree to a special provision allowing the taxation of fees for tecnical services along the lines suggested above. However, they may be more willing to agree to a more limited provision with respect to such fees. For example, a special provision with respect to fees for technical services that is limited to services performed in a country or to services provided to a related person may be more acceptable to some countries.

Part 4

Tax Administration Manual

Chapter 1

Introduction

Part 4 of the present *Portfolio* deals with issues of tax administration with respect to the taxation of income from services and focuses on the prevention of base erosion and profit shifting (BEPS). Chapter 2 deals with disclosure and information reporting requirements. Chapter 3 deals with audit and verification activities by tax officials to detect and counter BEPS. Chapter 4 examines the issues involved in the administration of the provisions of a country's tax treaties with respect to the taxation of income from services.

As with the other parts of this *Portfolio*, part 4 is concentrated on the risks of BEPS with respect to income from services. Each country must decide for itself whether and to what extent it is concerned about the risks of BEPS, and if so, the appropriate action to take to combat those risks. Countries must consider a wide variety of factors in addition to the risks of base erosion in establishing their tax policy for the taxation of non-residents on income from services. Therefore, the material in this *Portfolio* should not be regarded as providing recommendations that developing countries should adopt to prevent base erosion. Instead, the *Portfolio* is intended to provide guidance for developing countries to consider in deciding whether to adopt measures to prevent base erosion and, if they decide to adopt such measures, guidance concerning the application of those measures.

The tax administration issues involved in combating base erosion with respect to income from services depends on each country's situation: its domestic tax legislation, its tax treaties and the organization of its tax administration. The guidance provided in part 4 is general and must be adapted and modified to the needs of any particular country.

Tax is imposed pursuant to a country's domestic law. Tax treaties generally limit the tax imposed under domestic law. Therefore, if a country does not impose tax on income derived by non-resident service providers under its domestic law, the provisions of its tax treaties are irrelevant. If a country does impose tax on non-resident service providers under its domestic law, then that country must ensure that the tax is correctly determined and collected and that any reductions in domestic tax available under a tax treaty are properly applied.

As noted several times in this *Portfolio*, the risks of base erosion are greater with respect to non-residents earning income from services than they are with respect to residents earning such income. Accordingly, part 4 focuses more heavily on the tax administration issues with respect to non-residents.

In general, non-resident service providers are subject to tax in two fundamental ways, depending on the circumstances. First, in some situations they may be taxable on their net income in the same manner as residents. In this case, they are usually required to file tax returns showing their income subject to tax and the tax payable. The payments for services that they derive may be subject to withholding, but such withholding is provisional and represents payments on account of the non-resident's tax payable as finally established by the assessment of the non-resident's tax return. The tax finally assessed may be more than the amount of tax withheld, in which case the non-resident is liable to pay the balance, or it may be less than the tax withheld, in which case the non-resident is entitled to a refund of the excess. Second, in other situations non-resident service providers may be subject to final withholding taxes on the gross payments they receive from their clients. In this case, the tax withheld is the final tax; the non-resident is not required or allowed to file a tax return and pay tax on a net basis.

The tax administration issues differ significantly depending on whether non-resident service providers are subject to interim or final withholding or are taxable only by assessment. Where non-resident service providers are taxable by assessment, compliant taxpayers will file tax returns that provide the tax authorities of the country with a starting point to verify the amount of income and tax payable. However, if a non-resident service provider is not compliant, either intentionally or inadvertently (because the non-resident does not think that it is subject to tax by the country), then the tax authorities of the country face the difficult task of identifying non-resident service providers that it considers to be subject to tax as a preliminary step to ensuring that such non-residents comply with their tax obligations under domestic law. These difficulties can be minimized if non-resident service providers are subject to interim or final withholding. To the extent that non-resident service providers are subject to withholding, the obligations to identify non-residents subject to tax and the amount of the tax are effectively shifted to the withholding agents.

Chapter 2

Disclosure and information reporting requirements

2.1 Introduction

The tax authorities of a country require various types of information in order to apply the provisions of its domestic law and tax treaties to ensure that income from services derived by residents and non-residents is taxed properly and the country's tax base is not eroded. With respect to residents of a country, the information that the tax authorities need depends on whether the residents are exempt from tax in the country on foreign income from services or are taxable with a credit for the foreign taxes on the foreign income. As noted in chapter 1 above, what information is necessary with respect to non-resident service providers depends on whether they are taxable on a net basis or are subject to interim or final withholding taxes. In addition, to the extent that the rules for the taxation of services derived by non-residents under a country's domestic law or its tax treaties differ depending on the type of services, the country will need information about the type of services provided by a non-resident.

2.2 Disclosure and information reporting requirements for residents earning income from foreign services

In general, the information necessary for purposes of properly taxing residents of a country on their income from services provided outside the country is available from three main sources:

- The resident
- The tax authorities of another country with which the country has a tax treaty providing for exchange of information
- Public information

If residents of a country are taxable on their worldwide income, including income from foreign services, they will usually be required by the laws of that country to provide information in their tax returns or supporting schedules with respect to the amount of such income, the country or countries in which the income is earned and the amount of foreign tax on the income. This information is necessary to determine a resident's worldwide income subject to tax and also the possible entitlement of the resident to a foreign tax credit for foreign taxes on the foreign income. Perhaps the best evidence of the amount of the income earned in another country and the amount of tax paid to that country is the taxpayer's foreign tax return.

Even if a resident is not subject to tax on foreign income from services, a country may require the resident to provide information about that income. This information can be used to verify that the resident is not claiming an exemption for foreign income from services in excess of the amount of such income. Also, for countries that exempt a resident's foreign source income but take that income into account to determine the rate of tax (exemption with progression), such information is important to verify that the tax rate applied is correct.

Where residents earn income from services provided to non-residents with whom they do not deal at arm's length, the tax authorities need information about those transactions in order to apply the transfer pricing rules. Thus, residents can be required to provide information to the tax authorities about transactions with related non-residents, including service transactions. Such information can be provided in a resident's tax return or in separate information returns. The information should include at least the name and address of the recipient of the payment, the country of residence of the recipient, the amount of the payment, and the nature of the services.

If a country has tax treaties with other countries, it can request its treaty partners to provide information pursuant to the exchange of information provisions in those treaties.

