

5 April 2004

**PROPOSED CLARIFICATION OF THE SCOPE OF PARAGRAPH 2 OF ARTICLE 15
OF THE MODEL TAX CONVENTION**

Public discussion draft

Paragraph 2 of Article 15 of the OECD Model Tax Convention provides that a non-resident employee who performs services in a country is not subject to tax in that country under certain circumstances.

It has been suggested that the exact scope of the paragraph is unclear when services are provided through intermediaries. Paragraph 8 of the Commentary on Article 15, which deals with so-called “hiring-out of labour”, addresses one aspect of that issue. There are questions on the interpretation of the word “employer” (found in subparagraphs 2 b) and c) of Article 15 of the Model Tax Convention), in particular as regards the domestic law definition of that term. It has also been suggested that the application of paragraph 2 should be discussed in the context of the distinction between employment and self-employment, which is a common issue that tax authorities and taxpayers must confront. It has also been suggested that practical examples should be provided to illustrate the application of the paragraph in various common situations.

For that reason, Working Party No. 1 on Tax Conventions and Related Questions¹ has invited a few of its delegates to draft proposals for clarification of the Commentary on Article 15 regarding this issue. The proposals included in this draft have been prepared by that small group.

Since the proposals deal with a number of situations that currently arise in practice, the Working Party has decided to seek the views of interested parties before discussing these proposals. The Working Party wishes to stress that since it has not yet discussed the proposals included in this discussion draft, these should not be regarded as reflecting the views of the Working Party or of any of the OECD Member countries.

Comments on the proposals below should be sent **before 30 June 2004** to:

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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.

PROPOSED CLARIFICATION OF THE SCOPE OF PARAGRAPH 2 OF ARTICLE 15 OF THE MODEL TAX CONVENTION

Proposals for changes to the Commentary on Article 15

1. *Replace existing paragraph 1 of the Commentary on Article 15 by the following (additions to the existing text of the paragraph appear in **bold italics**)*

“1. Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. ***The issue of whether or not services are provided in the exercise of an employment may sometimes give rise to difficulties which are discussed in paragraphs 8.1 ff.*** Employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid. One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State.”

2. *Replace existing paragraph 8 of the Commentary on Article 15 by the following:*

"8. There is a direct relationship between the principles underlying the exception of paragraph 2 and Article 7. Article 7 is based on the principle that an enterprise of a Contracting State should not be subjected to tax in the other State unless its business presence in that other State has reached a level sufficient to constitute a permanent establishment. The exception of paragraph 2 of Article 15 extends that principle to the taxation of the employees of such an enterprise whose employment activities are carried on in the other State for a relatively short period. Subparagraphs (b) and (c) make it clear that the exception is not intended to apply where the employment services are rendered to an enterprise that is subjected to tax in a State either because it is a resident of that state or because it has a permanent establishment therein to which the services are attributable.

8.1 It may be difficult, in certain cases, to determine whether the services rendered in a State by an individual resident of another State, and provided to an enterprise that is resident of the first State (or that has a permanent establishment in that State), constitute employment services, to which Article 15 applies, or services rendered by a separate enterprise, to which Article 7 applies or, more generally, whether the exception applies. While the Commentary previously dealt with cases where arrangements were structured for the main purpose of obtaining the benefits of the exception of paragraph 2 of Article 15, it was found that similar issues arose in many other cases that did not involve tax-motivated transactions and the Commentary was amended to provide a more comprehensive discussion of these questions.

8.2 In some countries, a formal contractual relationship would not be questioned for tax purposes unless there were some evidence of manipulation and these countries, as a matter of domestic law, would consider that employment services are only rendered where there is a formal employment relationship. States where this is the case and which are concerned that such approach could result in granting the benefits of the exception provided for in paragraph 2 in unintended situations (e.g. in so-called “hiring-out of labour” cases) are free to adopt bilaterally a provision drafted along the following lines:

"Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is not a resident of that other State if:

- (a) the recipient renders services in the course of that employment to a person other than the employer who, directly or indirectly, supervises, directs or controls the manner in which those services are performed; and
- (b) the employer is not responsible for carrying out the purposes for which the services are performed."

8.3 In many countries, however, various legislative or jurisprudential rules and criteria (e.g. substance over form rules) have been developed for the purpose of distinguishing cases where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of services) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services). That distinction keeps its importance when applying the provisions of Article 15, in particular those of subparagraph 2(b) and (c). It is a matter of domestic law of the State of source to determine whether services rendered in that State are provided in an employment relationship or under a contract for services between two separate businesses, and that determination will govern how that State applies the Convention.

8.4 In some cases, services rendered by an individual to an enterprise may be considered to be employment services for purposes of domestic tax law even though these services are provided under a formal contract for services between, on the one hand, the enterprise that acquires the services, and, on the other hand, either the individual himself or another enterprise by which the individual is formally employed or with which the individual has concluded another formal contract for services.

