E/C.18/2013/CRP.16

Distr.: General
09 October 2013

Original: English

Committee of Experts on International Cooperation in Tax Matters
Ninth session
Geneva, 21-25 October 2013
Item 6 (a)(x) of the provisional agenda
Taxation of services – including provision on taxation of fees for technical services

TAXATION OF CROSS-BORDER TRADE IN SERVICE: A REVIEW OF THE CURRENT INTERNATIONAL TAX LANDSCAPE AND THE POSSIBLE FUTURE POLICY OPTIONS

Summary

The paper was written by Mr. Tizhong Liao at the request of the Committee for a study of the issue of taxation of services, complementing the work of the Subcommittee on Services. The paper gives some insights on the current difficulties country tax administrations face and will continue to face in this area as the international trade in services and other intangibles continue to evolve. The paper then puts forwards some recommendations for a more effective taxation of revenues from services performed in a source state for the Committee to discuss.

TAXATION OF CROSS-BORDER TRADE IN SERVICE: A REVIEW OF THE CURRENT INTERNATIONAL TAX LANDSCAPE AND THE POSSIBLE FUTURE POLICY OPTIONS

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October 21-25, 2013
Geneva

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1. Introduction

The service sector currently accounts for approximately 70% of the world's Gross Domestic Product ("GDP").[1] Following the development of today's highly integrated and globalised economy, growth in the cross-border trade in services now exceeds growth in the cross-border trade in goods.[2] Given the magnitude of the global trade in services it is imperative that tax authorities ensure that income from trade in services is taxed efficiently, effectively and equitably.

The aim of this report is to review the current international tax landscape for the taxation of service income in a cross-border context, including its current strengths and deficiencies, in its current state under the United Nations Model Tax Convention. The report outlines various alternatives available for consideration by the United Nations for the taxation of service income.

The current arrangements for the taxation of services income, within both the traditional and digital economic environments, remain relatively robust in an international context. While wholesale changes to the international tax system do not seem appropriate at this juncture, ensuring that the commercial activities of multinational corporations align with their taxable presence should remain a key focus of the United Nations as was discussed by the United Nations Committee of Experts on International Cooperation in Tax Matters' report on the eighth session[3].

The United Nations should remain cautious to ensure that any changes in its approach to the taxation of services income do not result in a misalignment in the taxation treatment of trade in services as against trade in goods. It is from this premise that we base our discuss of the alternative options available to the United Nations to develop its Model Tax Convention to continue to provide a framework for the equitable taxation of services income by member States.

[1] Refer to 2010 data, The World Bank, 2013
Data source: http://data.worldbank.org/indicator/nv.srv.tetc.zs

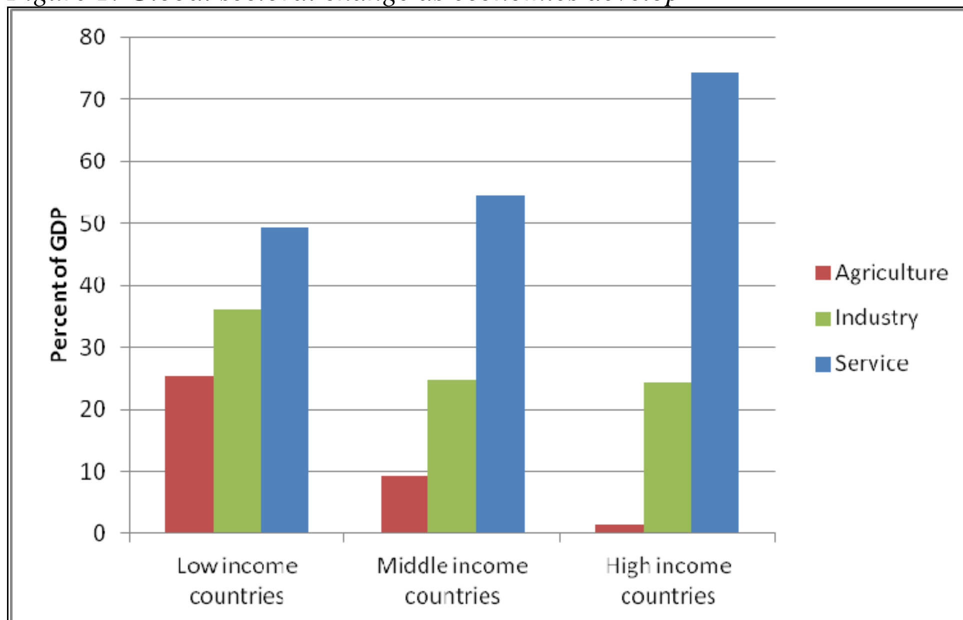
[2] LENNON, Carolina, "Trade in Services: Cross-Border Trade vs. Commercial Presence. Evidence of Complementarity", The Vienna Institute for International Economic Studies, Working Papers 59, November, 2009 at page 35

[3] United Nations Committee of Experts on International Cooperation in Tax Matters, Report on the eighth session (15-19 October 2012) Economic and Social Council Official Records, 2012 Supplement, No. 25.

2. Importance of the service industry

The service industry is a major component of today's global economy. As we see income per capita rising, the agricultural sector typically loses its importance, giving way first to a rise in the manufacturing industry then finally a rise in the service industry. These two shifts are commonly referred to as industrialization and post-industrialization. Once these incomes continue to increase, people's needs become less material and they begin to demand further services for example in health, education and entertainment.[4] As shown in Figure 1 below, high income countries can attribute the lion's share of their GDP to the service sector with only a very small portion from the Agricultural sector.

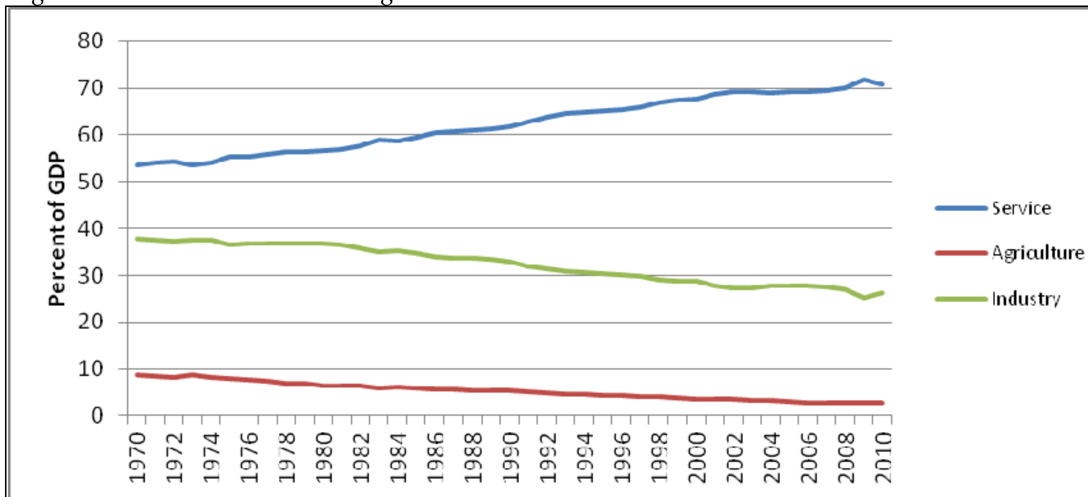
Figure 1: Global sectoral change as economies develop



Source: Compiled by the author with data from the World Bank, *Data,* 2010.