2.3 Disclosure and information reporting requirements for non-residents

2.3.1 Introduction

In general, the information necessary to tax non-residents on income from services properly is available from five main sources:

- The non-resident service provider
- A local agent or representative of the non-resident
- Persons, usually residents of the country, making payments to the non-resident service provider
- The tax authorities of another country with which the country has a tax treaty providing for exchange of information
- Public information

The following sections of this chapter are organized on the basis of the type of information that a country needs to tax non-residents on income from services. The sources for the information are discussed in each section.

It is assumed for the purposes of the following discussion that the tax authorities of a country have the authority under domestic law to obtain the necessary information from the taxpayer, the person making payments to a non-resident or other persons.

2.3.2 Identification of non-resident service providers

In order to impose tax on non-residents earning income from services, it is necessary, at a minimum, to know the names and addresses of the non-residents. Sometimes this information will be provided by non-residents pursuant to business registration requirements, in applications for taxpayer identification numbers or in tax returns. In other situations, if the payments to a non-resident service provider are subject to withholding tax, the withholding agent will be required to obtain and supply this information in order to comply with its withholding obligations.

With respect to income from services, some countries require persons visiting the country for the purpose of carrying on business activities to obtain a visa. If the information obtained pursuant to the visa process is available to the tax authorities, it will identify the non-resident and allow the tax authorities to follow up and determine whether the non-resident is subject to tax under the country's domestic law and whether the provisions of a tax treaty are applicable. Some countries require non-residents engaged in business activities in the country to register with the tax authorities or with some other government agency. Sometimes non-residents may also be required to obtain taxpayer identification numbers or to appoint a local agent or representative.[1] However, where non-resident service providers visit a country for only a short period of time, it may be difficult to identify them and to impose tax effectively on the income they derive. In many situations, the amounts of income earned from such short business visits may not be significant. However, certain non-residents, such as entertainers and athletes, can sometimes earn substantial amounts from short visits. As discussed below, the provisions of the United Nations and the Organisation for Economic Co-operation and Development (OECD) Model Conventions[2] allow the country in which entertainment and athletic services are performed to tax the income generated by these activities.

In some situations, it may be impossible for the tax authorities to obtain information about the identity of non-residents deriving income from services. For example, the tax authorities are unlikely to know if a non-resident provides services to persons in the country but does not spend any time in the country.

In situations where it is difficult or impossible for the tax authorities to identify non-residents deriving income from services in

[1] See Colin Campbell, "Taxation of non-residents", in *United Nations Handbook on Selected Issues in the Administration of Double Tax Treaties for Developing Countries*, (New York: United Nations, 2013) chapter IV, at 173–191, available from http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Handbook_DTT_Admin.pdf.

[2] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011); and Organisation for Economic Co-operation and Development (OECD), *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

a country, the only effective way to identify such non-residents may be to require persons resident in the country that pay for the services to provide information concerning the identity of the non-resident as part of an obligation to withhold tax from the payment. The administrative aspects of withholding taxes on payments for services are dealt with below in section 4.7.2.

Where a non-resident is not subject to withholding and does not voluntarily file a tax return, the tax authorities of a country may sometimes use public information to identify non-residents earning income from services in the country. For example, if big-name entertainers or athletes visit a country to make appearances or participate in events, these visits will usually be a matter of public knowledge and often be aggressively promoted. Similarly, if non-resident shipping companies or airlines take on passengers or cargo in a country, this information will usually be made public. It may be useful for the tax authorities to monitor public information about these types of services.

2.3.3 Amount of income derived by non-residents

Where non-resident service providers are taxable on their net income, they will be required by a country's domestic law to provide information necessary to compute their net income subject to tax. This information, which is usually provided in a tax return or other supporting schedules, provides a starting point for the tax authorities to determine whether the amount of income is correctly reported. In particular, these non-residents should be required to keep financial books and records that are necessary to support the computation of their net income for tax purposes. The general requirement to keep books and records for non-residents who are subject to tax in a country on a net basis should be the same as that for residents.

Other information may also be useful. For example, it would be useful to have information from persons resident in a country or non-residents with a permanent establishment (PE) or fixed base in the country that make payments for services to non-residents. If the payments are subject to interim or final withholding, the withholding agent can be required to supply information concerning the name and address of the non-resident payee, the amount of the payment, the nature of the services and whether the payer is related to the non-resident. However, even if the payments are not subject to withholding, a country might require the payers to provide such information. As discussed in section 2.3.5 below, for this purpose the country may wish to consider providing prescribed forms that withholding agents can use to provide this information.

If the non-resident service provider is a resident of a country with which the source country has a tax treaty, the source country can request that country to provide information about the non-resident. This source of information is unlikely to prove fruitful because the tax authorities of the source country must know at least the name of the non-resident in order to make a request for information.

2.3.4 Information concerning related-party services

Where services are provided by a non-resident enterprise to an enterprise that is resident in a country, the possibility arises that the price paid by a resident of the country for the services may not be equal to the amount that would have been paid for those services had the enterprises been dealing with one another at arm's length. A country may be concerned because the amount paid by its resident is more or less than the arm's length price of the services. If the amount paid is greater than the arm's length price of the services, the resident will be claiming an excessive amount as a deduction in computing its income. If the amount paid is less than the arm's length price, the amount of any withholding tax imposed on the payment for the services will be less than it should be.

Many countries have transfer pricing rules that require the prices charged for goods and services in transactions between a resident and a related non-resident to be adjusted if they are not equal to the prices that parties dealing at arm's length would charge. Any tax treaties that a country has entered into will likely contain provisions similar to Article 9 (Associated enterprises) of the United Nations and OECD Model Conventions.

A country may wish to consider requiring enterprises resident in the country and non-resident enterprises with a PE or fixed base in the country that make payments for services to related non-resident enterprises to provide information to the tax authorities about those payments. Taxpayers may already be required to provide such information pursuant to a country's transfer pricing rules. If so, the tax authorities need to ensure that the information is also available to the officials who deal with withholding taxes. The requirement to provide this information might be limited to payments that are deductible by the payers.

