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Taxation of Services – Article on technical services

Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services.

Attached is a draft Article and Commentary prepared by Mr. Brian Arnold as a consultant for the Subcommittee on Tax Treatment of Services in accordance with its mandate and for consideration by the Committee at its Tenth Session.

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UN MODEL TAX CONVENTION

Article XX – Payments for Technical Services

1. Payments for technical services arising in a Contracting State and paid to a resident of the other Contracting State who furnishes [in consideration of] those services may be taxed in that other State.

2. However, notwithstanding Article 14 and subject to the provisions of Articles 8, 17 and 20, such payments for technical services may also be taxed in the Contracting State in which the payments arise [and according to the laws of that State]* but the tax so charged shall not exceed ___ percent of the gross amount of the payments (the percentage to be established through bilateral negotiations).

3. The term "payments for technical services" as used in this Article means any payment in consideration for any service of a managerial, technical or consultancy nature, unless the payment is the reimbursement of actual expenses incurred by the person providing the service or is made to an employee, director or top-level managerial officer of the person making the payments.

4. The provisions of paragraphs 1 and 2 shall not apply if the recipient of payments for technical services [person who furnishes the technical services], being a resident of a Contracting State, carries on business in the other Contracting State in which the payments for technical services arise through a permanent establishment situated in that other State, or performs in the other Contracting State independent personal services from a fixed base situated in that other State, and the technical services [in respect of which the payments are made] are effectively connected with

   a) such permanent establishment or fixed base, or
   b) business activities referred to in (c) of paragraph 1 of Article 7.

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

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

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

∗ This wording appears in Article but is probably unnecessary.

DRAFT COMMENTARY ON ARTICLE XX – PAYMENTS FOR TECHNICAL SERVICES

Note: • The text in square brackets before the paragraphs of the Commentary have been inserted for convenience to explain the rationale for those paragraphs. They are not intended to be included in the Commentary as finally adopted.

A. General Considerations

[The first paragraph describes the new article in general terms.]

1. Article XX was added to the UN Model in 20__ to allow a Contracting State to tax payments technical and other services made to residents of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States. In general, it is sufficient if the payments are made by a resident of the State or by a nonresident with a permanent establishment or fixed base in the State if the payments are borne by the permanent establishment or fixed base; it is not necessary for the technical services to be performed in that State.

[Paragraphs 2-4 describe the provisions of the UN Model potentially applicable to fees for technical services prior to the adoption of the new article.]

2. Until the addition of Article XX, income from services generally, including income from technical services, was taxable exclusively by the residence State unless the enterprise carried on business through a permanent establishment in the source State or provided professional or independent services through a fixed base in the source State. In the absence of a permanent establishment or fixed base in the source State, it was thought that an enterprise resident in the other Contracting State was not sufficiently involved in the economy of the source State to justify that State taxing the income. However, with the rapid changes in modern economies, particularly with respect to cross-border services, it is now possible for an enterprise resident in one State to be substantially involved in another State's economy without a permanent establishment or fixed base and without being physically present in that other State.

3. The United Nations Model Convention recognizes certain exceptions to the general rule of exclusive residence-State taxation of income from services in the absence of a permanent establishment or fixed base in the other Contracting State. These exceptions are limited to certain types of services. For example, under Article 8 (alternative A), income from international transport is taxable exclusively by the State in which the place of effective management of the enterprise is located; under Article 8 (alternative B), the source country is entitled to tax income from the operations of ships in international traffic if the operations in that country are more than casual.

4. Exceptions are also found in Articles 16 and 17. Under Article 16, a Contracting State is entitled to tax directors' fees and the remuneration of top-level managerial officials derived by residents of the other State if the fees or remuneration are derived by those residents in their capacity as directors or officials of companies resident in the first State. In this case, the State in which the company paying the fees or remuneration is resident is entitled to tax irrespective of whether the services are performed inside or outside that State. Under Article 17, a Contracting State is permitted to tax income from the activities of an artiste or sportsperson if the activities take place in that State. No permanent establishment or fixed base threshold is necessary. Nor is it necessary for the artiste or sportsperson to be present in the source State for a certain minimum amount of time.

[Paragraphs 5-9 describe the application of the provisions of the UN Model – Articles 7, 12, 14 and 21 – to fees for technical services prior to the addition of the new article.]