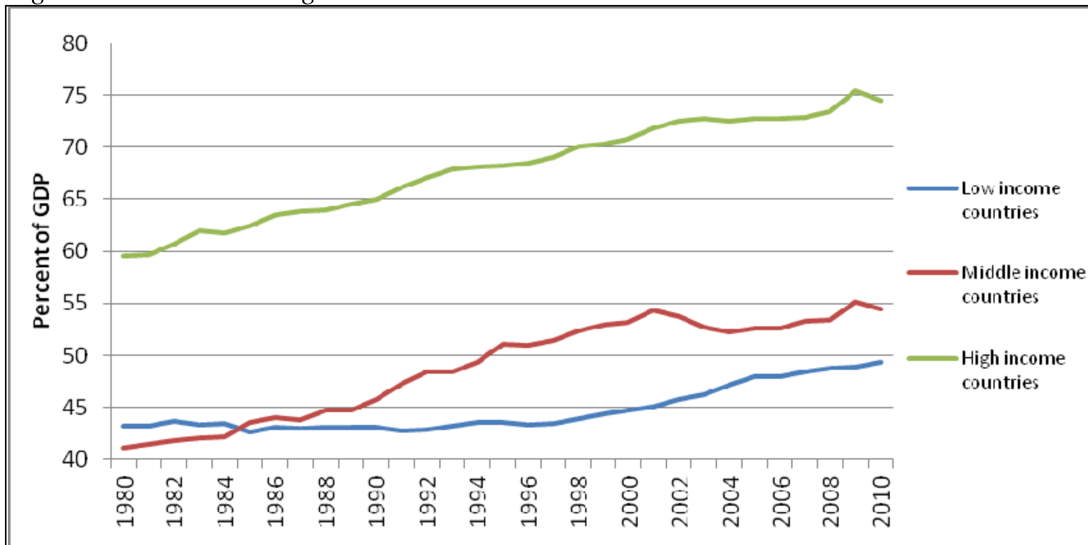
4 SOUBBOTINA, Tatyana, P., and SHERAM, Katherine, A., "Beyond Economic Growth: Meeting the Challenges of Global Development", The World Bank, 2000 at page 51

Figure 2: Global sectoral change over time



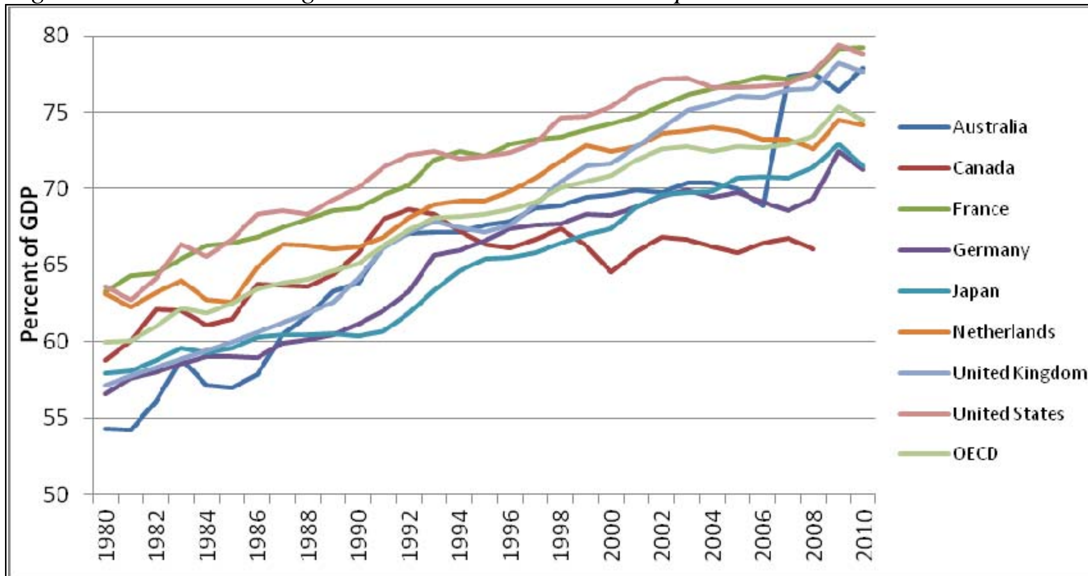
Source: Compiled by the author with data from the World Bank, *Data,* various years.

Figure 3: Growth in the global service sector over time



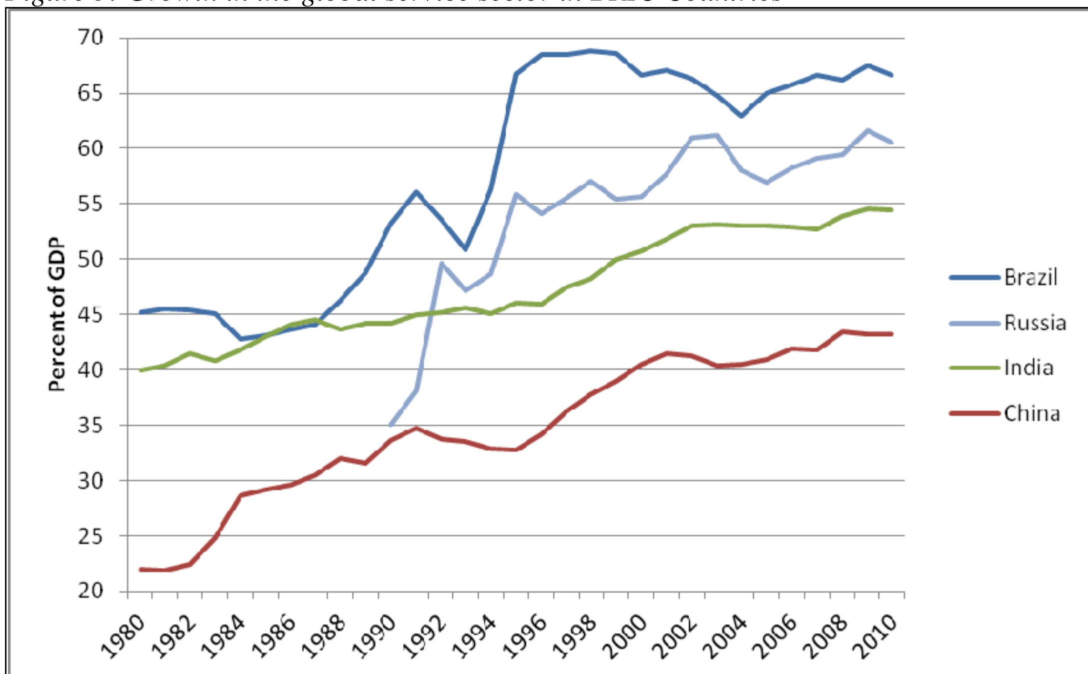
Source: Compiled by the author with data from the World Bank, *Data,* various years.

Figure 4: Growth in the global service sector in Developed Countries



Source: Compiled by the author with data from the World Bank, *Data,* various years.

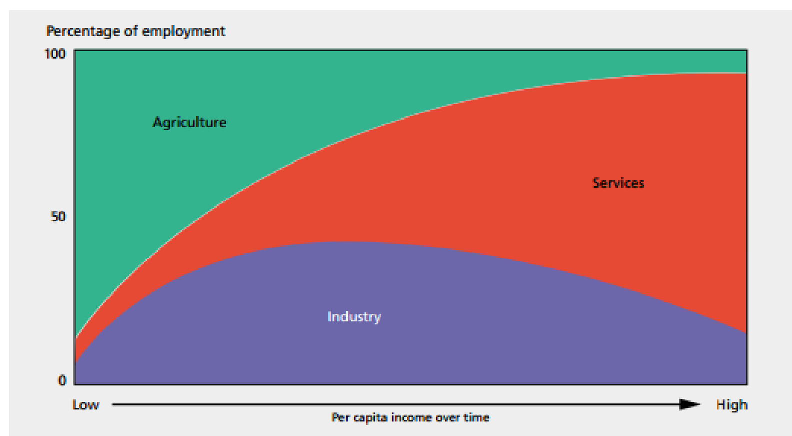
Figure 5: Growth in the global service sector in BRIC Countries



Source: Compiled by the author with data from the World Bank, *Data,* various years.