The type of information that might be required includes:

- The name and address of the non-resident service provider
- The legal relationship between the payer and the non-resident service provider
- The amount of the payment
- The type of services provided; the information about the types of services should reflect the different types of services that are taxable under a country's domestic law and tax treaties
- Where the services are performed
- How many days, if any, the non-resident service provider or its employees spend in a country
- Whether the non-resident service provider has a fixed place of business in a country

Transfer pricing rules typically apply only to related or associated enterprises such as corporations. However, similar issues can arise with respect to the performance of services by a non-resident individual to a related individual (or other non-corporate entity) resident in a country. If the amount paid for the services is more or less than the fair market value of the services, that country's tax base may be eroded. Therefore, the tax authorities of that country may also require resident persons, other than entities subject to the transfer pricing rules, to provide information about payments for services to related non-residents. As with transfer pricing documentation, this information reporting might be limited to deductible payments.

Such information may also be important for purposes of applying the new Article on fees for technical services in the United Nations Model Convention. That Article includes a provision similar to Articles 11 (6) (Interest) and 12 (6) (Royalties) of the United Nations Model Convention dealing with payments that are excessive because of a special relationship between the payer and the payee. Thus, under the new Article dealing with fees for technical services, if payments for such services are excessive, the excess portion of the payments will not qualify for the lower rate provided in the new Article, but will be taxable in accordance with the domestic laws of the contracting States with due regard to the other provisions of the treaty.

2.3.5 Information forms

It would be useful for a country to prescribe forms for taxpayers and withholding agents to use to provide information required by the tax authorities to properly tax income from services derived by non-residents. Such forms will help to ensure that the proper information is provided and that the information is uniform and consistent. Penalties can be imposed for failure to provide the forms, failure to provide them on a timely basis and failure to provide all of the required information.

A sample information form is shown below.

Payments to non-residents for services

Year ____

Non-resident recipient's name and address

____

Non-resident recipient's taxpayer identification number

____

Payer's name and address

____

____

____

Payer's taxpayer identification number _________

Amount paid _________ ________

Tax deducted _________ ________

Type of services performed ____________________________

Number of days recipient was present in the country ______________

This type of form should be required to be filed for each payment to a non-resident for services. A copy of the form should also be provided by the payer to the recipient. In addition, it would be useful for payers to be required to file an annual form showing all of the payments made to non-residents for services, the amount of tax deducted, the amount of tax remitted to the tax authorities and the total number of forms filed for payments to non-residents for service.

Chapter 3

Auditing and verifying income from services

3.1 Introduction

Chapter 3 deals with the audit and verification activities of the tax authorities of a country to ensure that the provisions of the country's domestic law with respect to the taxation of residents and non-residents on their income from services have been complied with. The audit and verification activities undertaken by the tax authorities are dependent upon the provisions of domestic law. For purposes of this discussion, it is assumed that countries tax all income from services derived by non-residents. Obviously, if a country chooses not to impose tax on certain income from services derived by non-residents, it is unnecessary for the tax authorities of that country to monitor compliance to that extent.

This chapter is not intended to provide basic guidance as to standard auditing techniques. The same auditing techniques that are used with respect to other types of income are equally applicable to income from services generally and to services that involve the erosion of a country's tax base. Although this chapter focuses on base-eroding payments for services, such payments are merely one aspect of non-compliance. The tax authorities of a country should perform an assessment of the risks of non-compliance by residents and non-residents generally, and with respect to income from services specifically, based on the guidance provided in chapter 4 of part 2 of this *Portfolio*. They should target their audit resources on the areas where there are the greatest risks of non-compliance and where the taxes generated from the enforcement efforts are likely to be greatest.

As noted above, the audit and verification activities of the tax authorities of a country are dependent upon the country's domestic law with respect to the taxation of residents and non-residents on income from services. In particular, it is worth noting that if a country's domestic law treats income from services derived by non-residents differently, depending on the nature of the services and whether the services are provided by a related party, the compliance burden imposed on withholding agents and the administrative burden imposed on the tax authorities will be significantly greater than if all payments for services to non-residents are treated similarly. For example, if all deductible payments to non-residents for services are subject to withholding, whether provisional or final, withholding agents will not be required to distinguish between various types of payments for services (for example, professional services, entertainment and athletic services, technical services, other business services, or services provided by related non-residents). Auditing activities by the tax authorities will be similarly simplified.

3.2 Auditing the taxation of residents on income from foreign services

3.2.1 Introduction

Auditing and verification activities with respect to the taxation of residents on their income from foreign services is the same as the auditing of the foreign source income of residents generally.

3.2.2 Checklist

1. If income from foreign services is taxable:
   - Verify the amount of foreign services income earned in each foreign country from the resident's tax return, supporting books and records and foreign tax return
   - Verify the amount of foreign tax paid to each foreign country from the foreign tax return
   - Verify that the limitation on the foreign tax credit is properly computed
     - Check whether expenses are properly allocated to foreign services income

2. If foreign services income is exempt:
   - Verify the amount of foreign services income qualifying for exemption from the resident's tax return, supporting schedules and foreign tax return
     - If the foreign income is taken into account to determine the resident's tax rate, verify the rate
   - Verify that expenses allocated to exempt foreign services income are not deductible
3. Related-party transactions:
   - Verify that any payments for services performed by residents for related persons are equal to the arm's length amount
     - Apply transfer pricing rules

3.3 Taxation of non-resident service providers on a net basis

Usually, non-residents that are subject to tax on their income from services on a net basis provide their services through a permanent establishment (PE) or fixed base in a country. If this is the case, the audit and verification activities of the tax authorities can focus on the books and records of the PE or fixed base. As noted in section 2.3 of chapter 2 above, any non-residents carrying on business in a country through a PE or fixed base should be required under the country's domestic law to keep the necessary books and records to support the computation of their income in accordance with the country's domestic rules. The books and records should be similar to the books and records that resident taxpayers engaged in business must keep.

The tax authorities can check the non-resident's books and records to determine whether they have been maintained properly and to verify amounts against original documents such as invoices and banking records.

Where non-resident service providers are subject to provisional withholding on payments received from residents of a country or from non-residents with a PE or fixed base in the country, the tax authorities of the country can use the information provided by the withholding agents to verify that any payments made to non-residents have been included in their income. This assumes that the withholding agents are required to provide useful information, as discussed in section 3.4 below, and that the tax authorities have the necessary resources to use the information effectively.

3.4 Provisional or final withholding taxes

If certain persons — usually residents and non-residents with a PE or fixed base in a country — are required to withhold tax from payments for services provided by non-residents, the tax authorities need to audit the withholding agents to ensure that they have withheld the proper amounts. Where non-residents are subject to provisional withholding and are entitled to file tax returns and pay tax on a net basis, the tax authorities have access to both the information provided by the non-residents in their tax return and the information provided by the withholding agents. These two sources of information can be cross-checked to determine whether the non-residents have reported the correct amount of income and tax payable and the withholding agents have withheld the correct amounts.

