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NOTE BY THE SECRETARIAT: ADDITIONAL NOTE BY MR BRIAN ARNOLD ON THE TAX TREATMENT OF SERVICES

Summary

This paper was prepared by the consultant Mr Brian Arnold in order to supplement the note prepared in relation to the work of the Subcommittee on Services on the Taxation of Services under the United Nations Model Tax Convention (E/C.18/2010/CRP.7).

In particular, this note addresses more specifically aspects of the Subcommittee's mandate, namely, the identification of "possible building blocks and potential ways to go forward." It should not necessarily be taken as reflecting the views of the Subcommittee.

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ADDITIONAL NOTE ON THE TAXATION OF SERVICES UNDER THE UNITED NATIONS MODEL TAX CONVENTION

1. Introduction

1. The purpose of this note is to supplement the note on The Taxation of Services under the United Nations Model Tax Convention (UN Model) (E/C.18/2010/CRP.7) prepared in relation to the work of the Subcommittee on Services for the sixth session of the Committee of Experts on International Cooperation in Tax Matters. In particular, this note addresses more specifically aspects of the Subcommittee's mandate, namely, the identification of "possible building blocks and potential ways to go forward."

2. Factors Involved in Source Country Taxation of Income from Services under the Provisions of the UN Model

2. Note E/C.18/2010/CRP.7 analyzed the existing provisions of the UN Model dealing with income from services and identified several factors that are used to determine under what conditions, and how, a source country is entitled to tax such income. The factors identified were as follows:

- the allocation of jurisdiction to tax income from services between the residence and source countries;
- the types of services;
- threshold requirements for source country taxation;
- income from services subject to source country taxation; and
- the method of source country taxation permitted.

Two additional factors should be added to this list: the legal capacity in which the services are performed and the identity of the client or person to whom the services are rendered.

Legal Capacity in Which Services Are Provided

3. Several articles of the UN Model apply exclusively to employees (Articles 15, 18 and 19). The term "employment" is not defined; as a result, under Article 3(2) the term has the meaning for purposes of the treaty that it has under domestic law unless the context requires a different meaning. Article 16 deals with nonresident directors and top-level managers of resident companies. The treatment of the income derived by these persons differs from the treatment accorded to nonresident employees under Article 15. Therefore, even if directors or top-level managers are also employees of the company under domestic law, the UN Model requires different treatment for any fees and remuneration derived in their capacity as directors and managers and any income derived in their capacity as employees. Only one article of the UN Model, Article 17 (Artistes

and Sportspersons), applies to both employees and independent service providers. Articles 7, 8, and 14 deal exclusively with income from business or independent services.

4. The distinction between employment services and independent services is apparently a basic feature of most countries' legal systems. An employee is generally integrated into the employer's business and is subject to the employer's control. In some circumstances, whether a taxpayer is an employee or an independent contractor is largely a matter of legal form. This is problematic because of the substantially different treatment given to employment income and business income under the UN Model: income from services of a nonresident employed by a resident employer is taxable by the source country without any threshold on a gross basis, but income from independent services is taxable on a net basis only if the nonresident has a PE or fixed base or spends a significant amount of time in the source country. The taxation of employment income on a gross basis is justified because generally employees do not incur significant expenses in earning their income.

Identity of the Person for Whom Services are Provided

5. For purposes of the provisions of the UN Model dealing with employees, directors, and top-level managers, the identity of the client – the person for whom the services are performed – is an important factor. Any remuneration or pension derived by a nonresident employee for services provided to the government of a country is taxable by that country. In contrast, services provided to a government by an independent service provider are taxable only in accordance with the conditions in Articles 7 and 14. Directors' fees and remuneration of top-level managers are subject to source country tax under Article 16 only if the payer is a company resident in the source country. In contrast, such fees and remuneration paid by other companies (for example, nonresident companies with a PE or fixed base in the source country) is taxable only in accordance with Article 14 or 15. Finally, employment income derived by a nonresident employee of a resident employer or a nonresident employer with a PE or fixed base in the source country is taxable if the employment is exercised in the source country. In contrast, employment income derived by nonresidents employed by other employers is taxable only if the employee is present in the source country for more than 183 days.

