

**Comments on Public Discussion Draft****The Tax Treaty Treatment of Services  
Proposed Commentary Changes****1. Comments on para 42.12**

The arguments contained in this paragraph do not appear to be strong enough to justify non-taxation of services.

**1.1 Non-disclosure**

This para contemplates a situation wherein “services provided to customers would not be disclosed to the source country’s tax administration”. What is sought to be conveyed is not clear. It is a basic assumption behind the entire treaty network that the tax payer would honestly disclose all the facts. If there is a fear of the tax payer not disclosing something then it should apply to any provision of the treaty. For example a tax payer may never disclose that a particular office premises are at its disposal, he may never disclose that he has a dependent agent in the source country.

The Contracting States are expected to address such issues separately say by exchange of information and other remedies under the domestic law.

**1.2 Unexpected circumstances**

This para opposes ‘time spent’ as a criteria for taxation of services on the basis that it may result in ‘unexpected circumstances’ and it may be difficult to determine how long personnel would be present’ absence of accounting records etc.

However, it should be noted that such uncertainty prevails for any business. A service provider may be in a position to determine how long the project would last. Similar uncertainty also prevails for construction / installation projects as Article 5(3) also gives the threshold of twelve months.

Interestingly interpretation of Article 5(1) results in biggest uncertainty as one does not know when the permanence test is met. PE is created if an office premises are at the disposal of the enterprise but should the period of three, six or nine months be treated as long enough to result in PE is not clear.

Absence of books of accounts etc. is also not uncommon in the OECD model. When an agency PE is created [Article 5(3)] the enterprise does not have any books of accounts etc. in the source country and similar issues arise. Thus this cannot be a strong argument for not taxing services based on time spent.

**2. Comments on para 42.21**

The last limb of this para is worded as follows:

“...would be taxable by that State if they are not attributable to a permanent establishment situated therein”.

This gives an impression that the permanent establishment exists in the source country but the services are not attributable such PE. However, what is sought to be covered is also a situation wherein the PE does not exist at all.

There could be three situations as follows:

1. The enterprise rendering services has a PE in the source country and the services are attributable to such PE.
2. The enterprise rendering services has a PE in the source country and the services are not attributable to such PE.
3. The enterprise rendering services does not have a PE in the source country.

The first situation is covered by the existing provisions.

The last part of Para 42.21 copied above seem to be covering only the second situation above and not the third one. However, apparently the intention seems to be to cover both second and third situation above.

### **3. Comments on para 42.23**

#### **3.1 Presumption as to existence of PE**

The concluding part of the suggested para contains the words "...shall be deemed to be carried on through a permanent establishment that the enterprise has in that other State,..."

This sentence gives an impression that the suggested para shall apply only in a situation wherein PE exists. If the enterprise does not have a PE in the other State then this para may not be applicable. This observation is similar to item no. 2 above in respect of para 41.21.

The words "that the enterprise has" may be deleted. After such deletion the sentence would read as follows:

"...shall be deemed to be carried on through a permanent establishment in that other State,..."

#### **3.2 Placement of suggested paras**

It may be provided that the proposed paras may be included in Article 5. Para 42.23 does not refer to Article 5 at all.

The suggested para refers to paragraph 1, 2, 3 and 4. Thus the new provision cannot be placed at these numbers. Further, paragraph 5 & 6 are linked. Accordingly, the suggested paras may be numbered (7) or (8).

#### **3.3 Comments on clause (a)**

##### **3.3.1 Importance of physical presence as against rendition of services**

This clause requires the individual to be present for period exceeding 183 days. Thus what is considered important is physical presence of an individual as against rendition /performance of services. This clause should ideally provide that the performance of services should continue for a period exceeding 183 days.

