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Discussion of substantive issues related to international cooperation in tax matters: tax treatment of services

Taxation of fees for technical and other services under the United Nations Model Convention

Note by the Secretariat

1. The note contained in the annex to the present note has been prepared by Professor Brian J. Arnold[1] at the request of the Secretariat, acting on behalf of the Subcommittee on Services. The Subcommittee was mandated by the Committee of Experts on International Cooperation in Tax Matters at its seventh session, in 2011, as follows:

> It was 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.[2]

2. The views expressed in the annexed note should not be taken as necessarily representing the views of the United Nations, and are solely intended to assist the Subcommittee and the Committee in their work.

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* E/C.18/2012/1.

[1] Senior Adviser, Canadian Tax Foundation.

[2] See E/2011/45, para. 97. The report on the seventh session is available from http://www.un.org/esa/ffd/tax/seventhsession/index.htm.

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Annex

Note on the taxation of fees for technical and other services under the United Nations Model Convention*

I. Introduction

1. At the fifth session of the United Nations Committee of Experts on International Cooperation in Tax Matters (hereinafter referred to as the Committee), in 2009, the Subcommittee on Services was established, its mandate set out in the following terms:

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

2. In furtherance of its mandate, the Subcommittee commissioned Brian Arnold to prepare a paper on the taxation of services under the United Nations Model Convention (E/C.18/2010/CRP.7 and Add.1), which was discussed briefly at both the sixth and seventh sessions of the Committee. At the seventh session, held from 24 to 28 October 2011, the Committee agreed that the Subcommittee should prepare proposals for the taxation of income from technical services, for consideration during the eighth session, to be held in October 2012. Further:

> It was 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 (see E/2011/45, para. 97).

3. The purpose of the present note is to start the work on technical services assigned to the Subcommittee. The note sets out options for dealing with the treatment of technical and other similar services under the United Nations Model Convention so that the members of the Subcommittee can decide on which option or options they would prefer to present or recommend to the Committee at its eighth session in Geneva in October 2012. The note provides some brief background information on the issue of technical fees but does not discuss the various options in much detail. Once the Subcommittee decides on which option or options to pursue, a more detailed note, setting out a draft version of any new article or commentary for consideration by the Subcommittee, can be prepared. Assuming the Subcommittee can agree on a new article or commentary with respect to the appropriate treatment of income from technical services, a note thereon would be prepared for the eighth session. If the Subcommittee cannot agree on the appropriate treatment, it may be possible for the Subcommittee to provide the Committee with a note in which the range of possible approaches is narrowed, that is to say, a note in which some of the possible options are rejected as being, in the Subcommittee's view, inappropriate for inclusion in the next update of the United Nations Model Convention.

4. Before setting out the options, the present note briefly discusses the problem of defining technical services and provides a description of the existing provisions

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of the United Nations Model Convention that are applicable to the issue of income from services and the problem presented by fees for technical and similar services.

II. What are technical and other services?

5. The identification of the types of services that are to be given special treatment under the United Nations Model Convention is important to the Subcommittee in its work. Unfortunately, no clear definition of technical services is available. Under some treaties, technical services are limited to services that are closely linked to royalties. Under other treaties, special provisions apply to "managerial, technical and consulting services", but no definition of such services is provided.

6. It is inherently difficult to distinguish between managerial, technical and consulting services and other types of business and professional services. In practice, income from business and professional services derived by a non-resident enterprise is subject to source-country taxation under article 7 or article 14 only if a high threshold in terms of the non-resident's connections to the source country is met (permanent establishment, fixed base or a substantial amount of time working or staying in the source country). In contrast, a lower threshold of some type would presumably be applied to income from technical and other similar services.

III. Treatment of fees for technical and other similar services under the existing provisions of the United Nations Model Convention

7. The United Nations Model Convention does not contain specific provisions dealing with fees for technical, management and consulting services provided by a resident of one contracting State to a resident of the other contracting State. In general, income from business services performed in a country is governed by article 7 (Business profits) or article 14 (Independent personal services). Under article 7 (1), a country is entitled to tax business profits only if the non-resident carries on business in the country through a permanent establishment and only to the extent that the profits are attributable to the permanent establishment or are similar to the profits derived through the permanent establishment (limited force-of-attraction rule). A permanent establishment is defined in article 5 (1) as a fixed place of business (which exists for a minimum period of generally six months). It is easy for non-resident service providers to avoid falling under this aspect of the definition by simply moving from place to place in the source country before the six-month time-threshold is reached.