5. Where an enterprise of one Contracting State provides technical, consulting or management services to residents of the other Contracting State or to nonresidents carrying on business through a permanent establishment in that State or providing independent services through a fixed base in that State, the other State will not generally be able to impose tax on the income from services derived by the enterprise unless the enterprise has a permanent establishment or fixed base in that State that is used to perform the services. Under Article 7 of the UN Model, a Contracting State is not entitled to tax business profits derived by an enterprise of the other Contracting State unless the enterprise has a permanent establishment in the first State and the profits are attributable to the permanent establishment. Under Article 5, a permanent establishment is defined to be a fixed place of business that must generally be maintained by the enterprise for a minimum period of 6 months. Under Article 5(3)(b), a permanent establishment is deemed to exist if an enterprise furnishes services in the other State for the same or a connected project for a period or periods aggregating more than 183 days in any 12-month period. With modern means of communication and information technology, it is relatively easy for an enterprise of one Contracting State to provide substantial services in the other Contracting State without having any fixed place of business in that State and without being present in that State for any substantial period. As a result, the State in which the payments arise, is often precluded from taxing income from technical and other similar services under Article 7.

6. A similar analysis applies with respect to the possible application of Article 14 in the case of professional and other independent services for those countries that choose to retain Article 14 in their bilateral treaties. Under Article 14, a Contracting State is entitled to tax income from such services provided by a resident of the other Contracting State only if the resident has a fixed base in the first State regularly available to him and the income is attributable to that fixed base or if the resident is present in the first State for 183 days or more in any 12-month period. Thus, a resident of one Contracting State can often provide independent services to persons in the other Contracting State without having a fixed base in that State and without being present there for any substantial period. In the absence of a fixed base or presence for at least

183 days, a State is not allowed to tax the payments for technical or other similar services of an independent nature despite the fact that the payments arise in that State.

7. It is also worth noting that the State from which payments for technical services are paid to a resident of the other Contracting State cannot generally tax such payments as royalties under Article 12 of the United Nations Model Convention. Article 12 permits a Contracting State in which royalties arise to tax the gross amount of the royalty payments at a rate to be negotiated between the Contracting States. Royalties are defined in Article 12(2) 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. Under a so-called "mixed contract," an enterprise may provide both services and the right to use property or know-how to a customer. In such situations, in accordance with paragraph 12 of the Commentary on Article 12 (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention), the payments under the contract must be disaggregated into separate elements of payments for services and royalties unless one element is only ancillary and largely unimportant. The negotiation of a rate of tax for payments 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.

8. The meaning of the expression "information concerning industrial, commercial or scientific experience" in Article 12 of the United Nations Model Convention is unclear. [Some countries take the position that the provision of brain-work and technical services are covered by this phrase and that therefore payments for such services are taxable under Article 12. (See paragraphs 14 and 16 of the Commentary on Article 12.)]

9. [Finally, some States may take the view that income from technical and other similar services is not derived from carrying on a business and therefore such income is not dealt with in Article 7 or in any of Articles 6-20 of the United Nations Model Convention. Consequently, they consider income from such services to be covered by Article 21 (Other Income). If such income arises in a Contracting State, that State is entitled to tax the income in accordance with Article 21(3). Other countries consider that income from services is always dealt with in one or more of Articles 6-20 and cannot be included in Article 21.]

[Paragraphs 10-14 describe the shortcomings – uncertainty and base erosion – of the provisions of the UN Model with respect to the taxation of fees for technical services prior to the adoption of the new article.]

10. This uncertainty concerning the treatment of payments for technical and other similar services under the provisions of the United Nations Model Convention is undesirable for both taxpayers and tax authorities. It may discourage cross-border trade in services, contrary to the fundamental purpose of the United Nations Model Convention and bilateral tax treaties generally. It may also result in unrelieved double taxation or double non-taxation.

11. Technical and other similar services may also result in the erosion of the tax base of source countries if such countries are prevented from taxing such payments by the provisions of the United Nations Model Convention. Payments for technical and other similar services are usually deductible against a country's tax base if the payer is a resident of the country or a nonresident with a permanent establishment or fixed base in the country. The reduction or erosion of a country's tax base by deductible payments for technical services is not generally objectionable. If the payer is an enterprise, the payments are legitimate expenses incurred by the payer for the purpose of earning income and should be deductible. If the country is entitled to tax the nonresident service provider, the reduction of the country's tax base by the deductible payments will be offset by the country's tax on those payments.

12. Where technical and other similar services are provided by an enterprise of one Contracting State to an associated enterprise in the other Contracting State, there is the possibility that the payments may be excessive. Within a multinational group, technical services may sometimes be used to shift profits from a profitable group company, Company A, resident and operating in one country, Country A, to another group company, Company B, resident in a low-tax country, Country B. Company B provides technical or other similar services to Company A, but Company B arranges its affairs so that it does not have a permanent establishment in Country A within the meaning of the tax treaty between Country A and Country B. Assuming that the tax treaty between Country A and Country B is similar to the United Nations Model Convention, Company B can avoid having a permanent establishment in Country A by not establishing a fixed place of business in Country A or by not furnishing services in Country A for 183 days or more in any 12-month period. Thus, even if Company B is subject to tax on its income from services provided to Company A under the domestic tax law of Country A, the income is not taxable by Country A if there is a tax treaty between Country A and Country B similar to the United Nations Model Convention. In addition, Company B may not be taxable by Country B on its income from services provided to Company A or may be subject to a low rate of tax on such income. Thus, the multinational enterprise has effectively shifted profits from a relatively high-tax country (Country A) to a relatively low-tax country (Country B).

