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Taxation of Services – Article on technical services

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

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

* E/C.18/2014/1

UN MODEL TAX CONVENTION

Article XX – Payments for Technical Services

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

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

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

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

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

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

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

6. For the purposes of this Ad at3-2.5( )r–denf thi.0006 Tc .0004 Tw [(persth)-5d payat3,ningpu(at3-2

This wording appears in Article but is probably unnecessary.

DRAFT COMMENTARY ON ARTICLE XX – PAYMENTS FOR TECHNICAL SERVICES

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

A. General Considerations

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

1. Article XX was added to the UN Model in 20__ to allow a Contracting State to tax payments technical and other services made to residents of the other Contracting State on a gross basis at a rate to be negotiated by the Contracting States. In general, it is sufficient if the payments are made by a resident of the State or by a nonresident with a

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

7. It is also worth noting that the State from which payments for technical services are paid to a resident of the other Contracting State cannot generally tax such payments as royalties under Article 12 of the United Nations Model Convention. Article 12 permits a Contracting State in which royalties arise to tax the gross amount of the royalty payments at a rate to be negotiated between the Contracting States. Royalties are defined in Article 12(2) to mean payments for the use of, or the right to use, any copyright, patent, trademark, design, plan, secret formula or process, any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience. In general, royalties mean payments for the use of, or the right to use, intellectual property, equipment or know-how (information concerning industrial, commercial or scientific experience). Thus, royalties involve the transfer of the use of or the right to use property or know-how. In contrast, typically when an enterprise provides services to a customer, the enterprise does not transfer its property or know-how or experience; instead, the enterprise simply performs work for the customer. Under a so-called “mixed contract”, an enterprise may provide both services and the right to use property or know-how to a customer. In such situations, in accordance with paragraph 12 of the Commentary on Article 12 (quoting paragraph 11.6 of the .7(t)6.t99(e)2.6 nsprise 32crmmcle 12 Mothev Tw [(1hd(r)-7.9(o)),(e thp.9(o) 7(a)8(any

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

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

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

16. The OECD Model Convention has no similar provision dealing with technical services. The OECD considers that there is a fundamental principle underlying the OECD Model Convention that a Contracting State is entitled to tax income from services derived by residents of the other Contracting State only if the services are physically performed in the first State. The United Nations Committee of Experts rejects this as a fundamental principle of the United Nations Model Convention. Base erosion is a sufficient nexus to justify source country taxation of income from employment under Article 15 and directors' fees and remuneration of top-level managerial officials under Article 16. Although taxation of employmentation of invmA398(mhou)-4.-4.5(.6(-5.7398(m1.9t4[(5d)-7 .3(a)

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

Paragraph 2

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

29. When considered in conjunction with Article 23, paragraph 2 establishes the primary right of the country in which payments for technical services arise to tax those

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

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

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

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

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

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

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

> However, notwithstanding Article 14 and subject to the provisions of Articles 8, 17 and 20, such payments for techni9 TD .0036 Tc .1r tec(,)-5.3(ym)10.8(ent)10.479 Tcl

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

48. Although the term “services” in the phrase “payments for technical services” is

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

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

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

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

84. If there is a bilateral tax treaty between State R and the third State in which S Company has a permanent establishment, and that treaty contains a provision comparable to Article XX of the United Nations Model Convention, the payments for technical services would be considered to arise in that third State for purposes of the treaty. As a result, that treaty would allow the third State in which the permaneana pv8lhmcane s

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

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

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

- The parties might decide not to include paragraph 6 in Article XX and to revise paragraph 5 so that payments for technical services could be considered to arise in a Contracting State only if the payer is a resident of that State and the technical services are used or consumed by the payer in that State, or if the payer, not being a resident of a Contracting State, has a permanent establishment or fixed base in a Contracting State and the payments for technical services are borne by that permanent establishment or fixed base. In this case, technical services used or consumed by a resident of a Contracting State outside that State would not be considered to arise in that State and that State would not be entitled to tax payments for such services under Article XX. Paragraph 6 would be unnecessnate and r'e-1.1532 TD