For this purpose the discussion draft has heavily relied on the OECD Commentary on Article 15(2)(a). However, it should be noted that there is a difference between the scope of Article 15 and Article 5. Article 15 deals with income generated by employment. The remuneration for employment i.e. salaries are linked to period of a month and generally remains same without considering the weekends etc. In other words if an employee earns USD 10,000 as a salary per month then this amount would generally remain constant for all the months irrespective of the fact that in February there are only 28 days or in December there are 10 holidays.

As against this the remuneration for the services contemplated to be resulting in a PE would not be linked to a period of time. Such remuneration would be linked to completion of job or rendition of services. For example a professional would charge based on the number of hours spent by him on the job. He would not charge on the same basis for the weekends or national holidays unless he has worked on these days.

No doubt it may be administratively most convenient to tax services just on the basis of physical presence but this has the potential of creating undesired results. Based on a five day working week this would result in a situation wherein out of 100 days services would be rendered for only 71 days and the PE will be considered for 100 days (29% of the time / days gets loaded or with national holidays etc. 33% or 1/3<sup>rd</sup> period is considered without any economic activities). This may be considered as a one of the stringent PE definition wherein the enterprise would be deemed to have performed economic activities for the entire period even when 1/3<sup>rd</sup> of the period is without any activities.

Having said that it may not be easy to establish the exact number of days on which services were rendered. However, a better approach perhaps could be to leave it open for the tax payer to establish and the tax authorities to examine this fact. If the provision is worded with respect of physical presence as against performance of services then the tax authorities would not even attempt to examine this issue.

In this context it is relevant to take note of the UN Model Article 5(3) which provides that “if the activities of that nature continues for a period.....”.

### **3.3.2 Period of twelve months**

The words “..within any twelve month period” may be used instead of “in any twelve month period”.

### **3.3.3 Test of 50%**

The logic behind the 50% test and the test itself are difficult to understand.

Apparently, this requires that to constitute PE / deemed PE during the relevant period substantial / major part of the income earned by the enterprise from its business activities should be arising from the activities of the individual.

This is difficult to understand as such tests do not appear for other forms of PE. The existence of PE is not linked to the revenues earned by the PE.

### **Active business of the enterprise**

An enterprise may be considered as a business unit and may have several activities within its fold.

This test does not give exact direction as to what is ‘active business’. Should this consider any business carried by the enterprise in the home country or in any part of the world?. Should one consider only that particular segment of business which is carried on through the PE?

‘Active business of an enterprise’ is a too broad term. This may be examined in the context of a simple law firm. This firm has two main activities i.e. ‘advisory’ and ‘litigation’. Further, the law firm specializes in four major areas such as ‘corporate law’, ‘property laws’, ‘tax laws’ and ‘environment laws’.

Should one consider only a particular transaction with the counter party and examine the level of activities performed in the source country and the residence country? If the revenue attributable to the activities carried out in the source country is higher than the revenue arising from the services performed for the same project in the residence country then the test should be considered as being met.

### **Applicability to larger enterprises**

This test presupposes that the enterprise has a restricted amount of activities. A bigger enterprise could have several activities and only a small portion of the business may be carried on in the source country wherein the employee renders services. Thus an enterprise having 100 employees may be earning gross revenue of USD 100bn during the relevant period. This enterprise has sent one employee in the other State and earns USD 1 bn from the activities of this employee. Although USD 1 bn may be considered to be a significant amount, this would get lost against the total revenue of the enterprise.

### **Determination of gross revenue for the relevant period**

Para 42.37 tries to give some guidance on how to determine gross revenue for the relevant period. This determination could result in major difficulties. Take a hypothetical situation wherein one is required to determine gross revenue for the period January 23 to July 17. This may be extremely difficult. Para 42.37 also sets aside the normal principles followed for tax purpose under the domestic law etc.

### **General**

The 50% test does not seem to be serving any purpose and it is strongly recommended that this should be dropped.

## **3.4 Comments on clause (b)**

### **3.4.1 During a period or periods**

This clause uses the words “ performs services in the other Contracting State during a period or periods exceeding in the aggregate.....”.

