**Papers on Selected Topics in Protecting the Tax Base of Developing Countries**

**Draft Paper No. 2**

May 2013

# The Taxation of Income from Services

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**DRAFT**

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May, 2014

# PROTECTING THE TAX BASE OF DEVELOPING COUNTRIES: THE TAXATION OF INCOME FROM SERVICES

## INTRODUCTION

With the support of the G-20 nations, in 2011 the OECD launched an ambitious project to deal with base erosion and profit shifting ("BEPS") by multinational enterprises.[1] In October 2012, the OECD issued a BEPS action plan, which involves 15 actions to be taken to prevent to prevent base erosion and profit shifting.[2] These actions range from the completion of ongoing work by the OECD dealing with hybrid mismatch arrangements and transfer pricing to an examination of the effects of the digital economy on base erosion and profit shifting and the possibility of a multilateral treaty as a means of implementing tax treaty measures intended to prevent base erosion and profit shifting. The OECD's BEPS project has a tight timeframe with many of the actions to be completed by September, 2014, others by September, 2015 and the balance by the end of 2015.

The OECD has been careful to involve developing countries in the BEPS initiative and, not surprisingly, the developing countries have indicated their enthusiastic support. Obviously, the tax bases of developing countries are equally, if not more, susceptible to base erosion and profit shifting as the tax bases of developed countries. Moreover, many developing countries have less capacity in terms of administrative resources and expertise to deal with base erosion by multinational enterprises than developed countries.

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1 OECD, *Addressing Base Erosion and Profiting Shifting* (Paris: OECD, 2011) available at www. oecd.org/ctp.

2 OECD, BEPS Action Plan

Although base erosion and profit shifting are equally important for both developed and developing countries, they affect developed and developing countries in different ways. The OECD BEPS action plan does not identify the provision of services as a means of eroding the tax base of countries that requires action. Some of the BEPS action points, such as the digital economy and the avoidance of permanent establishment status artificially, may touch on the provision of services. In contrast, developing countries have become increasingly concerned about the erosion of their domestic tax bases by multinational enterprises through payments by residents for management, consulting and technical services provided by related nonresident companies. The United Nations Committee of Experts has been considering the taxation of services for several years and in 2013 endorsed the addition of a new article to the UN Model dealing with fees for technical services. Therefore, because of the importance of services for developing countries, this paper examines the taxation of income from services in the context of the BEPS initiative from the perspective of developing countries.

As noted above, it is relatively easy for multinational enterprises to reduce the tax payable to a source country in respect of a group company resident and doing business in that country through payments for services rendered to that company by other nonresident group companies. The payments will generally be deductible in computing the income of the company resident in the source country but may not be taxable by the source country in the hands of the nonresident service provider. For example, even if payments for services performed by the nonresident company are taxable under the domestic tax law of the source country, an applicable tax treaty along the lines of the UN Model would prevent the source country from taxing such payments unless the nonresident has a PE or fixed base in the source country. The same type of base erosion may occur with respect to developed countries; however, if the flow of services is relatively equal between the two countries, the erosion of the tax base of the source country may not be a serious concern because that country's tax revenues are increased in its capacity as the country of residence.

The paper begins with a brief discussion of the taxation of income from services performed by nonresidents under the domestic law of developing countries. This

discussion emphasizes that protecting the tax base of developing countries involves both the provisions of domestic law and tax treaties. The paper then provides an overview of the provisions of the UN Model dealing with income from services. This overview is intended to provide the necessary background to determine which provisions of the UN Model may be problematic in terms of base erosion. These overviews of the provisions of the UN Model and domestic law dealing with income from services are followed by a detailed discussion of the opportunities for base erosion through the performance of services by nonresidents and the possible responses to prevent such base erosion. This discussion is organized on the basis of various types of services including the treatment of fees for technical services. The paper does not deal with digital services which are the subject of a separate paper by Jinyan Li. The potential responses of developing countries to the problem of base erosion include changes to tax treaties and domestic law and some type of coordinated international action. The paper does not make any recommendations for action by developing countries to protect their tax bases against base erosion; it simply identifies possible actions and provides some brief comments on their advantages and disadvantages. The paper ends with a brief conclusion.

## DOMESTIC LAW WITH RESPECT TO THE TAXATION OF INCOME FROM SERVICES

### Introduction

Not surprisingly, the treatment of income from services under the domestic laws of developing countries varies considerably.[3] The following discussion is not intended to comprehensively identify all of the different rules in the various developing countries. Instead, the discussion is intended to describe the most common patterns for the taxation of services and the major factors that affect the domestic taxation of services.

At the outset it should be noted that this paper is primarily concerned with the treatment of income from services derived by nonresidents of developing countries.

[3] See generally Ariane Pickering, General Report, in International Fiscal Association, Enterprise Services, vol. 97a *Cahiers de droit fiscal international* 2012, 17-60, at 23-35.

Income derived by residents of developing countries from services performed outside their country of residence or services performed for nonresidents (i.e. foreign source income) is dealt with only briefly here because such services do not provide opportunities for base erosion and profit shifting for most developing countries as serious as those provided by inbound services.[4] For countries that tax on a territorial basis, income derived from services performed outside the country is not taxable. Thus, in these countries there is a structural incentive for residents to earn foreign source income in low tax countries. The significance of this incentive depends on the extent to which residents of a territorial country earn foreign source income from services and on the extent to which the services are geographically mobile. Countries that tax on a territorial basis can eliminate some of these problems by moving to a worldwide system or by extending the concept of domestic source income to include at least some services rendered outside the country.

For countries that tax on a worldwide basis (i.e. residents are taxable on both their domestic and foreign source income), income derived by residents from services performed abroad is ordinarily taxed like any other business income on a net basis at the generally applicable rate. The residence country ordinarily allows a credit against residence country tax payable for any tax paid to the foreign country in which the services are performed in order to eliminate double taxation. Thus, under a worldwide system income from foreign services is taxable at the higher of the tax rate in the country of residence or the tax rate in the source country (the country in which the services are performed or used); as a result, there appear to be limited opportunities for the avoidance of residence country tax. However, residents of a country that taxes on a worldwide basis can establish a controlled foreign corporation (CFC) to provide services outside that country. Since a foreign corporation is generally considered to be a taxable entity separate from the persons who own the shares of the corporation, a CFC is not subject to tax on its income in the country in which the controlling shareholders are resident unless

[4] It is notable that the OECD's Action Plan on BEPS did not identify the performance of services as an area of concern.

the income earned by the CFC is sourced in that country.[5] Many developed countries (and some developing countries)[6] have rules, referred to as controlled foreign corporation (CFC) rules, to limit the use of CFCs to defer or avoid residence country tax.[7] Some countries apply their CFC rules to income from services provided to residents of the country in which the controlling shareholders of the CFC are resident, to related parties or to persons outside the country in which the CFC is resident.[8] The use of CFCs to avoid or defer residence country tax especially with respect to passive investment-type income but also with respect to certain types of business income, including income from services, is relatively easy and inexpensive. Developing countries need to consider carefully whether it is appropriate or necessary for them to adopt CFC rules and whether such rules should apply to income from services.

**A Framework of Analysis**

The taxation of business profits, including income from services derived by nonresidents under a country's domestic laws and under tax treaties, can be usefully examined in terms of the following framework of analysis involving six stages.[9]

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5 If a treaty applies with terms similar to those of the UN Model, the CFC would be subject to tax in that country only if the income was attributable to a permanent establishment in that country or if the CFC performed services in that country for more than 183 days in any twelve-month period.

6 Developing countries with CFC rules include Brazil, China, Estonia, Egypt, Indonesia, Hungary, South Africa and Venezuela.

7 See generally Brian J. Arnold, *The Taxation of Controlled Foreign Corporations: An International Comparison* (Toronto: Canadian Tax Foundation, 1986); Brian J.Arnold, "A Comparative Perspective on the U.S. Controlled Foreign Corporation Rules," (2012) Vol. 65, No. 3 *Tax Law Review* 473-504.

8 Such income is generally referred to as base company services income.

9 The framework set out in the text is adopted from the framework for the taxation of business profits in Brian J. Arnold, "Threshold Requirements for Taxing Business Profits Under Tax Treaties," in Brian J. Arnold, Jacques Sasseville, and Eric M. Zolt, eds., *The Taxation of Business Profits Under Tax Treaties* (Toronto: Canadian Tax Foundation, 2004).

1) There must be some connection or nexus between the nonresident's service activities or income and a country before the country can tax a nonresident.[10] This initial question of jurisdiction to tax or nexus is a question of domestic law and is probably determined primarily on the basis of the practical ability of a country to enforce any taxes imposed on nonresidents as much as some theoretical justification for taxing nonresidents.

2) For many countries, the type of services involved must be determined because different rules apply to different types of services. For this purpose, the major types of services are employment, professional services, technical services, international transportation services, entertainment, insurance, construction and other business services.

3) A country must decide whether it wants to tax any and all income from services performed by nonresidents in the country or whether it will tax such income only if the nonresident's activities in or with the country meet or exceed a minimum threshold. The most common threshold requirement is a permanent establishment (PE) or fixed base. Some developing countries use the PE concept, not as a threshold requirement, but to determine whether a nonresident is taxable on a net or gross basis.

4) Once it has been established that any minimum threshold for taxation has been met or that no threshold is appropriate, rules are necessary to determine what income from services derived by a nonresident is attributable to and taxable by the source country.[11] These rules (often referred to as geographical source rules) are necessary for both revenue and expenses. They allocate the income between the residence and source countries.

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[10] Any type of connection would appear to be sufficient for this purpose: services performed in the country, services rendered to residents of the country, or services utilized or consumed in the country. See generally the sources listed in note 4, supra.

