



**THE TAX TREATY TREATMENT OF SERVICES:
PROPOSED COMMENTARY CHANGES**

Public discussion draft

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In 2004, Working Party No. 1 on Tax Conventions and Related Questions¹ of the OECD Committee on Fiscal Affairs set up a Working Group to analyse the treatment of services under the current provisions of the OECD Model Tax Convention and, in particular, to examine the policy considerations for the allocation of taxing rights between the State of residence and the State of source with respect to income from services.

The work from the Working Group benefited from previous work done on that issue by the Technical Advisory Group on Monitoring the Application of Existing Treaty Norms for Taxing Business Profits. Section 4.A.g) of the final report of the Technical Advisory Group ("Are the Current Treaty Rules for Taxing Business Profits Appropriate for E-Commerce?") includes an analysis of a possible alternative to the existing treaty rules applicable to services.

The report of the Working Group concluded that no changes should be made to the provisions of the OECD Model Tax Convention and that services should continue to be treated the same way as other types of business activities. Under the applicable rules of the OECD Model, the profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein (as long as they are not covered by other Articles of the Convention that would allow such taxation). This result, under which these profits are only taxable in the State of residence of the enterprise, is supported by various policy and administrative considerations. It is indeed consistent with the principle of Article 7 that until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State.

The report acknowledged, however, that some States are reluctant to adopt the above principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated on their territory but that are performed on that territory and noted that these States propose alternative provisions to preserve source taxation rights, in certain circumstances, with respect to the profits from such services.

The Working Group considered that it was important to circumscribe the circumstances in which States that did not agree with its conclusion could, in a bilateral treaty, provide that profits from services performed by a foreign enterprise could be taxed by them even if not attributable to a permanent establishment situated on their territory. In particular, the Group considered that it was important to stress that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State, that only the profits from services, as opposed to the gross payments for these services, should be subjected to tax and that it was appropriate, for compliance and

¹ That working party is the sub-group of the OECD Committee on Fiscal Affairs which is responsible for updating the OECD Model Tax Convention.

other reasons, not to allow a State to tax the profits from services performed on their territory in certain circumstances (e.g. when such services are provided during a very short period of time).

In light of these conclusions, the Working Group has proposed changes to the Commentary on Article 5 that reflect its conclusion that the current provisions of the OECD Model Tax Convention are appropriate to deal with services, that discuss the various reasons that support that conclusion, that present the views of States that do not agree with that conclusion and that suggest an alternative provision that these States could use to secure more taxation rights with respect to services but that would follow the above principles that source taxation should not extend to services performed outside the territory of a State, should apply only to the profits from these services rather than to the payments for them and should only be allowed if there is a minimum level of presence in a State.

In the course of its work, the Working Group also discussed whether Article 17 (Artistes and Sportsmen) should continue to allow the taxation of gross income, as opposed to the net profits, from the activities covered by that Article. The Group agreed that the Commentary should be amended to include a provision that Contracting States wishing to do so could use to allow taxpayers covered by Article 17 to be taxed on their net income as if they were residents. It drafted proposed changes to the Commentary on Article 17 for that purpose.

The Commentary changes proposed by the Working Group were discussed by the Working Party at its meetings of February and September 2006. In accordance with its policy of consulting interested parties on significant changes to the Model Tax Convention, the Working Party has decided to seek the views of interested parties before reaching a conclusion on these proposals.

Comments on the proposals below should be sent **before 16 February 2007**, preferably by email, to:

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Proposed Commentary Changes

1. *Add the following new paragraphs 42.11 to 42.45 to the Commentary on Article 5:*

The taxation of services

42.11 The combined effect of this Article and Article 7 is that the profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State are not taxable in the first-mentioned State if they are not attributable to a permanent establishment situated therein (as long as they are not covered by other Articles of the Convention that would allow such taxation). This result, under which these profits are only taxable in the other State, is supported by various policy and administrative considerations. It is consistent with the principle of Article 7 that until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State. Also, the provision of services should, as a general rule subject to a few exceptions for some types of service (e.g. those covered by Article 8 and 17), be treated the same way as other business activities and, therefore, the same permanent establishment threshold of taxation should apply to all business activities, including the provision of independent services.