8. A permanent establishment is deemed to exist if a non-resident has a person in the source country who has, and habitually exercises, the authority to conclude contracts on behalf of the non-resident. This deemed-agency permanent establishment is not likely to be relevant for the taxation of fees for technical services.

9. Under article 5 (3) (b) of the United Nations Model Convention, a permanent establishment may be deemed to arise if a non-resident enterprise furnishes services in the source country for more than 183 days in any 12-month period in respect of the same or connected projects. It is generally accepted that any tax levied on

business profits under article 7 must not ordinarily exceed the tax computed on a net basis with any deductions allowed for expenses incurred in earning the income.[a]

10. Article 5 of the United Nations Model Convention also contains special provisions dealing with construction (article 5 (3) (a)) and insurance services (article 5 (6)). Arguably, a construction site must meet the conditions of article 5 (1); if this is the case, construction activities are effectively treated in the same way as other service activities. Under article 5 (6), if a non-resident enterprise collects insurance premiums or insures risks in the source country, it is deemed to have a permanent establishment there.

11. Under article 14 of the United Nations Model Convention, income from professional and other independent services derived by a non-resident from the source country are taxable if the non-resident has a fixed base in the source country regularly available to the non-resident and the income is attributable to the fixed base. In this respect, article 14 is very similar to article 7. Article 14 also allows the source country to tax income from professional and other independent services derived by a non-resident if the non-resident stays in the source country for 183 days or more in any 12-month period. It is not completely clear whether article 14 permits source-country taxation on a gross basis.[b]

12. The term "professional and other independent services" is not defined in the United Nations Model Convention. As a result, article 3 (2) indicates that the term should retain the meaning that it encompasses under the domestic law of the country applying the treaty, unless the context of the treaty requires a different meaning. It is certainly possible that some technical services could be considered to be covered by the meaning of the term "professional and other independent services", either as a result of applying the meaning under domestic law or because the meaning of the term in the treaty includes some technical services.

13. Other provisions of the United Nations Model Convention dealing with special types of services — article 8 (Shipping, inland waterways transport and air transport), article 15 (Dependent personal services), article 16 (Directors' fees and remuneration of top-level managerial officials), article 17 (Artistes and sportspersons) and article 19 (Government service) — will not have any application to technical services except, perhaps, in rare cases. Article 12 (Royalties) does not apply to fees for technical and other 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 or equipment or information. However, the commentary on article 12 indicates that, in practice, if a contract covers both royalties and services and the services part of the contract is "of an ancillary and largely unimportant character",

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[a] Article 7 provides a limit on the tax that may be imposed by the State in which the permanent establishment is located. It does not expressly provide that the profits must be taxed on a net basis. However, article 24 (3) provides that the source country cannot impose less favourable taxation on a permanent establishment of a non-resident than it imposes on the profits of a resident carrying on the same activities. As a result, assuming that the source country taxes the business profits of its own residents on a net basis, it would be required not to tax non-residents carrying on business through a permanent establishment less favourably.

[b] Like article 7, article 14 does not contain any express requirement for taxation on a net basis. Article 24 (3) refers only to taxpayers carrying on business through permanent establishments and not through fixed bases; therefore, literally, article 24 (3) does not prevent a source country from taxing non-residents deriving income from professional and other independent services on a gross basis, while taxing residents deriving the same income on a net basis.

all of the amounts payable under the contract may be treated as royalties.[c] In other situations involving mixed contracts, the portions attributable to services and to the use of, or the right to use, intellectual property must be broken down and treated separately.

14. Finally, income from technical and other similar services may be taxable by the source country under article 21 (Other income). If income from technical and other services is not considered to be income from carrying on business dealt with under article 7 or income from professional or independent personal services dealt with under article 14, such income may be taxable by a source country if the income arises in the source country in accordance with article 21 (3). Whether income arises in a country is generally determined in accordance with domestic-source rules. There is no limit on source-country taxation of other income under article 21, so that such tax may be imposed as a flat-rate withholding tax on the gross amount of the payment.