Where non-resident service providers are subject only to a final withholding tax, the only issue for the tax authorities to verify is whether the withholding agent withheld the proper amount from any payments to non-residents for services. In addition, the only source of information for this purpose is information provided by or in the hands of the withholding agents. As discussed in chapter 2 above, withholding agents should be required to provide certain information with respect to the amounts withheld and remitted to the tax authorities. This information can be checked against the withholding agent's books and records and its banking records. For example, if a resident payer claims a deduction for amounts paid to a non-resident service provider, the payer's books and records and the information provided in its tax returns or information reporting forms can be cross-checked against the information provided with respect to the amounts withheld.

If withholding agents are subject to serious penalties for failure to withhold properly, they will be more likely to withhold properly in order to avoid the penalties. Such penalties may reduce the need for the tax authorities to audit withholding agents with respect to payments to non-residents for services. For example, if persons paying non-residents for services fail to withhold, they may be made liable for the tax payable by the non-residents and/or they might not be allowed to claim a deduction for the amount paid for the services.

Each country must carefully consider the compliance burden imposed on payers to withhold from payments to non-resident service providers and to provide information about such payments. Where the payers are individuals resident in a country and the services represent personal consumption, it may be difficult to enforce withholding obligations on such individuals, especially since usually they will not claim deductions for the amounts paid.

If a country provides waivers from the obligation to withhold tax from payments for services in certain circumstances, it will be necessary for the tax authorities to review and audit the waiver programme to ensure that it is operating properly.

3.5 Checklist

1. If non-residents are taxable on a net basis:
   - Identify non-resident service providers
     - If payments to non-resident service providers are subject to provisional withholding, verify that payers are withholding properly on the basis of withholding information returns, payers' tax returns and other information
   - Determine whether any threshold is met
     - PE, fixed base or other domestic threshold
     - Verify that non-residents are not avoiding any threshold requirement
     - Determine the source of income if only income from services performed in the country is taxable or if income from services is taxed differently depending on whether the services are performed inside or outside the country
   - Verify the amount of income subject to tax from the tax return, supporting books and records and third-party information returns

2. If non-residents are taxable on a withholding basis:
   - Verify that payers are withholding tax properly on the basis of withholding information returns, payers' tax returns, books and records and other information
   - Check the deduction of amounts paid to non-residents for services
3. Related-party transactions:
   - Verify that any payments for services performed by residents for related persons are equal to the arm's length amount
     - Apply transfer pricing rules

Chapter 4

Administration of tax treaty provisions to prevent base erosion with respect to income from services

4.1 Introduction

If a country is not entitled to tax non-residents on certain income from services under its domestic law, then the provisions of its tax treaties are irrelevant. This is due to the fundamental proposition that for most countries tax treaties do not have the effect of imposing tax; they limit the tax imposed under a country's domestic law. Therefore, if a country's tax base is being eroded with respect to income from services derived by non-residents because the country's domestic tax law does not impose tax on that income, the country may wish to consider whether its domestic law is appropriate in this regard or whether the law should be changed to expand the country's taxation of income from services derived by non-residents. Part 3 of the present *Portfolio* provides a discussion of the provisions of domestic law that might be adopted to prevent base erosion and profit shifting (BEPS) with respect to income from services.

However, even if a country imposes tax on income from services derived by non-residents under its domestic law, it may be required to give up that tax pursuant to the provisions of the tax treaties that it enters into. Part 3 of this *Portfolio* also provides guidance for developing countries to minimize the risks of base erosion with respect to the provisions of tax treaties dealing with income from services. Like the provisions of domestic law, the provisions of a country's tax treaties are not self-executing. The tax authorities must ensure that the provisions are applied properly so that the benefits of a treaty are given only in situations where the taxpayer is entitled to those benefits. This chapter deals with the administration and application of the provisions of tax treaties by developing countries to minimize base erosion, and provides guidance for the tax officials of developing countries in applying the provisions of their tax treaties dealing with income from services.

This chapter focuses primarily on the risks of base erosion with respect to the provisions of tax treaties dealing with income from services. For this reason, it deals only with the application of tax treaty provisions that affect the taxation of non-residents earning income from services. It does not deal with treaty provisions affecting residents of a country, such as provisions that require the country to provide relief from international double taxation. Similarly, the chapter does not deal with the administration and application of tax treaties generally. For information and guidance concerning the administration of tax treaties generally, including the organizational structure of the tax administration and the relationship between tax treaties and a country's domestic law and between its tax treaties and its trade and investment treaties, see *United Nations Handbook on Selected Issues in the Administration of Double Tax Treaties for Developing Countries*.[3] As the *Handbook* explains, tax treaties do not contain many rules dealing with the application of their provisions. Thus, the rules for the application of the provisions of a country's tax treaty must be found in its domestic law; yet few countries have such provisions. As a result, the *Handbook* suggests that developing countries may wish to consider the adoption of uniform legislative or administrative rules for the application of the provisions of their tax treaties. Most importantly, these rules would deal with the procedural requirements for non-residents to qualify for claiming the benefits of a tax treaty.

4.2 Identification of non-residents deriving income from services

As discussed in section 2.3.2 above, the first step for any country that imposes tax on the income of non-residents, including income from services, is to identify those non-residents. This step is crucial for the

[3] *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (New York: United Nations, 2013), available from http://www.un.org/esa/ffd/wp-content/uploads/2014/08/UN_Handbook_DTT_Admin.pdf.

imposition of domestic tax as well as the application of the provisions of an applicable tax treaty. If a country cannot identify the non-residents deriving income from the country, the issue of whether such non-residents are entitled to treaty benefits is irrelevant. Therefore, every country should have strategies in place to identify non-residents doing business in or deriving income from the country, as discussed in chapter 2 above.

For the purposes of this chapter dealing with the application of tax treaties, it is assumed that a country has identified the non-residents earning income from services that are subject to tax under that country's domestic tax law. Therefore, the issues in this chapter are: is a non-resident entitled to a reduction or exemption from a country's tax under a tax treaty and, if so, how are the provisions of the treaty applied by the tax authorities of the country?