42.12 One of the administrative considerations referred to above is that the extension of the cases where source taxation of profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State would be allowed would increase the compliance and administrative burden of enterprises and tax administrations. This would be especially problematic with respect to services provided to consumers, which would not be disclosed to the source country's tax administration for purposes of claiming a business expense deduction. Since the rules that have typically been designed for that purpose are based on the amount of time spent in a State, both tax administrations and enterprises would need to take account of the time spent in a country by personnel of service enterprises and these enterprises would face the risk of having a permanent establishment in unexpected circumstances in cases where they would be unable to determine in advance how long personnel would be present in a particular country (e.g. in situations where that presence would be extended because of unforeseen difficulties or at the request of a client). These cases create particular compliance difficulties as they require an enterprise to retroactively comply with a number of administrative requirements associated with a permanent establishment. These concerns relate to the need to maintain books and records, the taxation of the employees (e.g. the need to make source deductions in another country) as well as other non-income tax requirements.

42.13 Also, the source taxation of profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State that does not have a fixed place of business in the first-mentioned State would create difficulties concerning the determination of the profits to be taxed and the collection of the relevant tax. In most cases, the enterprise would not have the accounting records and assets typically associated with a permanent establishment and there

would be no dependent agent which could comply with information and collection requirements. Moreover, while it is a common feature of States' domestic law to tax profits from services performed in their territory, it does not necessarily represent optimal tax treaty policy.

42.14 Some States, however, are reluctant to adopt the principle of exclusive residence taxation of services that are not attributable to a permanent establishment situated on their territory but that are performed on that territory. These States propose changes to the Article in order to preserve source taxation rights, in certain circumstances, with respect to the profits from such services. States that believe that additional source taxation rights should be allocated under a treaty with respect to services performed in their territory rely on various arguments to support their position.

42.15 These States may consider that profits from services performed in a given state should be taxable in that state on the basis of the generally-accepted policy principles for determining when business profits should be considered to have their source within a jurisdiction. They consider that, from the exclusive angle of the pure policy question of where business profits originate, the state where services are performed should have a right to tax even when these services are not attributable to a permanent establishment. They would note that the domestic law of many countries provides for the taxation of services performed in these countries even in the absence of a permanent establishment (even though services performed over very short periods of time may not always be taxed in practice).

42.16 These States are concerned that some service businesses do not require a fixed place of business in their territory in order to carry on a substantial level of business activities therein and consider that these additional rights are therefore appropriate.

42.17 Also, these States consider that even if the taxation of profits of enterprises carried on by non-residents that are not attributable to a permanent establishment raises certain compliance and administrative difficulties, these difficulties do not justify exempting from tax the profits from all services performed on their territory by such enterprises. Those who support that view may refer to mechanisms that are already in place in some States to ensure taxation of services performed in these States but not attributable to permanent establishments (such mechanisms are based on requirements for resident payers to report, and possibly withhold tax on, payments to non-residents for services performed in these States).

42.18 It should be noted, however, that all Member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State. Under tax conventions, the profits from the sale of goods that are merely imported by a resident of a country and that are neither produced nor distributed through a permanent establishment in that country are not taxable therein and the same principle should apply in the case of services. The mere fact that the payer of the consideration for services is a resident of a State does not constitute a sufficient nexus to warrant allocation of income taxing rights to that State.

42.19 Another fundamental issue on which there is general agreement relates to the determination of the amount on which tax should be levied. In the case of non-employment services (and subject to possible exceptions such as Article 17) only the profits derived from the services should be taxed. Thus, provisions that are sometimes included in bilateral conventions and that allow a State to tax the gross amount of the fees paid for certain services if the payer of the fees is a resident of that State do not seem to provide an appropriate way of taxing services. First, because these provisions are not restricted to services performed in the State of source, they have the effect of allowing a State to tax business activities that do not take place in that State. Second, these rules allow taxation of the gross payments for services as opposed to the profits therefrom.

42.20 Also, Member States agree that it is appropriate, for compliance and other reasons, not to allow a State to tax the profits from services performed in their territory in certain circumstances (e.g. when such services are provided during a very short period of time).