Use of word “for” may be considered as against the word “during”. One of the meanings of the word “during” is “throughout” and accordingly it gives the desired meaning.

However, the word “during” also means “at some stage in” and if this meaning is adopted then it would not give the desired meaning. If I say that “I have written five articles during the year 2006” it does not convey that for the entire year (365 days) 2006 I kept on writing articles. I may have spent at the most 10 days writing these articles.

The possibility of using the word “for a period or periods” may be considered.

### **3.4.1 Importance of physical presence as against rendition of services**

The last limb of clause (b) contains the words “...or are present in that other State for the purpose of performing such services”. This gives importance to physical presence as against actual performance. The comments at para 3.3.1 above would equally apply to clause (b) as well.

This clause is slightly better than clause (a) as it uses requires the presence to be for the purpose of performing such services. However, this may still be considered to be harsh. Lets consider the following Example:

**Example 1**

A Ltd., a company resident of Country A enters into an agreement to render particular type of services to B Ltd. in Country B. For this purpose A Ltd. draws a team of five engineers X,Y,Z, P and Q. Further, to avoid any interruption in services A Ltd. also includes R and S in the team. Thus there are 7 individuals - engineers in the team but only five are going to render services and two engineers (R,S) are reserve. The employees of A Ltd. are required to perform services with effect from February 8. Accordingly, the main team reached country B on February 7. However, when the team was finalized R & S were rendering services in Country C. Considering the proximity of Country C, these employees were instructed to directly go to Country B instead of coming back to Country A. Thus two reserve employees R & S reached Country B on February 1.

The issue that may arise is would the presence of R & S for the period February 1 to February 7 be considered for the purpose of counting 183 days? These employees were in reserve and did not have the opportunity to render any services during the entire project. However, these employees would be considered as "present in the other State for the purpose of performing such services".

**Variation A**

Extending the same example lets assume that the team completed the project in five and half month. However, the nature of work is such that at times it may require follow up action in next three weeks. To cater to any such situation two engineers X and Y were told to stay back in Country C for three more weeks. X & Y were not required to provide services only if some fault occurs. Although X & Y were present in Country C for the subsequent three weeks they did not have a situation wherein they were required to work.

The issue that may arise is would the presence of X & Y for the period of subsequent three weeks be considered for the purpose of counting 183 days? These employees were present as a back up but did not have the opportunity to render any services during the entire project. However, these employees would be considered as "present in the other State for the purpose of performing such services".

**Variation B**

In this example assume that B Ltd. does not involve R & S in the project. Instead two local engineers (E & F) from Country C are involved. Both E & F become employees of C Ltd. with effect from February 1. Their role is akin to the role of R & S i.e. they were required to provide services only in a situation wherein either of X,Y,Z, P & Q were not in a position to render services. Further, their employment continued with B Ltd. for the period up to three weeks subsequent to completion of project in five and half months. For the period of three weeks after completion of project they were required to perform any follow up action if required. However, they were not required to render any such services even during the period of three weeks subsequent to the completion of the project. Thus in effect E & F were employed by B Ltd. for the purpose of performing services in Country C but did not have the opportunity to render any services as they were kept as an additional or reserve employees.

The issue that arises should the period of February 1 to 7 and three weeks subsequent to completion of the project be considered for the purpose of calculating 183 days? During these period E & F were employed 'for the purpose of rendering services' but did not render any services.

It will be relevant to take note of the comments at Para 42.41. This para provides a specific provision as regards local employees and accordingly, it suggests that in the context of local employees the terms 'presence for the purpose of rendering services' would not be relevant. This is because the number of days worked by them would be considered.

### Example 2

The basic pattern of the first example can be followed. The only change is that only one employee (X) is required for rendering services and the second employee (R) is sent as a reserve. Only X renders services and R does not get an opportunity to serve. However, as in Example 1 R spends more days in Country B.