[11] See Brian J. Arnold and Jacques Sasseville, "Source Rules for Taxing Business Profits under Tax Treaties" in The Taxation of Business Profits Under Tax Treaties, supra note 9.

5) The next stage involves the rules that apply for the purpose of computing the income from services derived by a nonresident from a country that is subject to tax by that country. These rules are the detailed computational rules for determining the nonresident's net income. Generally, these rules will be the same for resident and nonresident taxpayers, although some special rules may be appropriate to reflect the different circumstances of residents and nonresidents.[12] These computational rules are different from, but closely related to, source rules.[13] Tax treaties generally rely on domestic law to provide the detailed computational rules, subject only to broad principles of nondiscrimination, separate accounting, and the arm's length standard.[14]

6) Finally, a country must have rules to determine the tax payable and to collect the tax.[15] These rules may be different for residents and nonresidents to reflect the greater difficulty in collecting tax from nonresidents.

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[12] For example, nonresidents are typically not entitled to the personal deductions or credits available to residents. Also, as discussed below, several developing countries have rules that prescribe the amount of a nonresident's income (so-called presumptive taxation).

[13] The computational rules deal with what amounts are included in income, what amounts are deductible in computing income, and the timing of such inclusions and deductions. In general, these types of provisions apply irrespective of the geographic source of the income or expenses. For example, the deduction of entertainment expenses may be prohibited even if they are incurred inside the country. Source rules, on the other hand, are used to determine the revenue and expenses to be taken into account in calculating the income from a particular country. For example, payments for services might be considered to be derived from a country if the services are performed in the country; and interest expense might be considered to be sourced to a country if the borrowed funds are used in that country.

[14] The only detailed rules for the computation of the income of a PE in the UN Model Convention are Articles 7(3) and 7(5). Article 7(3) requires a source country to allow deductions for expenses incurred for the purposes of a PE wherever the expenses are incurred and denies the deduction of notional expenses. Article 7(5) requires the same method of computing the business profits of a PE to be used consistently from year to year.

[15] See Robert Couzin, "Imposing and Collecting Tax," in *The Taxation of Business Profits Under Tax Treaties,* supra note 9.

The six stages in this framework of analysis are intimately connected. For example, a threshold requirement, such as a PE or fixed base, or gross basis taxation through a withholding tax may be adopted because it makes the collection of tax more effective. Not all of the stages may be involved with respect to all types of income from services taxable by a particular country under its domestic law. For example, a final gross basis withholding tax usually eliminates the need for source and computational rules. Similarly, a threshold requirement obviates the need for the application of source and computational rules for those nonresidents who do not meet the threshold. Nevertheless, it is useful to think about each stage separately as part of the framework of analysis even though not all stages apply in all circumstances. First, in some circumstances all of the stages will apply. This is the case where income from services derived by a nonresident enterprise are derived through a PE in the source country and are dealt with under Article 7 of an applicable tax treaty.[16] Second, where one or more of the stages is not applicable, that will usually be the result of a conscious policy decision by the particular country. For example, if a country imposes a final gross basis withholding tax on certain income from services, as noted above, the necessity for source and computational rules is effectively eliminated for payments by residents to nonresidents that are subject to withholding tax. But not all such payments may be subject to withholding tax. Payments for services subject to withholding tax may be limited to certain types of services – for example, independent personal services – and to payments by residents or nonresidents with a PE or a fixed base in the source country. Other services may be subject to net-basis taxation only if the services are performed in or used in the source country. In effect, the decisions

[16] In these situations the jurisdictional nexus is the performance of services in the source country by the nonresident; source country taxation applies only to income from services that are derived from a business; the requirement for a PE is the threshold for source country tax; the source rule is that any income attributable to the PE is subject to source country tax; the computational rules are usually the general rules that apply to determine income from a business under domestic law; and the tax is assessed on a net basis.

about the source of income from services and the basis of taxation are embedded in the decisions about what types of services are subject to withholding tax.

**An Overview of the Domestic Laws of Developing Countries with Respect to the Taxation of Income from Services Derived by Nonresidents**

In this section of the paper, the domestic laws of developing countries with respect to the taxation of income from services by nonresidents are examined in terms of the framework of analysis described in the preceding section. The discussion does not focus on the treatment of income from services in any particular country or countries, although occasional references to the rules in particular countries are made by way of example.

First, the jurisdictional basis for taxing nonresidents on income from services is simply a manifestation of a particular country's domestic tax rules. Although there are no effective limitations on domestic taxation of nonresidents under international law, there are practical constraints on the ability of a country to enforce taxes imposed on nonresidents in the absence of some connection with the country.

Second, in several countries the rules vary depending on the type of services involved. Some countries treat income from services derived by nonresidents in the same way as other business income derived by nonresidents, although even these countries often have special rules for certain types of specialized services such as international shipping and transportation, insurance, construction, and entertainment. Surprisingly, even for countries that treat income from services differently from other business income, few of them have any statutory definition of services.[17] Some South American countries

[17] Russia's tax code contains a statutory definition of services as actions with intangible results consumed in the course of the actions that confer benefits to the customer. The definition excludes actions with tangible results provided to the customer, financial, rental, licenses of intellectual property, and assignment of rights. Despite the definition, there is considerable uncertainty about the meaning of services. See Dzhangar Dzhaichinov and Peter Popov, "Russia," in International Fiscal Association, *Cahiers de droit fiscal international* 2012, supra note 3, 579-91 at 502.

have judicial or administrative pronouncements concerning the meaning of services. In general, the meaning is quite broad and includes a wide range of activities performed by one person for the benefit of another person in consideration for a fee.[18]

Where countries have special rules for particular types of services, there are often definitions for those types of services. For example, several countries treat income from professional and other independent services differently from other services. Article 14(2) of the UN Model provides a definition of professional services to include "independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

Under the domestic laws and tax treaties of some countries, it is often necessary to distinguish between payments for services and other types of payments such as royalties, payments for leasing of industrial, commercial or scientific equipment and payments for know-how.[19] Distinguishing between these types of payments is especially difficult where services and other transfers are made under so-called mixed contracts and where services are provided as an ancillary and subsidiary aspect of a transfer of intellectual property, a lease of equipment or supply of know-how. In some situations, intangible property such as know-how may be transferred to a related entity in a low-tax country through the provision of services or the secondment of highly skilled employees.[20]

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The International Fiscal Association, *Cahiers de droit fiscal international* 2012 is referred hereafter as "IFA, Enterprise Services 2012."

[18] See for example Sandra Benedetto and Liselott Kana, "Chile," IFA, Enterprise Services 2012, 191-208 at 195, Sergio André Rocha, "Brazil," IFA, Enterprise Services 2012, 155-167 at 158, Roderigo Castillo Cottin and Ronald Evans Maquez, "Venezuela," IFA, Enterprise Services 2012, 747-59 at 749.

[19] For example, only certain payments, such as royalties, may be subject to withholding tax.

[20] See Pickering, General Report, supra note 3, at 28-29. Countries usually deal with this issue through the application of their transfer pricing rules.

Countries take different positions with respect to whether automated activities, such as the provision of access to a database, online gaming or gambling and communications, are treated as services, royalties or other income.[21] Some countries take the position that services must involve activities performed by individuals while other countries do not consider intervention by individuals to be necessary.

Several countries, particularly in Europe, provide a threshold requirement for the taxation of income from certain services derived by nonresidents.[22] Typically, the threshold is similar to the PE and fixed base requirements in the UN Model, although the domestic concepts are often broader than the treaty concepts. Alternatively, some countries (for example, Mexico) use a simple time threshold. The threshold requirement may apply only to certain types of services.

In several South American counties, the concept of a PE is used not as a minimum threshold requirement for the taxation of nonresidents, but as a means of determining whether income from services is taxable on a net or gross basis.[23] In general, if a nonresident earns income from services attributable to a PE in the source country, the income is taxable on a net basis; otherwise, it is subject to a gross withholding tax. In some countries, any income derived by nonresidents from those countries is subject to tax

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21 See South Africa, IFA, Enterprise Services 2012, at 660.

22 See, for example, Ukraine, IFA, Enterprise Services 2012, at 687; Russia, IFA, Enterprise Services 2012, at 503-84; Mexico, IFA, Enterprise Services 2012, at 482; and Hungary, IFA, Enterprise Services 2012, at 341.

23 See, for example, Venezuela, IFA, Enterprise Services 2012, at 748 and 751; Uruguay, IFA, Enterprise Services 2012, at 735 and 750; South Africa, IFA, Enterprise Services 2012, at 601; Peru, IFA, Enterprise Services 2012, at 547; India, IFA, Enterprise Services 2012, at 353; Czech Republic, IFA, Enterprise Services 2012, at 254-55; Colombia, IFA, Enterprise Services 2012, at 231-2 and 238; Chinese Taipei, IFA, Enterprise Services 2012, at 193-94; and Argentina, IFA, Enterprise Services 2012, at 65-66.

without any minimum threshold requirement except as provided pursuant to an applicable tax treaty.[24]

There is considerable variation in the rules used by developing countries to determine the geographical source of income from services. Some countries have detailed statutory rules, while other countries have only judicial or administrative rules that are vague and uncertain. All counties treat income from services that are physically performed in the country as domestic source income. However, several counties also subject income from services derived by a nonresident to domestic tax even if the services are performed outside the country, in the following circumstances:

- the services are performed in connection with or through a PE in the country;
- the services are used or consumed in the country;[25] and
- payments for services are deductible by residents of that country or by nonresidents with a PE in the country.[26]

These rules under which income from services performed outside the country is subject to domestic tax often apply only to certain services such as professional services, remuneration of directors and top-level officials of resident corporations and technical services. In addition, special source rules apply to international transportation services and insurance. Income from international transportation services and insurance premiums are generally subject to domestic tax if cargo or passengers are taken on board in the country or if the insured risk is located in the country respectively.