42.21 The Committee therefore considered that it was important to circumscribe the circumstances in which States that did not agree with the conclusion in paragraph 42.12 above could, if they wished to, provide that profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State would be taxable by that State if they are not attributable to a permanent establishment situated therein.

42.22 Clearly, such taxation should not extend to services performed outside the territory of a State and should apply only to the profits from these services rather than to the payments for them. Also, there should be a minimum level of presence in a State before such taxation is allowed.

42.23 The following is an example of a provision that would conform to these requirements; States are free to agree bilaterally to include such a provision in their tax treaties:

"Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

- a) through an individual who is present in that other State during a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual, or
- b) during a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed for the same project or for connected projects through one or more individuals who are performing such services in that other State or are present in that other State for the purpose of performing such services,

the activities carried on in that other State in performing these services shall be deemed to be carried on through a permanent establishment that the enterprise has in that other State, unless these services are limited to those mentioned in paragraph 4 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph."

42.24 That alternative provision constitutes an extension of the permanent establishment definition that allows taxation of income from services provided by enterprises carried on by non-residents but does so in conformity with the principles described in paragraph 42.22.

42.25 The provision has the effect of deeming a permanent establishment to exist where one would not otherwise exist under the definition provided in paragraph 1 and the examples of paragraph 2. It therefore applies notwithstanding these paragraphs. As is the case of paragraph 5 of the Article, the provision provides a supplementary basis under which an enterprise may be found to have a permanent establishment in a State; it could apply, for example, where a consultant provides services over a long period in a country but at different locations that do not meet the conditions of paragraph 1 to constitute one or more permanent establishments. If it can be shown that the enterprise has a permanent establishment within the meaning of paragraphs 1 and 2 (subject to the provisions of paragraph 4), it is not necessary to apply the provision in order to find a permanent establishment. Since the provision simply creates a permanent establishment when none would otherwise exist, it does not provide an alternative definition of the concept of permanent

establishment and obviously cannot limit the scope of the definition in paragraph 1 and of the examples in paragraph 2.

42.26 The provision also applies notwithstanding paragraph 3. Thus, an enterprise may be deemed to have a permanent establishment because it performs services in a country for the periods of time provided for in the suggested paragraph even if the various locations where these services are performed do not constitute permanent establishments pursuant to paragraph 3. The following example illustrates that result. A self-employed individual resident of one Contracting State provides services and is present in the other Contracting State for more than 183 days during a 12-month period but his services are performed for equal periods of time at a location that is not a construction site (and are not in relation to a construction or installation project) as well as on two unrelated building sites which each lasts less than the period of time provided for in paragraph 3. Whilst paragraph 3 would deem the two sites not to constitute permanent establishments, the proposed paragraph, which applies notwithstanding paragraph 3, would deem the enterprise carried on by that person to have a permanent establishment.

42.27 Another example is that of a large construction enterprise that carries on a single construction project in a country. If the project is carried on at a single site, the provision should not have a significant impact as long as the period required for the site to constitute a permanent establishment is not substantially different from the period required for the provision to apply. States that wish to use the alternative provision may therefore wish to consider referring to the same periods of time in that provision and in paragraph 3 of Article 5.

42.28 The situation, however, may be different if the project, or connected projects, are carried out in different parts of a country. If the individual sites where a single project is carried on do not last sufficiently long for each of them to constitute a permanent establishment (see, however, paragraph 20 of the Commentary on Article 5), a permanent establishment will still be deemed to exist if the conditions of the alternative provision are met. That result is consistent with the purpose of the provision, which is to subject to source taxation non-resident enterprises that are present in a country for a sufficiently long period of time notwithstanding the fact that their presence at any particular location in that country is not sufficiently long to make that location a fixed place of business of the enterprise. Some States, however, may consider that paragraph 3 should prevail over the alternative provision and may wish to amend the provision accordingly.

42.29 The suggested paragraph only applies to services. Other types of activities that do not constitute services are therefore excluded from its scope. Thus, for instance, the paragraph would not apply to a foreign enterprise that carries on fishing activities in the territorial waters of a State and derives revenues from selling its catches (in some treaties, however, activities such as fishing and oil extraction may be covered by specific provisions).