The issue is which clause would be attracted? Should clause (a) be applied on the basis that only one individual has rendered services? If that is the case then what happens to the numbers of additional days spent by R in Country B?

Alternatively, should clause (b) be applied on the basis that more than one individual are involved?

### 3.4.2 Passive PE

The test of physical presence brings in the concept of passive PE i.e. PE is deemed to have been created even if the employees are present for the purpose of rendering services but do not actually render services.

Well lets compare it with basic rule PE i.e. Article 5(1). If I hire an office in a commercial building in London then such office is at my disposal. But does it become my PE unless I use it for my business purpose. The obvious answer is "NO". For constituting PE what is equally important is that the "business is carried on through such PE". Article 5(1) defines PE to mean a "fixed place of business through which business of the enterprise is wholly or partly carried out".

The question is should the deeming provisions be more stringent than the main provisions? If mere presence of employees is considered as resulting in deeming PE then would it be consistent with the approach adopted for the purpose of Article 5(1)?

## 3.5 General comments on clause (a) & (b)

### 3.5.1 Presence for the purpose of

Both clause (a) & (b) consider 'presence' in the other State for the purpose of calculating 183 days. However, under clause (b) the presence should be 'for the purpose of performing services'. These words certainly reduce the scope of clause (b) as presence is to be considered only if it is for the purpose of rendering services. Clause (a) however does not provide this obvious condition.

Interestingly, for both the clauses one is expected to rely on the principles applicable to interpretation of Article 15(2)(a) which are summarized in para 5 of the Commentary on Article 15.

### 3.5.2 Need for two separate clauses

It is difficult to understand why there are two separate tests. Apparently, the difference between the two is the number of individuals involved in rendering services. If a single individual is rendering services then clause (a) applies and if more than one individual are involved then clause (b) would apply. The commentary does not seem to be any satisfactory reason why the test of PE should differ depending on the number of persons performing services.

Even the difference in two tests is difficult to understand. Under clause (a) the amount of revenue (50%) is a crucial factor whereas for clause (b) this is not required. If the proportion of revenue earned by the enterprise is important then why should this not be considered when more than one employee are involved?

For clause (b) presence should be counted only if it is for the purpose of rendering services. However, for the purpose of clause (a) it is not essential that the presence should be 'for the purpose of rendering services'.

If an individual renders services for two unrelated projects and the total period exceeds 183 days then it results in a PE in terms of clause (a). However, if two individuals work on two unrelated projects then they do not create PE even in a situation wherein total stay exceeds 183 except in a case wherein stay for a single project exceeds 183 days.

#### 4. Comments on para 42.28

Para 42.28 as well as the words "Notwithstanding the provisions of paragraphs 1,2 and" of the suggested new provision indicate that the proposed provision would override the provisions of Article 5(3). Ideally this may be avoided.

The general principle is that special provision would override general provision. Para 3 of Article 5 is a special provision dealing with construction / installation and ideally this should not be tampered by other provisions. If the intention is to reduce the threshold number of days for para 3 of Article 5 then specific amendment may be made to para 3 or to the commentary to this para.

#### 5. Comments on para 42.30

##### 5.1 Rendition of services to a third party

Para 42.30 clarifies that the employee must render services to a third part and not to the enterprise itself.

If the enterprise opens an office in the other State and the employees of the enterprise render services to no one else but only to the head office, then such office would constitute PE in terms of Article 5(1). However, the same services would not result in a PE in terms of the proposed provisions if carried out without an office.

Is it a conscious decision to adopt such different stands for different types of PEs?

##### 5.2 Involvement of third party service provider

The last sentences of para 42.30 does not adequately convey the message. One of the following two examples may better what is sought to be conveyed.

###### Example 2

A Ltd., resident of State A enters into an agreement with B Ltd., resident of State B for provision of services. A Ltd. does not provide such services on its own but sub-contract it to C Ltd., resident of State B. The employees of C Ltd. render services to B Ltd.