The shift towards the service sector also creates a shift in how labour is deployed across the economy. As the service sector require less mechanisation, employment in the service sector continues to grow while employment in agriculture and industry declines as technology continues to improve which in turn increases labor productivity (Figure 6). Eventually the service sector replaces the industrial sector as the dominant sector of the economy.[5]

Figure 6: Changing structure of employment by sector



Source: Tatyana P. Soubbotina and Katherine A. Sheram, *Beyond Economic Growth: Meeting the Challenges of Global Development*, The World Bank, 2000 at page 51.

[5] SOUBBOTINA, Tatyana, P., and SHERAM, Katherine, A., "Beyond Economic Growth: Meeting the Challenges of Global Development", The World Bank, 2000 at page 51

3. Categorisation of services

The World Trade Organization ("WTO") defines services broadly in Article 1 of its *General Agreement on Trade in Services*:

"(2) For the purposes of this Agreement, trade in services is defined as the supply of a service:
  (a) from the territory of one Member into the territory of any other Member;
  (b) in the territory of one Member to the service consumer of any other Member;
  (c) by a service supplier of one Member, through commercial presence in the territory of any other Member;
  (d) by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member.

(3) For the purposes of this Agreement:
  (b) "services" includes any service in any sector except services supplied in the exercise of governmental authority;
  (c) "a service supplied in the exercise of governmental authority" means any service which is supplied neither on a commercial basis, nor in competition with one or more service suppliers."

3.1. Cross-border modes of supply

One of the most important achievements of the Uruguay Round trade negotiations (1986-1993) is to have brought international trade in services under common multilateral rules. Entering into force on 1 January 1995, the WTO General Agreement on Trade in Services is the first set of multilaterally negotiated and legally enforceable rules covering international trade in commercial services (i.e. excluding government services).[6]

From a taxation perspective, it is useful to consider the way in which service supplies are generally taxable with respect to the four broad modes of supply:

Mode 1 - Cross-border supply: supply of a service from the territory of one WTO member into the territory of any other member;

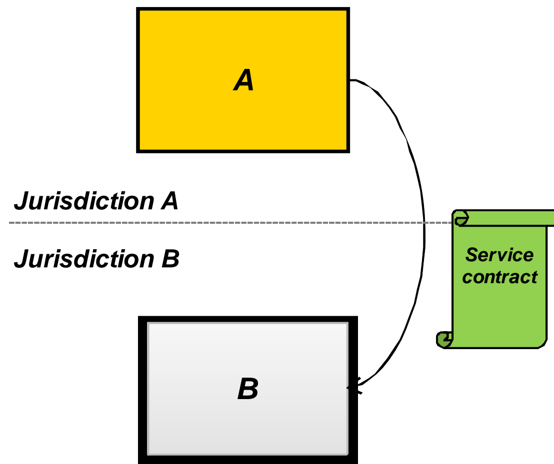
Mode 2 - Consumption abroad: supply of a service in territory of one member to the service consumer of any other member;

Mode 3 - Commercial presence: supply of a service by a service supplier of one Member, through commercial presence (including through ownership or lease of premises) in the territory of any other Member;

Mode 4 - Presence of natural persons: supply of a service by a service supplier of one member, through the presence of natural persons of a member in the territory of any other member.

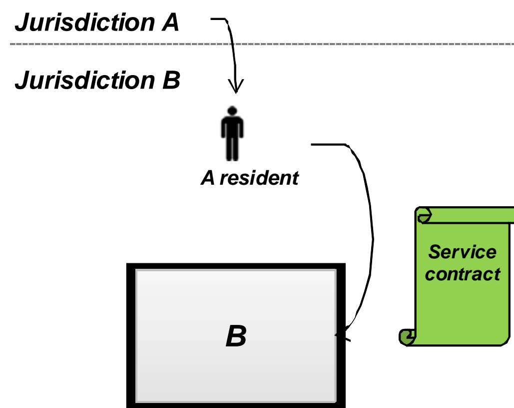
[6] World Trade Organisation, "Measuring Trade in Services: A training module produced by WTO / OMC Update includes changes in the Manual on Statistics of International Trade in Services 2010", 2010 at page 10

3.1.1. Mode 1 – Cross-border supply: A provides services to B



In Mode 1 only the service crosses the border. The delivery of the service can take place, for example, through telecommunications (telephone, fax, television, Internet, etc.), or the sending of documents, disks, tapes, etc.[7]

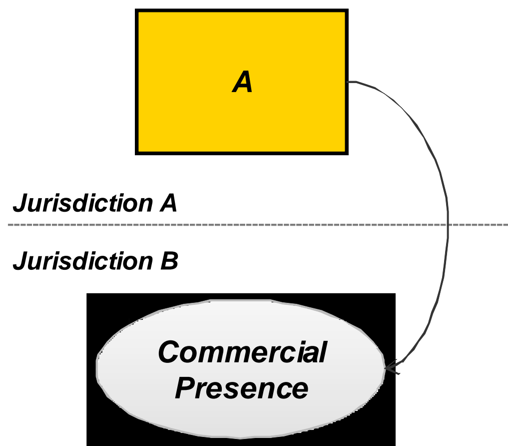
3.1.2. Mode 2 – Consumption abroad: B provides services to A resident in jurisdiction B



In Mode 2 an individual consumer has moved temporarily into the foreign State where the service provision is made, and that individual is a resident of the home State. For example, medical treatment and language courses taken abroad are being provided services under this mode of supply.[8]

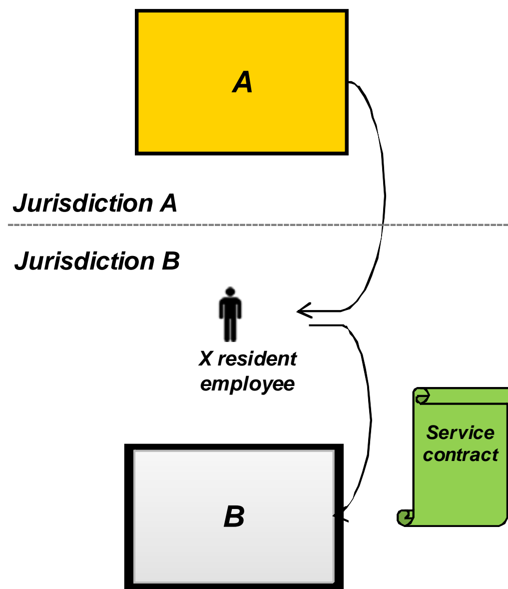
[7] Ibid.
[8] Ibid.