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[24] See, for example, Sri Lanka, IFA, Enterprise Services 2012, at 647; South Africa, IFA, Enterprise Services 2012, at 595; and Brazil, at 156-57.

[25] Colombia, India, Peru, Ukraine, Uruguay, and Venezuela. In Peru, income from technical assistance and digital services are sourced in Peru if they are "economically utilized" in Peru, and such services are economically utilized in Peru if the recipient of the services deducts the payment for the services in computing its income subject to Peruvian tax.

[26] Brazil, Chile, Colombia, Czech Republic, India, and Peru.

Peru has a special deeming rule that applies to apportion the gross income derived by a nonresident between Peruvian and foreign sources where services are performed partly inside and partly outside Peru.[27] For example, 1 percent of gross income from transportation activities beginning or ending in Peru is deemed to be derived from Peru and is subject to a 30 percent withholding tax.

With respect to the rules for the computation of income from services derived by nonresidents that is subject to tax by source countries, the critical issue is whether the source country tax is imposed on a gross or net basis. If the tax is imposed by way of a final withholding tax on the gross payments to nonresidents, no computational rules are necessary. The withholding tax is generally imposed at the time the amount is paid (or shortly thereafter) on the full amount paid without the deduction of any expenses incurred in earning the income. If the tax is imposed on the net income earned by nonresidents, generally the same computational rules (amounts deductible, timing, etc.) apply that apply to business income earned by residents of that country. However, several South American countries as well as India impose tax on a presumptive amount of income derived by nonresidents.[28] The presumed amount is a percentage of the amount of gross payment to the nonresident. The justification for this presumptive tax base is to provide some standard relief for the expenses that might typically be incurred by nonresidents in providing the services. The presumptive tax base eliminates the need for taxpayers to keep track of their actual expenses and for the tax authorities to verify those expenses. The same result can be achieved – although not as transparently – by reducing the rate of

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[27] Peru, IFA Enterprise Services 2012, at 548.

[28] Argentina and Uruguay are the countries that use this presumptive income approach. See Argentina, IFA, Enterprise Services 2012, at and Uruguay, IFA, Enterprise Services 2012, at 739. The approach is also used in several other countries (Peru, Venezuela and India) although it is applied to a narrower range of payments for services. For example, in India nonresidents providing construction, air transportation, shipping, prospecting or extraction of oil services are taxable on 10, 5, 7.5, and 10 percent of the amounts receivable for such services.

withholding tax so that the tax imposed approximates the tax that would be payable if a nonresident's actual net income were taxable at the ordinarily applicable rates.

Although many developed countries provide an election for nonresidents to pay tax on a net basis with respect to certain income from services, developing countries do not generally provide such an election due to inadequate administrative resources.[29] Similarly, few developing countries, India is an exception,[30] use a non-final withholding tax as a collection device for taxes on income from services derived by nonresidents. Such a non-final withholding tax is creditable against the tax payable by the nonresidents on a net basis when they file their tax returns and any excess withholding tax is refundable at that time. Non-final withholding taxes impose compliance burdens on taxpayers to file returns and resident payers to withhold as well as administrative burdens on the tax officials to assess tax returns and refund any amounts withheld in excess of the tax payable.

In some countries the withholding tax is used as a means of policing the deduction of payments to nonresidents for services. Such payments may not be deductible unless tax is withheld or the payer provides the tax authorities with prescribed information concerning the nonresident and the payment.[31]

Final gross basis withholding taxes on payments for services are often restricted to certain types of services such as entertainment, international transportation, insurance professional services and technical services.

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[29] Uruguay provides an election for corporations earning income from transportation, films and television and international news. See Uruguay, IFA, Enterprise Services 2012, at 739.

[30] India, IFA, Enterprise Services 2012, at 362-63.

[31] Pickering, General Report, supra note 3, at 35.

The rates of final withholding taxes on income from services vary considerably from country to country depending on the type of services. Rates are generally low (5-10 percent) on payments for international transportation but can be as high as 35 percent in some South American countries. The most common rate appears to be 15 percent.[32] As noted above, in some countries a relatively high rate of withholding tax is applied to a percentage of the relevant payment for services. For example, in Venezuela only one-half of the gross amount of payments for technical services is subject to tax at the rate of 34 percent resulting in an effective tax rate of 17 percent.[33] Argentina uses this presumptive approach for most types of income subject to the nominal rate of withholding tax of 35 percent. Since varying percentages of income are subject to tax, the effective tax rates range from 12.5 percent to 31.5 percent.[34]

India applies a general withholding tax rate of 10 percent although the rate increases to 20 percent if the nonresident service provider does not have a taxpayer identification number. Brazil and Venezuela apply an increased rate of withholding tax on payments for services made to residents of listed low-tax jurisdictions.

## AN OVERVIEW OF THE PROVISIONS OF THE UN MODEL DEALING WITH INCOME FROM SERVICES

### Introduction

This section of the paper contains a brief description of all of the provisions of the UN Model that deal with income from services.[35] The purpose of this overview is to

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[32] See the Czech Republic, South Africa, Chile (for technical services), and Brazil.

[33] See Venezuela, IFA, Enterprise Services 2012, at .

[34] See Argentina, IFA, Enterprise Services 2012, at .

[35] The material is this section of the paper is based on Brian J. Arnold, The Taxation of Income from services under Tax Treaties: Cleaning Up the Mess – Expanded

provide sufficient background information about the provisions to allow the identification of those provisions that potentially permit the erosion of the tax base of developing countries. The identification of the provisions that are problematic in this regard is essential in order to properly target any potential responses to the problems.

**Business Profits Derived from Services Provided by Enterprises: Articles 5 and 7**

Under Article 7 of the UN Model, income from services provided in a contracting state (the source country) by an enterprise resident in the other contracting state may be taxed in the source country only if the enterprise carries on business in the source country through a permanent establishment (PE) in the source country. If the enterprise carries on business through a PE in the source country, that country is entitled to tax the profits that are attributable to the PE and also certain other profits that are similar to those earned from the activities carried on through the PE. This limited force of attraction rule allows the source country to also tax profits derived from sales of goods and merchandise and from other business activities similar to those made or carried on through the PE if the sales or activities take place in the source country. This limited force of attraction rule is included in only about 10 percent of all bilateral tax treaties. It is intended to function as an anti-avoidance rule.

The determination of the profits attributable to a PE is made on the basis of two important assumptions under Article 7(2):

- the PE is a separate entity engaged in the same activities under the same conditions; and
- the PE deals independently with the other parts of the enterprise of which it is a part.

These principles effectively ensure that the profits attributable to a PE are determined in accordance with the arm's length principle that applies under Article 9 of the UN Model to transactions between related or associated enterprises. Article 7(3) of the UN Model requires that any expenses incurred by an enterprise for the purposes of the PE are

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Version," online IBFD publications (expanded version of article published in (February 2011) Vol. 65, No. 2 *Bulletin for International Taxation*).

deductible in computting the profits of the PE irrespective of whether the expenses are incurred in the PE state or exclusively for the purposes of the PE. Article 7(3) clarifies explicitly that notional expenses or internal charges for royalties, interest or fees for services made between a PE and the head office or other parts of the enterprise are not deductible or includible in computing the profits attributable to the PE. In summary, the profits attributable to a PE under Article 7 of the UN Model are the net profits computed in accordance with the arm's length principle as if the PE were a separate entity.

In general terms, a PE is defined in Article 5(1) of the UN Model to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on. The general practice of countries is that a place of business will not be considered to be "fixed" in a temporal sense unless it lasts for a minimum of six months.[36] Accordingly, income from services derived by a non-resident enterprise from services performed in the source country are taxable by that country only if the non-resident has a fixed place of business in the source country at its disposal for a minimum of six months and the services are provided through that fixed place of business. Under Article 5(5), a non-resident enterprise is also considered to have a PE if the enterprise has a dependent agent that has and habitually exercises an authority to conclude contracts on its behalf. The dependent agent PE rule is unlikely to have much significance for service businesses.

**Construction Services**

Under Article 5(3)(a) of the UN Model, a building site, construction, assembly or installation project or supervisory activities in connection with such a site or project constitutes a PE if the site, project or activities last more than six months. It is unclear whether Article 5(3)(a) is a deeming provision or whether construction sites and projects must meet the requirements of a fixed place of business under Article 5(1).[37] However,

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[36] See paragraph 3 of the Commentary on Article 5 of the UN Model quoting paragraph 6 of the Commentary on Article 5 of the OECD Model.

[37] If Article 5(3)(a) is a deeming provision, construction activities taking place in different geographical locations would be aggregated for purpose of the six-month time threshold if they are part of the same project. However, if construction activities must meet the requirements of Article 5(1), it would be necessary to consider each place separately.

the better view is that even under the UN Model construction and other related activities must be conducted through a fixed place of business to be a PE.[38]

**Services in General**

Under Article 5(3)(b) of the UN Model, the furnishing of services by a non-resident is deemed to be a PE if the activities continue in the source country for 183 days or more in any 12-month period and take place with respect to the same or a connected project. For this purpose only days during which services are performed in the source country by the enterprise through employees or other personnel ("working days") are taken into account. Days during which employees or other personnel are merely present in the source country but are not working are not counted. Projects are considered to be connected if they have commercial coherence, which is a question of fact. If, however, projects are carried out pursuant to contracts concluded with the same person or related persons and involve the same type of work, they will ordinarily be considered to be connected especially if the same individuals perform the services under the various projects.

**Insurance**

Under Article 5(6) of the UN Model, a PE is deemed to exist where a non-resident enterprise collects insurance premiums or insures risks in the source country, unless such activities are conducted by independent agents. Article 5(6) does not require the activities to occur through a fixed place of business in the source country or for any minimum period of time. It is sufficient if the specified activities – collecting premiums – take place in the source country or if the risks that are insured are in the source country.