Para 42.30 conveys that the employees of C Ltd. do not create PE for A Ltd.

**Example 3**

B Ltd., resident of State B provides various accounting services. Various companies outsource their work to B Ltd. Under one such arrangement, A Ltd., a resident of State A, has outsourced accountancy work to B Ltd. The employees of B Ltd. visit country A and render accountancy services. These employees work under the supervision and control of A Ltd.

Para 42.30 conveys that the employees of B Ltd. does not create B Ltd's PE in State A.

Example 2 seems to be a better interpretation but para 42.30 should be simplified.

**6. Comments on para 42.31****6.1 Services to a resident of the source country**

This para conveys that the services should be furnished to a resident of the State. However, if this is strictly followed then it may not produce desired results. This can be explained on the basis of the following examples.

**Example 4**

A Ltd. is a banking company resident of State A. A Ltd. operates in several countries through its branches. One such branch has been established in State B. C Ltd. is a tax resident of State C and specializes in rendering particular type of services. C Ltd. enters into a contract with the branch of A Ltd. in State B. Pursuant to this contract A Ltd. sends its employees to State B for rendering services.

From the perspective of domestic laws of State B, A Ltd.'s branch is not a resident in State B. In terms of the explanation contained in para 42.31 the presence of A Ltd's employees in State B should not result in PE because the employees are not rendering services to a person resident of B. However, this could not be the desired result.

**Example 5**

A Ltd. is a banking company resident of State A. A Ltd. operates in several countries through its branches. One such branch has been established in State B. C Ltd. is a tax resident of State C and specializes in rendering particular type of services. C Ltd. enters into a contract with the branch of A Ltd. in State B. Pursuant to this contract A Ltd. sends its employees to State A for rendering services. The employees of C Ltd. render services from State A to the branch of A Ltd. in State B.

From the perspective of domestic laws of State A, A Ltd. is a resident in State A. In terms of the explanation contained in para 42.31 the presence of C Ltd's employees in State A would result in PE because the employees are not rendering services to a person resident of A.

**6.2 Presence of beneficiary of the services in the State - Direct utilization / consumption of services**

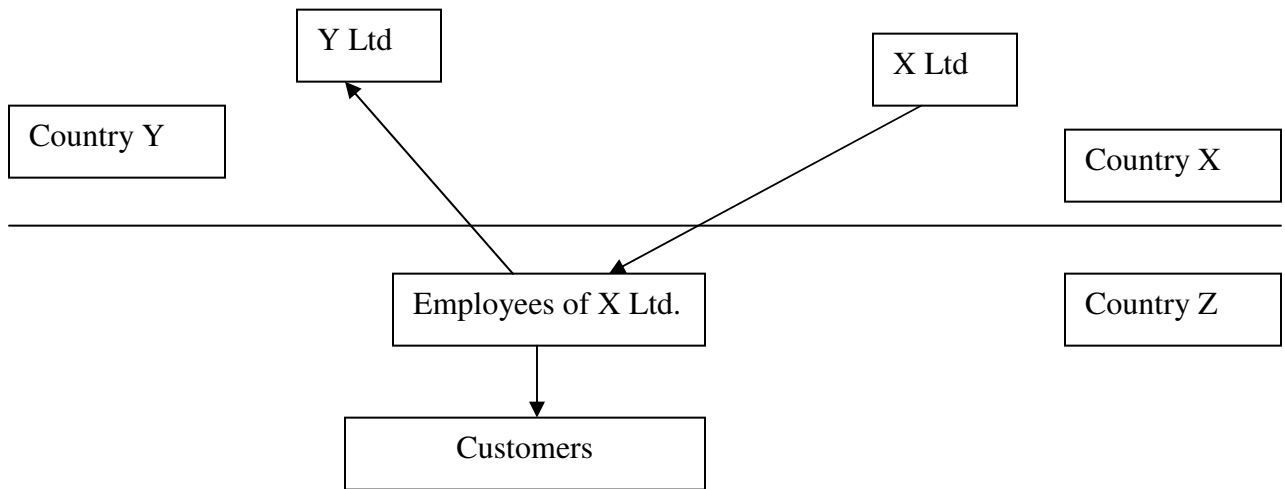
In the world of outsourcing and with advancement of technology various situations are possible. It may be desirable to examine and clarify at this stage as to how the proposed position would apply in such situations.