3.1.3. Mode 3 – Commercial presence: A provides services to B



In Mode 3 the service supplier establishes its commercial presence in another country, for example, through a branch or subsidiary. For example, banking services supplied by a subsidiary of a foreign bank.[9]

3.1.4. Mode 4 - Presence of natural persons: A provides services to B



In Mode 4 an individual has moved temporarily into the State of the consumer in the context of the service supply, however the individual is neither a resident of the territory in which the service is being provided nor the State in which the employing entity is located. For instance, architects moving abroad to supervise construction work are providing services under this mode of supply.[10]

9 Ibid.

10 Ibid.

We illustrate below the modes of supply in terms of presence of the supplier and the recipient with examples and diagrams respectively:

<table>
<tr><th></th><th>Supplier Presence</th><th>Consumer Presence</th><th>Examples</th></tr>
<tr><td>Mode 1: Cross-border supply</td><td rowspan="2">the territory of one Member where the supplier is resident (“Supplier Territory”)</td><td>the territory of another Member where the consumer is resident (“Consumer Territory”)</td><td>Banking or architectural services transmitted via telecommunications or mail</td></tr>
<tr><td>Mode 2: Consumption abroad</td><td>Supplier Territory</td><td>International tourist activities and amusement parks abroad</td></tr>
<tr><td>Mode 3: Commercial presence</td><td rowspan="2">Consumer Territory or territory of any other member but for the Residence and Consumer Territories</td><td rowspan="2">Consumer Territory or territory of any other member than Residence and Consumer Territories</td><td>Domestic subsidiaries of foreign insurance companies or hotel chains</td></tr>
<tr><td>Mode 4: Presence of natural persons</td><td>Foreign accountants, doctors or teachers providing services in the Recipient Territory</td></tr>
</table>

3.2. Classification of Services

As the transaction value of services increases so too does the need to accurately categorise the various types of services into meaningful sectors or divisions.
The General Agreement of Trade on Services (GATS) employs the Services Sectoral Classification List (“W120 List”) of the WTO, which includes the following 12 discrete service sectors[11]:

- Business services;
- Communication services;
- Construction and related engineering services;
- Distribution services;
- Educational services;
- Environmental services;
- Financial services;
- Health related and social services;
- Tourism and travel related services;
- Recreational cultural and sporting services;
- Transport services;
- Other services not included elsewhere.

This sector based classification is intended to cover all service sectors bar “services supplied in the exercise of governmental authority” and “services directly related to the exercise of air traffic rights”.

[11] The World Trade Organization, “MTN.GNS/W/120”, 1991

4. Review of the current tax landscape

4.1. International tax agreements

The purpose of a tax treaty is to strengthen the ability of jurisdictions to impose taxes fairly and effectively on taxpayers engaged in cross-border trade and investment (and, thus, to facilitate cross-border trade and investment).[12]

There are various Articles that deal with the taxation of services income. For example, under Article 7 (the Business Profits Article) where a foreign taxpayer is resident in a State which has a tax treaty with the other State in which services are being performed, such taxpayer will generally only be taxable under the Business Profits Article where it is taken to have a permanent establishment ("PE") in that other State, or under a royalty Article where relevant. Where taxation is possible under more than one Article of a treaty the more specific will generally apply.

Significantly this outcome is similar to that of a foreign taxpayer resident in a State which has a tax treaty with the country into which it is exporting goods for sale. Such taxpayer will generally only be taxable under the Business Profits Article where it is taken to have a PE in the consuming State by virtue of any activities it may undertake in the consuming State. It would, however, be unusual for the foreign taxpayer to create a taxable presence in the consuming State merely by virtue of gaining access to the consuming market.

The following comments outline the treatment of services in the context of creating a PE in the OECD and UN Model tax conventions and their related commentaries.

4.2. United Nations approach

4.2.1. Income from services under the UN Model Convention

Neither the UN nor OECD Model Conventions provide a specific article concerning international supply of services, instead considering the tax treatment of such income under particular forms or categories.

The UN Model Convention deals with income from services through as follows:

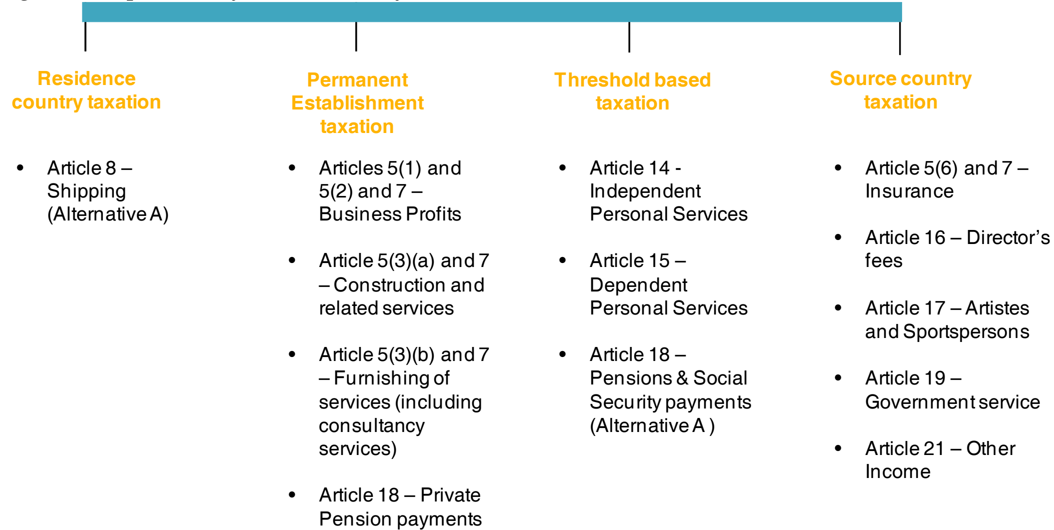
- Article 5 - Permanent Establishment
- Article 7 - Business Profits
- Article 8 - Shipping, Inland Waterways Transport and Air Transport
- Article 14 - Independent Personal Services (not included in the OECD Model Convention)
- Article 15 - Dependant Personal Services
- Article 16 - Directors' Fees and Remunerations of Top Level Managerial Officials
- Article 17 - Artists and Sportspersons

[12] WONG, Antonietta Pui-Kwok, "A comparative study of the taxation of business profits - especially 'online' profits – in Australia and the Hong Kong Special Administrative Region of the People's Republic of China", 2008 at page 3

- Article 18 - Pensions and Social Security Payments
- Article 19 - Government Services
- Article 21 - Other Income.

The operation of the various Articles dealing with the taxation of services may otherwise be represented in the following spectrum:

Figure 7: Spectrum for taxation of services under the UN Model Convention



Source: Compiled by the author with reference to the UN Model Convention, 2011.

From the perspective of cross boarder corporate service providers, the majority of Source state taxing rights should stem from Article 7, to the extent that the necessary taxable presence is shown to exist through the operation of Article 5.

While the OECD approach is to treat service income as business income under Article 7, the source State has no taxing rights unless the service income is attributed to a PE situated therein. The UN Model, however, grants greater taxing rights to the source State through the inclusion in Article 5 of a deemed service PE provision (Art. 5 (3) (b)), which is based on a time threshold (i.e. 183 days in any 12-month period) concerning the service activities within a Contracting State.

4.2.2. Permanent establishment Article

The UN Model Convention has a definition of PE to strengthen source State taxation, which is generally in the interest of developing nations. For example, a PE within that model tax treaty is defined to include independent agents in some circumstances, as well as the performance of services that last longer than 183 days:

> Article 3. The term "permanent establishment" also encompasses:
>
> "… (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned."