**Income from Shipping, Inland Waterways Transportation and Air Transportation – Article 8**

Under Article 8 of the UN Model, profits derived by an enterprise from international shipping and air transportation and inland waterways transportation are taxable

[38]. This conclusion raises the issue of whether or not Article 5(3)(b) of the UN Model is a deeming provision. In my view, Art. 5(3)(b) is clearly a deeming provision, although there is an argument that both parts of Art. 5(3) must be construed in the same manner.

exclusively by the country in which the enterprise has its place of effective management. Alternative B of Article 8 provides that profits from international shipping activities taking place in a country may be taxed in that country if the activities are more than casual. The phrase "more than casual" means scheduled stops in a country to take on cargo or passengers. For this purpose, the profits taxable by the source country are determined by allocating the enterprise's total net profits from shipping and the rate of tax on those profits is to be established through bilateral negotiations.

**Income from Independent Personal Services – Article 14**

Under Article 14 of the UN Model, income from professional services or other independent activities derived by an individual resident of one state is subject to tax by the other state (the source country) if:

(1) the individual has a fixed base in the source country that is regularly available for the purpose of performing the services, or.
(2) the individual is present in the source country for 183 days or more in the aggregate in any 12-month period.

In the first case, only the income attributable to the fixed base is taxable by the source country. Such income may include income from services performed outside the source country. In the second case, however, only income from activities performed in the source country is taxable by the source country.

Article 14 applies to professional and other independent services. Professional services are defined in Article 14(3) to include "independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

In general, a fixed base for purposes of Article 14 has the same meaning as a fixed place of business under Article 5(1) although some countries consider the two expressions to have different meanings. The computation of the profits attributable to independent personal services performed through a fixed base under Article 14 is

generally considered to be subject to the same principles as the computation of profits attributable to a PE under Article 7.[39] However, Article 14 and its Commentary do not contain detailed rules concerning the attribution of profits to a fixed base similar to the rules in Article 7 and its Commentary. If Article 14 is subject to the same principles as Article 7, the source country would be entitled to tax only the net profits derived from independent services by an individual resident of the other contracting state.

Article 14 of the OECD Model was deleted in 2000 with the result that income from services generally, i.e., other than such income dealt with in specific articles, is dealt with exclusively under Article 7. The deletion of Article 14 with several consequential changes (the most important of which is the inclusion of a provision in Article 5 equivalent to Article 14(1)(b)) is provided as an alternative in the Commentary on Article 5 of the UN Model.[40]

**Income from Employment – Article 15**

Under Article 15 of the UN Model, income from employment (dependent personal services) derived by an individual resident of one state from employment exercised in the other state may be taxed in that other state (the source country) in any one of the following three situations:

- if the employee is present in the source country for 183 days or more in any 12-month period, or
- if the employee's remuneration is paid by an employer resident in the source country, or
- if the employee's remuneration is borne by a PE or fixed base that a non-resident employer has in the source country.

Thus, if the remuneration paid to the employee is deductible by the employer in computing income for purposes of the source country's tax base (either because the

[39] As noted in paragraphs 10 and 11 of the Commentary on Article 14, some countries take the position that Article 14 permits taxation of independent services on a gross basis. This argument is based in part on the fact that Article 24(3) is expressly applicable only to a PE not to a fixed base.

[40] Paragraphs 15.1-15.26.

employer is a resident of the source country or because the employer is a non-resident with a PE or a fixed base in the source country), the remuneration derived by the employee is taxable by the source country even if the employee is present in the source country for only a very short period. In these situations, the only condition for source country tax is that the employment activities must be exercised in the source country; in other words, the employee must be present and perform the employment services in the source country. If the employee's remuneration is not paid by a resident employer or a nonresident employer with a PE or a fixed base in the source country, the source country is entitled to tax employment income derived by an individual resident in the other country only if the individual is present in the source country for more than 183 days in any 12-month period.

There are no limitations under Article 15 on the rate of tax imposed by the source country on the income from employment activities exercised in the source country.

**Directors' fees and the remuneration of top-level managerial officials – Article 16**

Under Article 16 of the UN Model, fees derived by non-resident directors and remuneration derived by non-resident top-level managers of a company resident in the source country may be taxed by the source country. The only condition for source country tax under Article 16 is that the company paying the fees or remuneration must be a resident of the source country in accordance with Article 4 of the treaty. It is not necessary for the services to be performed by the directors or managers in the source country.

**Entertainers and athletes – Article 17**

Under Article 17 of the UN Model, income derived by a resident of one contracting state from personal activities as an entertainer or sportsperson exercised in the other

contracting state (the source country) may be taxed by the source country.[41] The only condition for source country tax under Article 17 is that the entertainment or athletic activities must take place in the source country. There are no limitations on the amount of income subject to tax or the rate of tax imposed by the source country. The source country's right to tax under Article 17 also applies to any income from entertainment or athletic activities that accrues to a person other than the individual entertainer or athlete (for example, a company owned by that individual). Entertainment activities are limited to performance artists such as actors and musicians and do not include behind-the-camera personnel such as directors or visual artists. Athletic activities include traditional sports but also car racing, billiards and chess.

**Pensions and social security payments – Article 18**

Under Article 18 of the UN Model, social security payments (public pensions) are taxable exclusively by the country making the payments.[42] Private pensions are taxable exclusively by the country in which the recipient is resident under Article 18 (Alternative A) or alternatively under Article 18 (Alternative B) by both the country in which the recipient is resident and the country in which the payer of the pension is resident or has a PE. Alternative B reflects the fact that contributions to the pension plan by both the employer and the employee may have been deductible in computing the income subject to tax by the source country (in the case of a PE, only if the contributions are effectively connected with the PE). Since that country's tax base is reduced by the deductions for the pension contributions, it seems reasonable to allow that country to tax the recipient of the pension payments to offset the prior deductions. The country in which the employment services that resulted in the pension were rendered is irrelevant for purposes of both versions of Article 18.

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[41] The heading to Article 17 of the OECD Model refers to "artistes and sportsmen," while the heading to Article 17 of the UN Model refers to "artistes and sportspersons." I have used the expression "entertainers and athletes" to avoid using the non-gender neutral "sportsmen," the clumsy "sportsperson," and the archaic and possibly misleading "artiste" (because visual artists are not included).

[42] Article 18 (alternative A) (2) and (alternative B) (3).

**Income from Government Services – Article 19**

Under Article 19 of the UN Model, the right to tax salary, wages and other remuneration and pensions in respect of employment services provided by an individual to the government of a country is ordinarily allocated exclusively to the country paying the amount. However, if a government employee is a resident and a national of the other state and the services are provided in that state, the remuneration is taxable exclusively by that state. Similarly, pension payments made by a contracting state are taxable exclusively by the other state if the recipient individual is a resident and a national of the other state.[43] Article 19 does not apply to salaries and pensions paid by a contracting state in connection with a business carried on by it.[44]

**Other Income – Article 21**

Under Article 21 of the UN Model, income not dealt with in any other article is taxable exclusively by the residence country subject to a throwback rule if the taxpayer carries on business through a PE or a fixed base in the source country.[45] However, under Article 21(3), a source country is entitled to tax items of income derived by a resident of the other state if those items of income are not dealt with in another article of the treaty and arise (i.e., have their source) in the source country. Consequently, the only condition for source country taxation of other income under Article 21(3) is that the income must have its source in that country. No rules are provided in Article 21 or in the Commentary for determining the source of income.

Article 21(3) is potentially applicable to income from services although that should not frequently happen because such income will usually be dealt with in another article of

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[43] Article 19(2) of both Models.

[44] Article 19(3) of both Models.

[45] Article 21(2) of both Models. The right or property in respect of which the income is paid must be effectively connected with the PE or fixed base.

the UN Model. In some circumstances, the scope of application of the other provisions of the Model depends on the domestic laws of the source country.[46]

## PROBLEM AREAS: OPPORTUNITIES FOR THE EROSION OF THE TAX BASE OF DEVELOPING COUNTRIES THROUGH THE PROVISION OF SERVICES BY NONRESIDENTS AND POSSIBLE RESPONSES

### Introduction

In conceptual terms, the protection of a country's tax base requires coordination between the provisions of its domestic law and the provisions of its tax treaties. It may also require coordination between the treatment of the income under the domestic tax laws of the residence and source countries. The provisions of a country's domestic tax law must ensure that tax is levied effectively on any income from services derived by nonresidents that the country wants to tax and that the tax so levied can be collected efficiently. For this purpose a country must also consider the deductibility of amounts paid by residents (and nonresidents) to nonresidents for services in computing income subject to domestic tax. To the extent that such amounts are deductible they erode the domestic tax base. If the payments are subject to source country tax in the hands of the nonresident recipients of the payment, the domestic tax base will be eroded only to the extent of the difference, if any, between the reduction in tax as a result of the deduction and the tax imposed on the nonresident service provider. For example, in principle, there will be no erosion of the domestic tax base if nonresidents are subject to tax on their net income at the same rates applicable to resident taxpayers. However, the domestic tax base will be eroded if nonresident service providers are subject to a final gross basis withholding tax that is levied at a rate less than the ordinary rate applicable to resident taxpayers. For example, if the ordinary tax rate is 35 percent and the rate of withholding tax on services is 15 percent, the domestic tax base will be eroded to the extent of 20 percent of the gross amounts paid to nonresidents for services assuming, of course, that the expenses incurred by the nonresident in providing the services are nominal. The

[46] For example, Article 7 applies only if a taxpayer is carrying on a business and, as an partially defined term, the meaning of "business" must be determined under domestic law unless the context requires otherwise.

erosion of the domestic tax base is greatest where the amounts paid to nonresidents for services are deductible but the nonresident service providers are not subject to domestic tax for some reason.