This may be analysed based on the following examples:

**Example 6**

X Ltd., a company based at country X, specializes in rendering machine maintenance services. This service requires actual testing; cleaning etc. of the machine.

Y Ltd., a company situated in Country Y wants maintenance services for the machines sold by it to its customers in Country Z. Y Ltd. engages X Ltd. for this purpose. The employees of X Ltd. visit Country Z and carry out maintenance for the machines sold by Y Ltd.



With regard to the above structure the following issues may arise:

- 1) The employees of X Ltd. are rendering services to whom? To the customers in Country Z or to Y Ltd based in Country Y?
- 2) If the services are rendered to Y Ltd., then can it be said that the services are not furnished in Country Z as the beneficiary (Y Ltd) is situated in Country Y. Does presence of employees result in a PE of X Ltd. in Country Z?

### **6.3 Absence of person availing services in the country - Indirect utilization of services**

It may happen that the person availing services is not present in the country where the employees carry out activities. However, the services may ultimately be utilized in the same country.

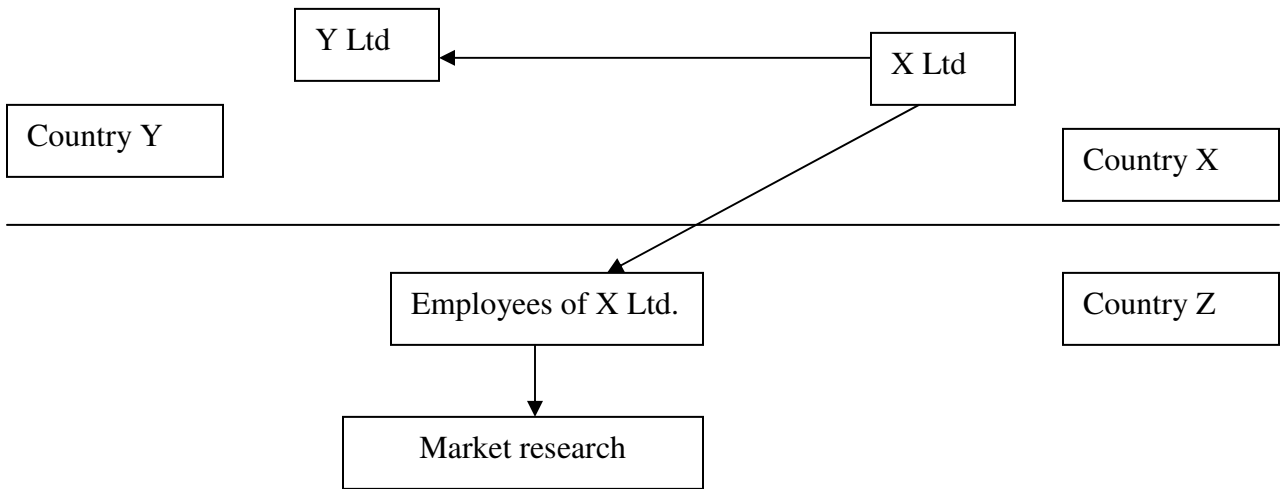
This may be explained on the basis of following example:

**Example 7**

X Ltd., a company based at country X, specializes in real estate related issues.