13. In addition, ordinarily the payments made by Company A to Company B for the services will be deductible by Company A in computing its income subject to tax by Country A. This deduction erodes the tax base of Country A and Country A cannot impose tax on the payments by Company A to Company B as discussed in paragraph 12 to offset the effect of the deduction.

14. The base erosion and profit shifting illustrated in this example raise serious concerns for both developed and developing countries. The G-20 and the OECD have identified base erosion and profit shifting ("BEPS") as a serious problem and launched an ambitious

project with 15 actions to control and limit base erosion and profit shifting (www.oecd.org/ctp). The OECD BEPS project does not identify the performance of services as a base-erosion or profit-shifting issue to be dealt with. However, as illustrated by the preceding example, services can be used by multinationals with relative ease to shift profits out of a country and erode that country's tax base. This problem is especially serious from the perspective of developing countries because they are disproportionately importers of such services and may not have the administrative capacity to control or limit such base erosion and profit shifting through anti-avoidance rules in their domestic law and their tax treaties.

[Paragraphs 15-18 describe the underlying policy and fundamental features of the new Article dealing with fees for technical services.]

15. As a result of these considerations, the United Nations Committee of Experts identified as a priority the provision of technical and similar services as part of its larger project on the taxation of services under the United Nations Model Convention. After considerable study and debate, the Committee decided to add a new article to the United Nations Model Convention allowing a Contracting State to tax payments made by residents and nonresidents with a permanent establishment or fixed base in that State.

16. The OECD Model Convention has no similar provision dealing with technical services. The OECD considers that there is a fundamental principle underlying the OECD Model Convention that a Contracting State is entitled to tax income from services derived by residents of the other Contracting State only if the services are physically performed in the first State. The United Nations Committee of Experts rejects this as a fundamental principle of the United Nations Model Convention. Base erosion is a sufficient nexus to justify source country taxation of income from employment under Article 15 and directors' fees and remuneration of top-level managerial officials under Article 16. Although taxation of employment income under Article 15 is limited to employment exercised in a country, Article 16 allows a country to tax directors' fees and the remuneration of top-level managerial officials if they act for a resident company irrespective of whether the services are rendered inside or outside the country. Moreover, even under Articles 7 and 14, a country is entitled to tax income derived outside the country as long as the income is attributable to a permanent establishment or fixed base.

17. Article XX allows income from technical services to be taxed by a Contracting State on a gross basis. In contrast, income from services is generally considered to be taxable on a net basis under Article 7 or Article 14. The OECD takes the view that income from services should invariably be taxed on a net basis (paragraph 42.18 of the Commentary on Article 5 of the OECD Model Convention). However, many developing countries have limited administrative capacity and need a simple, reliable and efficient method to enforce tax imposed on income derived by nonresidents from services. A withholding tax imposed on the gross amount of payments made by residents of the country, or nonresidents with a permanent establishment or fixed base in the country, is well established as an effective method of collecting tax imposed on nonresidents. Such a method of taxation also simplifies compliance for enterprises providing services in another State since they are not required to compute their net profits or file tax returns.

Moreover, enterprises resident in a Contracting State that are substantially involved in the economy of another Contracting State can take the necessary steps to establish a permanent establishment or fixed base in that State to ensure that the profits derived from the services performed through that permanent establishment or fixed base are taxable by that State on a net basis.

18. Article XX does not require any threshold, such as a permanent establishment, fixed base or minimum period of presence in a country as a condition for the taxation of income from technical and other similar services. In this regard, Article XX is significantly different from Article 7 and Article 14, which require a relatively high threshold for source-country tax. However, in the case of technical and other services, modern methods for the delivery of services allow nonresidents to furnish substantial services in or to a country with no or limited presence there. This ability to derive income from a country with little or no presence there, combined with concerns about the base-erosion and profit-shifting aspects of technical services, justifies the absence of any threshold requirement as a condition for source-country taxation.

[Paragraphs 19 - 24 describe the relationship between new Article XX and the other distributive articles of the Model Convention.]

19. Where payments for technical services are dealt with in both Article XX and Article 7, Article 7(7) provides that the provisions of Article XX prevail. However, this priority for Article XX does not apply if the recipient of the payments carries on business through a permanent establishment in the Contracting State in which the payments arise and the technical services are effectively connected with the permanent establishment or business activities referred to in (c) of paragraph (1) of Article 7. In this situation, paragraph 4 of Article XX provides that the provisions of Article 7 apply instead of Article XX.