The provisions of the UN Model deal comprehensively with all types of services. However, the treatment accorded to different types of services varies enormously. Several specific types of services, such as government service, employment, pensions, shipping and air transportation, are given special treatment in separate articles of the Model. In contrast, Article 7 deals with business profits generally and includes income from services in certain circumstances.[13]

Historical reports of the UN's Ad Hoc Group of Experts on Tax Treaties provide insights into the provision's development. Management and consultancy services were found to not be specifically provided in the OECD Model Convention on the basis that such activities lacked sufficient economic substance.[14] In addition to this, in establishing a threshold for determining source-State taxation the six-month minimum period was effectively a compromise between developing and developed member countries. The six-month period appeared to be a practical solution in terms of recognizing significant activity. The inclusion of the words "for the same or a connected project" was a further compromise. Members of developed countries were concerned that foreign investment in new projects would be discouraged where unrelated projects were aggregated and took the view that such an approach would create impermissibly excessive uncertainty.[15]

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13 LENNARD, Michael, "The UN Model Tax Convention as Compared with the OECD Model Tax Convention – Current Points of Difference and Recent Developments" *Asia-Pacific Tax Bulletin*, 2009 at page 7

14 United Nations, Ad Hoc Group of Experts on Tax Treaties, Tax Treaties Between Developed and Developing Countries: Second Report (New York: United Nations, Department of Economic and Social Affairs, 1970) at paragraphs 65 referred to in REID, Marsha, "The New Services PE Provision of the Canada -US Tax Treaty", (2010) vol. 58, no 4, 845 – 96 Canadian Tax Journal at page 859

15 United Nations, Ad Hoc Group of Experts on Tax Treaties, Tax Treaties Between Developed and Developing Countries: Second Report (New York: United Nations, Department of Economic and Social Affairs, 1970) at paragraphs 68 & 71 referred to in REID, Marsha, "The New Services PE Provision of the Canada -US Tax Treaty", (2010) vol. 58, no 4, 845 – 96 Canadian Tax Journal at page 859

The different treatment of various types of income from services under the UN Model raises difficult issues of qualification. For example, if services are considered to constitute the carrying on of a business, the source State is authorized to tax the income from such services only if, in general, the business is carried on through a PE or a fixed base in the source State. On the other hand, if the services are performed by an employee or an entertainer or sportsperson, the source State is entitled to tax the income from such services simply if the activities take place in the source State. Moreover, although the UN includes a services Article in its model convention, from a policy perspective, the fundamental question is whether the services PE sets an adequate and equitable threshold for the taxation of business profits.[16]

4.3. OECD approach

4.3.1. Services definition

The new OECD Model services PE paragraph applies in all economic environments if the formal requirement of "service" is met and the beneficiary of the service is a third party. This formal requirement follows from Para. 42.30 of the OECD Model Commentary, i.e. "services ... provided ... to a third party". "Internal" services, such as when an employee abroad is performing services towards his employer and/or enterprise, do not result in a PE.

4.3.2. Services provision

Although most OECD Member countries accept the appropriateness of the OECD Model provision for the allocation of taxing rights on business profits, some countries are reluctant to adopt the principle of exclusive residence taxation of income from services that are performed in their territory but not attributable to a permanent establishment situated therein.
The 2008 Update to the OECD Model reconciles these different positions by leaving the permanent establishment definition in the text of the OECD Model unchanged and at the same time adding to the Commentary on Article 5 of the OECD Model an alternative provision for States wishing to include it in their double tax conventions. Under this alternative provision, a permanent establishment is deemed to exist in certain circumstances even if there is no fixed place of business of the foreign enterprise through which the services are performed in the source state:

> "42.22 Clearly, such taxation should not extend to services performed outside the territory of a State and should apply only to the profits from these services rather than to the payments for them. Also, there should be a minimum level of presence in a State before such taxation is allowed.
>
> 42.23 The following is an example of a provision that would conform to these requirements; States are free to agree bilaterally to include such a provision in their tax treaties:
>
> Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

[16] REID, Marsha, "The New Services PE Provision of the Canada -US Tax Treaty", (2010) vol. 58, no 4, 845 – 96 Canadian Tax Journal at page 860

a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
b) for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are present and performing such services in that other State.

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment of the enterprise situated in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. For the purposes of this paragraph, services performed by an individual on behalf of one enterprise shall not be considered to be performed by another enterprise through that individual unless that other enterprise supervises, directs or controls the manner in which these services are performed by the individual.

42.24 That alternative provision constitutes an extension of the permanent establishment definition that allows taxation of income from services provided by enterprises carried on by non-residents but does so in conformity with the principles described in paragraph 42.22."

The new OECD Commentary stresses the three basic policy principles that underlie the alternative services permanent establishment paragraph:

1. services performed outside of the source State are not taxable therein;
2. tax should be levied on a net rather than gross basis; and
3. source State taxation is allowed only when a certain threshold is reached.

Paragraph 42.18 of the Commentary states that only services physically performed in the PE State can give rise to a services PE and services performed outside that State cannot (Also refer paragraph 42.31).

The introduction of a services PE means that, under Article 7 of the OECD Model, the maximum amount that can be attributed to a PE is the net profit (refer paragraph 42.19). Article 7 of the OECD Model, however, says nothing regarding the computation of the taxable basis under the domestic law of the PE State. Where countries levy withholding tax, this situation results, or should result, in a refund of withholding taxes to the extent that these taxes on gross income exceed the tax on a net basis. The administrative issues to match domestic law's gross taxation with the treaty's net taxation are considerable, both for the taxpayer and the tax authorities.

A services PE exists in two different sets of circumstances. Subparagraph a) of the alternative services PE paragraph considers the days of presence of the individual in combination with the gross revenue. Subparagraph b) of the alternative services PE paragraph considers the days of activities for the project(s).

4.4. Multilateral tax treaties - Andean Pact and potential OECD action

4.4.1. Background

The Andean Pact is a multilateral tax agreement between Colombia, Bolivia, Ecuador and Peru signed in 1971 and updated in 2005.

The genesis of the Andean Pact was in the formation of the Latin American Free Trade Association (LAFTA). In 1959, the Secretariat of the Economic Commission for Latin America had stated that “there are grounds for asserting that a common market could be established, within which development would be more rapid than if the market were not organized, not only in Latin America as a whole, but in each of the individual countries of the region.”[17]

The Treaty of Montevideo was signed by Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay in 1960, establishing LAFTA. They were soon joined by Bolivia, Colombia, Ecuador and Venezuela. The countries were classified according to their level of economic development and less developed countries were given preferential treatment to promote development. However, this classification failed to recognise the presence of an intermediate level of medium level developed countries which were distinct from the lesser developed countries and the three more developed countries, Argentina, Brazil and Mexico. It was this failure coupled with the slow progress in LAFTA which led the medium level developed countries and two of the lesser developed countries (Bolivia and Ecuador) to form the Andean Pact.[18]

4.4.2. Source taxation approach

The Agreement is different to the OECD or UN Models in that it allocates the right to tax exclusively to source jurisdictions, i.e., the country where the income is generated:

> "Regardless of nationality or domicile of the persons, the income of any kind as they may obtain shall be taxable only in the member country in which such income having their source of production, except the cases specified in this Decision".

The Andean Pact primarily prescribes the source of different types of income and concepts such as the residence of the taxpayer are not relevant. The adherence to exclusive source country taxation means that countries are not permitted to tax income earned outside that country or income which has already been taxed in another country.