Y Ltd., a company situated in Country Y wants to enter real estate sector in Country Z. Y Ltd. engages X Ltd. for the purpose of studying the real estate market in Country Z. The employees of X Ltd. visit Country Z and carry out the market research activities. The employees of X Ltd. carry out various activities in Country Z for 190 days and at the end of the assignment the employees go back to Country X, prepare the final report and send it to Y Ltd. Y Ltd. uses such report for the purpose of future investments in Country Z.

This is diagrammatically represented as follows:



The person availing services, Y Ltd. is not present in Country Z. Further, the employees of X Ltd. do not interact with Y Ltd. during their stay in Country Z. The employees carry out various activities related to market research in Country Z and prepare the final report in Country X.

In this situation the issue that may arise is whether X Ltd. can be said as performing services ‘in’ Country Z?

If one accepts the direction given in para 42.31 then the PE would not arise as the services are not rendered to a resident on Country Z. A better view could be that the employees are rendering services to X Ltd. and not to anyone else.

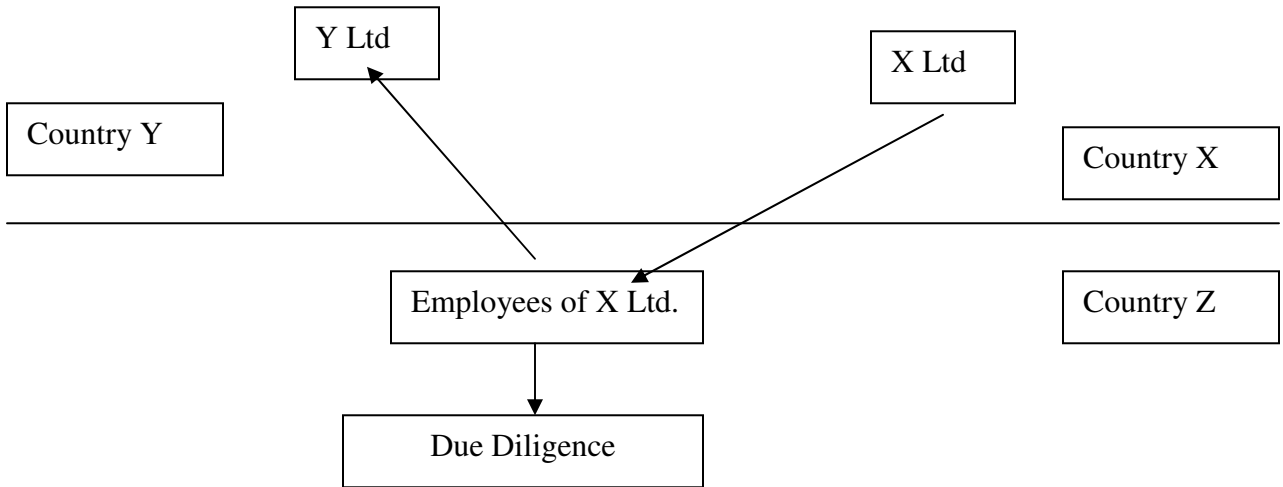
**Example 8**

X Ltd., a company based at country X, specializes in cement industry.

Y Ltd., a company situated in Country Y and proposes to make investments in cement companies based in Country Z. Y Ltd. engages X Ltd. for the purpose of carrying out due diligence of the proposed target companies. The employees of X Ltd. visit Country Z and carry out the due diligence activities. This involves checking the records and activities of the cement companies based at Country Z. The employees of X Ltd. regularly interact

with Y Ltd. and discuss their findings and give their recommendation as to whether or not to make investments in a particular company. The employees of X Ltd. carry out various activities in Country Z for 190 days. Based on the recommendation of X Ltd. (through its employees), Y Ltd. purchases or sells the shares of the cement companies.

This is diagrammatically represented as follows:



In this example the employees are actively interacting with Y Ltd. and advising Y Ltd. The question is whether X Ltd. has rendered services ‘in’ Country Z? especially when the person availing services i.e. Y Ltd. is not a resident in Country Z.