In addition, the treatment of the nonresident service providers in their countries of residence must be taken into account. A nonresident enterprise may perform services in another country through a branch or PE there, through a subsidiary corporation established in that country or directly (i.e. not through a branch or PE) to residents of that country. Ordinarily, the source country will impose tax on any income from services derived by a resident subsidiary or on income earned by the nonresident through a PE or branch but may not impose tax on other income from services derived by a nonresident service provider. The country in which the enterprise is resident may tax any income from services derived by the enterprise from services, including services provided outside the country unless that country taxes on a territorial basis or is a tax haven or provides an exemption for foreign source business income earned through a PE. If the country of residence taxes the income, it will usually provide a credit for any source country tax on the income. The country of residence will not generally tax the income from services earned by a foreign subsidiary of a resident enterprise except if the CFC rules apply.

Even if the provisions of a source country's domestic law impose comprehensive taxation on income from services performed by nonresidents, the provisions of a country's tax treaties may limit that domestic tax. To the extent that there is a conflict between the provisions of domestic law and the provisions of a tax treaty, the provisions of the tax treaty will generally prevail. Based on the overviews of the provisions of the domestic law of developing countries dealing with the taxation of income from services derived by nonresidents and the provisions of the UN Model dealing with income from services, certain types of income from services, such as income from entertainment and athletic activities, directors' fees and remuneration of top-level managerial officials, insurance and certain employment income, do not raise serious concerns about base erosion or profit shifting. However, business profits from services and income from independent services, including income from technical, management and consulting services, are taxable by the source country only if the income is earned through a PE or

fixed base and only if the income is attributable to the PE or fixed base or the services are performed in the source country.

In this part of the paper, various types of services are examined to determine whether they provide serious opportunities for multinational enterprises to erode the tax base of developing countries and what actions developing countries might take to protect their tax base.

**Employment Income**

Most countries, both developed and developing, tax employment income derived by nonresidents if the employment services are performed in the country. Employment services performed by a nonresident (including government service) outside a country are not subject to tax by that country even if the nonresident is an employee of a resident enterprise or the employment services are consumed or used by residents of the country. This general practice reflects a consensus that the source of employment income is the country in which the employee is present and performing the duties of employment. The practice is clearly justified because the income from employment exercised in a country is closely connected with that country.

The taxation of nonresidents on income from employment exercised in a source country usually applies irrespective of whether the employer is a resident or nonresident of the source country (or if the employer is a nonresident, irrespective of whether the nonresident has a PE or fixed base in the source country to which the employment is connected), irrespective of the duration of the employment in the source country or the amount of income derived and irrespective of whether the nonresident employee's remuneration is deductible by the employer against the source country's tax base.[47] In summary, under Article 15 of the UN Model a source country is prevented from taxing a

[47] These conclusions are based on Article 15 of the UN Model

nonresident on employment income only if the nonresident is employed by a nonresident employer that does not have a PE or fixed base in the source country or if it has a PE or fixed base, the employee's remuneration is not deductible in computing the profits attributable to the PE or fixed base and the nonresident employee is not present in the source country for 183 days or more in any 12-month period.

The broad scope of source country taxation of income from employment earned by nonresident employees suggests that opportunities for tax avoidance of source country tax are limited, as discussed below. It also suggests that the enforcement of source country tax on the employment income of nonresidents may be problematic in certain circumstances. Typically, income from employment is taxed on a gross basis or a quasi-gross basis, with standard deductions allowed, and the tax is collected by means of a withholding obligation imposed on employers. This collection mechanism is effective and efficient (although it places the compliance burden on the employer). However, the withholding obligation on the employer can be effectively enforced only if the employer is a resident or a nonresident with a PE or fixed base in the source country. Where the employee is employed by a nonresident employer without a PE or fixed base in the source country, it is difficult for the source country to enforce its tax on the nonresident employee, especially if the employee is present in the source country for a short period of time.

In terms of protecting the source country's tax base, perhaps the most serious concern is that a nonresident employee should be subject to tax if the employee's remuneration for employment services (performed in the source country) is deductible by the employer in computing income subject to source country tax. The employee's remuneration will usually be deductible if the employer is a resident or a nonresident carrying on business in the source country through a PE or a fixed base located in the source country. In these circumstances, the nonresident employee's income from employment should be subject

to tax and the employer is usually required to withhold the tax from the remuneration. Some countries make the employer's deduction conditional on the employer withholding tax from the employee's remuneration.

There are several ways in which a source country's tax base in respect of income from employment may be eroded. Some involve the provisions of domestic law alone; some involve the provisions of tax treaties; and some involve the provisions of both tax treaties and domestic law.

First, the source country's tax base may be eroded where a nonresident is employed by a resident employer to perform services outside the source country. Assuming that the source country taxes on a worldwide basis, the nonresident employee's remuneration will be deductible in computing the employer's worldwide income subject to tax, but the employee's remuneration will not be taxable by the source country because the employment is not exercised in the source country. An important exception under Article 16 of the UN Model may apply where directors and top-level managerial officials are involved.

Second, the tax base may be eroded where nonresident employees perform services in the source country on behalf of a nonresident employer that avoids having a PE or fixed base in the source country. In this situation Article 15(2) of the UN Model would prevent the source country from taxing the nonresident's employment income unless the employee is present in the source country for more than 183 days. If, however, the nonresident employer has a PE or fixed base in the source country, the source country would be entitled to tax not only the profits attributable to the employer's PE or fixed base, but also the employment income borne by the PE or fixed base. There are several

ways, including the use of artificial structures, in which nonresidents can avoid having a PE or fixed base in the source country.[48]

Third, a source country's tax on the employment income of a nonresident can be avoided by altering the legal status of the nonresident from employment to independent contractor. If a nonresident is employed by a resident enterprise or a nonresident enterprise with a PE or a fixed base, under Article 15 of the UN Model the source country is entitled to tax income from employment exercised by the nonresident employee in the source country. The source country's right to tax applies irrespective of the length of time spent in the source country or the amount of income earned. On the other hand, if the nonresident is an independent enterprise, Article 7 or 14 of the UN Model will limit the source country's right to tax to situations in which the nonresident has a PE or a fixed base in the source country and the income is attributable to the PE or fixed base. If a nonresident individual does not have a fixed base in the source country, the source country's tax is limited to situations in which the individual stays in the source country for 183 days or more in any 12-month period and the income is derived from activities performed in the source country.[49] The time period in Article 5(3)(b) and Article 14(1)(b) for independent contractors is similar to or longer than the time period in Article 15(2)(a) for employees.[50] Therefore, the real difference between the treatment of nonresident employees and nonresident independent contractors is that the latter may carry on activities in the source country for up to 6 months without becoming subject to source country tax, whereas employees of resident employers or nonresident employers with a PE or fixed base are taxable irrespective of how long they spend in the source country. The same distinction may exist under some countries' domestic law.

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48 See the paper on this topic in this volume by Adolfo Martin Jimenez.

49 Article 14(1)(b).

50 Under Article 5(3)(b) an enterprise must perform services in the source country for more than 183 days and only working days are counted for this purpose.

Thus, even if a nonresident service provider is taxable under the domestic law of the source country, any tax treaties entered into by the source country that are based on the UN Model or OECD Model will limit the source country's tax more severely for employees than for independent contractors. Nonresident service providers have an incentive to structure their relationships to avoid employment status.

Neither the UN Model nor the OECD Model provides a definition of employment or independent services. Article 14(2) of the UN Model provides an inclusive definition of professional services, but that definition simply refers to "independent' activities without defining what the term "independent" means. Under Article 3(2), the terms "employment" and activities of an "independent character" in the case of Article 14 or "business" in the case of Article 7, have the meanings for purposes of the treaty that they have under the domestic law of the source country unless the context requires otherwise.[51] Most countries distinguish between employment and independent services for various legal purposes, including tax.

Where a country's domestic law allows the formal contractual arrangement to be ignored and the nature of the services to be determined based on the substance of the relationship between the service provider and the customer, the provisions of the treaty will respect the application of domestic law in this regard.[52] However, according to the Commentary, the decision to disregard the formal contractual arrangements must be based on objective criteria and the Commentary provides important guidance and examples in this regard.[53] Even if the formal contractual relationship is adhered under

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[51] In this situation, the source country is the country applying the treaty.

[52] Paragraph 1 of the Commentary on Article 15 of the UN Model quoting paragraph 8.7 of the Commentary on Article 15 of the OECD Model.

[53] Paragraph 1 of the Commentary on Article 15 of the UN Model quoting paragraph 8.11-28 of the Commentary on Article 15 of the OECD Model. Important factors for this purpose are whether the services provided by the individual constitute an integral

domestic law, a contracting state may deny the benefits of the exemption in Article 15(2) in abusive cases in accordance with the Commentary on Article 1 dealing with the improper use of tax treaties.[54]

A related difficulty with the legal meaning of employment for purposes of tax treaties is the international hiring-out of labour.[55] Under this practice, international human resource agencies hire out individuals to enterprises resident in other countries. The individuals purport to be employees of the agency and the agency purports to provide services to the enterprise resident in the source country, but does not have a PE in the source country. The Commentary on Article 15 contains a provision that countries might consider including in their tax treaties to deny the exemption in Article 15(2) where the individual renders services to a person, other than the formal employer, who supervises or controls the manner in which the services are performed and the services are an integral part of the business carried on by that person.[56]

The provisions of Article 15 of the UN Model dealing with employment income do not apply if the provisions of Articles 16, 17, 18 or 19 apply. With the possible exception of Article 17 dealing with entertainment and athletic services, which is analyzed separately below, these Articles do not raise any serious concerns about base erosion or profit shifting.

Government Service

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part of the employer's business and who bears responsibility for the results of the individual's work.