15. The foregoing brief overview of the provisions of the United Nations Model Convention that are potentially applicable to income from technical and other services shows that it is relatively easy for an enterprise resident in a contracting State to avoid tax on such income in the other contracting State, especially where the services are rendered to a related enterprise in the source country. As long as the non-resident enterprise does not have a permanent establishment or fixed base in the source country, does not furnish services for more than 183 days, or does not stay in the source country for more than 183 days, the income is not taxable by the source country under article 7 or article 14. The income might be subject to tax in accordance with article 21 if the income is not considered to be dealt with in article 7 or 14; however, in most cases, income from technical and other similar services would be considered to be business profits or income from professional or other independent services, so that article 21 would not apply.

16. This result is problematic from the perspective of some countries because the fees paid to non-residents for technical and other services are ordinarily deductible in computing the income of the person to whom the services are provided.[d] The payments for technical services erode the source country's tax base, but such payments are often not taxable by the source country under the provisions of the United Nations Model Convention treaty. As a result, multinational enterprises sometimes use fees for technical, management and consulting services to strip the profits of their subsidiaries. Not surprisingly, some countries, especially developing countries, find this situation unacceptable and look for ways to negotiate provisions in their tax treaties or, sometimes, to interpret their tax treaties when they do not contain a specific article on technical services that allow them to tax income from technical and other services. Countries have adopted a variety of provisions in their bilateral treaties to deal with income from technical and other services.

[c] See para. 12 of the commentary, which quotes para. 11 of the commentary on article 12 of the OECD Model Convention.

[d] Payments made by residents or non-residents with a permanent establishment in the source country would generally be deductible for purposes of tax payable in the source country.

IV. Options for dealing with income from technical and other services

A. Revise the commentary so as to provide a discussion of the treatment of income from technical and other services

17. At the very least, the next update of the United Nations Model Convention should include a discussion in the commentary on the issue of the treatment of income from technical and other similar services. The issue is obviously important to many countries, as indicated by the number of bilateral treaties with specific provisions dealing with such services. Therefore, the inclusion of a discussion of the issue in the commentary would be useful for identifying and explaining the issue for tax administrations of developing countries. Such a discussion could be presented in a neutral manner, setting out the arguments for and against including any special provisions dealing with technical and other services in tax treaties, without any suggestion regarding how countries might deal with the issue.

B. Reduce the threshold period for the application of articles 5 (3) (b) and 14 (1) (b)

18. Currently, income from services derived by a non-resident enterprise is subject to source-country tax under article 7 or article 14 only if the non-resident has a fixed place of business or fixed base in the source country for at least six months or spends at least six months performing services or being present in the source country. Under article 5 (3) (b), the threshold for source-country tax is based on the number of working days spent in the source country; moreover, the services must be performed for the same or a connected project. Under article 14 (1) (b), the threshold for source-country taxation of income from professional and other services is presence in the source country for 183 days or more in any 12-month period.

19. If the time thresholds for the purposes of articles 5 (3) (b) and 14 (1) (b) were reduced to, say, 90 or 120 days in any 12-month period, source countries would have expanded taxing rights over income from business and professional services, including income from technical and other services. A few countries currently use this reduced time threshold approach in their treaties, although it is unclear whether they have done so in order to deal with technical services or with other types of services.[e] The benefit of this approach is its simplicity and straightforwardness. The necessary changes to articles 5 and 14 would be simple and would not necessitate defining technical and other services. Either the current time thresholds could be replaced by lower thresholds or the threshold could be left for negotiation by the parties in each case. It would also be possible to leave the articles unchanged and revise the commentary to enable it to address the option of countries to adopt reduced time thresholds.

20. This approach does not deal specifically with income from technical and other services. Some countries may take the position that the existing time thresholds in

[e] See Wim Winjen, Jan de Goede and Andrea Alessi, “The treatment of services in tax treaties”, *Bulletin for International Taxation*, vol. 66, No. 1 (January 2012), pp. 30 and 34.

articles 5 (3) (b) and 14 (1) (b) are appropriate for services generally but not for technical and other services. For these countries, reduced time thresholds would be appropriate only for technical and other services. This approach would require a definition of the types of services that would be subject to the reduced time thresholds. As discussed above, such a definition is difficult to formulate in such a manner as to provide sufficient certainty for taxpayers and tax officials.

