

February 20, 2007

Dear Jeffrey,

BIAC has carefully considered the substance and the implications of the OECD Public Discussion Draft *"The Tax Treaty Treatment of Services: Proposed Commentary Changes"*, dated December, 8, 2006.

The Draft raises fundamental issues. We are concerned that the approach taken in the Draft inappropriately facilitates deviations from the straightforward application of the Permanent Establishment rules of Article 5. We do not support this approach.

Furthermore, although we understand the differences of opinion by OECD Member States that give rise to proposals such as this, it is most important that the OECD and its Committee on Fiscal Affairs maintain the consistency of principles of international taxation that are set forth in Article 5. As such, it is also critical to the value of the Model Tax Convention as the international standard for tax treaties that the methodology by which its principles are formulated be consensus based. The proposal on its face is not consensus based.

The case for providing this facilitation and implicit endorsement for deviating from the fundamental principles is simply not made in this case, and thus it is the position of BIAC that the proposed changes should not be carried out. In our opinion, carrying out the proposal would undermine the role of the Model Tax Convention as the continued standard for good international taxation.

The attached paper sets forth our views in detail.

We would be happy to discuss this with you and the Secretariat.

Sincerely,



Patrick J. Ellingsworth
Chair, BIAC Committee on Taxation and Fiscal Affairs

Mr. Jeffrey Owens
Director
Centre for Tax Policy and Administration
OECD

BIAC Comments on the OECD Public Discussion Draft:

***The Tax Treaty Treatment of Services:
Proposed Commentary Changes***

February 16, 2007

BIAC appreciates this opportunity to provide the following comments on the OECD Public Discussion Draft: *“The Tax Treaty Treatment of Services: Proposed Commentary Changes.”*

We would be pleased to answer any questions or further discussion the views outlined in this note.

Position Summary:

BIAC Does Not Support Inserting the Alternative Approach into the Commentary

- Under policy considerations **BIAC fully supports the traditional approach** to the attribution of taxation rights on business profits under the general rules of Article 5 of the OECD Model Tax Convention, which includes the provision of services. The permanent establishment threshold is well-known and accepted worldwide and a point of reference to states and taxpayers in a global business environment.
- The proposed new Commentary defines a framework of rules and conditions that should govern states if they decide to deviate from the general permanent establishment standard under Article 5 and introduce a special deemed permanent establishment threshold for services taxation in their tax treaties. The business community sees the intention of OECD to provide more guidance to countries that intend to follow such an approach and understands that there is pressure from certain countries to at least go half-way by inserting the new approach in the Commentaries. **BIAC is, however, of clear opinion that these reasons do not justify a deviation from the fundamental principles governing the OECD PE approach, as laid down in paragraph 1 of Article 5.**
- Major feasibility and policy issues regarding an alternative treaty provision on services are not addressed by the proposed Commentary and apparently left for states to be resolved. These issues concern key elements inherent to the alternative approach, such as legislative and administrative application, attribution of profits, intermediate financing of refundable withholding tax, the threat of the creation of market barriers and possible unequal treatment of resident and non-resident service providers. These questions should rate high in importance for governments and business taxpayers alike. **It seems almost impossible to fully appreciate the possible impact of the alternative approach to the taxation of services in the absence of any substantial and coherent information on these issues.**
- **Generally, BIAC is very concerned about OECD’s plan to include fundamentally differing attribution rules like the proposal on deemed permanent establishments in the Commentary, which may create problems future efforts to develop consensus positions on important issues.** So far, states disagreeing could voice disagreement in the section called “Observations on the Commentary” or section “Reservations on the Article”. For article 5, there are many such observations and reservations. Those states wanting to

go for a deemed services permanent establishment approach ought to voice their observation or reservation in the specific sections.

- **BIAC requests that the Committee on Fiscal Affairs undertake further work on these policy and feasibility considerations, and not adopt this proposal.**

The following are Comments Regarding Specific Issues Raised by the Discussion Draft:

I. Standard OECD Approach: The Permanent Establishment Threshold

1. As a starting point, the proposed paragraphs 42.11-42.13 to the Commentary reflect the view of many OECD Member States which hold that the permanent establishment concept as it stands in the current wording of Article 5 of the OECD model tax treaty is the appropriate basis to deal with the provision of cross-border services in the context of tax conventions. In the view of these Member States there is no need for specific rules concerning the cross-border provision of services. The general permanent establishment concept applies to services just as it does to any other types of economic activities which a resident of one treaty state performs in the other treaty state. The taxation rights are exclusively attributed to the state of residence of the service provider unless it provides its services through a permanent establishment situated in the other state (which is a party to tax treaty with the first-mentioned state).