[54] Paragraph 1 of the Commentary on Article 15 of the UN Model quoting paragraph 8.8 of the Commentary on Article 15 of the OECD Model.

[55] Paragraph 1 of the Commentary on Article 15, quoting paragraphs 8.1 – 8.3 of the Commentary on Article 15 of the OECD Model.

[56] Paragraph 8.3 of the Commentary on Article 15.

Under Article 19, income from government services, including pensions, is generally taxable by the country that pays the remuneration, so there is no erosion of that country's tax base assuming that the country actually taxes the income. Article 19 applies only to nonresident individuals employed by the government of the source country; it does not apply to nonresidents providing independent services to the government. Accordingly, the same issues with respect to the distinction between employment and independent or business services also applies to nonresidents providing services to the government. However, since the legal relationship is with the government, the opportunities for tax avoidance are limited. The only circumstance in which the government paying the employee or former employee is not entitled to tax the income is if the employee is a resident and national of the other country and the services are performed in that country. Therefore, with respect to income from government service, the source country simply has to ensure that such payments are taxable under its domestic law in order to protect its domestic tax base.

Directors' Fees and Remuneration of Top-Level Managerial Officials

With respect to the remuneration of directors and top-level managerial officials, under Article 16 of the UN Model, the country in which the company paying the remuneration is resident is entitled to tax the remuneration. It is irrelevant whether the services are provided inside or outside the source country. In terms of base erosion, the resident company will likely deduct the remuneration paid to nonresident directors and senior managers. Although the remuneration is deductible in computing the company's income, that deduction may be offset by the tax on the director or top-level managerial official (assuming, of course, that the nonresident director or official is taxable on the remuneration under domestic law). Therefore, countries that wish to tax nonresident directors and senior managers of resident companies on their remuneration, irrespective of where the services are performed, must ensure that the provisions of their domestic

law impose tax in these circumstances and that any tax treaties that they enter into contain a provision comparable to Article 16 of the UN Model. Such countries must recognize however, that in the absence of a tax treaty, the imposition of tax on the remuneration of nonresident directors and senior managers of resident companies from services performed outside the country may result in double taxation. They should also recognize that, where a tax treaty applies, they give up the first right to tax directors and senior managers of companies resident in their treaty partners on their remuneration from services performed in the source countries.

Pensions

Pensions paid to nonresidents may reduce a source country's tax base because the nonresident recipients are not subject to tax and the payers of the pensions claim deductions for such payments [or pension contributions were deductible] in computing their income for source country tax purposes. Source countries that are concerned about the potential base erosion with respect to pensions should ensure that pensions paid to nonresidents by resident employers, by nonresident employers with a PE or fixed base in the source country, and by the government are subject to domestic tax. Moreover, they must ensure that any tax treaties they enter into do not limit their ability to tax such pensions (i.e., the treaties should contain Article 18 (alternative B) of the UN Model).[57]

The extent of any base-erosion issue with respect to pensions relates to the amount of pension income derived by nonresidents from prior employment services performed in a source country and must be balanced against the amount of pension income received by

[57] Article 18 of the OECD Model and Article 18 (alternative A) of the UN Model provide that pensions (other than social security payments and pensions paid by the government under Article 18 (alternative A) of the UN Model are taxable exclusively by the country in which the recipient of the pension is resident.

residents of the source country from prior employment services performed in another country. Pensions do not involve any serious tax avoidance issues.

**Entertainment and Athletic Services**

Some entertainers and athletes can make large sums of money in a short period. These entertainers and athletes may be self-employed independent contractors, employees of an entity such as a team, orchestra, or other enterprise, or employees of an entity that they control or are associated with. Because Article 17 of the UN Model applies to both employees, independent contractors and enterprises, income derived by nonresidents from entertainment and athletic activities are discussed separately from employment income and business profits from services.

Developing countries that wish to tax income derived by nonresident entertainers and athletes must ensure that the provisions of their domestic law and tax treaties allow them to tax such income irrespective of the legal structure of the arrangements. It is generally accepted that a country in which entertainment and athletic activities are performed has the first right to tax such income. This right to tax is justified by practical considerations rather than concern about the protection of the tax base. Often the source of the income is generated from ticket sales to consumers, which will not be deductible in computing the source country's tax base. Nevertheless, the source country supplies the market for the entertainment or athletic event and the income-earning activities are performed there.

Despite the general acknowledgement that the country in which entertainment and sports activities take place has the first right to tax the income from such activities, developing countries face serious challenges to tax such income effectively. First, domestic law must impose tax on income derived by nonresident entertainers and athletes from activities performed in the country irrespective of how long the activities continue. For this purpose, the source country tax is generally imposed on the gross amount paid to

the nonresident entertainer or athlete and collected by way of a withholding obligation imposed on the promoter of the event. Some countries may allow the nonresident to file a return and pay tax on the net income; however, this requires a commitment of administrative resources to assess returns and make refunds of excessive tax paid if appropriate. Countries must give careful consideration to the type of entertainment and athletic activities that are subject to tax; for example, it may be appropriate to exempt entertainment and athletic activities of a cultural nature or activities that do not generate much income. Countries must also carefully consider the rate of withholding tax, especially if a final withholding tax is used. Second, they must have an information-gathering mechanism to identify when and where entertainment and sporting events are taking place in their country. Third, they must have an effective tax collection mechanism to enforce the tax liability on nonresident entertainers and athletes.

Countries must also have provisions in place to deal with techniques used by nonresident entertainers and athletes to avoid source country tax. Common avoidance schemes in this regard involve the assignment of income by a nonresident entertainer or athlete to another person, usually related to the taxpayer, or the use of an entity of which the nonresident entertainer or athlete is a shareholder and employee. An example of the latter scheme might operate as follows:

- the entertainer or athlete owns all or a majority of the shares of a corporation that enters into contractual arrangements with the promoter of an event;
- the contractual arrangements require the corporation to provide the services of the entertainer or athlete;
- the entertainer or athlete has an employment contract with the corporation under which the employee's salary is modest, a small percentage of the total gross revenue derived by the corporation from the event.

In the absence of special domestic rules, the tax consequences of such an arrangement would be that the salary derived by the nonresident entertainer or athlete would be subject

to source country tax because the employment is exercised in the source country. If the source country has entered into tax treaties based on the UN or OECD Models, Article 17 of those treaties would not limit the source country's ability to tax because the entertainment or sports activities are performed in the source country. However, the source country might not be able to tax the income derived by the corporate employer of the entertainer or athlete under the provisions of domestic law or under any applicable tax treaties because the employer does not have a PE in the source country. Therefore, the source country must have rules in its domestic law to allow the taxation of any income derived from employment or athletic activities performed in the country irrespective of whether the income is derived by the entertainer or athlete or by some other person such as a related entity. The source country must also ensure that its treaties contain a provision comparable to Article 17(2) of the UN Model.

**Business, Professional and Other Independent Services**

This section of the paper deals with income from business services, including professional and other independent services, with the exception of entertainment and athletic services which are discussed in the preceding section. The section begins with a discussion of business services in general followed by a discussion of several specific types of services: construction, international shipping and air transportation, insurance and technical services.

As noted above, under their domestic laws developing countries generally tax business, professional and other independent services provided by nonresidents if the services are physically performed in the country. Some countries tax income derived by a nonresident from such services only if they are performed through a PE or fixed base in the country. These countries have generally aligned the provisions of their domestic law with the provisions of their tax treaties.

However, for many other developing countries, the taxation of income from business, professional and other independent services derived by nonresidents under domestic law is significantly different from the taxation of such income allowed under the provisions of the UN Model. Many of these countries also tax income from such services under their domestic law if the services are consumed or used in the source country or the payments for the services are deductible against the country's tax base by a resident payer or a nonresident payer with a PE or fixed base in the country. Moreover, several countries tax income from such services on a gross basis unless the nonresident service provider has a PE or fixed base in the country. Under the provisions of Articles 7 and 14 of the UN Model, a nonresident service provider is taxable exclusively by the country in which he, she or it is resident unless the services are provided through a PE or fixed base in the source country or, in the case of professional and other independent services provided by an individual, the individual stays in the source country for at least 183 days in any 12-month period. If the source country is entitled to tax income from services derived by a nonresident service provider under Article 7 or Article 14, it is entitled to tax any income "attributable" to the PE or fixed base. Such income may include income earned outside the source country (foreign source income) as long as it is attributable to the PE or fixed base. However, the consumption or use of services in the source country and the deduction against the source country's tax base of the payments for services to nonresidents is insufficient to justify taxation by the source country under the provisions of the UN Model. In effect, the source country's entitlement to tax under Article 7 or Article 14 is subordinated to the residence country's right to tax unless a substantial minimum threshold requirement (PE or fixed base or 183 days of presence) is met. Moreover, even if the conditions of Article 7 or Article 14 for taxation by a source country are met, the source country must impose tax on a net basis.[58] As a result, if a

[58] Not all countries agree that net-basis taxation is required under Article 14.

country taxes nonresident service providers on a gross basis, it will be required under any tax treaties to allow nonresidents to file tax returns, claim deductions for any expenses incurred in earning the income and pay tax only on their net income.

Therefore, developing countries that tax income from services derived by nonresidents significantly differently from the provisions of Articles 7 and 14 of the UN Model should consider whether they wish to limit their taxing rights by entering into tax treaties.