C. Revise the commentary to provide a discussion of the issue and identify alternative provisions that countries might adopt based on existing country practices

21. Under this approach, not only would the commentary be revised to include a discussion of the issue of the treatment of income from technical and other similar services but it would also go further and describe briefly the provisions dealing with such services that have been adopted in actual treaties. However, there would be no attempt to assess these provisions or recommend the types of provisions that countries should adopt if they conclude that income from technical services should be dealt with in their treaties. The commentary on article 1 of the United Nations Model Convention (paras. 47-56) dealing with treaty-shopping could be used as a model in this regard.

D. Revise the commentary to provide a discussion of the issue and alternative provisions that might be adopted by countries

22. Under this approach, not only would the commentary be revised to include a discussion of the issue but it would also go further than the previous approach by including alternative provisions that countries would be encouraged to use if they concluded that technical and other services should be dealt with in their treaties. The provisions under this approach would be similar to the alternative provisions in the current commentary on article 10 with respect to branch profits tax (paras. 22-26). One or more alternatives could be provided. For each alternative provision, the commentary should provide an explanation of the purpose of the provision and a discussion of how the provision should be interpreted and applied. Possible alternative provisions include the options set out in subsections E to I below.

E. Revise article 12 to include technical and other services

23. Article 12 could be revised to apply to fees for technical and other similar services linked to royalties. The treaty between India and the United States of America provides the model for this type of provision. It applies to payments from rendering technical or consultancy services if the services are "ancillary and subsidiary to the application or enjoyment of the right, property or information" covered by article 12 or if the services "make available technical knowledge, experience, skill, know-how or processes, or consist of the development of a technical plan or technical design".[f] Alternatively, the commentary on article 12

[f] Article 12 (4) of the treaty between India and the United States. Article 12 (5) provides that certain amounts are not to be included as fees for technical services.

could be revised to include this type of provision as an alternative that countries might consider including in their treaties. Such commentary could include a discussion of the advantages and disadvantages of a provision of this type.

F. Revise article 14

24. In addition to reducing the time threshold in article 14 (1) (b), as discussed above, article 14 could be revised to incorporate the base-erosion conditions in article 15 (2). In other words, the application of article 14 would allow source-country taxation of any payments for technical and other similar services to a non-resident enterprise if the payments are made by a resident of the source country or are borne by a fixed base or permanent establishment of a non-resident enterprise in the source country. Such payments are deductible in computing income for purposes related to the source country's tax base and therefore, arguably at least, the source country should be entitled to tax the non-resident recipient of the payments.

25. Currently, only a few treaties use this approach. Some of them achieve this result by including professional and other services in article 15, and others by including the base-erosion conditions in article 14.

G. Revise article 21

26. As noted above, article 21 (3) of the United Nations Model Convention allows a source country to tax income not dealt with in any other article of the Model Convention if the income arises in the source country. Thus, arguably, if income from technical and other services is characterized as income, other than business profits or income from professional and other independent services, under the domestic law of the source country, such income is taxable by the source country if it arises in the source country. Apparently, this represents the position of Brazil.[g] On the other hand, if income from technical and other services is considered to be business profits or income from professional or independent services, it is dealt with in article 7 or article 14 and is not taxable by the source country even if it arises in that country.

27. There is no basis in the language of the United Nations Model Convention for suggesting that income from technical and other similar services is different than that from other services dealt with under articles 7 and 14. Therefore, if such services are to be treated differently — i.e., as subject to a lower threshold for source-country tax than other business and professional services — this should be set out expressly in the treaty.

28. If income from technical services is subject to source-country tax under article 21 (3), there is no limit on source-country tax: such tax may be levied at an unlimited flat rate on the gross amount of the payment. Accordingly, if income from technical services is taxable under article 21 (3), it may be desirable to limit any source-country tax on such income to a fixed percentage or a percentage to be negotiated by the parties.

[g] See Winjen, de Goede and Alessi, "The treatment of services in tax treaties", p. 36.