The facts of this example are akin to the earlier one except that the employees are directly interacting with the customer i.e. Y Ltd.

**7. Comments on para 42.32**

Para 42.32 read with para 10 suggests that ‘dependent agent’ should be considered as an individual for the purpose of determination of PE.

The issue that arises is does it create any conflict with Article 5(5) dealing with Agency PE. If in terms of Article 5(5) only certain activities are considered as resulting in agency PE then would the proposed provision be considered as extending the scope ?

**8. Comments on para 42.34**

This para indicates that clause (a) applies in a situation to “an enterprise carried on by a single individual”. This would generally mean a ‘sole proprietorship’. However, para 42.35 indicates that clause (a) would apply to partnership or a company as well. Can these statements be considered as conflicting?

The second sentence of para 42.34 says “It *also* covers,.....” . The word “also” does not seem to have been appropriately used. This is because the conditions contained in clause (a) are cumulative.

The third sentence “Such extension is necessary.....of that company” does not convey what is sought to be conveyed.

#### 9. Comments on para 42.40

The examples contained in OECD Commentary on Article 5 in the context of “commercial coherence” may be adopted for the purpose of explaining “connected projects”.

#### 10. Comments on para 42.41

This para effectively brings out the inherent weakness in the OECD approach of adopting ‘physical presence’ as a criterion for calculation of 183 days.

This para requires different test to be adopted for the local employees i.e. for local employees effectively the test of ‘physical presence’ should not be applicable. The words “***generally*** not be considered to be present” do not indicate an authoritative / directive or a confident statement. It does not give certainty to the issue. If working group is clear in their mind then they should state “***should*** not be considered to be present”. Similarly, the words “would ***most often*** be covered” indicates that its not certain whether it would be covered or not. This should be more authoritative statement.

#### 11. Man days v. solar days

It may happen that more than one employee of an enterprise may be rendering services in another contracting state on a particular day. In such situations the services should be considered as being rendered for one single day or for one day for each employee (i.e. man days) needs to be decided. This may be explained on the basis of the following example:

##### Example 9

A Ltd. is a company resident in Country A and has been engaged by B Ltd., a company situated in Country B. The employees of A Ltd. traveled to Country B and rendered services. The details of stay in Country B are tabulated hereunder:

Days of presence	No. of days	No. of employees	Man days
May 1 to May 15	15	2	30
June 15 to June 30	15	3	45
July 1 to July 15	15	4	60
<b>Total</b>	<b>45</b>		<b>135</b>

In this example if the number of days is taken as ‘solar days’, then the services are rendered in Country B for a total period of 45 days. However, if the number of days is taken as ‘man days’ then the services are rendered for a total period of 135 days.

**11. Twelve months**

Some explanation may be inserted in the commentary as regards interpretation of the words “twelve months”. Does it mean a period of 360 (30\*12) or 365 or 366 days? Should the term “twelve months” means “April 15 to April 14 of the next year”?

**12. General**

Some aspects of the suggested provisions (e.g. need for two separate clauses and the difference between the two, the logic behind 50% test etc.) are unclear. Apparently, the approach could have been to draft provisions which are different from the provisions of the UN Model. However, in the process certain issues remain unanswered.

I have in Chapter 20 of book titled by *The Taxation of Permanent Establishments an International Perspective* (Spiramus, 2006) authored by Taxation of Permanent Establishments authored by elaborately several issues as regards interpretation of Service PE clause of the Un Model. The proposed commentary contain answers to some the issues examined by me in the book. Some more issues I have discussed in the aforesaid paras.

In my book I have also analysed the Service PE clause of the treaties signed by China, France, India, Netherlands, UK and USA with most of the other countries of the world. This analysis gives understanding of the Service PE clause adopted by the countries in the DTAAAs signed by them and the variations from the UN Model provisions.

The working Group may consider referring to this Chapter 20 of my book for additional material on the subject.