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Taxation of services – including provision on taxation of fees for technical services

Secretariat Note – Recent Work of the Committee on Tax Treatment of Services

Summary

This note is an historical perspective on where the discussions on taxation of services within the Committee currently stand. It is a summary of discussions in the Committee since 2008, intended to give an overall picture, especially to the new members of the Committee. The summary reviews the discussions on the current treatment through different Articles and the potential inconsistencies that exist. This note complements separate notes by Mr. Brian Arnold (E/C.18/2013/CRP.5) and Mr. Tizhong Liao (E/C.18/2013/CRP.16).

Secretariat Note – Recent Wor

In the two papers, Mr. Arnold 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;
the method of source country taxation permitted;
the legal capacity in which the services are performed; and
the identity of the client or person to whom the services are rendered.

Mr. Arnold raised a number of key points which he considered any future work in harmonizing the treatment of services for tax purposes would need to address issues of:

consistency;
non-discrimination;
the source principle;
the threshold principle – the appropriate threshold requirement for source country taxation;
the base erosion principle;
the enforcement principle; and
the net basis taxation principle.

Mr. Arnold also addressed the particular issues related of payments made by the residents of a country to foreign residents for the provision of services supplied to the former – so-called "fees for technical services". He noted (at paragraph 89) that:

> The erosion of the source country's tax base by payments for such technical services has led some countries to add specific provisions to their treaties to allow them to tax technical fees on a gross basis. Alternatively, some countries may take the position based on their domestic law that income from technical and other similar services is not income from carrying on business or income from professional or independent personal services; 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). There is no limit on source country taxation of other income under Article 21 so that such tax may be imposed as a flat 0 Tc 0 Tw -1.5

amounts up to a ceiling, as established in Articles 11 and 12 of the UN Model. Source country tax in these situations can be justified by reference to the base erosion principle. Mr. Arnold discussed how such a result could be achieved by possible amendments to the UN Model. At paragraphs 99-100 of E/C.18/2010/CRP.7, he noted policy changes and minor drafting changes that might in his view improve the Mode, though they did not constitute firm recommendations. The suggestions were:

A. Policy changes

1) Article 5(3)(b) and Article 14(1)(b) should be replaced with a provision similar to, but broader than, the alternative services PE provision contained in the Commentary on Article 5 of the OECD Model. For those countries that decide to delete Article 14 from their treaties, the alternative services PE provision would replace Article 5(3)(b). For those countries that choose to retain Article 14, fundamental changes to that Article are the subject of a separate note prepared for the Subcommittee on Article 14. That note recommended, in substance, that Article 5(3)(b) should be moved to Article 14 and the fixed-base requirement should be deleted. Even if those recommendations are accepted, Article 14 should be further revised along the lines of the OECD alternative services provision, with modifications in accordance with other recommendations in this note (for example, the deletion of the same or a connected project requirement).

2) The adoption of a combined threshold based on both days of presence and days of work in the source country for purposes of Articles 5(3)(b), 14(1)(b), and 15(2) should be studied.

3) The adoption of a shorter time threshold (90 or 120 days) for purposes of Articles 5(3)(b), 14(1)(b), and 15(2) should be considered.

4) The same or a connected project requirement should be deleted from Article 5(3)(b).

5) The 6-month time frame threshold for construction and related activities should be changed to 183 days, and possibly be reduced to 90 or 120 days, or left up to bilateral negotiations. The possible deletion of the requirement to treat each project separately should be considered, especially if the same or a connected project requirement in Article 5(3)(b) is deleted. It might be useful to survey the provisions of existing treaties to determine how many treaties already use a threshold of less than 6 months or 183 days for construction and other activities.

6) Several changes to the provisions of Article 17 dealing with entertainment and sports activities should be considered:

    a) Article 17 could be revised to apply only to entertainment and sports activities engaged in by independent individuals or enterprises. As a result, income from such activities derived by employees would be dealt with under Article 15.

b) The scope of Article 17 could be expanded to include other high-value services.
c) A monetary threshold could be added to Article 17 in order to exclude from source country taxation taxpayers earning relatively small amounts from entertainment or sports activities performed in the source country.
d) Article 17 could be revised to require source country taxation on a net basis or, if taxation on a gross basis continues to be allowed, to limit source country tax to a fixed percentage (to be agreed on through bilateral negotiations) of the gross revenue derived from the source country.

7) The provisions of the UN Model or Commentary should be revised to permit source country taxation of income from technical and other similar services provided in the source country, especially if those services are provided by a nonresident to an associated enterprise in the source country. A first step in the work on this issue might be to canvass the existing provisions of bilateral treaties dealing explicitly with technical services. This work might be followed by a survey of country positions on various options (four of which are identified in this note) for the taxation of income from technical and other similar services.

8) If a source country is authorized by the provisions of the UN Model to tax income from services performed in the source country, that country should be required to tax the income on a net basis or, if taxation on a gross basis is allowed, the source country's tax should be limited to a fixed percentage (to be agreed on through bilateral negotiations) of the gross revenue derived. However, unlimited gross-basis taxation by a source country should be permitted in situations in which the expenses incurred in earning the income from services are negligible.

9) The Commentary on Article 18 should be revised to add alternative provisions for the source country taxation of pension payments. B. Minor changes in the wording of the existing provisions. Currently, there are several unnecessary inconsistencies in the wording of the provisions of the UN Model dealing with services. These inconsistencies should be eliminated. For example:

1. All threshold requirements based on time should be measured in days rather than months.

2. Various terms are used to refer to the performance of services: a) Article 5(3)(b) – "furnishing" b) Article 14(1) – "performing" or "performed" c) Article 19 – "rendered". All of these provisions, except perhaps Article 15, should be revised to refer to "performing" services or the "performance of" services. If the UN Model is changed in this way, the Commentary should state that the changes are not intended to alter the meaning of the provisions.