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

21. There can be no overlap between Article XX and Articles 15, 16, 18 and 19 dealing with income from employment, directors' fees and remuneration of top-level managerial officials of a company resident in a Contracting State, pensions and government services respectively because the definition of payments for technical services in paragraph 3 of Article XX expressly excludes these amounts. Similarly, since paragraph 2 of Article XX is subject to the provisions of Articles 8, 17 and 20, Article XX does not apply to the payments for technical services covered by those provisions. Although it is unlikely that payments for activities covered by Article 17 or Article 20 would be within the definition of payments for technical services, it was considered to be desirable to eliminate any uncertainty in this regard. Therefore, for example, if payments are made by residents of a Contracting State to an entertainer or

sportsperson resident in the other Contracting State for technical services, such payments are not subject to tax by the Contracting State in which the payers are resident if the technical services are performed outside the Contracting State.

22. It is unlikely that payments for technical services would be included in profits from international shipping, inland waterways transport and international air transport dealt with in Article 8. However, to eliminate any uncertainty, Article XX(2) provides that it is subject to Article 8. Thus, any payments for technical services that result from the operation of ships or aircraft in international traffic or the operation of boats in inland waterways are taxable exclusively in accordance with Article 8 of the United Nations Model Convention.

23. There is the potential for the application of both Article XX and Article 12 dealing with royalties in particular cases. The distinction between technical services and royalties is clear in principle and guidance for making the distinction on a practical basis in particular situations is provided in the Commentary on Article 12.

B. Commentary on the Paragraphs of Article XX

Paragraph 1

24. This paragraph establishes that payments for technical services may be taxed in the Contracting State in which the person who furnishes the services is a resident. It does not, however, provide that such payments are taxable exclusively by the State of residence.

25. In most cases, the person who furnishes the technical services will be the recipient of the payments for those technical services. If the person who receives the payments for technical services is not the person who furnishes the technical services, it is a matter of domestic law as to who is the proper taxpayer. If payments for technical services are made to a person other than the person who furnishes the services, Article XX does not apply to the payments. In this situation, the payments would be subject to tax in the Contracting State in which the payments arise in accordance with Article 21(3) of the United Nations Model Convention.

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

27. Article XX deals only with payments for technical services arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to payments for technical services arising in a third State. Paragraphs 5 and 6 specify

when payments for technical services are deemed to arise in a Contracting State and deemed not to arise in a Contracting State. However, unlike Articles 10 and 11, which do not apply to dividends paid by a company resident in a third State or interest arising in a third State, Article XX applies to payments for technical services made by a resident of a Contracting State or a third State that are borne by a permanent establishment or fixed base that the resident has in the other Contracting State.

Paragraph 2

28. This paragraph lays down the principle that the Contracting State in which payments for technical services arise may also tax those payments. However, the amount of tax imposed by that State on payments for technical services may not exceed a maximum percentage of the gross amount of the payments, to be established through bilateral negotiations.

29. When considered in conjunction with Article 23, paragraph 2 establishes the primary right of the country in which payments for technical services arise to tax those payments. Accordingly, the residence country is obligated to prevent double taxation of those payments. Under Article 23, the residence country is required to provide relief from double taxation through exemption or credit for any source-country tax imposed on payments for technical services in accordance with Article XX.

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

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

- the possibility that a high rate of withholding tax might cause nonresident services providers to pass on the cost of the tax to customers in the source country, which would mean that the source country would increase its revenue at the expense of its own residents rather than the nonresident service providers;
- the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment;
- the possibility that some nonresident service providers may incur high costs in providing technical services so that a high rate of withholding tax on the gross payments may result in an excessive effective tax rate on the net income;
- the fact that a lowering of the withholding rate has revenue and foreign-exchange consequences for the source country; and
- the relative flows of payments for technical services (e.g., from developing to developed countries).

32. Article XX applies notwithstanding Article 14. Under Article 14, income from the performance of professional or other independent personal services by a person who is a resident of a Contracting State is taxable by the other Contracting State only if the

services are performed through a fixed base in the other Contracting State that is regularly available to the person or if the person stays in that State for 183 days or more in any twelve-month period commencing or ending in the fiscal period.

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

34. Article XX takes priority over Article 7 as a result of Article 7(7). Thus, the conditions for the taxation of the business profits of an enterprise under Article 7 do not apply to payments for technical services covered by Article XX. Payments for technical services are taxable by a Contracting State under Article XX(2) if the payments arise in that State irrespective of whether the enterprise performing the services has a permanent establishment in that State or performs services that are similar to those effected through the permanent establishment. However, by virtue of paragraph 4 of Article XX, if a resident of one Contracting State performs services through a permanent establishment in the other Contracting State and receives payments for technical services within the meaning of paragraph 3 of Article XX, Article 7 will apply to those payments in priority to Article XX.