> “The Andean experience highlights an important lesson that tax treaties must adhere to international norms if they are to be widely accepted. Worldwide rather than territorial

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[17] Cited in ATCHABAHIAN, Adolfo, “The Andean Subregion and its Approach to Avoidance or Alleviation of International Double Taxation” (1974) XXVIII(8) Bulletin 309, at page 309 and referred to in JOGARAJAN, Sunita, “A Multilateral Tax Treaty for ASEAN —Lessons from the Andean, Caribbean, Nordic and South Asian Nations”, *Asian Journal of Comparative Law*, University of Melbourne, Volume 6, Issue 1, 2011 at page 10

[18] ATCHABAHIAN, Adolfo, “The Andean Subregion and its Approach to Avoidance or Alleviation of International Double Taxation” (1974) XXVIII(8) Bulletin 309, at pages 311-312 and referred to in JOGARAJAN, Sunita, “A Multilateral Tax Treaty for ASEAN —Lessons from the Andean, Caribbean, Nordic and South Asian Nations”, *Asian Journal of Comparative Law*, University of Melbourne, Volume 6, Issue 1, 2011 at page 10

> taxation is proving to be the international norm and tax treaties which push for exclusive source country taxation are unlikely to succeed"[19]

4.5. Domestic taxation

Service income earned by a non-resident is generally only assessable where such income is derived directly or indirectly from domestic sources. To the extent that a tax treaty is in place, it should only allocate taxing rights where there is a preexisting domestic right to tax. Broadly, the need for a nexus to exist between the foreign taxpayer and the State of source seeking to tax income will be a necessary precondition to the taxation of the foreign taxpayer.[20]

In respect of service income which relates to physical services being performed, the source of the consideration for the performance of work, or the rendering of services, will generally be considered to be the place where the services are performed.[21]Conversely, to the extent that the relevant acts giving rise to income consist largely of the making of contracts, and the place of their performance is unimportant, the place where the contracts are made may be the only significant determinant of source.[22]

4.6. Taxation of e-commerce income

The ability to complete work off-site anywhere in the world and split tasks has changed the relationship between the service provider's location and the client's location. Service providers may now find it easier to be mobile while providing their services. With the growth of Internet connectivity, evolving tax policy should remain cautious when focusing on the fairest ways to allocate income between the residence and the source jurisdictions.[23]

When considered in this way, e-commerce service income can fairly be regarded as a subset of traditional service income which happens to be delivered through a non-traditional platform or medium. In adopting such a view it follows that by establishing robust mechanisms for the clear characterization of such income as being attributable, for taxation purposes, to a particular place or source (i.e. through the activity of tangible persons or equipment), the fundamentals of an effective e-commerce taxation regime may be set.

There has been recent media attention on the taxation of several high profile digitally focused service providers (e.g. Google and Amazon). It is important to note that the tax issues being considered were not associated with a lack a physical presence but rather the nexus between physical activity and the source state of income.

The Committee of Public Accounts ("PAC") in the UK, appointed by the House of Commons in UK, issued a report on 10 June 2013 which was highly critical of Google Inc., a large

[19] JOGARAJAN, Sunita, "A Multilateral Tax Treaty for ASEAN —Lessons from the Andean, Caribbean, Nordic and South Asian Nations", *Asian Journal of Comparative Law*, University of Melbourne, Volume 6, Issue 1, 2011 at page 11

[20] *FC of T v United Aircraft Corporation* (1943) 68 CLR 525

[21] *CIR v. Magna Industrial Co Ltd* [1997] HKLRD 171; *FCT v French* (1957) 98 CLR 398

[22] *Thorpe Nominees Pty Ltd v FC of T* 88 ATC 4886; *CIR v. Magna Industrial Co Ltd* [1997] HKLRD 171

[23] WONG, Antonietta Pui-Kwok, "A comparative study of the taxation of business profits - especially 'online' profits – in Australia and the Hong Kong Special Administrative Region of the People's Republic of China" (2008) at page 254

multinational web-based company, for avoiding UK corporation tax on its advertising revenue through the adoption of an artificial tax structure.[24] The PAC expressed concern that Google Inc.'s physical operations in the UK were not being adequately taxed and that significant amounts of advertising revenue were being booked offshore.

Google Inc. explained to the committee that it houses certain UK operational activities through a separate UK subsidiary. As the UK subsidiary and staff have no authority to execute sales, no advertising revenue is booked in the UK. Her Majesty's Revenue & Customs' ("HMRC") made general statements to the committee to explain that unless Google Inc. has a PE in the UK, its profits should not be taxable in the UK. The HMRC went on to say that where the UK subsidiary does provide greater value to the overall group, this should impact the transfer pricing of services payments being made to the subsidiary.[25]

The PAC did not directly accuse Google Inc. of failing to comply with the current tax laws of the UK. Moreover the responses given to the committee from both Google Inc. and the HMRC demonstrate a misalignment between the views of committee, particularly in respect of the equitable taxation of commercial activity and the subsequent value creation, as against those views of both taxpayer and tax authority as to the correct implementation of the UK's international tax laws.

In 2009, Amazon was issued an income tax assessment by the Tokyo Regional Taxation Bureau on the basis that it had a PE in Japan. As with the Google Inc. case discussed above, the central issue to the Amazon case was the nexus between Amazon's activities in Japan and its Japanese sales and whether this was sufficient to create a PE in Japan.

These cases highlight the importance of distinguishing between the traditional business operations of e-commerce businesses (e.g. management, marketing, investment decisions, supplier negotiations and contracting) and those that are delivered through the e-commerce platform (e.g. online sales and online marketing).

On 12 February 2013 the OECD issued its report "Addressing Base Erosion and Profit Shifting". This was followed by the release of the OECD's "Action Plan on Base Erosion and Profit Shifting" on 19 July 2013. These publications highlight e-commerce as an area of interest and the OECD is due to release a more comprehensive report in September 2014 addressing the taxation of e-commerce. Given the substantial work currently being undertaken in this area, we have refrained from providing detailed analysis in respect of the taxation of e-commerce services [and recommend that this area be reconsidered after the release of the OECD's September 2014 report].

4.7. Service taxation deficiencies

There is no universal set of source rules that can readily be applied to every circumstance to determine the source or locality of profits. The growth in international trade, supported by the development of e-commerce, prompts a consideration of the adequacy of current tax laws. This is particularly evident where multinationals are increasingly able to structure their

[24] Committee of Public Accounts, "Tax Avoidance–Google", *House of Commons*, Ninth Report of Session 2013–14 at page 5

[25] Committee of Public Accounts, "Tax Avoidance–Google", *House of Commons*, Ninth Report of Session 2013–14 at page 14 at pages 13-4

finances and conduct their affairs without being constrained by geography or national boundaries.
The modern global economy differs from the environment within which many of our traditional sourcing rules were developed in many respects[26]:

- A substantial amount of international trade consists of services and intangible products.
- A physical presence may no longer be required for the conduct of business.
- Intangible assets are of vital economic importance.
- Communications are instantaneous.
- Capital is highly mobile internationally.
- People are highly mobile.

Under these conditions, in many cases a fixed place of business is not required to carry out substantial business activity. In particular, businesses in the service sector do not have to incorporate a subsidiary or open a branch to service customers in another country; they can simply send employees to work temporarily at the client's site in that country. Further, contracts can be structured to minimize the risk of creating a fixed place of business by ensuring that the business has limited control over the client's premises. For example, contracts can specify that agents or employees of the business do not have a general right of access to the client's premises (for instance, by requiring special identification tags and authorizations) and that the client has the ultimate discretion in terms of providing space (instead of contractually providing dedicated space). Steps can also be taken to ensure that the client's premises are not identified as a place of business of the non-resident.