2. BIAC strongly supports this principled view and the important policy and administrative considerations which back it (proposed paragraphs 42.11 to 42.13 to the Commentary on Article 5). The traditional permanent establishment concept has the important merit of providing a well-established rule which in its many years of existence and application proved an adequate means for delimiting the residence and the host state's taxing rights and avoiding double taxation. The service sector in general and cross-border services of various kinds are becoming more and more important for the business community. Business entities providing services internationally are dependent on clear, transparent and easily applicable rules dealing with the allocation of taxing rights and the calculation of taxable amounts. The current Commentary is reflecting this by making taxation in the state where services are received contingent on the presence of a permanent establishment of the service provider. A provider of cross-border services will thus face a limited tax liability in the state where the services are being rendered only if it has a permanent establishment there. In all other cases the taxing right remains with the state in which the service provider is a resident.

ii. Proposed Alternative Approach: Deviation from Residence or Permanent Establishment-Based Taxation of Services

3. As the new commentary proposed by the OECD puts forward, some states "*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*" (42.14). These states - as a matter of differing policy - claim taxing rights even in the absence of a regular permanent establishment (under the existing rules), based on their view 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.

4. With the proposed change of Commentary, OECD's Committee on Fiscal Affairs makes an attempt at defining the framework that states should respect if they decide to agree on treaty provisions which attribute taxation rights regarding cross-border services that are not attributable to a permanent establishment on their territory but that are performed on that territory.

Three prerequisite conditions are set in the proposed alternative approach (42.22):

- (1) taxation should not extend to services performed outside the territory of a State,
- (2) taxation should be dependent on a minimum level of presence in a State (time period, relative level of revenue), and
- (3) taxation should apply only to the profits and not to gross amounts payable for services received.

5. **BIAC does not believe that meeting these proposed minimum conditions in the alternative approach should ever be a principle of international taxation.** Taxability ought require the substantial presence described in the general rules of Article 5.

6. **The example of an alternative provision for the attribution of taxing rights on services given in paragraph 42.23** of the proposed commentary sets a 183-days threshold in any given twelve month period and thereby addresses the prerequisite of a minimum level of presence. It remains unclear, however, how the 183 days would be calculated (e.g. in succession or not). Importantly, the **thorny issues of tax liability and profit-based tax calculation** in the absence of a regular permanent establishment of the service provider are not addressed. And there is no indication on how an alternative provision regarding services would relate to other sections of Article 5 (it might have to be clarified that those other sections would be non-effective).

In BIAC's view and for the sake of clarity and a better understanding, it would seem appropriate that states which advocate the deviation from residence or permanent establishment-based taxation of services **furnish details of their rules and regulations to illustrate how they deal with these issues in practice.** This concerns particularly reporting requirements which are imposed on service providers and the calculation of profits taxable in the state where a permanent establishment is deemed to exist.

7. Subparagraphs a) and b) of the alternative provision (42.23) serve the purpose 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.*”

In particular, subparagraph a) determines **that a given state's taxing right** regarding the provision of services by an individual in the absence of a permanent establishment **is dependent on a minimum level of more than 50 percent of gross revenues attributable to active business activities of the enterprise during the given period derived from the services performed in that other State through that individual.** Although BIAC understands the reasoning, our members strongly fear that the dual line approach of relating to either gross revenues or profits further complicates matters (42.37). It would seem that the criterion is likely to raise technical issues relating to the attribution of gross revenues (or profits) and to bookkeeping requirements. It also leaves open questions about the timing of reporting and related reporting requirements in the jurisdiction concerned. The proposed requirement is likely to create compliance risks and is a reason of concern to business.

8. BIAC sees a number of further, specifically technical issues with the proposed commentary changes which would need to be elaborated upon:

- o The relationship of the list of (auxiliary) activities deemed not to be included in the permanent establishment definition (paragraph 4 of Article 5) with the proposed alternative provision on services, specifically in respect to the “collection of information” exception should be clarified;

- Explanations regarding the **term “connected projects”** as used in subparagraph b) of the alternative provision (42.23) should be provided. In particular, the description in paragraph 42.40 should be expanded to (a) specify that contracts would not be considered connected where the services are provided by different entities (even if related) or the services were contracted for in separate negotiations. Furthermore, construction and maintenance work on a project should not be dealt with as connected projects and be assessed separately;
- Guidance on **counting and double-counting issues** relating to the presence of personnel, of subcontractors and their employees or of local employees in the state where the services are performed would be needed. For example, it would be useful to specify that days of arrival and departure are excluded in counting the number of days considered present in the state and that days spent exclusively on preparatory work would not be counted. Additionally, sub-contractors executing a project should not be considered and taken into account to give rise to a deemed services permanent establishment.