35. The application of paragraph 2 of Article XX is expressly subject to the provisions of Articles 8, 17 and 20. It may be unlikely that payments for international shipping, air transportation or inland waterways transport under Article 8, entertainment or sports activities under Article 17, or services provided by students, apprentices or business trainees would be within the definition of payments for technical services in paragraph 3 of Article XX. However, to eliminate any uncertainty in this regard, Article XX(2) explicitly provides that in any situation in which both Article XX and one of Article 8, 17 or 20 apply to the same services, Article 8, 17 or 20 will apply rather than Article XX.

36. Paragraph 2 of Article XX does not require the recipient of payments for technical services to be the “beneficial owner” of the payments. Article XX differs from Articles 10, 11 and 12 in this regard. Those articles use the concept of beneficial owner to clarify the meaning of the words “paid to a resident of the other Contracting State” as they are used in paragraph 1 of those articles. The State of source is not obliged to give up taxing rights over dividends, interest or royalties merely because these amounts are directly received by a resident of a State with which the State of source has concluded a convention if that resident is acting as an agent, nominee or conduit for another person (i.e., is not the beneficial owner of the income).

37. The decision not to include the concept of beneficial owner in Article XX is based on the fact that the concept is not used in the provisions of the United Nations Model Convention dealing with income from services. Thus, for example, the concept of beneficial owner is not used in Article 7 (Business Profits), Article 14 (Independent Personal Services), Article 15 (Dependent Personal Services) or Article 17 (Artistes and Sportspersons).

38. The absence of any requirement in Article XX for the person who furnishes technical services or the recipient of payments for technical services to be the beneficial owner of those payments should not be construed as indicating that the State of source must give up its taxing rights in circumstances where payments for technical services are received by an agent, nominee or conduit acting on behalf of another person who furnishes those services but who is not a resident of a Contracting State.

39. As worded, paragraph 2 allows a Contracting State to impose tax on payments for technical services made by persons resident in that State even where such payments represent personal expenses rather than business expenses. The imposition of withholding tax obligations on such payments by individuals under domestic law would be difficult to enforce and might cause serious compliance problems for individuals utilizing technical services supplied by nonresidents.

40. In bilateral negotiations, the Contracting States may agree to limit the application of Article XX to payments for technical services made by enterprises. In this case, paragraph 2 of Article XX might be worded as follows:

> However, notwithstanding Article 14 and subject to the provisions of Articles 8, 17 and 20, such payments for technical services may also be taxed in the Contracting State in which the payments arise, [and according to the laws of that State] if the payments are made by or in the course of an enterprise, but the tax so charged shall not exceed ___ percent of the gross amount of the payments (the percentage to be established through bilateral negotiations).

41. This alternative wording would prevent a Contracting State in which payments for technical services arise from taxing those payments where the payments are made by individuals for personal consumption rather than as expenses incurred in the course of a business.

Paragraph 3

42. This paragraph specifies the meaning of the phrase “payments for technical services” for purposes of Article XX. The definition in paragraph 3 is exhaustive. “Payments for technical services” are limited to the payments described in paragraph 3; other payments for services are not included and are not dealt with in Article XX.

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

a) the definition generally covers most types of services that are regarded as technical services under the domestic law of the countries that tax such services;
b) such a reference would introduce a large element of uncertainty;
c) future changes in a country's domestic law with respect to the taxation of payments for technical services could otherwise have an effect on the Convention; and
e) in the Model Convention reference to domestic laws should be avoided as far as possible.

It would be inconsistent with this definition of payments for technical services for the meaning of terms used in the definition, especially the terms "management," "technical" and "consultancy," to be determined in accordance with the domestic law of the country applying the treaty under Article 3(2).

44. As expressly provided in paragraph 3, payments for technical services for purposes of Article XX do not include payments of salary, wages or other remuneration to an employee of the payer. Where such payments are made by an employer resident in one Contracting State to an employee resident in the other Contracting State, they are covered by Article 15 or Article 19 of the Convention. Similarly, payments for technical services do not include fees paid to the directors of a company resident in a Contracting State or salary, wages and other remuneration paid to top-level managerial officials of a company resident in a Contracting State. Such items of income are covered by the provisions of Article 16. In addition, since pensions arise in respect of prior employment, they are excluded from Article XX and are dealt with by Article 18 even if the employment involved the provision of technical services to the employer.

