

Asia
Pacific
Bangkok
Beijing
Hanoi
Ho Chi Minh City
Hong Kong
Jakarta
Kuala Lumpur
Manila
Melbourne
Shanghai
Singapore
Sydney
Taipei
TokyoEurope &
Middle East
Almaty
Amsterdam
Antwerp
Bahrain
Baku
Barcelona
Berlin
Bologna
Brussels
Budapest
Cairo
Düsseldorf
Frankfurt / Main
Geneva
Kyiv
London
Madrid
Milan
Moscow
Munich
Paris
Prague
Riyadh
Rome
St. Petersburg
Stockholm
Vienna
Warsaw
ZurichNorth & South
America
Bogotá
Brasília
Buenos Aires
Caracas
Chicago
Chihuahua
Dallas
Guadalajara
Houston
Juarez
Mexico City
Miami
Monterrey
New York
Palo Alto
Porto Alegre
Rio de Janeiro
San Diego
San Francisco
Santiago
Sao Paulo
Tijuana
Toronto
Valencia
Washington, DC

February 15, 2007

Mr. Jeffrey Owens
Director, Centre for Tax Policy and Administration
Organisation for Economic Co-Operation
and Development
2, rue André Pascal
75775 Paris
FRANCE

Gary D. Sprague
Tel: +1 650 856 5510
gary.d.sprague@bakernet.com**VIA ELECTRONIC DELIVERY**

RE: Tax Treaty Treatment of Services: Proposed Commentary Changes

Dear Mr. Owens:

We are writing on behalf of the Software Coalition, an industry association representing many of the world's leading computer software companies, to submit comments on the proposed changes to the OECD Commentary on Article 5 regarding the tax treaty treatment of services as described in the public discussion draft released by the OECD on December 8, 2006 (the "Proposed Changes").

I. Introduction

The services line of business is a significant and growing component of the business operations of many software companies. Software companies offer end users various distinct software-related services, such as (i) pre-license consulting, (ii) installation and/or customization, and (iii) training and technical support. These software-related services assist end users to achieve optimal use of the computer software program.

Since all or nearly all members of the Software Coalition (the "Coalition Members") offer software products and software-related services to customers located in multiple OECD Member States, the cross-border provision of software-related services is quite common. Accordingly, the proposed changes to the OECD Commentary on Article 5 have the potential of having a significant impact on software companies.

II. Overview of Software Company Service Models

The software industry is best characterized by its rapid innovation and technological developments. These two forces create a highly competitive and fluid business environment. To be successful, software companies must adopt businesses models which serve to (i) lower total costs to end users, and (ii) make the best products and services available to customers as quickly as possible. These market drivers play a significant role in determining how software companies structure their operations to deliver software-related services to customers.

There are two common models that software companies have implemented to deliver software-related services to end users: (i) the center of excellence model; and (ii) a decentralized model. Companies choose between these two models based on various factors, which include the location of qualified personnel and their proximity to customers.

Under a center of excellence model, companies establish one or more regional hubs that provide software-related services to customers located in multiple countries across a region (*e.g.*, Asia-Pac or Europe). The central hub employs personnel trained to provide software-related services and those personnel are deployed to customer locations on an “as-needed” basis. Due to the need for highly skilled workers, many companies have established their centers of excellence in various OECD Member States, such as the United Kingdom, France, Germany and Australia.

Under a decentralized service model, software companies maintain localized support centers in each of their major markets. To the extent possible, personnel employed by the local entities provide local customers with software-related services. From time to time, however, personnel may be required to provide cross-border services, either if there is no local entity in the customer’s country of residence or if there is an imbalance in available labor, requiring an entity to borrow personnel from another nearby entity. This model results in a very large number of cross-border relationships, as workloads commonly are balanced by employing resources from other jurisdictions, and any given project could involve personnel from multiple entities.

Accordingly, under both service models, the provision of software-related services by multinational software companies requires a significant amount of cross-border activity in order to operate efficiently, as personnel are dispatched cross-border from regional or localized support centers. Currently, companies typically do not have a tracking system in place to identify and track the deployment of personnel used in the provision of short term cross-border services.

III. International Consensus on Tax Policy

A. OECD Is a Consensus-Building Organization

The business community has long appreciated the value of the OECD as a forum in which to achieve international consensus on a wide range of complex international tax issues. The OECD Model Convention and its Commentary provide both taxpayers and tax administrators with helpful guidance by establishing an articulated and generally accepted understanding of international norms, which helps relieve double taxation in the case of divergent domestic laws. It is this ability to create consensus that is the foundation of the OECD’s admired position in the world as the body which sets global standards for international tax principles and practice. The OECD’s leadership role also clearly extends to non-Member States, largely due to the OECD’s success in setting consistent, clear and uniform standards.