6. The identity of the client is a relevant factor in allocating taxing rights to source countries in these circumstances, possibly because of concerns about base erosion. Payments by resident companies (Article 16) and resident employers (Article 15) will ordinarily be deductible in computing the payer's income for purposes of source country tax. Payments by governments (Article 19) to nonresident employees reduce the source country's financial resources directly. Base erosion also occurs with respect to payments by residents and governments of source countries for services provided by independent nonresident service providers. However, source countries are not given the right to tax with respect to income from such independent services.

3. General Principles for the Taxation of Income from Services under the UN Model

7. Note E/C.18/2010/CRP.7 identified several general principles for the taxation of income from services by source countries that emerged from the analysis of the existing provisions of the UN Model. It was suggested in that note that these principles should guide any revisions to the provisions of the UN Model dealing with income from services. The general principles that were identified are as follows:

- source principle: source countries should be limited to taxing income from services performed in the source country;
- threshold principle: source countries should tax nonresident service providers only if their involvement in the economic life of the source country exceeds a minimum threshold;
- base erosion principle: source countries should be entitled to tax income from services derived by nonresidents if the payments are deductible by the payers against the source country's tax base;
- enforcement principle: source countries should be given taxing rights over income from services only if those rights can be enforced effectively;
- net basis taxation principle: source countries should be required to tax income from services derived by nonresidents on a net basis unless the expenses incurred in earning the income are not significant; alternatively, if gross basis tax is permitted, the rate of tax should be limited.

8. Two additional principles are relevant for the purposes of any revisions of the provisions of the UN Model dealing with income from services: the consistency principle and the nondiscrimination principle. The consistency principle suggests that all income from services derived by nonresidents should be taxable by source countries in accordance with the same rules unless there are good reasons to justify the different treatment of certain types of services. Although the consistency principle is clearly justified in theory, pragmatic considerations may require departures from that principle in order to satisfy other principles or achieve other goals. The nondiscrimination principle requires a source country to treat nonresident enterprises deriving income from services performed in the source country no less favourably than enterprises of the source country carrying on the same activities. Under Article 24 of the UN Model, nonresident service providers are entitled to protection against discrimination only if they are providing services through a PE in the source country (Article 24(3)). In theory, all nonresident service providers should be entitled to protection against discriminatory taxation by the source country. In practice, however, it is very difficult to provide such protection because nonresident service providers are not in the same circumstances as resident service providers. One of the most important features of protection against discrimination is the right to be taxed on a net basis if resident enterprises are taxable on that basis. Therefore, if the UN Model were revised to require source countries to allow nonresident service providers who are likely to incur significant expenses in earning their income to deduct their expenses, or to limit the rate of any source country tax on nonresident service providers levied on a gross basis, the need for nondiscrimination protection would be reduced considerably.

9. The general principles for the taxation of income from services under the UN Model identified above often conflict, and the difficult issue is which principle or principles should prevail with respect the treatment of any particular type of income from services. A complete discussion of these conflicts is beyond the scope of this note. An example may be useful to illustrate the problems. The source principle is probably the most fundamental principle governing the taxation of income from services by source countries. Article 16 is an exception to the source principle because it allows a source country to tax directors' fees and the remuneration of top-level managers of resident companies irrespective of where their services are performed. This exception may be justified on the basis of the base erosion principle and the enforcement principle. However, those principles are equally applicable to the remuneration derived by all nonresident employees of resident employers or nonresident employers with a PE or fixed base in the source country. Nevertheless, under Article 15, source country taxation is limited to employment activities exercised in the source country. This inconsistency is difficult to justify.

4. Future Work

10. The Subcommittee's mandate requires it to identify "some possible building blocks and potential ways to go forward." This aspect of the Subcommittee's mandate can be addressed by posing some basic questions:

- Are the existing provisions of the UN Model dealing with income from services satisfactory?
- If the existing provisions are not satisfactory, what are the major deficiencies?
- Can the provisions of the UN Model or its Commentary be revised to eliminate these deficiencies without discouraging the cross-border flow of services?
- What is the most appropriate way to advance work on revising the provisions of the UN Model and Commentary dealing with income from services?