The issue of how States should respond to the global service-based economy then arises. As services are able to be provided absent the physical presence of the service provider, a situation akin to that of the importing and exporting of tangible and intangible goods appears to result. As such, any modifications to the way in which the modern service industry is brought to tax should be consistent with more traditional approaches taken to the taxation of mobile goods (i.e. through a focus on commercial activity rather than attempting to price market access).

[26] MCLURE, Charles E. Jr., "Globalization, Tax Rules and National Sovereignty" (2001) vol. 55, no. 8 Bulletin for International Fiscal Documentation 328-41, at page 334 referred to in REID, Marsha, "The New Services PE Provision of the Canada -US Tax Treaty", (2010) vol. 58, no 4, 845 – 96 Canadian Tax Journal at pages 858-9

5. Alternatives / options

We have set out below a discussion of various alternatives which may support existing tax rules for the taxation of an equitable share of income for services performed in the source State, including possible amendments to the UN Model Tax Convention. We have attempted to order these alternatives based on their perceived complexity, from least complex to most complex.

5.1 Possible changes to the UN Model Tax Convention Commentary

5.1.1 Deemed PE treatment

- Deeming a subsidiary to be a permanent establishment of its non-resident parent, therefore any income derived by the parent from services rendered to the subsidiary would be attributable to the permanent establishment and subject to tax by the source country. This would deal with intra-group services and could be extended to different kinds of services, not just technical services, but should not apply to "arm's length" services. In this particular case, it would also be necessary to decide on services provided by related entities.[27]

At present an offshore entity can mitigate having a PE through a legal entity established in the source country. It will then remunerate that entity on an arm's length basis. However, this may not be reflective of the true economic substance. This allows the split of the economic group into separate legal entities.

There have been recent instances where domestic courts have concluded that subsidiary entities are, in fact, operating as a PE of the foreign parent.[28] By deeming a subsidiary as a PE, this may allow for a fairer allocation of profits. With this approach profits of the parent (if any) attributed to the subsidiary, according to transfer pricing rules, would be subject to tax in the Source country. Treating a domestic subsidiary as a PE of its non-resident parent corporation can raise some difficulties related to the definition of a subsidiary and the treatment of payments made between related entities.[29]

As previously mentioned any changes proposed for the taxation of service income should be consistent with the taxation of goods. Deeming a subsidiary as a PE could potentially assist in revenue authorities allocating a greater share of income to the source State, in industries which may have historically allocated small margins to their source State subsidiaries. Examples may include:

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[27] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Report on the eighth session (15-19 October 2012) at page 12

[28] For instance refer to, ES: TS, Judicial Review Chamber (Section 2), 12 Jan. 2012, STS 201/2012, recurso no. 1626/2008, *DSM Nutritional Products Europe Ltd (formerly Roche Vitamins Europe Ltd) v. General State Administration, Tax Treaty Case Law IBFD and Intl*. Tax L. Rpts. 4, pt. 5, pp. 892-952 (2012)

[29] E/C.18/2012/CRP.4/Add.1, Committee of Experts on International Cooperation in Tax Matters Eighth session Geneva, 15-19 October 2012, Item 3 (c) of the provisional agenda, Tax treatment of services at page 4

1. Local Manufacturer – A company manufactures products, which are then on-sold and delivered to local customers. The key contracts, decisions, and risks are held offshore. Through the use of transfer pricing the majority of the income generated through the sale transaction may be booked offshore with only a small margin taxable in the source country.
2. Banking services – An offshore private equity group or investment bank sends its employees to a local country for less than 6 months at a time (i.e. not sufficient to give rise to a service PE under applicable tax treaty) to advise a local third party corporation on a financial transaction (e.g. IPO or M&A activity). In return for these services the private equity group or investment bank receives a service fee which is taxable in the offshore jurisdiction and not subject to tax in the local country.
3. E-commerce business – A company manufactures products offshore, which are then subsequently sold and delivered to local customers by a non-resident entity which does not have a PE in China through an offshore e-commerce platform (such as an online store). The sale transaction is booked entirely offshore and not subject to tax in the local country.

In each of these examples the foreign corporation would have a local subsidiary with employees to support its foreign operations.

5.1.2 Mixed service supplies

- Issuing qualifying guidance that includes approaches similar to the United States 50/50 method, under which one half of the gross income from the sale of goods is considered to be attributable to production activity services in the foreign State and one half is considered to be attributable to sales activity services in the source State.[30]

Adopting an interpretation similar to the 50/50 method may change the way in which the local manufacturer taxpayer at 5.1.3.4 (above) would be taxed by introducing the assumption that one half of the relevant income received is attributable to manufacturing service activity (in the foreign State) and one half is attributable to sales activity (in the source State). Income from the sale of manufactured products may thus be regarded as partially attributable to the sale of the goods and partly attributable to source State support services.

[30] "US Taxation of Cross-Border Enterprise Services" *Bulletin for International Taxation* (2012) at pages 190-1

5.2 Possible changes to the UN Model Tax Convention

5.2.1 Thresholds changes

- Reduction of the time thresholds in Article 5 (3) (b) and in Article 14 (1) (b) to less than the current 183 days. The new threshold would apply either to all services or solely to technical services.[31]

This approach can be relevant for developing countries as it expands taxing rights over income from business and technical services as for other types of services. However, it will be necessary to define the scope of the income that will be concerned by the reduced time threshold. It may be more equitable to specify the reduced time threshold in the articles to be negotiated by the Contracting States.[32] It may also be appropriate to consider industry specific reduced thresholds to target key industries in which significant value can be contributed over short time horizons.

The Committee may also consider the use of a monetary amount based on gross revenue from sales or services as a general threshold requirement in place of the current PE definition[33] or a combination of a monetary and timing thresholds as appropriate.

5.2.2 Revision of Other Income Article

- Revision of Article 21 (3), in which income from technical services could be defined as "other income" to fit the purpose of Article 21 (3). Currently there is no limitation on source country tax under Article 21 (3) but this could be added.[34]

In general, Article 21 can only be applicable to fees for technical services in a very limited number of cases. As, the UN Model Convention does not contain specific provisions dealing with fees for technical, management, and consulting services provided by a resident of one contracting state to a resident of the other contracting state, income from business services performed in a country is governed by Article 7 (Business Profits) or Article 14 (Independent Personal Services). However, as there is no clear and complete definition of services, Article 21 can apply in some cases.[35]

[31] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Report on the eighth session (15-19 October 2012) at page 12

[32] E/C.18/2012/CRP.4/Add.1, Committee of Experts on International Cooperation in Tax Matters Eighth session Geneva, 15-19 October 2012, Item 3 (c) of the provisional agenda, Tax treatment of services at page 2

[33] ARNOLD, Brian, SASSEVILLE, Jacques, and ZOLT, Eric, M., "Symposium: Summary of the Proceedings of an Invitational Seminar on the Taxation of Business Profits Under Tax Treaties", Canadian Tax Journal, 2002 at pages 1988-90

[34] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Report on the eighth session (15-19 October 2012) at page 12

[35] E/C.18/2012/CRP.4/Add.1, Committee of Experts on International Cooperation in Tax Matters Eighth session Geneva, 15-19 October 2012, Item 3 (c) of the provisional agenda, Tax treatment of services at page 3

5.2.3 Revision of Royalty Article

- Revision of Article 12 to include technical services related or connected to the transfer of intellectual property. The change could also be included only in the commentary to Article 12 as an alternative provision.[36]

This option would not deal with the issue of technical services specifically; consequently, the provision of Article 12 would be more complex and difficult to understand and implement, as its scope would become wider.[37]

5.2.4 New Technical Services Article

- Adding a new article and commentary dealing with income from technical services. While pointing out that some bilateral treaties include such a provision, Professor Arnold raised a number of questions that may need to be answered before going forward with this option: what are the conditions for source country tax; how is the source country going to tax (gross or net basis); and how technical services are defined. It may also be possible to include such provisions in the commentary as an alternative, which is being done by OECD for the provision of technical services related to PE.[38]

This option has the advantage of being more relevant and appropriate. It points out clearly the position of the UN Model Tax Convention. The commentary which goes with the new article can elaborate in respect of its application where necessary.