3. Article 14(1)(b) refers to a taxpayer's "stay" in the other Contracting State, whereas Article 15(2)(a) refers to the recipient's "presence" in the other

issues. Others were of the view that if that approach were followed, it would not be possible to achieve concrete results within a reasonable period of time.

It was ultimately agreed that the Committee would start with work on "fees for technical assistance" with a view to achieving concrete results for the next annual session, but it would also have a longer-term plan of work with a view to a comprehensive review of services issues for the United Nations Model Convention.

Eighth Session of the Committee (2012) – A Decision on Fees for Technical Services

At the eighth session of the Committee in 2012 the taxation of services was discussed based on a new more detailed options paper by Mr. Arnold (E/C.18/2012/4), a paper that explored in detail the specific option of adding a new article and commentary dealing expressly with the taxation of income from technical and other services (E/C.18/2012/CRP.4) and a paper from El Hadji Ibrahima Diop, a Member of the Committee addressing some of the issues in E/C/2012/CRP.4 from another perspective (E/C.18/2012/CRP.4/Add.1).

Mr. Arnold indicated in E/C.18/2012/CRP.4 that his overall findings on treatment of services, as indicated in his earlier papers for previous annual sessions (E/C.18/2010/CRP.7 and E/C.18/2011/CRP.7) revealed that there is no coherence or consistency on the topic in either the United Nations Model Convention or the OECD Model Convention. Before describing how technical services are handled through different articles in the United Nations Model, he pointed out the inherent difficulty in seeking to define the term "technical services", a term sometimes used for managerial, consultancy or administrative services.

In the United Nations Model Convention, he continued, no specific article deals comprehensively with taxation of income from technical services. It is currently dealt with in several articles, mainly article 7 and article 14, except for specialized services, for example construction and insurance. Under article 7, he said, income or business profits from technical services can be taxed by the source country only if the non-resident taxpayer has a fixed place of business in the source country and the income is attributable to the permanent establishment. According to article 5(3)(b) an establishment is considered to be a permanent establishment if the non-resident furnishes services in the source country for more than 183 days in any 12-month period in connection with the same or connected project. This would result in the source country being able to tax the income from those services.

With regard to article 14, if a non-resident has a fixed base regularly available in the source country then income from any profession and independent services attributable to that fixed base is taxable by the source country. In addition, if the non-resident stays in the source country for at least 183 days and furnishes services there, then the income derived from those services is taxable by the source country.

Mr. Arnold noted how easy it could be for a non-resident enterprise to earn substantial income in a source country without being subjected to tax in that country. That problem is even more apparent when a resident is paying a non-resident for such services, as such a payment is often tax deductible in the source country. Such an erosion of the tax base, he said, is often more accentuated in the case of intra-group dealings involving multinationals, where such business practices can be used to reduce taxable income from a source country. Mr. Arnold then outlined a number of options to address taxation of services in a more consistent manner. The

After extensive discussions it was agreed by a majority of members and observers that there would be a new provision dealing with technical services. Some of the issues to be addressed in that provision will be:

(a) A definition or a framework of what could qualify as "technical services";

(b) Consideration of the modality of how the service is performed, including whether there is a need for physical presence in the source country. If that is the case, the threshold time for such presence must be determined;

(c) Consideration of whether the fact that the payment for services is simply borne by a resident of the source country or a permanent establishment situated therein should warrant the allocation of taxing rights to the source country.

Ninth Session of the Committee (2013) – Re-constitution of the Subcommittee?

At the Ninth Annual Session from 21-25 October the Committee will have to decide whether to re-constitute the Subcommittee, and should it decide to do so the Committee will also need to decide on its composition, leadership and mandate/ work programme.

Draft Provisions on Fees for Technical Services with Notes

As to the technical issues for consideration, paper E/C.18/2013/CPR.5 for the ninth session of the Committee in 2013 is a note by consultant Mr. Brian Arnold on possible drafts of a fees for technical services article, with an outline of some of the issues raised by each draft, as well as the broad issues raised whichever draft was chosen – such as the definition of "fees for technical services".

Additional Study by Mr. Tizhong Liao

It was also agreed at the eighth session that a more complete study should be carried out with respect to services and its taxation. Jacques Sasseville, Head of the OECD Tax Treaty Unit, and Tizhong Liao, a member of the Committee, agreed to establish liaison in order to undertake this extensive work. As a result, Tizhong Liao has presented a paper for consideration at the ninth session of the Committee in 2013 (E/C.18/2013/CPR.16).That paper gives some insights on the current difficulties that tax administrations face and will continue to face as the international trade in services and other intangibles continue to evolve. In particular the paper notes that: "There is no universal set of source rules that can readily be applied to every circumstance to determine the source or locality of profits. The growth in international trade, supported by the development of e-commerce, prompts a consideration of the adequacy of current tax laws. This is particularly evident where multinationals are increasingly able to structure their finances and conduct their affairs without being constrained by geography or national boundaries. The modern global economy differs from the environment within which many of our traditional sourcing rules were developed in many respects:…"

In light of this assessment, E/C.18/2013/CPR.16 makes some recommendations for a fairer taxation of revenues from services performed in the source states. The changes proposed concerns a range of articles in the UN Model Tax Convention. They include deemed permanent establishment treatment, providing that