45. As expressly provided in paragraph 3, the definition of payments for technical services does not include the reimbursement of actual expenses incurred by a service provider. For example, where under the terms of the contract a service provider resident in a Contracting State furnishes technical services to a resident of the other Contracting State in consideration for a fee plus the reimbursement of the service provider's travel expenses, the other Contracting State is entitled to impose tax only on the payment of the fee, not on the reimbursement of the travel expenses. However, where a service provider receives an amount not as a reimbursement of actual expenses incurred by the service provider, but as an allowance for expenses that the service provider may or may not actually incur, the payment of the allowance is not excluded from the definition of payments for technical services. Only the reimbursement of expenses that are identifiable separately from a service provider's fee are excluded from the definition of payments for technical services. Thus, the reimbursement of expenses based on a percentage of a service provider's fee would not qualify for exclusion from the definition of payments for technical services. Any payments by an enterprise for the reimbursement of expenses incurred by an associated enterprise are subject to the arm's length standard in Article 9 of the Convention.

47. Although paragraph 3 defines the phrase "payments for technical services," it does not provide a definition for the term "services." Similarly, the other articles of the United Nations Model Convention dealing with various types of services do not contain any definition of the term "services." Neither Article 14, which deals with professional and other independent services, nor Article 19, which deals with services rendered to the

government of a Contracting State, provides a definition of "services." Similarly, the General Agreement on Trade in Services does not contain any definition of the term "services."

48. Although the term "services" in the phrase "payments for technical services" is undefined in the context of Article XX, it should be understood to have a broad meaning in accordance with ordinary usage to generally include activities performed by one person for the benefit of another person in consideration for a fee.

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

50. Article XX applies only to payments for technical services, and not to all payments for services. Paragraph 3 defines payments for technical services as payments for managerial, technical or consultancy services. Given the ordinary meanings of the terms "managerial," "technical" and "consultancy," the fundamental concept underlying the definition of payments for technical services is that the services must involve the application by the service provider of specialized knowledge, skill or expertise on behalf of a client. Services that do not involve the application of specialized knowledge, expertise or skill are not within the scope of Article XX.

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

52. The ordinary meaning of the term "technical" involves the application of specialized knowledge, skill or expertise with respect to a particular art, science, profession or occupation. Therefore, the payments received for services provided by regulated professions such as law, accounting, architecture, medicine, engineering and dentistry would be payments for technical services within the meaning of paragraph 3 of Article XX. Thus, if a person receives payments for professional services referred to in Article 14(2) from a resident of a Contracting State, those payments would be payments for

technical services. If the payments arise in that Contracting State because they are made by a resident of that State or borne by a permanent establishment or fixed base in that State, the payments would be subject to tax by that State in accordance with Article XX(2) irrespective of the fact that the services are not performed in that State through a fixed base in that State.

53. Technical services are not limited to the professional services referred to in Article 14(2). Services performed by other professionals, such as pharmacists, and other occupations, such as scientists, academics, etc., may constitute technical services if those services involve specialized knowledge, skill and expertise.

54. The ordinary meaning of "consultancy" involves the provision of advice or services of a specialized nature. Professionals usually provide advice or services that fit within the general meaning of consultancy services although, as noted in paragraphs 52 and 53, they may also constitute technical services.

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

56. Example 1: X is a resident of State R and a skilled heart surgeon. X’s practice is carried on primarily in State R, although X occasionally travels to other countries to perform surgery. X performs surgery in State R on an individual resident in State S. The tax treaty between State R and State S contains a provision identical to Article XX of the United Nations Model Convention. Under Article XX(3), the payments made by the patient, a resident of State S, to X would be considered to be payments for technical services that arise in State S. As a result, the payments would be taxable by State S in accordance with Article XX(2).

57. The result in Example 1 would be the same if X travelled to State S and performed the surgery in State S.

58. Although Article XX(2) allows State S to impose tax on the payments for technical services on the facts of Example 1, countries should carefully consider whether it is feasible or desirable to impose tax under their domestic law in these circumstances. Such a tax would be difficult for a country to enforce and might discourage residents of that country from seeking essential technical services that are not available from residents of that country or not available in the country.

59. Example 2: R Company is a resident of State R. R Company’s business is the collection, organization and maintenance of various databases. R Company sells access to these databases to its clients. One of R Company’s clients is Company S, resident in State S. State R and State S have a tax treaty that contains a provision identical to Article XX of the United Nations Model Convention. The payments that R Company receives from S Company for access to its databases would not be payments for technical services within the meaning of paragraph 3 of Article XX. Although R Company used its knowledge, skill and expertise in creating the database, the services

that R Company provides to S Company – access to the database – does not involve the application of R Company's knowledge, skill and expertise for the benefit of S Company. Accordingly, Article XX would not apply to the payments.

60. If, however, S Company entered into a contract with R Company under which R Company created a specialized database tailored for S Company's use from information supplied by S Company, the payments by S Company to R Company would be payments for technical services under paragraph 3 of Article XX. In this situation, R Company would be applying its knowledge, skill and expertise for S Company's benefit. As a result, the payments would be taxable by State S in accordance with Article XX(2).

