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February 15, 2007

Mr. Jeffrey Owens
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Carol A. Dunahoo
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and Federal Express**Re: Tax Treaty Treatment of Services: Proposed Commentary Changes

Dear Mr. Owens,

I am writing on behalf of a group of large global companies to provide comments on the public discussion draft released on December 8, 2006, proposing the addition to the Commentary on Article 5 (Permanent Establishment) of the OECD Model Tax Convention of a new section regarding services. The companies in our group conduct business worldwide in a variety of sectors, in which the cross-border provision of services is an increasingly significant component. They are all headquartered in Canada, the United Kingdom, or the United States.

We appreciate the efforts of Working Party No. 1 on Tax Conventions and Related Questions and its Working Group on the treatment of services under tax treaty provisions. Both the Working Party and the Working Group clearly have given this matter much consideration, and we concur in the majority view on many points addressed in the discussion draft. We particularly appreciate the firm stand taken against the extra-territorial taxation of services provided directly to a resident of a country from outside that country and in support of taxation on a net rather than a gross basis. For the reasons set forth below, however, we believe that both tax administrations and taxpayers would be best served by withdrawal of the proposed new provisions.

1. The role of the OECD and the Model Convention and Commentaries is to build, articulate, and maintain a broad international consensus.

The value of the OECD as an institution lies in the expertise and reputation it has developed over the decades in forging a broad international consensus on issues of cross-border taxation. The OECD is now recognized as the leading forum for achieving consensus among member countries themselves and with major non-member economies and the international business community. This demonstrated

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ability to create and maintain consensus is the source of the OECD's *de facto* position as the world standard setter on issues of international tax policy and administration. Tax authorities and taxpayers alike have come to rely on the OECD's leadership in this arena.

Consensus building is not only the role of the OECD as an institution but also the main purpose of its Model Convention and Commentaries. As the Model Convention itself acknowledges, its role is "to clarify, standardize, and conform the fiscal situation of taxpayers ... through the application by all countries of common solutions to identical cases of double taxation" and to provide "a means of settling on a uniform basis the most common problems that arise in the field of international juridical double taxation." The role of the Commentaries on the Model Convention is, as stated in the Introduction to the Model Convention, similarly, to "facilitate[] the interpretation and the enforcement of ... bilateral conventions along common lines."

The Model Convention and Commentaries are important not only as a means of articulating the international consensus reached through the OECD but also as a mechanism for developing and maintaining that consensus. In their absence, there would be no impetus for countries to meet, analyze issues, and develop common positions and interpretations, and no means of memorializing the consensus reached. The negotiation and interpretation of bilateral tax conventions would become substantially more difficult and time-consuming. The number of cross-border tax disputes would increase significantly, with no international standards or procedures for resolution.

2. The proposal of alternative treaty provisions or interpretations is inconsistent with the role of the OECD as a consensus-building organization.

The Model Convention and Commentaries have value only to the extent that they reflect a broad international consensus. If a broad consensus is not clearly articulated and maintained, the Model will lose its status and viability as such and the Commentaries will fail to provide persuasive interpretive guidance.

The Model Convention and Commentaries are relevant, however, only if they represent a true, rather than only an ostensible, consensus. In recent years, the OECD appears, for reasons that are unclear, to be making efforts to accommodate minority perspectives and minimize departures by its member countries from the Model Convention and Commentaries by facilitating the adoption of alternative treaty texts and reflecting alternative interpretations in the Commentaries. While this may reduce the number of overt dissents in the form of reservations or observations

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to the Model Convention and Commentaries, the inclusion of alternative positions and interpretations within the Model Convention and Commentaries does not promote the formation of a consensus. In fact, by catering to the various policy preferences of its member countries rather than pressuring them to resolve their differences, this approach may actually inadvertently undermine the prospects for consensus.

For example, the recent project on pension taxation resulted in the inclusion in the Article 18 Commentary of not one but four alternative treaty provisions: exclusive source taxation of pension payments, non-exclusive source taxation of pension payments, limited source taxation of pension, and source taxation of pension payments only where the State of residence does not tax these payments. The Commentary refrains from recommending any of these approaches, and does not indicate which member countries intend to follow which approach. While only one member country filed an observation to these provisions, this exercise clearly did not promote the formation of an international consensus. The topic of pension taxation is, admittedly, a difficult and divisive one, but the fact that multiple views have been incorporated in the Commentary would appear to have relieved member countries of any pressure to strive for an international consensus rather than a series of disparate, bilaterally negotiated compromises.

The Article 18 Commentary is but one example of an apparent trend of which the Article 5 services proposal is but the most recent example. A similar dynamic developed, for example, in connection with the Article 7 project on the attribution of profits to permanent establishments. That project was originally prompted in significant part by the disagreements that had surfaced among some OECD member countries regarding the method for attributing capital and the associated interest expense to a permanent establishment. While a single methodology was proposed at one point in this multi-year project, it now appears that the outcome of the project will be to permit member countries to pick and choose from among several alternative approaches.

The changes now proposed to the Article 5 Commentary would provide an alternative treaty text, in the form of a lower permanent establishment threshold that could be adopted by countries wishing to impose increased taxation at source on income from the performance of cross-border services. This would constitute a significant departure from the long-standing OECD consensus position on the permanent establishment threshold. Indeed, it would effectively abolish the current permanent establishment threshold for services entirely, permitting taxation at source even with no fixed place of business or contract-concluding dependent agent.