9. The **"anti-abuse" provision** in paragraph 42.42 seems overly broad. There should be a requirement that two enterprises are used with an intent to evade the 183-day threshold. Alternatively, it should be possible to avoid application of this provision by a showing that the use of two enterprises is within the normal business practice of the enterprise.

10. Last but not least, **the proposed Commentary does not define the term “services” used in the proposed alternative provision**. This should be reconsidered. Experience with the application of value added taxes shows how difficult it is in many instances to distinguish between services and other business activities. There are also many situations where services are a more or less important part of other business activities. General treaty rules refer to states’ domestic laws for a definition of the term “services”. There is a risk of a mismatch between the interpretations which countries may give to the term in practice. A definition would contribute to ensure that states and taxpayers all could have a common understanding of the economic activities which would be covered by specific treaty provisions dealing with the taxation of services. BIAAC strongly recommends that the OECD provide guidance regarding the distinction between services and other business activities.

A definition would be needed for example to ensure that the simple provision of know-how is not caught under the services provision, that a secondment is not treated as a provision of services, or that the mere collection of data by means of an office or field visit to enable the provision of services from the other state is not deemed to be a service.

ii. **Specific Feasibility and Policy Issues with the Alternative Approach**

11. BIAAC members raised a number of other, more fundamental issues regarding the proposed alternative approach. These concern on one side the **practical consequences** of such an approach and on the other side the **policy impact** of the proposed extension of the permanent establishment concept on the OECD Commentary, a document which is meant to govern the conclusion and application of tax treaties between the OECD members. BIAAC believes that this is a crucial limitation.

12. The alternative approach will have to be implemented in practice following the rules laid down in Article 7. It is therefore necessary to have a closer look at the practical implication of such a new approach. Those states which advocate source-based taxation of services seem to generally rely on a **system of withholding to collect the tax**. Withholding however is feasible only on gross amounts paid, whereas the proposed Commentary rightfully insists on taxation on a net basis, i.e. of profits only (42.19).

13. Taxation on a gross basis is prone to have **distorting outcomes**, which includes the possibility of a gross tax being imposed in the absence of any net income. For this reason states willing to impose services at source under a deemed permanent establishment scheme may therefore consider to provide non-resident service providers the facility to elect to file a tax return in the source country and be taxed on a net basis. It seems however that even states which provide the possibility of filing a tax return will subject the payment in remuneration of the services to a prior withholding on the gross amount.

From a perspective of the service providers the choice of opting for the tax return has far-reaching administrative consequences. Considerable compliance costs are incurred by a taxpayer with filing returns, a burden which weighs especially heavy in cases where it is uncertain whether the deemed permanent establishment threshold will be met. Obtaining a (partial or full) refund of tax withheld in a foreign state where it has no fixed base is in any case a **burdensome exercise for a foreign service provider**. On the other end, the **tax authorities** are confronted with non-negligible administrative costs to ensure that the withholding deduction is made, that potentially complex tax returns (for deemed permanent establishments) are correctly administered and refunds to taxpayers are correctly calculated and paid.

14. Furthermore, the refundable part of **withholding tax is tied up in the hands of the fiscal authorities of the source state** for the lapse of time between withholding deduction and refund, which may put a substantial strain on the financial liquidity of the service providers concerned and possibly discourage potential non-resident service providers from offering their services altogether. If resident service-providers are not subject to the same withholding as non-resident providers under the applicable rules of the source state, the result will be a distortion of competition and markets.

15. BIAAC members also mention a more policy-related aspect associated with the proposed extension of the permanent establishment concept. **The alternative approach as suggested by OECD resembles what the UN model provides for tax treaties between developed and developing countries**. There used to be consensus among many OECD Member States - and to our understanding this still is the case today - that a deemed permanent establishment approach should not be followed given the fact that major economic inconsistencies and practical difficulties subsist, as was described above. **BIAAC is clearly of the opinion that it would be wrong to insert the alternative approach in the OECD Commentary. The mission of the OECD is to pursue and promote the broadest international consensus on issues such as tax policy, and not defer to a few member countries who may not agree with the consensus on broad principles of tax policy. If the OECD includes such alternative language, countries will overlook any disclaimer that this does not represent the OECD position and could therefore conclude that a six-month services clause is acceptable. Countries can look otherwise to the UN Model Treaty to negotiate six-month services provisions.**