61. Example 3: R Company, a resident of State R, is engaged in the insurance business in both State R and State S. R Company provides insurance against a wide variety of risks. State R and State X have a tax treaty that is the same as the United Nations Model Convention, including Articles 5, 7 and XX. R Company would be deemed to have a permanent establishment in State S under Article 5(6) to the extent that it collects premiums or insures risks in State S other than through an agent of independent status. Therefore, by virtue of Article XX(4), R Company's insurance activities in State S would be taxable by State S in accordance with Article 7.

62. Even if R Company is not deemed to have a permanent establishment in State S, Article XX would not apply because the insurance premiums received by R Company cannot be considered to be payments for technical services within the meaning of paragraph 3 of Article XX. Although R Company uses its knowledge, skill and expertise to develop its various insurance products that are sold to its clients, R Company is not applying its knowledge, skill and expertise directly for the benefit of its clients.

63. Example 4: R Company is a financial institution resident in State R. R Company provides a wide variety of financial services to its customers, including acceptance of deposits, extension of credit, credit and debit cards, payment and transmission services, bankers drafts, guarantees, foreign exchange, negotiable instruments, derivative products, investment research and advisory services. R Company's business is conducted primarily in State R but it also has clients in other countries, including State S. State R and State S have a tax treaty that is identical to the United Nations Model Convention.

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

65. However, where a financial institution uses its knowledge, skill and expertise to provide research, analysis or advice to a client related to that clients' particular circumstances,

the payments received by the financial institution for those services could be payments for technical services within the meaning of paragraph 3 of Article XX. This would be the case, for example, if R Company provides advice to S Company, resident in State S, with respect to a potential merger or acquisition involving S Company. As a result, the payments for such advice would be taxable by State S in accordance with Article XX(2). If, however, R Company provides the services through a permanent establishment located in State S, the payments for those services will be taxable by State S in accordance with Article 7 rather than Article XX by virtue of paragraph 4 of Article XX.

66. Under most contracts for the use of satellites (often called "transponder leasing" agreements), satellite operators provide transmission capacity rather then physical possession of a transponder to their clients. For this reason, the OECD Commentary on Article 12 (paragraph 9.1) considers that the payments received under these contracts should be characterized as payments for services. If this is the case, the question arises as to whether the payments would be payments for technical services for purposes of Article XX. Payments for the use of satellite capacity do not involve the application of the knowledge and expertise of the satellite owner/operator for the benefit of the client. Therefore, in most cases payments for the use of satellite capacity will not be payments for technical services covered by Article XX. Such payments may be royalties under Article 12 as payments for the use of, or the right to use, equipment.

Paragraph 4

67. This paragraph provides that paragraphs 1 and 2 do not apply to payments for technical services if the person who furnishes the services has a permanent establishment or fixed base in the source country and the technical services are effectively connected with the permanent establishment or fixed base. It is similar to paragraph 4 of Article 10, paragraph 4 of Article 11 and paragraph 4 of Article 12.

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

69. The paragraph does not define the meaning of the expression "effectively connected." As a result, whether technical services are effectively connected with a permanent establishment, fixed base or business activities similar to those carried on through a permanent establishment must be determined on the basis of all the relevant facts and circumstances of each case. In general, technical services would be considered to be effectively connected with a permanent establishment or fixed base if the technical services are closely related or connected to the permanent establishment, fixed base or business activities similar to those effected through the permanent establishment. This will be the case where the remuneration paid to the person performing the services is borne by the permanent establishment or fixed base in the source country.

70. Where paragraph 4 applies, the payments for technical services are taxable in the State of source as part of the profits of the permanent establishment in accordance with Article 7 or income of the fixed base in accordance with Article 14. Thus, paragraph 4 relieves the State in which the payments for technical services arise from the limitations on its taxing rights imposed by Article XX. Where Article 7 applies as a result of the application of paragraph 4 of Article XX, most countries understand and intend that the State in which the permanent establishment is located may tax only the net profits from the technical services. Most countries also understand and intend that where Article 14 applies, the State in which the services are performed may tax only the net income from the technical services. However, it may be useful to clarify these issues during negotiations (see paragraphs 9 and 10 of the Commentary on Article 14).

Paragraphs 5 and 6

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

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

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

74. Paragraph 5 is subject to paragraph 6, which provides a source rule for payments for technical services to supplement the source rule in paragraph 5. Paragraph 6 deems payments for technical services made by a resident of a Contracting State not to arise in that State where the payer carries on business through a permanent establishment in the other Contracting State or in a third State, or performs independent personal services through a fixed base in the other Contracting State or in a third State and the payments for technical services are borne by that permanent establishment or fixed base. As a result, in these circumstances, the Contracting State in which the payer is resident is not allowed to tax the payments for technical services under Article XX(2).