4.3 Determining the country of residence of the non-resident service provider in order to establish the relevant treaty

4.3.1 Treaty residence

Assuming that a country has identified a non-resident earning income from services that is taxable under the country's domestic tax law, the first step in applying the provisions of a tax treaty is to determine whether the country has a treaty with the country in which the taxpayer is a resident. Only residents of a contracting State are entitled to the benefits of that State's tax treaties. Therefore, to determine whether a particular non-resident service provider is entitled to the benefits of one of a country's tax treaties, it must be determined whether the non-resident is a resident of a country with which the country has a tax treaty. For this purpose, the test of residence is usually established in Article 4 of the treaty and depends on whether the non-resident is liable to tax under the laws of the other country on the basis of residence, domicile, place of management or any other similar criterion, which might include nationality or substantial periods of presence.

The important point about the determination of residence of a non-resident taxpayer for tax treaty purposes is that the question must be determined under the law of the treaty partner, not under the source country's law. Article 4 (Resident) states that a person is a resident of a country if the person is liable to tax "under the laws of that State". A country's tax authorities may not be knowledgeable about the laws of its treaty partners as to the residence of taxpayers. Therefore, where a taxpayer claims the benefits of a tax treaty, it is customary for the tax authorities to verify that the taxpayer is a resident of the other country by requesting the taxpayer to provide a certificate from the tax authorities of the other country verifying that the taxpayer is a resident.

The use of residence certificates is widespread. Where there is substantial cross-border activity between two countries, it may be beneficial to formalize the use of residence certificates (as well as other matters, as discussed below) through an agreement between the competent authorities of the treaty partners as provided by Article 25 (Mutual Agreement Procedure) of the United Nations Model Convention.[4] The efficiency of the use of residence certificates can be improved if special forms for the purpose are created in the relevant languages of the two countries. In this way, the taxpayer can obtain a certificate from its country of residence and provide it to the country from which treaty benefits are claimed. Alternatively, the tax authorities of the country of residence can send the form directly to the tax authorities of the source country.

A country may require the tax authorities of the other country to certify other things besides residence. For example, a country may require the foreign tax authorities to certify that the taxpayer is the beneficial owner of fees for technical services in order to get the benefit of the reduced rate of source country tax under the new Article of the United Nations Model Convention.

There are potential problems with the requirement of residence and other certifications from the tax authorities of the other countries. Although the requirement of a certificate of residence imposes some additional compliance burden on the taxpayer and administrative burden on the tax authorities, this additional burden does not

[4] United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (New York: United Nations, 2011).

seem overly onerous if it is simply an annual requirement. If, however, a separate certificate is required for each payment, the burden could be significant. Another problem is the potential delay in obtaining the benefits of the treaty caused by the necessity to obtain residence or other certifications from the foreign tax authorities. The delay is dependent upon how frequently such certificates are required and how much information about the tax affairs of the taxpayer must be certified by the foreign tax authorities.

Unfortunately, some countries do not apply rigorous standards in granting residence certificates to taxpayers, since it is another country's tax that will be reduced. Therefore, countries should be cautious about accepting residence certificates without any verification.

Some countries allow withholding agents to reduce the amount withheld pursuant to a treaty based on the address of the recipient. In effect, if the non-resident's address reflects a location in the treaty partner country, treaty benefits in the form of lower withholding tax are granted. Relying on addresses in this way makes the delivery of treaty benefits much more efficient, but it is also susceptible to abuse. Therefore, a country may consider not allowing a withholding agent to rely on a recipient's address if the agent has reason to suspect that the recipient is not a resident of the other contracting State. In this case, the taxpayer or the withholding agent must obtain a residence certificate in order to obtain the benefit of the lower treaty rate of withholding. Otherwise, withholding agents are likely to withhold the higher amount required by domestic law, in which case non-resident service providers will be required to apply for refunds.

In order for a taxpayer to qualify as a resident of a country for tax treaty purposes, the taxpayer must be a "person" for purposes of the treaty. Tax treaties based on the United Nations Model Convention provide a broad definition of "person", which includes individuals and legal entities. The definition of a person is discussed below in connection with the qualification for treaty benefits.

In addition to the requirement that a person must be a resident of one of the contracting States to obtain the benefits of a tax treaty, some treaties contain anti-treaty shopping provisions (also known as "limitation-on-benefits" provisions) to further restrict the granting of treaty benefits to "real" residents of a country.[5] For example, a resident of one country may wish to make an investment in another country. If there is no treaty between those two countries, the investor may establish a shell company in a country that does have a treaty with the country in which the investment will be made. However, that company may have little or no substance (that is, no employees, no business in the country in which it is established and no assets other than the investment in the other country). The anti-treaty shopping rule in the Commentary on Article 1 of the United Nations Model Convention would prevent such a company from getting the benefits of the treaty.

4.3.2 Dual residence

Situations in which a taxpayer is considered to be resident in both contracting States for purposes of a tax treaty are frequently encountered because countries' residence rules tend to be overly broad. In these dual-resident cases, the United Nations Model Convention and the Organisation for Economic Co-operation and Development (OECD) Model Convention[6] provide tie-breaker rules to allocate residence exclusively to one contracting State for purposes of the treaty. Under Article 4 (2) of both Models, a hierarchy of four tie-breaker rules is provided for individuals, whereas under Article 4 (3) the tie-breaker rule for entities is the entity's place of effective management. The Commentary on both Models allows countries to substitute an alternative version of Article 4 (3) under which the dual residence of entities other than individuals is resolved on a case-by-case basis pursuant to the mutual agreement procedure instead of by reference to the entity's place of effective management.[7]

The application of the tie-breaker rules has important implications for the contracting States because it determines which country

[5] See paragraph 20 of the Commentary on Article 1 of the United Nations Model Convention for a discussion of this type of provision.

[6] OECD, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

[7] See paragraph 10 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraph 24.1 of the Commentary on Article 4 of the OECD Model Convention.

must give up its taxing rights. Consequently, the application of the tie-breaker rules should be carefully considered. For individuals, the tie-breaker rules are inherently factual and should be applied on a balanced basis to give residence to the country to which the individual is more closely connected. In addition, dual-resident entities are often used for tax avoidance purposes. Therefore, when the tax authorities of a country encounter dual-resident entities, they should consider whether the entities have been used for tax avoidance purposes, and if so, whether such tax avoidance can be countered by anti-abuse rules in the country's domestic law or tax treaties.