42.30 The provision applies to services performed by an enterprise. Thus, services must be provided by the enterprise to third parties. Clearly, the provision could not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. For example, services might be provided by an individual to his employer without that employer performing any services (e.g. an employee who provides manufacturing services to an enterprise that sells manufactured products). Similarly, if the employees of a separate enterprise (e.g. an enterprise providing outsourced services) provide services to third parties pursuant to a contract that the enterprise has concluded with another enterprise, the services performed through these employees are not performed by the latter enterprise even if they may provide an economic benefit to the business of that other enterprise.

42.31 Also, the provision only applies to services that are performed in a State by a foreign enterprise. It is therefore not sufficient that the relevant services be furnished to a resident of the State; these services must also be performed in that State. Where, for example, an enterprise provides telecommunication services to customers located in a State through a satellite located outside that State, the services performed through the satellite would not be covered by the provision because they are not performed in the State.

42.32 The alternative provision does not specify that the services must be provided "through employees or other personnel engaged by the enterprise", a phrase that is sometimes found in bilateral treaties. It simply provides that the services must be performed by an enterprise. As explained in paragraph 10, the business of an enterprise (which, in the context of the paragraph, would include the services performed in a Contracting State) "is carried on mainly by the entrepreneur or persons who are in paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents)". For the purposes of the alternative provision, the individuals through which an enterprise provides services will therefore be the individuals referred to in paragraph 10.

42.33 The circumstances in which the alternative provision will apply will vary depending on whether or not the services are primarily performed by a single individual. If that is the case, subparagraph a) of the provision looks at the duration of the presence of the individual in a way that is similar to that of subparagraph 2 a) of Article 15; if that is not the case, subparagraph b) looks at the duration of the activities, or the presence, of the individuals through which the services are performed.

42.34 Subparagraph a) deals primarily with the situation of an enterprise carried on by a single individual. It also covers, however, the case of an enterprise which, during the relevant period, derives most of its revenues from services provided by one individual. Such extension is necessary to avoid a different treatment where, for example, the same services are provided by an individual and by a company all the shares of which are owned by the only employee of that company.

42.35 The subparagraph may apply in different situations where an enterprise performs services through an individual, such as when the services are performed by a sole proprietorship, by the partner of a partnership, by the employee of a company etc. The main conditions are that

- the individual through which the services are performed be present in a State during a period or periods exceeding in the aggregate 183 days in any twelve month period, and
- more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during the period or periods of presence be derived from the services performed in that State through that individual.

42.36 The first condition refers to the days of presence of an individual. Since the formulation is identical to that of subparagraph 2 a) of Article 15, the principles applicable to the computation of the days of presence for purposes of that last subparagraph are also applicable to the computation of the days of presence for the purpose of the suggested paragraph.

42.37 For the purposes of the second condition, according to which more than 50 per cent of the gross revenues attributable to active business activities of the enterprise during the relevant period or periods must be derived from the services performed in that State through that individual, the gross revenues attributable to active business activities of the enterprise would represent what the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken

into account for tax purposes. Such active business activities are not restricted to activities related to the provision of services. Gross revenues attributable to “active business activities” would clearly exclude income from passive investment activities, including, for example, receiving interest and dividends from investing surplus funds. States may, however, prefer to use a different test, such as “50% of the business profits of the enterprise during this period or periods is derived from the services” or “the services represent the most important part of the business activities of the enterprise”, in order to identify an enterprise that derives most of its revenues from services performed by an individual on their territory.

42.38 Subparagraph b) addresses the situation of an enterprise that performs services in a Contracting State in relation to a particular project (or for connected projects) and which performs these through one or more individuals over a substantial period. The period or periods referred to in the subparagraph apply in relation to the enterprise and not to the individuals. It is therefore not necessary that it be the same individual or individuals who perform the services or are present throughout these periods. As long as, on a given day, the enterprise is performing its services through at least one individual who is doing so, or is present for that purpose, that day would be included in the period or periods referred to in the subparagraph.