75. The phrase "borne by" must be interpreted in the light of the underlying purpose of paragraphs 5 and 6 of the Article, which is to provide source rules for payments for technical services. A Contracting State is entitled to tax payments for technical services under Article XX(2) only if the payments arise in that State. The basic source rule in paragraph 5 is that payments for technical services arise in a Contracting State if the payer is a resident of that State. However, this basic rule is supplemented by another rule where payments for technical services are borne by a permanent establishment or fixed base in a Contracting State of a resident of the other Contracting State or a third State. In addition, the basic rule is limited by the rule in paragraph 6 where the payer is a resident of a Contracting State but the payments are borne by a permanent establishment or fixed base of the payer in the other Contracting State or a third State.

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

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

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

79. Example 1: R Enterprise is carried on by a resident of State R. It provides technical services to S Company, which is a resident of State S. There is a tax treaty between State R and State S containing a provision that is the same as Article XX of the United Nations Model Convention. S Company carries on business in State R (or a third State) through a permanent establishment situated there. However, the technical services provided by R Enterprise to S Company are related to S Company's business carried on in State S, not to the business carried on in State R (or a third State).

80. In this case, since the payments are made by a resident of State S and are not borne by a permanent establishment outside State S, the payments would be considered to arise in State S in accordance with paragraph 5. Therefore, State S would be entitled to tax the payments for technical services under Article XX(2).

81. Example 2: The facts are the same as in Example 1, except that the payments for technical services are borne by S Company's permanent establishment in State R or in a third State.

82. In this case, since the payments for technical services are borne by a permanent establishment of S Company situated outside State S, paragraph 6 applies to deem the payments for technical services not to arise in State S. Consequently, the payments are not taxable by State S under Article XX(2) but are taxable by State R under Article XX(1).

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

84. If there is a bilateral tax treaty between State R and the third State in which S Company has a permanent establishment, and that treaty contains a provision comparable to Article XX of the United Nations Model Convention, the payments for technical services would be considered to arise in that third State for purposes of the treaty. As a result, that treaty would allow the third State in which the permanent establishment is located to tax the payments.

85. Example 3: T Enterprise is carried on by a resident of State T. T Enterprise carries on business through a permanent establishment in State S or provides independent personal services through a fixed base in State S. T Enterprise pays R Company, a resident of State R, for technical services performed by R Company for T Enterprise in connection with its income-earning activities carried on in State S. The payments made by T Enterprise to R Company for the technical services are deductible in computing the profits attributable to the permanent establishment of T Enterprise in State S or the income attributable to the fixed base of T Enterprise in State S.

86. In this case, although the payments for technical services are not made by a resident of State S, the payments are borne by a permanent establishment or fixed base in State S. In these circumstances, the payments for technical services have a close economic connection to the income-earning activities carried on in State S. Thus, the payments are deemed to arise in State S under paragraph 5 of Article XX and State S is entitled to tax the payments in accordance with Article XX(2).

87. In the case of interest and royalties, paragraph 21 of the Commentary on Article 11 and paragraph 19 of the Commentary on Article 12 indicate that countries might substitute a rule that would identify the source of interest or royalties as the State in which the loan giving rise to the interest or the property or right giving rise to the royalties was used. A similar source rule might be substituted for purposes of Article XX. [Draft wording for

such a provision could be included in the Commentary, although alternative wording is not included in the Commentaries on Articles 11 and 12.] Similarly as suggested in the Commentary on Articles 11 and 12, where, in bilateral negotiations, the parties differ on the appropriate rule, a possible solution would be a rule that, in general, would accept the payer's place of residence as the source of payments for technical services, but where the technical services are used or consumed in a State having a place-of-use rule, the payment would be deemed to arise in that State.

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

- The parties might decide not to include paragraph 6 in Article XX. In this case, payments for technical services would be considered to arise in the State in which the payer is resident, even where the payments for technical services are incurred for purposes of a permanent establishment or fixed base of the payer situated outside the payer's State of residence.

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

[Note: Draft Article XX does not contain a provision similar to Article 11(6) or 12(6) dealing with excessive payments on the basis that such a provision is inappropriate and unnecessary in Article XX. Article 11(6) and 12(6) apply only if the rate of interest or royalties charged between non-arm's length parties is excessive, and not if the character of the payments is something other than interest or royalties. Those provisions do not apply to the recharacterization or reclassification of a loan as equity or royalties as some other type of payment. See paragraph 22 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 33 of the Commentary on Article 11 of

the OECD Model Convention and paragraph 20 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraph 22 of the OECD Model Convention.]

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