The tax base of developing countries can be eroded through the performance of services by nonresidents in two major ways. First, if a nonresident service provider does not have any PE or fixed base in the developing country, any income from services may not be taxable by the developing country under its domestic law or under the provisions of an applicable tax treaty. Moreover, even if the nonresident service provider has a PE or fixed base in the developing country, that country may be unable to tax income from services that is not attributable to the PE or fixed base. Second, if the services are provided outside the developing country but are deductible in computing the payer's income for purposes of the developing country's tax, the developing country may be unable to tax the income under its domestic law or under the provisions of an applicable tax treaty. If the nonresident service provider has a PE or fixed base in the developing country, the income attributable to the PE or fixed base under the provisions of Article 7 or 14 of the UN Model may include foreign source income if, for example, the remuneration of the employees performing the services is deductible in computing the profits of the PE or fixed base. Nevertheless, unless the domestic law of the developing country includes such foreign source income in the income of a nonresident, the fact that an applicable tax treaty allows the country to tax will be of no effect.

There are several ways in which taxpayers can structure their affairs to avoid having a PE or fixed base in a country. In some situations nonresident service providers can provide services in a developing country at various locations in the country without any one place being used for more than 6 months. Or a nonresident service provider may attempt to avoid having a PE or fixed base by using the fixed place of business of a client or a related enterprise. Although the Commentary on Article 5 of the UN Model indicates that a PE may exist in this situation,[59] it is necessary for the tax administration of the developing country to have the necessary information gathering resources to discover the facts required to assess tax. In other situations a nonresident can avoid having a PE or fixed base by fragmenting its activities among related enterprises. Some of these situations can be dealt with by anti-avoidance rules in domestic law or by the inclusion of specific anti-avoidance rules in tax treaties.

To avoid having a PE under Article 5(3)(b) of the UN Model, a nonresident service provider may simply limit its service activities in the source country to a period or periods of less than 183 days in any 12-month period. Thus, a multinational enterprise with a group company carrying on business in a developing country may use another group company resident in a low-tax country to provide various services to the company in the developing country. These services, which often include legal, accounting, management and technical services,[60] may not require employees of the nonresident service provider to be present in the developing country for long periods of time. It is difficult for developing countries to counteract this type of tax planning even with effective anti-avoidance rules in place. Some countries have insisted on a shorter period than 183 days to minimize the limitation on their ability to tax. A nonresident can also

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[59] Paragraph 3 of the Commentary on Article 5 of the UN Model quoting paragraph 4 of the Commentary on Article 5 of the OECD Model.

[60] The treatment of technical services is discussed in more detail below.

avoid having a PE under Article 5(3)(b) by using related nonresident enterprises to carry out connected projects. Under Article 5(3)(b) any services performed for the same or a connected project are aggregated for purposes of counting the number of days on which services are provided in the source country. There is no rule, however, to take into account services provided by related enterprises with respect to the same or connected projects. Specific anti-avoidance rules in domestic law or tax treaties might be useful in this regard although the application of such rules requires effective information gathering by the tax administration of the developing country.

Construction

Under the domestic law of most developing countries, construction activities conducted by a nonresident in the developing country are usually subject to tax by that country although in some countries they may be taxable only if they last for a minimum period of time. Under Article 5(3)(a) of the UN Model, a source country is entitled to tax income from construction activities in the source country only if they last for 6 months or more and are related to a single project. Thus, nonresident construction companies can avoid having a PE in a developing country by fragmenting a project into multiple projects that last less than 6 months or by having the projects carried out by different related entities. Some developing countries have negotiated a shorter time threshold for construction projects in their tax treaties. Anti-avoidance rules in domestic law or tax treaties might be useful in counteracting other strategies for avoiding PE status.

Insurance

Income from insurance services provided by nonresident insurance companies does not provide serious opportunities for the erosion of the tax base of developing countries. Under Article 5(6) of the UN Model, if a non-resident enterprise collects insurance premiums or insures risks in the source country, a PE is deemed to exist unless such

activities are conducted by independent agents. Therefore, assuming that a developing country has provisions in its domestic law allowing it to tax nonresident insurance companies that collect premiums or insure risks in the source country and that any treaties it enters into contain a provision similar to Article 5(6) of the UN Model, the potential for base erosion will be quite limited.

International Shipping and Air Transportation

In general, profits from international shipping and air transportation are earned outside any particular country's territory. As a result, the imposition of tax on such profits is difficult for any country other that the country in which the enterprise is resident or is effectively managed. For this reason, under Article 8 of both of the UN and the OECD Models the exclusive right to tax such income is given to the country in which the enterprise has its place of effective management. Article 8(2) (alternative B) of the UN Model allows a country to tax shipping activities (not air transportation) within the country if those activities are more than casual. The tax must be levied on a net basis.

International shipping and air transportation services present problems of base erosion for developing countries where the profits derived by nonresidents from such activities are not subject to tax by developing countries and where the payments made for such services are deductible by the payers for purposes of developing country tax. Some developing countries impose a low-rate, gross-based withholding tax on income from international shipping and air transportation derived by nonresidents from goods or passengers taken on board in the developing country. Developing countries that wish to tax such income must carefully consider whether to include in their tax treaties a provision similar to Article 8 (alternative A) of the UN Model because that provision will preclude source country tax completely or Article 8 (alternative B) because that provision

will limit source country tax to shipping and air transportation activities in the source country that are more than casual and require net basis taxation.

**Fees for Technical Services**

Introduction

The UN Committee of Experts has been working since 2008 on the provisions of the UN Model dealing with the taxation of income from services, including income from technical, managerial, consulting and other similar services (referred to here for convenience as "technical services").[61] A Subcommittee on the Taxation of Services with Ms. Liselott Kana of Chile as chair was established in 2009. Over the course of the next few years the Committee and the Subcommittee continued to discuss the taxation of services. They examined a report by the IBFD on the provisions of recent tax treaties dealing with income from services[62] and papers by this author analyzing the provisions of the UN Model dealing with services and identifying options for change.[63] In 2011 at its Eighth Session the Committee decided to work on the taxation of fees for technical services as a matter of priority. In 2012 at the Ninth Session the Committee examined and debated a wide-ranging list of options to deal with income from technical services and decided to proceed with work on a new article covering such income to be added to the UN Model. In 2013 at its Tenth Session the Committee discussed three options concerning the scope of a new article dealing with income from technical services:

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61 See Secretarial Note - Recent Work of the Committee on Tax Treatment of Services, 11 October 2013, E/C.18/2013/CRP.17 available at www.**un**.org/esa/ffd/**tax.**

62 W. Wijnen, J. de Goede and A. Alessi, The Treatment of Services in Tax Treaties, 66 Bulletin for International Taxation 1 (2012)

63 See Brian J. Arnold, Taxation of Services, E/C.18/2010/CRP.7 and E/c.18/2010/CRP.7/Add.1; Brian J. Arnold, Note on the Taxation of Fees for Technical and Other Services under the United Nations Model Convention, E/C.18/2012/4 available at www.**un**.org/esa/ffd/**tax.**.

- Option 1: a broad provision applicable to services performed inside and outside the source country, no threshold for source country taxation and taxation on a gross basis,

- Option 2: a provision applicable only to services rendered in the source country with no threshold and taxation on a gross basis at a limited rate,

- Option 3: a narrow provision restricted to services performed in the source country with a time threshold for source country tax and taxation on a net basis).[64]

A majority of the Committee decided to proceed with the drafting of the wording for a new article and Commentary along the lines of Option 1.[65]

The Treatment of Technical Services Under Domestic Law

As discussed above, some developing countries have special rules in their domestic law and tax treaties for income from technical services. One basic difficulty with these rules is that the types of services to which the rules apply are often not defined precisely. Some countries distinguish between technical assistance which generally involves a transfer of know-how or technical expertise (analogous to the transfer of the right to use intellectual property) and technical services which involve the application of specialized knowledge or skills.

The definition of technical services is similarly problematic under the provisions of tax treaties. According to an IBFD study in 2011, 134 of 1600 bilateral tax treaties

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[64] See Brian J. Arnold, Note on a New Article of the UN Model Convention Dealing with the Taxation of Fees for Technical and Other Services, E/C.18/2013/CRP.5 available at www.un.org/esa/ffd/tax.

[65] Committee of Experts, Report on the Tenth Session, 21-25 October 2013, E?2013?45-E/C.18/2013/6 available at www.un.org/esa/ffd/tax.

concluded in the period 1997-2012 contained a special provision dealing with "managerial, technical and consulting services" without defining such services. Some countries, such as India, extend Article 12 dealing with royalties to include payments for services that are ancillary or subsidiary to the application of the intellectual property or that make available technical knowledge, skill, know-how or processes or that involve the development of a technical plan or design.

The distinction between technical services and professional and business services that involve technical expertise is unclear. For example, engineering services would often be considered technical services; however, the independent activities of engineers are included in the definition of "professional services" for purposes of Article 14 of the UN Model.[66] Thus, income from engineering services, at least those performed by individuals, would be taxable by a source country only if the engineer has a fixed base in that country or stays in that country for 183 days or more in any 12-month period.

The Taxation of Income from Technical Services under the Provisions of the UN Model and Bilateral Tax Treaties

Even if the provisions of a developing country's domestic law impose tax on income from technical services earned by a nonresident, the provisions of an applicable tax treaty may limit that tax. This section of the paper provides a brief review of the provisions of the UN Model potentially applicable to income from technical services and an overview of the provisions dealing with income from technical services that some developing countries have included in some of their tax treaties.

The current UN Model does not contain any specific provisions dealing with income technical services provided by a resident of one state in the other contracting state or to a

[66] Article 14(2).

resident of the other contracting state. In general, income from business services is covered by Article 7 or 14. Under Article 7(1) a country is entitled to tax a nonresident's business profits only if the nonresident carries on business in the country through a PE. A PE is defined in Article 5 to be a fixed place of business which lasts for a minimum period of 6 months and a nonresident is deemed to have a PE in the source country if it furnishes services in the source country for more than 183 days in any 12-month period in respect of the same or connected projects. The fixed place of business rule is easily avoided by some nonresident service providers by moving from place to place before the 6 month threshold is met. Under Article 14 of the UN Model income derived by a nonresident from professional or other independent services performed in the source country is taxable by the other state only if the income is attributable to a fixed base in that country that is regularly available to the nonresident or if the nonresident is present in the source country for 183 days or more in any 12-month period. It is generally accepted that the source country must tax income under Article 7 or 14 on a net basis.