H. Add a new article and commentary dealing expressly with the taxation of income from technical and other services

29. Several existing treaties have a specific provision dealing with technical and other similar services.[h] However, the number of treaties with such a specific provision is relatively small — less than 10 per cent of the treaties concluded in the last 14 years. Consequently, the addition of a specific provision dealing with technical services might be considered inappropriate to the extent that it would suggest that all countries using the United Nations Model Convention as the basis for their tax treaties should include such a provision in their treaties. This issue could, however, be dealt with by a clarification in the commentary to the effect that the new article should be included only if countries conclude that a specific provision for technical services is necessary. Alternatively, the new article could be set out in the commentary as an alternative provision which countries might include in their treaties if they considered it necessary or appropriate.

30. The most serious challenges presented by a specific provision dealing with technical services concern agreeing on the wording of such a provision and on the definition of the services to be covered. One alternative would be to follow the wording of the existing provisions used by various countries. In general, these provisions refer to "managerial, technical and consulting services" without defining such services. Obviously, it would be preferable to provide some additional clarification regarding the types of services covered and the differences between these services and other services. Another alternative would be for the new article to apply to all types of services (so that a definition of technical and other similar services would be unnecessary) but at the same time only to those of them provided to related or associated enterprises.

31. Any new article applying to technical services should require source-country taxation only on the net profits derived by the non-resident enterprise; or if taxation on the gross revenue is allowed, source-country taxation should be limited to a fixed percentage specified in the article or negotiated by the parties. Also, contracting States could be encouraged to allow non-resident enterprises to elect to be taxed on a net basis with respect to income from technical and other similar services.

I. Deem a subsidiary to be a permanent establishment

32. A radically different and much broader solution than any represented by the above-mentioned options would be to treat a domestic subsidiary as a permanent establishment of its non-resident parent corporation.

33. If a non-resident parent corporation provides services to its subsidiary, the income derived by the parent will often not be subject to source-country taxation

[h] Ibid., p. 33. A total of 134 of the almost 2,000 treaties concluded in the last 14 years have such provisions.

because the parent will not ordinarily have a permanent establishment or fixed base in the source country.[i]

34. Moreover, the payments by the subsidiary will be deductible in computing its income and will thus erode the tax base of the source country. These difficulties would be eliminated if the subsidiary were deemed to be a permanent establishment of its non-resident parent corporation. Thus, any income derived by the parent corporation from services provided to its subsidiary would be subject to source-country taxation in accordance with the rules of article 7.

35. The function of a threshold requirement such as that involving a permanent establishment is to preclude source-country taxation of the business profits of a resident of the other country unless that resident has substantial economic connections with the source country. The establishment or ownership of a subsidiary corporation in a country is usually indicative of a substantial economic connection with that country. The existence of a subsidiary provides certainty for taxpayers and the tax authorities. The compliance burden on a non-resident parent corporation does not seem to be a serious impediment to source-country taxation because the subsidiary must comply with the tax laws of the source country. The existence of a domestic subsidiary provides the source country with an effective means of enforcing any tax liability of the non-resident parent corporation, since the relevant payments by a subsidiary to its non-resident parent can be subject to withholding.

36. Treating a subsidiary corporation as a permanent establishment of its non-resident parent corporation presents a number of problems. For example, it would be necessary to define a subsidiary corporation. It would also be necessary to deal with payments to related entities rather than to the parent corporation itself. For example, if a subsidiary makes payments for services rendered by an entity related to the parent (whether the related entity is resident in the country of the parent or in another country), the source country would not be able to tax the income from the services unless the subsidiary was considered to be a permanent establishment of the related entity. Therefore, the extension of the definition of permanent establishment to include subsidiary corporations would be easy to avoid unless special rules were adopted to deal with payments to related entities.[j]

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[i] If a parent corporation uses the business facilities of its subsidiary to carry on its own business for the required time, the parent corporation may be considered to have a permanent establishment in the country in which the subsidiary is established. See the commentary on article 5, para. 3, of the United Nations Model Convention which states that: “Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance, where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.” It is often difficult for the tax authorities to obtain the necessary evidence to establish that a permanent establishment exists in these situations; and it is usually easy for the parent corporation to plan its affairs in such a way as to avoid having a permanent establishment.

[j] The use of related or associated enterprises to avoid tax also arises with respect to other provisions of the United Nations Model Convention dealing with income from services and other types of income.