42.39 The reference to an “enterprise [...] performing these services for the same project or for connected projects” should be interpreted from the perspective of the enterprise that provides the services. Thus, an enterprise may have two different projects to provide services to a single customer (e.g. to provide tax advice and to provide training in an area unrelated to tax) and while these may be related to a single project of the customer, one should not consider that the services are performed for the same project.

42.40 The reference to “connected projects” is intended to cover cases where the services are provided in the context of separate projects carried on by an enterprise but these projects involve the provision of services of the same or of a similar nature and within the framework of contracts concluded with the same enterprise or with associated enterprises. [The Working Group invites comments in particular on the meaning of “connected projects”]

42.41 Subparagraph b) requires that during the relevant periods, the enterprise is performing services through individuals who are either performing such services in the State or are present in that State for the purpose of performing such services. For that purpose, a period during which individuals are performing services means a period during which the services are actually provided, which would normally correspond to the working days of these individuals. On the other hand, a period during which an individual is present in a State for the purpose of performing such services would normally be any period of presence computed by reference to the principles applicable for the purposes of subparagraph 2 a) of Article 15, but taking into account the periods of presence when the individual has travelled to a State for purpose of performing the services. Since local employees hired for purposes of a specific project could generally not be considered to be present in a State for purposes of performing services in that State, their periods of services would most often be covered by the part of the subparagraph that deals with a period during which the services are actually provided rather than to the part that deals with periods of presence for purposes of performing such services.

42.42 The 183-days thresholds provided for in the alternative provision may give rise to the same type of abuse as is described in paragraph 18 above. As indicated in that paragraph, legislative or judicial anti-avoidance rules may apply to prevent such abuses. Some States, however, may prefer to deal with them by including a specific provision in the Article. Such a provision could be drafted along the following lines:

"For the purposes of paragraph [x], where an enterprise of a Contracting State that is performing services in the other Contracting State is, during a period of time, associated with another enterprise that performs substantially similar services in that other State for the same project or for connected projects through one or more individuals who, during that period, are performing such services in that State or are present in that State for the purpose of performing these similar services, the first-mentioned enterprise shall be deemed, during that period of time, to be performing services in the other State for that same project or for connected projects through these individuals. For the purpose of the preceding sentence, an enterprise shall be associated with another enterprise if one is controlled directly or indirectly by the other, or both are controlled directly or indirectly by the same persons, regardless of whether or not these persons are residents of one of the Contracting States."

42.43 According to the provision, the activities carried on in the other State by the individuals referred to in subparagraph a) or b) through which the services are performed by the enterprise during the period or periods referred to in these subparagraphs are deemed to be carried on through a permanent establishment that the enterprise has in that other State. The enterprise is therefore deemed to have a permanent establishment in that other State for the purposes of all the provisions of the Convention (including, for example, paragraph 5 of Article 11 and paragraph 2 of Article 15) and the profits derived from the activities carried on in the other State in providing these services are attributable to that permanent establishment and are therefore taxable in that State pursuant to Article 7.

42.44 By deeming the activities carried on in performing the relevant services to be carried on through a permanent establishment that the enterprise has in a Contracting State, the provision allows the application of Article 7 and therefore, the taxation, by that State, of the profits attributable to these activities. As a general rule, it is important to ensure that only the profits derived from the activities carried on in performing the services are taxed; whilst there may be certain exceptions, it would be detrimental to the cross-border trade in services if payments received for these services were taxed regardless of the expenses incurred for the purpose of performing these services.

42.45 This alternative provision will not apply if the services performed are limited to those mentioned in paragraph 4 of the Article 5 which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph. Since the provision refers to the performance of services by the enterprise and this would not cover services provided to the enterprise itself, most of the provisions of paragraph 4 would not appear to be relevant. It may be, however, that the services that are performed are exclusively of a preparatory or auxiliary character (e.g. the supply of information to prospective customers when this is merely preparatory to the conduct of the ordinary business activities of the enterprise; see paragraph 23 above) and in that case, it is logical not to consider that the performance of these services will constitute a permanent establishment.

2. *Replace paragraph 10 of the Commentary on Article 17 by the following (additions to the existing text appear in **bold italics**):*

10. The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc. ***Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the***

applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines:

“Where a resident of a Contracting State derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting State on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions.”