Article 12 of the UN Model dealing with royalties does not apply to fees for technical services because the definition of royalties in Article 12(3) is limited to payments for the use of, or the right to use, intellectual property, equipment or information. However, according to the Commentary, Article 12 could apply to services under a mixed contract if the services are "of an ancillary and largely unimportant character."[67]

Finally, income from technical services may be taxable under Article 21 (Other Income) of the UN Model if the income is not considered to be income from carrying on business or from professional or independent personal services under domestic law. As a result, such income is other income that is taxable by a source country if the income arises in the source country in accordance with Article 21(3) of the UN Model. There is no limit on source country taxation of other income under Article 21(3) of the UN Model

[67] Paragraph 12 of the Commentary on Article 12 of the UN Model quoting paragraph 11 of the Commentary on Article 12 of the OECD Model.

so that such tax may be imposed as a flat rate withholding tax on the gross amount of the payment. There is no threshold requirement for source country taxation of other income under Article 21(3) unlike income covered by Article 7 or 14. All that is necessary is that the income arises (has its source) in the source country.[68]

This overview of the provisions of the UN Model that are potentially applicable to income from technical services shows that it is relatively easy for a nonresident enterprise to avoid source country tax on such income especially where the services are provided to a related enterprise resident in the source country. As long as the nonresident service provider does not have a PE or fixed base in the source country or stay in the source country for more than 183 days, the income is not taxable by the source country under Article 7 or 14. The income could be covered by Article 21 if it is not considered to be dealt with by Article 7 or 14; however, in most situations income from technical services would be considered to be business profits or income from professional or independent services so that Article 21 would not apply.

This result is problematic from the perspective of base erosion because the payments for the technical services are ordinarily deductible in computing the income of the person to whom the services are provided (i.e. either a resident of the source country or a nonresident with a PE or a fixed base in the source country). Although the payments erode the source country's tax base, they are not taxable by the source country in the hands of the nonresident service provider. As a result, multinational enterprises can use technical services to strip the profits of subsidiaries resident in developing countries. Often the group company providing the technical services will be resident in a low-tax

[68] No rules are provided in Article 21 for determining the source of income so that it would likely be necessary to have recourse to domestic law for this purpose. Although the general source rule for income from services under the Models is the place where the services are performed, some countries consider income from services to be sourced where the services are used or where the payer is resident. Such a domestic source rule for income from services is inappropriate in the context of Art. 21(3) of the UN Model.

country so that the tax savings from the deduction of the payments in the source country will significantly exceed the tax on the payments to the nonresident service provider.

The erosion of the source country's tax base by payments for technical services and the inability of the source country to tax such payments has led some countries to add specific provisions to their domestic laws and their tax treaties to allow them to tax payments for technical services on a gross basis.[69] As noted above, the 2011 survey by the IBFD found that 134 of the 1600 tax treaties concluded between 1997 and 2011 contained a separate article dealing with fees for technical services.[70] Several other treaties extended the provisions of Article 12 dealing with royalties to include certain technical services. Under the separate articles, income from technical services are treated like royalties. Source country tax is allowed on a gross basis at a fixed rate that varies; sometimes the rate is higher than the rate on royalties and sometimes lower. Typically, source country tax is limited to fees for technical services "arising" in the source country which usually means that the services must be performed in the source country. As noted above, typically these separate articles dealing with fees for technical services refer to "managerial, technical or consultancy services" without defining that expression.

In general, business profits and income from professional and independent services are taxable under the provisions of the UN Model only if the nonresident service provider has a PE or fixed base in the source country and are taxable on a net basis. Notwithstanding this general pattern, there seems to be widespread recognition that source countries should be entitled to tax interest, royalties and fees for technical services that constitute business profits, even in the absence of a PE or a fixed base, probably because these payments reduce the source country's tax base. This recognition is supported by the decision of the UN Committee of Expert's decision to work on a new

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[69] In some cases, the definition of royalties is amended to include technical fees; in other cases, a separate article dealing with technical fees is added to a tax treaty. See S.B. Law, "Technical Service Fees in Recent Treaties", *Bulletin for International Taxation* 5 (2010), pp. 250-52.

[70] Supra note 62.

article to allow source countries to tax income from technical services on a basis similar to the taxation of royalties (i.e. on a gross basis at a limited rate without any threshold requirement even if the services are provided outside the source country). If a new article with these features is added to the UN Model and developing countries are successful in negotiating the inclusion of the new article in their tax treaties, such countries will be able to tax income from technical services earned by nonresidents and protect their domestic tax base from erosion through payments for technical services. Although payments for technical services to nonresidents by residents of a developing country or nonresidents with a PE or a fixed base in the developing country will be deductible against that country's tax base, it will be entitled to tax such payments. Practically, however, there are several obstacles for developing countries to overcome in order to effectively tax income from technical services derived by nonresidents:

- The provisions of domestic law must allow the taxation of income from technical services derived by nonresident service providers;
- Developing countries must successfully negotiate the inclusion a new technical services article in their tax treaties which may be difficult since developed countries may be reluctant to agree to the inclusion of the new article without significant concessions on other issues;
- The rate of tax may be excessive and discourage investment;
- Taxation on services provided outside the source country may result in unrelieved multiple taxation since the countries in which the services are performed and in which the service provider is resident may also tax the income; and
- An efficient withholding system must be adopted to ensure that the tax imposed on nonresident service providers can be collected effectively.

## CONCLUSION

In broad general terms, situations that present base-erosion or profit-shifting problems for developing countries with respect to services involve:

1) payments to nonresidents by residents of a developing country or nonresidents with a PE or fixed base in that country that are deductible by the residents or nonresidents (in computing income attributable to the PE or fixed base) and are not taxable by the developing countries in the hands of the nonresidents;
2) income from services derived by nonresidents that should be subject to tax by developing countries, but because of deficiencies in domestic law or the provisions of an applicable tax treaty are not subject to tax; and
3) income from services derived by a resident of a developing country that is diverted or shifted to a nonresident entity controlled by or associated with the resident.

The first situation is obviously the most serious because not only is the income derived by the nonresident not taxable by developing countries, but also the payments for the services reduce their tax base. In general, this situation can be dealt with by developing countries if they tax the nonresidents on the income from services or if they deny a deduction for the payments for such services against the tax base of the developing countries.

Denying a deduction for payments for services to nonresidents by residents and nonresidents with a PE or fixed base is a draconian solution because it penalizes payers with respect to legitimate income-earning expenses. However, in certain situations in which it is difficult or impossible for developing countries to impose tax effectively on nonresident service providers, the denial of deductions might be justified as the only effective way to protect the tax base. This might be the case, for example, where the nonresident service provider is resident in a tax haven.

It should be emphasized that in these three situations base erosion and profit shifting are not problems if they result from deliberate tax policy choices made by developing countries. If a developing country decides not to tax certain income from services derived

by nonresidents as a deliberate tax policy decision or enters into a tax treaty with another country or countries in which it gives up its right to tax such income under domestic law, there can be no issue of inappropriate base erosion or profit shifting.

Base erosion and profit shifting are especially problematic with respect to services rendered by a nonresident company to a company resident in a developing country where both companies are members of a multinational group. In such situations, the payments for services will usually be deductible in computing the resident company's income subject to tax by the developing country; however, the income earned by the nonresident service provider may not be subject to tax by the developing country. Often, the group company providing the services will be resident in a low-tax country, with the result that the payment for the services is deductible against the developing country's tax base at relatively high rates but is taxed at relatively low rates, so that the tax savings from the deduction substantially exceed any tax on the income. Moreover, multinational companies have considerable flexibility to structure their affairs in a tax-efficient manner by manipulating the character of intergroup payments. In these situations, intergroup payments may be characterized as payments for services or royalties, whichever yields the best tax result. Fees from technical, management and consulting services are especially problematic.

In sum, the problems of base erosion and profit shifting with respect to income from services are complex and multifaceted. Many different types of services are involved and the legal form (for example, employment or independent contractor) in which they are provided varies.

The provisions of a developing country's domestic law and its tax treaties with respect to the taxation of income from services are both important. Moreover, the taxation of income from services should not be viewed exclusively from the perspective

of base erosion and profit shifting, or, more generally, through the lens of tax avoidance; it should be viewed in the broader context of a developing country's entire tax system and its economy as a whole. Developing countries need foreign investment and they must be cautious about adopting tax policies that discourage such investment. On the other hand, developing countries need tax revenues to fund public expenditures and this goal requires them to protect their domestic tax bases. These two goals – the need to attract or at least not to discourage foreign investment and the protection of the domestic tax base – must be carefully balanced. Simplistic solutions should probably be avoided. For example, it might be possible for a developing country to protect against base erosion and profit shifting by taxing nonresidents on all their income from services performed in the country or consumed or used in the country, or by denying the deduction of payments for services to nonresidents and by not entering into tax treaties that limit the country's right to tax income from services. Such a country might discover, however, that these tax policies are not in accordance with international practice and that they discourage nonresident service providers from performing necessary services in that country or for residents of that country.

This paper has not made any recommendations for developing countries to adopt to protect their tax bases against base erosion and profit shifting with respect to income from services. Instead, it has attempted to identify in a reasonably comprehensive fashion the ways in which the tax base of developing countries can be eroded with respect to income from services and the possible responses that developing countries might adopt in their domestic laws and their tax treaties to protect their tax bases. As a final point, it is worth noting that, in an increasingly globalized and integrated economy, the necessity for developed and developing countries to take coordinated action to deal with international tax problems is becoming more important.