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The public discussion draft on the Article 5 proposals helpfully notes that the report of the Working Group concluded that no changes should be made to the text of the Model Convention and that services should continue to be treated in the same manner as other business activities. The draft also notes a number of policy and administrative concerns regarding increased taxation at source of services. At least in this case, then, a majority OECD position has been stated. However, by acknowledging a significantly different minority position in the Commentary, the OECD is granting a quasi-imprimatur that can be expected to facilitate the increased adoption of the minority view in bilateral treaties. The countries espousing the minority view and advocating its incorporation in the Commentary presumably share this expectation.

3. The OECD already has an effective process for allowing member countries to express disagreement with the majority position.

Under long-standing OECD procedures, any member country that wishes to reserve the option of departing from the majority position on any issue may lodge a “reservation” on the relevant Model Convention provision, if any, or an “observation” on the interpretation reflected in the Commentaries. This is a time-honored process that obviously has been used on many occasions by many member countries over the years.

There is no apparent reason that the existing reservation process cannot be used by member countries wishing to tax services in a manner not provided for by the Model Convention. A reservation would formally express the country’s disagreement with the majority position reflected in the Model Convention and reserve that country’s right to seek to negotiate a different provision in its bilateral treaties.

Because they are published together with the Model Convention and Commentaries, reservations and observations also provide critical transparency regarding the national positions of OECD member countries. By requiring member countries to commit publicly to the OECD majority position or state an alternative position, transparency also helps to provide taxpayers with the certainty they need to conduct their cross-border businesses efficiently and to comply on a timely basis with their tax obligations around the world.

Member countries are already free to negotiate provisions in their bilateral agreements for increased taxation of services at source. In fact, some members, such as Australia, New Zealand, and Norway, routinely include in their bilateral agreements a provision similar to the one now proposed for the Article 5

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Commentary. Inclusion of this minority position in the Commentary is not needed for this purpose.

4. As a practical matter, the effects of the proposed provision may not be limited to future treaties in which it is included.

Inclusion of the proposed provision in the Commentary would grant an OECD quasi-imprimatur, effectively endorsing the proposed provision as an acceptable alternative. This could be interpreted as a general nod by the OECD to a change in the balance between source and residence state taxation. Indeed, this may be at least part of what has motivated the advocates of this new provision to press for its inclusion in the Commentary.

The alternative permanent establishment threshold could also have the effect of influencing the positions taken by tax administrations under the current permanent establishment standards, even under treaties that do not include this special provision. If this proposal goes forward, it would be critical also to include in the Commentary a firm statement that the alternative provision has no implications for the interpretation and application of treaties that do not include it. Unanticipated double taxation could otherwise result.

5. The discussion draft is notable for the absence of a stated policy rationale for the proposed provision.

The only stated rationale for adding the proposed provision to the Commentary is a desire on the part of some OECD member countries to tax service providers who do business within the source state but lack a permanent establishment there under the traditional OECD definition. There is no policy rationale given for the proposed provision; it is presented simply as a mechanism to permit countries that wish to impose tax on the performance of services on their territory even where no permanent establishment exists under the current OECD definition “to secure more taxation rights with respect to services.”

The imposition of additional tax at source is, of course, the goal underlying many provisions of the UN Model Convention that depart from the OECD Model. However, the inclusion of such a provision in the OECD Commentary would be extraordinary. The OECD should be cautious in lending its imprimatur to a provision that deviates so substantially from the principles that distinguish the OECD Model from the UN Model.

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6. The proposed provision leaves key interpretive issues open.

Although we are firmly opposed to the inclusion of the proposed provision in the Commentary, we would like to take this opportunity to note that it would raise numerous issues if included in its present form. As drafted, the proposed provision leaves room for significant differences in interpretation on a series of key issues. If the provision is adopted, it would be important to address these issues to provide guidance to minimize the latitude for controversy and the considerable compliance burdens that would be imposed on taxpayers.

A detailed discussion of the proposed provision is beyond the scope of our comments. However, we would note the following as examples of important issues that are not adequately addressed by the proposed text:

- When is a project a “connected project” for purposes of proposed paragraph 42.40? For this purpose, what constitutes a service of “a similar nature”? When does the provision of services fall within the “framework” of contracts concluded with the same or an associated enterprise?
- How are the profits attributable to a deemed permanent establishment under the proposal to be determined? For example, where valuable contributions such as services, know-how, and equipment were provided from outside the host country, how will these factors be taken into account?

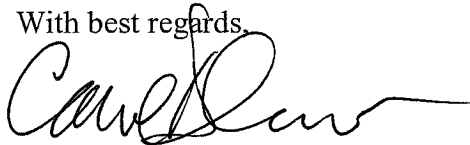
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In conclusion, we would reiterate the importance of the OECD as a consensus-building organization. The development of an international consensus on cross-border taxation is becoming ever more essential, as global trade and investment expand. If the OECD is to continue to play its leading role and to avoid having its Model Convention and Commentaries reduced to an exercise in comparative law, it

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is critical that the OECD refocus its efforts to achieve and maintain a broad consensus. To that end, we respectfully urge the OECD to reconsider its proposal to add the alternative permanent establishment definition to its Article 5 Commentary.

With best regards,



Carol A. Dunahoo

CAD/lac

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