Example 1

A Co is considered to be a resident of Country A because its place of management is located in Country A. A Co is also considered to be a resident of Country B because it is incorporated under the laws of Country B. Assume that A Co provides services to residents of Country B and to residents of Country A and pays 100 to another company resident in Country A for technical services. Assume that Country B imposes a withholding tax of 10 per cent on payments to non-residents for technical services. If Country B and Country A have entered into a tax treaty with provisions identical to those of the United Nations Model Convention, under Article 4 (3) A Co would be considered to be resident where its place of effective management is located. Although place of effective management is not precisely the same as place of management, assume that the place of effective management of A Co is considered to be in Country A. As a result, A Co would be considered to be resident in Country A for purposes of the treaty between Country A and Country B. Therefore, Country B would be required to provide the benefits of the treaty to A Co.

This would likely mean that Country B could not tax A Co on the income it derives from services performed for residents of Country B unless A Co has a permanent establishment (PE) in Country B and the services are provided through that PE. Further, under the treaty, Country B would not be entitled to tax A Co on the income it derives from services performed for residents of Country A. However, under the domestic law of Country B, the provisions of the treaty do not eliminate the obligation on A Co to withhold tax from the 100 payment to the company resident in Country A for technical services. A Co is a resident under the domestic law of Country B for purposes of its withholding tax; the tie-breaker rule in the treaty makes A Co a resident of Country A only for purposes of the treaty, not for all purposes. Note, however, that many countries have provisions in their domestic law that allow withholding agents to withhold only the amount required under an applicable tax treaty if the payments are made to a resident of that treaty country.

4.4 Determining the applicable provision of the treaty

4.4.1 Introduction

Once the tax authorities of a country have determined that a non-resident taxpayer is a resident of a country with which its country has a tax treaty, they must decide which provision of that treaty applies to the income from services earned by the non-resident. As discussed in part 2 of this *Portfolio*, the United Nations and OECD Model Conventions treaties contain several provisions potentially applicable to services, including Article 7 (on business profits), Article 8 (on international shipping and air transportation), Article 14 (on professional and other independent personal services), Articles 15, 18 and 19 (on employment), Article 16 (on directors' fees and remuneration of top-level managerial officials), Article 17 (on entertainment and athletic activities) and Article 21 (on other income).

In general, determining which article of the treaty applies in any particular case involves three issues:

1. Is the income derived from services?
2. What type of services are involved?
3. In what legal capacity are the services provided? For example, are the services provided by employees or independent contractors?

Each of these issues is discussed briefly below.

4.4.2 Services or other income

Neither tax treaties nor domestic law usually provides any definition of "services". Therefore, the term likely has its ordinary meaning, which is work performed by one person for another person for compensation. In most cases it will be obvious whether the income is derived from services or from other income-earning activities. However, in some cases, especially those involving royalties for the use of or the right to use property, it may be difficult to differentiate between income from services and other income. In general, the performance of services does not involve any transfer of property or the right to use property by the service provider to the client. Where there is a transfer of property or the right to use property, there should be payments (rents or royalties) in consideration for the use of the property.[8]

4.4.3 Types of services

As discussed in part 2, under the provisions of the United Nations and OECD Model Conventions, income from services is treated differently depending on the nature of the services. The risks of base erosion also vary depending on the nature of the services. Under the provisions of the United Nations Model Convention, the following types of services are treated differently:

- Business services
- Professional and other independent personal services
- Employment services
- Services of directors and top-level managerial officials
- International shipping and air transportation

This chapter does not discuss each of these types of services separately because the tax administration activities are generally the same for all types of services. Therefore, the following sections in this chapter deal with the various administrative activities that should be performed by the tax authorities in applying the provisions of tax treaties dealing with income from services. One of these activities involves determining the nature of the services involved in any particular situation.

4.4.4 Legal capacity in which services are performed

Except for Article 17 dealing with income derived from entertainment and athletic activities, the application of all of the other provisions of

[8] See paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraphs 11.1 – 11.6 of the Commentary on Article 12 of the OECD Model Convention; and paragraphs 14 – 16 of the United Nations Model Convention for guidance on this issue.

the United Nations and OECD Model Conventions depends on the legal capacity in which the services are provided. Thus, services performed by an employee are covered by Article 15, 16 or 19 depending on whether the employee is an ordinary employee, a director or top-level manager of a resident company or a government employee, respectively. In contrast, services performed by an independent service provider are covered by Article 7 or Article 14. It is generally accepted that Article 14 applies to services performed by individuals and Article 7 applies to services performed by legal entities. Since the conditions for the application of the treaty provisions dealing with services vary significantly, it is important to determine whether the services are performed by an employee or an independent contractor. This distinction is made on the basis of the domestic law of the country applying the treaty and is discussed in more detail in part 2.[9]

4.5 Qualification for treaty benefits

Once the tax authorities have determined which provision of the treaty is applicable to the income from services derived by the non-resident taxpayer, they must determine whether the non-resident satisfies all the conditions for entitlement to the benefits of that article. The requirements of the various provisions of the United Nations Model Convention dealing with services are discussed in detail in part 2; here we are concerned with how the tax authorities verify or ensure that the requirements for entitlement to treaty benefits are met.

A comprehensive list of the requirements for entitlement to treaty benefits (not all of these apply to every article) would include the following:

- The non-resident must be a person
- The non-resident must be a resident of the other country for purposes of the treaty
- The non-resident must be the beneficial owner of the income
- The non-resident must have a permanent establishment (PE) or fixed base in the source country or be present in that country for a minimum period of time

[9] See also paragraphs 8.1 – 8.28 of the Commentary on Article 15 of the United Nations Model Convention.

- The services must be performed in the source country
- The payer must be a resident of the source country
- Any anti-treaty shopping or limitation-on-benefits provision must not apply (see section 4.3.1 above for a brief discussion of such provisions).

As mentioned above, often the non-resident's residence in the other country is verified through a certificate of residence obtained from the tax authorities of the other country. Similarly, the treaty partner might be requested to certify that the non-resident is the beneficial owner of the income. (Note that this assumes that the meaning of beneficial owner is determined under the law of the recipient's country of residence. It is unclear under the provisions of the United Nations Model Convention which country's law should be applied for the purpose of determining who is the beneficial owner of the relevant payment.) However, all the other requirements must be determined by the source country's tax authorities on the basis of its own information and expertise.