B. OECD Should Not Endorse Multiple Standards

Under the current provisions of the OECD Model Tax Convention, 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 (“PE”). Based on the Proposed Changes, we understand that the OECD unequivocally intends to retain the traditional PE rule as the preferred nexus rule for the taxation of cross-border services. We agree with this view.

Some Member States, however, wish to depart from this current consensus view. Instead, these States have proposed that the Commentary incorporate alternative provisions to preserve source taxation rights with respect to the profits from certain cross-border services.

Anticipating that such alternative provisions may be adopted in bilateral treaty negotiations, the Proposed Changes seek to establish limits on any source-based taxation of services absent a PE. We are sympathetic to that goal. We believe, however, that introducing into the Commentary a deemed PE standard, even subject to the limitations suggested in the Proposed Changes, may have the unintended consequence of being interpreted as an OECD endorsement of this minority view. Therefore, we believe that including the Proposed Changes in the Commentary is counterproductive to the OECD’s mission of creating consensus and should not be pursued.

We fully appreciate that there are situations where a Member State may not agree with particular terms of the OECD Model Tax Convention or interpretation contained in the Commentary. For these situations, Member States may follow the long-established and time-honored practice of lodging Reservations on the relevant Article or Observations on the Commentary.¹ This procedure serves the goals of reducing the risk of international double taxation by enhancing transparency of each Member State’s views. There is no need to incorporate a minority approach in the Commentary, leaving taxpayers to wonder which Member States support the minority rule, when a better process already exists for Member States to make known their objections to the consensus position.

Despite the fact that the Proposed Changes clearly state that the deemed PE rule for services would not be effective unless treaty partners specifically agree to it, the mere incorporation of the Proposed Changes into the Commentary creates a sense of endorsement by the OECD of this minority position, which would be contrary to the OECD’s mandate to achieve an international consensus on issues. Instead of building a consensus, the OECD would be taking a step in the opposite direction by offering a menu of available tax policies.

¹ For example, ¶¶ 43-45.10 of the Commentary on Article 5 provide the Observations on the Commentary on Article 5 and ¶¶ 46-65 of the Commentary on Article 5 provide the Reservations on Article 5.

The co-existence of contradictory international tax policies is exactly the situation that could give rise to double taxation and thus should be discouraged by the OECD.

In the long run, businesses will establish their service centers in jurisdictions which provide an attractive tax environment. In this case, companies will have an incentive to establish their service centers in jurisdictions that have preserved the traditional PE rules in their treaties for services, as those jurisdictions create a more flexible and accommodating base from which to provide cross-border services.

IV. Interpretive Issues

A. Key Interpretive Issues Unaddressed

The Proposed Changes generally propose limiting source-based taxation of services not performed through a PE in three significant ways:

- i. Source taxation should not extend to services performed outside the territory of a state;
- ii. Source taxation should apply only to the profits from the services, rather than to the gross payments for them; and
- iii. Source taxation should only be allowed if there is a minimum level of presence in a state.

These proposed limitations are sound general principles, and we certainly endorse them. As a practical matter, however, these rather obvious principles fall short of offering meaningful guidance as to what detailed rules Member States should adopt in order to provide useful guidance and to avoid double taxation. If the intention is to provide useful guidance in this area, the following interpretive issues (at a minimum) must be more thoroughly addressed.

1. Profit Attribution to the Source State Deemed PE

The principal issue that will require further consideration in order to provide useful guidance is profit attribution. Merely stating that source state taxation should only apply to services performed in the state, and that the tax should be imposed on profits rather than on gross payments, is not very helpful in explaining how enterprises should allocate income and expenses to the deemed PE to determine the taxable profits derived from activities actually performed in the source state.

On the income side, it is typically the case that even where some portion of the service has been provided by personnel crossing a border to a customer location, not all of the service fee can be regarded as arising from local source. Typically, inputs deployed outside the source state in the nature of services, equipment, know-how, intangible property

or other elements contribute to the performance of the service. Customer payments which compensate the service providing entity for these inputs cannot be regarded as giving rise entirely to local source income, if the personnel temporarily present in the source state are only part of a larger service organization.