This proposal has the advantage of indicating clearly how the UN Model Convention is ready to treat technical fees and other services for tax matters. It offers the opportunity to specify the scope of the services to which these provisions apply. The fact that such an article exits in the UN model will be an opportunity for developing countries to negotiate their treaties with secure conditions in the way to preserve their taxing rights. Despite potential difficulties, it would be better to have a definition of the services dealt in that article or to determine some criteria or examples for those services (such as an article dealing with PE). Where not practical, clarifying further the wording of the existing provisions in some actual treaties would be possible.[39]

At present the UN Model Convention does not contain specific provisions dealing with fees for technical, management and consulting services provided by a resident of one contracting State to a resident of the other contracting State. Although a service PE can exist, it is

[36] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Report on the eighth session (15-19 October 2012) at page 12

[37] E/C.18/2012/CRP.4/Add.1, Committee of Experts on International Cooperation in Tax Matters Eighth session Geneva, 15-19 October 2012, Item 3 (c) of the provisional agenda, Tax treatment of services at page 3

[38] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Report on the eighth session (15-19 October 2012) at page 12

[39] E/C/2012/CRP.4, Committee of Experts on International Cooperation in Tax Matters Eighth session Geneva, 15-19 October 2012, Item 3 (c) of the provisional agenda, Tax treatment of services at page 4

relatively simple for non-resident service providers to avoid falling under this aspect of the definition by simply moving from place to place in the source country before the six-month time-threshold is reached.

At the fifth session of the United Nations Committee of Experts on International Cooperation in Tax Matters (the Committee), in 2009, the Subcommittee on Services was established. The Committee's mandate is set out in the following terms:

> "The Subcommittee is mandated to address the issue of the taxation treatment of services in general in a broad way including related aspects and issues. The issue of taxation of fees for technical services should also be addressed."

The Committee commissioned Brian Arnold (Senior Advisor, Canadian Tax Foundation) to prepare a paper on the taxation of services under the UN Model, which was discussed briefly at both the sixth and seventh sessions of the Committee:

> "The payments for technical services erode the source country's tax base, but such payments are often not taxable by the source country under the provisions of the UN Model Convention treaty. As a result, multinational enterprises sometimes use fees for technical, management and consulting services to strip the profits of their subsidiaries"

At the seventh session, held from 24 to 28 October 2011, the Committee agreed that the Subcommittee should prepare proposals for the taxation of income from technical services, for consideration during the eighth session, to be held in October 2012. At the eighth session of the Committee held in October 2012 it was decided to develop a new technical services article for inclusion within the Model Convention. US and UK delegates at the session were quick to deny that developing country tax bases were reduced by the movement of these service fees across borders.

Some of the issues to be addressed in the new technical services article will be:

- A definition or a framework of what could qualify as "technical services";
- Consideration of the modality of how the service is performed, including whether there is a need for physical presence in the source country. If that is the case, the threshold time for such presence must be determined; and
- Consideration of whether the fact that the payment for services is simply borne by a resident of the source country or a permanent establishment situated therein should warrant the allocation of taxing rights to the source country.[40]

Notwithstanding that over 100 treaties now include an Article of this kind, there is no standard Article in the UN Model. The debate and negotiation inside the UN committee (or its OECD equivalent) ensure greater scrutiny with regard to its Model Convention Articles.

The UN has stated that it is inherently difficult to distinguish between managerial, technical and consulting services and other types of business and professional services. In practice, income from business and professional services derived by a non-resident enterprise is subject

[40] United Nations, "Committee of Experts on International Cooperation in Tax Matters", Report on the eighth session (15-19 October 2012) at page 13

to source-country taxation under Article 7 or Article 14 only if a high threshold in terms of the non-resident's connections to the source country is met (PE, fixed base or a substantial amount of time working or staying in the source country).

The Committee may opt to employ a new article with lower thresholds when applied to income from technical and other similar services. However, the difficulties presented by the adoption of a new article dealing with income from technical and other similar services should not be underestimated. In particular, any attempt to distinguish between technical and other services (or potentially between technical services and amounts of royalty payments) seems likely to prove troublesome and a source of ongoing conflict.
It is also significant to note that fees for technical services may be substantial and usually the source country will be required to allow the resident payer to deduct such amounts in computing its income, resulting in a significant erosion of the source country's tax base. Fees for technical, managerial, and consulting services are not special in this regard.

5.2.5 New Services Article

- Adding a new and standalone article dealing with services income more broadly. This could serve as an alternative approach to allocate taxing rights to the source State for business profits originated from services. The implementation of a new general services article would be a significant undertaking and would necessitate a reshaping of the UN Model Tax Convention in its current form.

A new services article would likely require changes to be made in respect of the pre-existing deemed services PE under Sub-article 5(3) (Permanent Establishment) of the Model Tax Convention. The Committee could consider implementing a broader threshold test, which places less emphasis on having a fixed base of business, when triggering the source country's taxing rights. The Committee could also consider applying a profits taxation approach (net rather than gross basis) in respect of the new services article. This would be consistent with the treatment of services income currently taxed under Article 7 (Business Profits).

Benefits of a new services article would include potentially reducing the ability of taxpayers to artificially avoid the formation of a PE through personnel management and the possible resolution of difficulties faced by a new technical services article (discussed above) by removing the need to distinguish between technical and non-technical types of services. A new general services article could instead leverage the four modes of supply (i.e. cross-border supply, consumption abroad, commercial presence, and presence of natural persons) under the GATS as the conceptual framework to set out international taxation rules on services. A new general services article could also adopt a wide definition of services, such as that set out by the WTO and included at paragraph 1.2 above, could be implemented.

Issues associated with the implementation of a new services article would include the lack of certainty accompanying such a substantial change to the Model Tax Convention. It is likely that significant amounts of income otherwise dealt with under the current Article 7 (Business Profits) would fall under the new services article. From a practical perspective, the implementation of a new services article in the Model Tax Convention would result in significant adoption delays, being a purely prospective option (whereas changes to the Model Tax Convention Commentary could be adopted contemporaneously). It is significant to note also that the effectiveness of any new services article in capturing services income, which is

considered to be inappropriately taxed under the current regime, would be limited to the extent that Contracting States do not have domestic taxing rights. For example, without the appropriate mechanisms in place, such as withholding taxes on services income, amounts that are not ordinarily taxable domestically should not become so through the introduction of a new services article.

6. Summary / conclusions

The current international taxation rules on services appear to suffer the following deficiencies:

- Difficulty in identifying and substantiating the nexus between commercial activity and the creation of a taxable presence (i.e. a PE) in the source State. This is particularly evident where certain operations, such as source State support functions, are able to be quarantined within subsidiary entities such as corporate subsidiaries; and
- The ability for foreign enterprises to manipulate generous service PE time thresholds through careful control over personnel movement.

The Committee should remain cautious to ensure that any changes to its approach in respect of taxing services income do not lead to inequitable distortions between the taxation treatment of trade in services and trade in goods. This is particularly true should the Committee consider the inclusion of a new article in the UN Model Tax Convention.

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