Where the provisions of the treaty (Article 7 or 14) require a country to tax a non-resident's income from services on a net basis, the country must determine, first, whether the non-resident has a PE or fixed base in the country and, second, the income attributable to the PE or fixed base. The country's domestic law probably requires any non-resident carrying on business in the country through a PE or fixed base to register and file a tax return. These tax returns and the supporting financial information should provide the tax authorities with the necessary information to determine the amount of income and tax payable under its domestic law and under the treaty. If a non-resident does not file a tax return or does not file it on a timely basis, interest on unpaid tax and penalties should be imposed. However, in most situations where non-residents are claiming treaty benefits, they are likely to attempt to comply with the country's laws.

Therefore, the primary challenges with respect to the application of Article 7 or 14 consist of verifying:

(a) The taxpayer's claim that it has a PE or fixed base in the country or that it has spent the requisite amount of time in the country so that it is taxable on a net basis; and

(b) The amount of income attributable to the PE or fixed base.

For this purpose, the tax authorities will likely start with the information provided by the taxpayer and then use standard audit techniques to verify that information.

If a country has imposed withholding on amounts paid to non-residents that are taxable on a net basis under the terms of the treaty, the country must allow the non-residents to apply for a refund on any tax withheld in excess of the tax payable in accordance with the provisions of the treaty. Issues with respect to withholding taxes are discussed below in section 4.7.2.

4.6 Computation of income

Although the amount subject to tax by a country in accordance with the provisions of an applicable tax treaty may be limited, the rules for the computation of the income are the rules for that purpose under the country's domestic law. For example, a country's tax rules will determine what amounts are included in income, what amounts are deductible in computing income and the timing of those inclusions and deductions. Where the income from services derived by a non-resident is subject to tax on a net basis under Article 7 or 14 of a treaty based on the United Nations Model Convention, the treaty provides some basic rules for computing the amount of income that is attributable to a PE or fixed base. The rules in Article 7 of the United Nations Model Convention may be summarized as follows:

- The deduction of expenses is a matter of the domestic law of the country in which the PE is located; however, the deduction of expenses incurred on behalf of the PE cannot be denied on the basis that the expenses are incurred outside that country
- No deductions are allowed for amounts paid by a PE to its head office or other parts of the enterprise with respect to royalties, fees for services or interest (except for banking enterprises)
- Amounts charged by a PE to its head office or other parts of the enterprise with respect to royalties, fees for services or interest (except for banking enterprises) are not to be taken into account
- If it has been customary to determine the profits of a PE on the basis of apportionment, such an apportionment is acceptable if the result is in accordance with the principles of Article 7

- The profits of a PE must be determined consistently from year to year unless there is a good reason to make a change

Although Article 14 of the United Nations Model Convention does not provide similar rules for the computation of the profits attributable to a fixed base, it is generally considered that similar rules apply.

In addition, where the income is derived from transactions between an enterprise that is resident in a country and a related or associated enterprise resident in the other country, the transfer pricing provisions of the treaty will apply. Similarly, under the new Article of the United Nations Model Convention dealing with fees for technical services, payments that are excessive because of a special relationship between the parties will not be taxable in accordance with the provisions of the new Article. Therefore, with respect to payments for services between related parties, the tax authorities must determine whether the payments are in accordance with the arm's length standard in Article 9 of the treaty and, if not, how they should be treated.

Where the income from services derived by a non-resident is taxable under a country's domestic law and under the treaty on a gross basis, the amount subject to withholding will be the amount determined under the country's domestic law as limited by the treaty. For example, if a treaty allows the country to tax payments for technical services made to a resident of the other country, but the country imposes a withholding tax on all payments for services made to non-residents, the treaty will require the country to refund any withholding tax levied in respect of payments to the resident of the treaty partner for non-technical services.

4.7 Collection of tax

4.7.1 Tax imposed on a net basis

If a treaty requires a country to tax certain income from services on a net basis, it does not mean that the country cannot collect the tax through withholding tax. Instead, it means that to the extent that the withholding tax exceeds the tax on the net income subject to tax by the country in accordance with the treaty, the country must refund the excess to the non-resident. Alternatively, a country can collect tax from non-residents earning income from services in the same way that it collects tax from residents. Therefore, for example, some countries may require residents and non-residents carrying on business in the country to pay instalments of tax on a periodic basis and then to pay any balance owing when the tax return for the year is due. The instalments of tax should probably be set at an amount that approximates the amount of tax payable for the year and could be based on the tax payable for the previous year.

However, these techniques may not be effective with respect to non-residents that do not have significant assets in a country or are not physically present in the country. As discussed in section 4.7.3 below, Article 27 of the United Nations Model Convention (Assistance in the collection of taxes) provides a mechanism whereby a country can request its treaty partner to collect any tax owing to the country by a resident of the treaty partner as if the tax were tax owing to the treaty partner.

4.7.2 Withholding tax

Other than in Articles 7 and 14, the provisions of tax treaties based on the United Nations and OECD Model Conventions do not require a country to tax income from services derived by a resident of the other contracting State on a net basis. Many countries tax income from several types of services earned by non-residents by imposing an obligation on the payer for the services to withhold tax on behalf of the non-resident. The provisions of tax treaties do not specify how countries should impose or administer withholding taxes.[10] In general, tax treaties limit the rate at which dividends, interest and royalties can be taxed; they do not limit the rate at which the source country can tax income from services. However, the new Article to be added to the United Nations Model Convention dealing with fees for technical services will limit the rate of source country tax on such services.

Although withholding taxes are imposed on non-residents deriving income, the taxes are collected by requiring the payers to

[10] See paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraphs 18 and 19 of the Commentary on Article 10 of the OECD Model Convention, and paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraphs 12 and 13 of the Commentary on Article 11 of the OECD Model Convention.

withhold an amount from the payments for the services and remit that amount to the tax authorities as tax on behalf of the non-resident. The obligation to withhold is usually imposed on residents of a country and non-residents carrying on business in the country through a PE or fixed base. Some countries do not impose an obligation to withhold on individuals making payments to non-resident service providers, or impose an obligation to withhold only on payments that are deductible. Unlike a non-resident service provider who may have little connection with a country, residents and non-residents with fixed places of business in the country have substantial connections to the country, and that country can take enforcement action against them if they fail to withhold. Various penalties can be imposed on withholding agents to ensure that they withhold properly. These penalties include interest and financial penalties, liability (with the non-resident) for any tax that should have been withheld, and the denial of any deduction for the payments to the non-resident if tax is not withheld.