11. First, is the status quo satisfactory? The answer to this initial question is clearly "no," for the following reasons. First, as discussed in Note E/C.18/2010/CRP.7, the existing provisions of the UN Model dealing with income from services are unacceptably inconsistent and unprincipled with respect to the conditions for source country taxation, threshold requirements, the application of the base erosion principle, and the method of source country taxation permitted. Second, the existing provisions of the UN Model allow excessive source country taxation of income from services because the tax can be levied as a fixed rate withholding tax on the gross amount received by the nonresident service provider. Although there may be no double taxation of the income in these circumstances, such excessive source country taxation likely has a negative impact on the cross-border flow of services, contrary to one of the fundamental objectives of the UN Model. Third, the existing provisions of the UN Model do not provide sufficient recognition of source country taxing rights over income from business services. The recent trend appears to be for tax treaties to recognize increased source country taxing rights with respect to income from services. This trend can be seen in the adoption by the

OECD of the alternative services PE rule in the OECD Commentary on Article 5, and in the increasing number of bilateral treaties with special provisions dealing with the source country taxation of fees for technical and other similar services. Unless the desire for increased source country taxing rights over income from services is addressed in a satisfactory way, source countries may insist on provisions in their treaties that increase their taxing rights in ways that are inappropriate and that discourage the cross-border flow of services.

12. The major deficiencies in the provisions of the UN Model dealing with income from services are identified in the previous paragraph: the existing provisions are inconsistent and unprincipled, they permit excessive source country taxation, and they do not give source countries sufficient taxing rights over income from services. These deficiencies are broad and general and do not point to any specific changes to the UN Model. However, agreement on these deficiencies is an important first step in determining specific revisions to the UN Model to address the deficiencies.

13. In theory, it is clearly possible to identify revisions to the provisions of the UN Model dealing with income from services that would make those provisions more principled and consistent, that would eliminate excessive source based taxation, and that would increase source country taxing rights with respect to income from services. Note E/C.18/2010/CRP.7 identified several specific changes that might be considered in this regard: for example, the elimination of the same-or-connected-project requirement from Article 5(3)(b) and the lowering of the threshold for source country taxation under Article 5(3)(b) to 90 or 120 days from the current 183 days. However, before such specific changes are considered, it would be desirable to discuss and get agreement on:

1. the major deficiencies in the existing provisions of the UN Model dealing with income from services,
2. the general objectives of any revisions to the UN Model,
3. the general approach to be used, and
4. the priorities to be followed.

14. Some possible general objectives are set out above: making the existing provisions of the UN Model dealing with services more principled and consistent, eliminating the possibility of excessive source country taxation of income from services, and increasing source country taxing rights over income from services. It may be difficult to obtain agreement on these precise objectives. They can be modified as necessary.

15. One possible general approach that is often adopted in revising the UN Model is an article-by-article approach. This approach is not suitable for this project because the taxation of income from services under the UN Model involves several provisions. Instead, a comprehensive approach, in which all of the provisions dealing with income from services are considered, is necessary. In this way, source country taxing rights could be reduced or limited under some articles but any reduction or limitation could be offset by increased taxing rights under other articles. In the absence of such a comprehensive

approach, major reforms are likely impossible and only minor technical changes on an article-by-article basis will be possible.

16. Another possible general approach for revising the UN Model would be to recognize that, in general, threshold requirements are the key factor for allocating taxing rights between the residence and source countries. Accordingly, any reduction in source country taxing rights under some articles in order to make them more consistent and principled would be counterbalanced by increasing source country taxing rights through a lowering of the threshold for the taxation of business services under Articles 7 and 14 (and possibly employment services under Article 15).

17. It may be appropriate to accept the existing distinction between employment and business or independent services. Breaking the project into two segments might make it more manageable. If such a division of the project is acceptable, the taxation of business services, including fees for technical and similar services, should have priority because such services are more important commercially and the existing provisions of the UN Model are more deficient in this respect than the provisions dealing with employment.

18. Once agreement has been reached on the general objectives and scope of future work on the taxation of income from services under the UN Model, the work might progress in the following order:

1. information gathering: It would be useful to get information about the treatment of income from services under actual bilateral treaties, especially more recent treaties. For example, how many treaties have special provisions allowing source country taxation of fees for technical and other similar services? This information might be collected through a survey of member countries as well as independent research of tax treaty databases.

2. identification and analysis of possible major changes to the UN Model: This stage of the work is essential to narrow the focus of the work and prepare the way for the next stage. For example, in principle Article 17 should be eliminated; however, this change is likely to be unacceptable. Once a decision is taken to retain Article 17, work could proceed on various ways in which it could be improved.

3. identification and analysis of specific changes to the UN Model and Commentary: In this regard Note E/C.18/2010/CRP.7 identified several possible amendments to the UN Model.

4. preparation of draft wording for the changes to the Model and Commentary.