Similar allocation issues exist on the cost side. Significant costs exist in a service business beyond the direct compensation, etc. costs of the service providers. For example, significant costs arise from recruiting, training and covering “bench time” (i.e. periods when service providers are not fully utilized). These costs would need to be appropriately allocated to the source state deemed PE. Similarly, sales and marketing, G&A and other costs must be allocated to the deemed PE income.

2. Determination of Level of Presence

Another crucial interpretive issue is raised by the minimum presence test. An initial issue that must be addressed is how Member States should count the number of days an enterprise is present in a country providing services. It would be important to clarify that the relevant days should be only days during which the employees are actually providing services for compensation in the country. It would be inappropriate to count days of physical presence during which personnel of the enterprise are not actually providing services for compensation. For example, preparatory time (*e.g.*, marketing activities or preparing options for potential clients) spent in the country, but which are not directly compensated for by the customer, should not be included in the 183 day minimum threshold.

The term “connected project” requires further elaboration, if this guidance is to be of value to tax administrations and businesses. Paragraph 42.40 of the Proposed Changes states that the term “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 within the same enterprise or with associated enterprises.” This paragraph implies that there are two prongs to the “connected project” test: (i) the two engagements must be assessed to determine how similar in kind the various services are; and (ii) the overall contractual relationship (“framework”) must be assessed to determine whether the two engagements are essentially part of a single contractual relationship.

The results produced under the “connected project” test could be vastly different depending on how narrowly or broadly the term “same or similar nature” will be interpreted. For most software companies, there are temporal and functional distinctions in the types of software-related services most companies provide. The life cycle of software services begins with pre-software license consulting, where the enterprise reviews the customer’s information technology (“IT”) systems and determines how certain software products could improve the customer’s operations. Then, after a customer licenses the software product(s), the service team customizes and/or installs the software product to work within the

customer's IT environment. After the software product has been completely installed, the enterprise may provide training and on-going support of the software program.

The software service life cycle is similar to services rendered with respect to the acquisition of many other business assets. A prospective purchaser may receive advice from one service provider on its asset acquisition strategy, may engage a service provider to deliver and install the asset, and may engage a third service provider to provide warranty services.

While each of those stages all deal with a single asset – the installed software product – they each involve different skills, and can be provided by different enterprises. Accordingly, in the context of software services, the “same or similar nature” test normally should apply to not aggregate those three types of service.

V. Implications of Paragraph 42.30 of the Proposed Changes – Subcontracting Example

Paragraph 42.30 of the Proposed Changes, which confirms that Member States should not deem a PE to exist solely due to services performed by a contractor in that State, provides useful clarification which is equally applicable to cases where the consensus PE standard is applied to services. Paragraph 42.30 states, in relevant part:

...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 service 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.

This confirmation that contractors do not give rise to a PE of their principal, absent the application of Article 5(5), would be useful guidance to incorporate into the current Commentary on Article 5 (Permanent Establishment). We respectfully request the OECD adopt this principle in the Commentary along the lines suggested in paragraph 42.30.

We found the text of paragraph 42.30 somewhat unclear, however, especially as regards the contractual relationships which were assumed in that paragraph. Accordingly, we propose that an example could be included to clearly illustrate the intended effect of this provision:

For example, assume an enterprise in State 1 enters into a contract for the supply of services to a customer in State 2. In exchange for such services, the State 2 customer will pay the State 1 enterprise a service fee. The State 1 enterprise enters into a separate contract with a State 3 service provider, whereby the State 3 service provider agrees to perform the services to the

State 2 customer. In exchange for such services, the State 1 enterprise pays the State 3 service provider an arm's length service fee. Assume that the State 3 service provider does not constitute a dependent agent which has and habitually exercises an authority to conclude contracts in the name of the State 1 enterprise. Under these facts, the services performed by the State 3 service provider to fulfill the obligations of the State 1 enterprise to the State 2 customer will not give rise to a permanent establishment of the State 1 enterprise in State 3, even if the State 3 service provider conferred an economic benefit to the State 1 enterprise's business. The result would be the same if the customer were located in State 3.

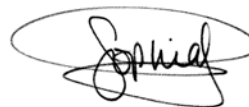
* * * * *

We thank you and the Members of the Working Party for the opportunity to provide you with our comments to the proposed changes to the OECD Commentary on Article 5 regarding the tax treaty treatment of services. We would be more than happy to elaborate further on any of our points discussed herein.

Sincerely,



Gary D. Sprague



Sophia J. Kim