An exception to this general pattern is made by the new Article to the United Nations Model Convention dealing with fees for technical services, which provides that the source country will be allowed to tax such fees, but not in excess of the rate agreed to by the contracting States. Even in cases where the treaty specifies a maximum rate of tax, it does not prevent a country from requiring payers to withhold at a higher rate; however, if it does so, the country would be required to refund any tax withheld in excess of the maximum rate provided in the treaty.

Since tax treaties do not deal with how a country imposes tax, the method of taxation is a matter of domestic law. Therefore, countries have flexibility in determining how to apply their withholding taxes. First, withholding can be imposed on an interim basis or as a final tax. If withholding is imposed on an interim basis, the taxpayer is entitled or obligated to file a tax return and determine the amount of income — usually on a net basis — and tax owing. This type of withholding imposes a considerable compliance burden on taxpayers and an administrative burden on the tax administration. Taxpayers must file returns and the tax administration must establish a unit to process those returns and make refunds of excessive tax withheld. In contrast, under a final withholding tax the amount withheld is the tax payable; no tax returns are filed and no refunds of tax are made.

Second, countries have flexibility to establish the rate of withholding in their domestic law at a rate that is more than, less than or equal to the rate specified in the treaty. If the domestic rate is less than or equal to the treaty rate, the country will meet its treaty obligations simply by applying its domestic law. The rate may be less than the treaty rate in order to attract investment from non-residents. If the domestic withholding rate is more than the treaty rate, the country must provide a procedure for non-residents to claim a refund for the excess tax withheld in order to meet its treaty obligations. If withholding agents are liable for the tax payable by the non-resident service provider in the event that the agents fail to withhold properly, the agents will likely be unwilling to accept the risk of withholding less than the full amount required by domestic law. As a result, the country may consider allowing withholding agents to withhold at the treaty rate under certain conditions (for example, upon receipt of a certificate of residence from the other treaty country or the filing a form with certain information).

Some countries have adopted procedures that allow non-residents or their withholding agents to apply to the tax authorities for waivers from the obligation to withhold. Such procedures require a significant commitment of resources. However, if the conditions imposed for reduced withholding are too onerous, the withholding agent is likely to withhold at the domestic rate, thus forcing the non-resident to apply for a refund. As a result, some countries have provisions in their domestic law that allow withholding agents to withhold at the rate specified in the treaty.

In summary, the application of reduced rates of withholding taxes provided by tax treaties requires a difficult balancing of the need to deliver the treaty benefit in an efficient manner with the need to ensure that the benefit of the reduced rate is not given in situations where it is unjustified. It may also be noted that the problems become more serious as the number of a country's tax treaties grows, especially if the provisions dealing with income from services and the rates of tax vary significantly.

4.7.3 Assistance in collection

If a country has provisions in its tax treaties similar to Article 27 of the United Nations and OECD Model Conventions, it may request its treaty partner to collect tax owing to the country by a resident of the country. Article 27 requires the requested country to collect the taxes owing as if they were taxes owed to that country. However, Article 27 is a relatively recent addition to the United Nations and OECD Model Conventions and countries may not have that Article in any of their tax treaties.

In the absence of a provision similar to Article 27 of the United Nations and OECD Model Conventions, a country will be unable to enforce a judgment that it obtains from its own courts for the recovery of unpaid tax owing by a non-resident in the courts of the country in which the non-resident is a resident.

4.8 Checklist

1. Determine whether the non-resident service provider is a resident of a country with which the country has a tax treaty
   - Residence certificates will often be useful for this purpose
2. Determine which provision of the treaty is applicable to the services derived by the non-resident
   - Depending on:
     - Whether the payments are for services or something else
     - The type of services (employment, business or professional services, entertainment, etc.)
     - The legal relationship between the service provider and the client (employer/employee, company/director or senior officer, employee/independent contractor)
3. Determine whether the non-resident service provider qualifies for the benefits of the particular article
   - Article 7:
     - Is the non-resident service provider a person?
     - Is the non-resident service provider a resident of the other country?
     - Does the non-resident service provider have a PE in the country?

- Are the activities performed at the PE purely preparatory and auxiliary activities?
- Is the income derived by the non-resident service provider attributable to the PE in the country?
- Is the income derived from services performed in the country or outside the country?

➤ Article 8:

- Where is the place of effective management of the enterprise located?
- If the place of effective management is located outside the country, are the profits of the enterprise derived from the operation of ships or aircraft in international traffic or boats in inland waterways transport?
- If Article 8 (alternative B) is included in a country's treaties, are the shipping activities of the enterprise in the country more than casual?

➤ Article 14:

- Is the non-resident a resident of the other country?
- Does the non-resident have a fixed base in the country that is regularly available?
- Does the non-resident perform professional services or other personal services of an independent character?
- Are those services performed through the fixed base?
- What is the income derived by the non-resident attributable to the fixed base in the country?
- Does the non-resident stay in the country for 183 days or more in any 12-month period beginning or ending in the relevant fiscal period?
- In this case, what is the income from the services performed in the country?

➤ Article 15:

- Is the non-resident a resident of the other country?
- Is the non-resident an employee?

  - Does the non-resident exercise the employment in the country?
    - As an employee of an employer resident in the country? Or
    - As an employee of an employer that has a PE in the country? Or
    - Is the employee present in the country for more than 183 days in any 12-month period beginning or ending in the relevant fiscal year?

    If any one of the above conditions is met, the country is entitled to tax the employee's income from employment exercised in the country.
  - Does the country have anti-avoidance rules to prevent employees from artificially avoiding employment status?

- Article 16:
  - Is the non-resident a resident of the other country?
  - Is the non-resident a director or managerial official of a company resident in the country?
  - Is the managerial official a top-level managerial official?
  - Are the payments received by the non-resident director in his or her capacity as a director of the company?
  - Are the salary, wages or other remuneration received by the managerial official in his or her capacity as a top-level managerial official of the company?
- Article 17:
  - Is the non-resident a resident of the other country?
  - Does the non-resident perform personal activities as an entertainer or athlete?
  - Are the activities performed in the country?
  - Does the income in respect of the entertainment or sports activities accrue to the entertainer or athlete or to another person?