8.5 In such cases, the relevant domestic law may ignore the way in which the services are characterized in the formal contracts. It may prefer to focus primarily on the nature of the services rendered by the individual and their integration into the business carried on by the enterprise that acquires the services to conclude that there is an employment relationship between the individual and that enterprise.

8.6 Since the concept of employment to which Article 15 refers is to be determined according to the domestic law of the State that applies the convention, it follows that a State which considers such services to be employment services will apply Article 15 accordingly. It will, therefore, logically conclude that the enterprise to which the services are rendered is in an employment relationship with the individual so as to constitute its employer for purposes of subparagraph 2(b) and (c). That conclusion is consistent with the object and purpose of paragraph 2 of Article 15 since, in that case, the employment services may be said to be rendered to a resident of the State where the services are performed.

8.7 Other countries arrive at a similar result through a different analysis. These countries focus on the express wording of the conditions that need to be met for the exception of paragraph 2 of Article 15 to apply. They consider that, regardless of any domestic law meaning of what is an employer, that term, when used in the context of sub-paragraph b) and c) of paragraph 2 of article 15, must be interpreted according to the object and purpose of paragraph 2. They note that it would be contrary to that object and purpose to provide a tax exemption for what is in substance the ordinary work force of resident enterprises.

8.8 These countries therefore conclude that the term employer, as used in subparagraphs b) and c), cannot apply to a person who is a formal employer where the main functions assumed by a normal employer are exercised by a resident enterprise (or a non-resident enterprise which has a permanent establishment through which these functions are performed). That approach is not affected by, and does not affect, the domestic law view of the relationship between an individual providing services and the enterprise to which these services are rendered. It seeks to ensure that the term employer is not interpreted in a way that would allow the exception provided for by paragraph 2 to apply in unintended situations, i.e. where the services rendered by the employee are more integrated to the business activities of a resident enterprise than to those of his formal employer.

8.9 Both approaches described above must, however, be applied on the basis of objective criteria. Under the first approach, for instance, a State could not argue that services are deemed, under its domestic law, to constitute employment services where, under the relevant facts and circumstances, it clearly appears that these services are rendered under a contract for the provision of services concluded between two separate enterprises. Similarly, in such a case, a State could not rely on the approach described in paragraphs 8.7 and 8.8 above to deny, for purposes of sub-paragraphs 2 b) and c), the status of employer to the enterprise that formally employs an individual through which such services are provided. Article 15 would be rendered meaningless if countries were allowed to deem services to constitute employment services, or to deny the quality of employer to an enterprise, in cases where there is clearly no employment relationship.

8.10 It will not always be clear, however, whether services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises [the preceding sentence was the first one of paragraph 8.14]. Any disagreement between States as to whether this is the case should be solved having regard to the following principles and examples (using, where appropriate, the mutual agreement procedure).

8.11 The nature of the services rendered by the individual will be an important factor since it is logical to assume that an employee provides services which are an integral part of the business activities carried on by his employer. Where that factor points to an employment relationship that is different from the formal contractual relationship, the following factors may be relevant to determine whether this is the case:

- who bears the responsibility or risk for the results produced by the individual's work;
- who has the authority to instruct the individual ;
- who controls and has responsibility for the place at which the work is performed;
- who bears, in an economic sense, the cost of the remuneration paid to the individual ;
- who puts the tools and materials necessary for the work at the individual's disposal;
- who determines the number and qualifications of the individuals performing the work.

8.12 *Example 1:* Aco, a company resident of State A, concludes a contract with Bco, a company resident of State B, for the provision of training services. Aco is specialised in training people in the use of various computer software and Bco wishes to train its personnel to use recently acquired software. X, an employee of Aco who is a resident of State A, is sent to Bco's offices in State B to provide training courses as part of the contract.

8.13 In that case, State B could not argue that X is in an employment relationship with Bco or that Aco is not the employer of X for purposes of the convention between States A and B. X is formally an employee of Aco whose own services, when viewed in light of the factors in paragraph 8.11, form an integral part of the business activities of Aco. The services that he renders to Bco are rendered on behalf of Aco under the contract concluded between the two enterprises. Thus, provided that X is not present in State B for more than 183 days during any relevant 12 month period and that Aco does not have in State B a permanent establishment which bears the cost of X's remuneration, the exception of paragraph 2 of Article 15 will apply to X's remuneration.

8.14 *Example 2:* Cco, a company resident of State C, is the parent company of a group of companies that includes Dco, a company resident of State D. Cco has developed a new world-wide marketing strategy for the products of the group. In order to ensure that the strategy is well understood and followed by Dco, which sells the group's products, Cco sends X, one of its employees who has worked on the development of the strategy to work in Dco's headquarters for 4 months in order to advise Dco with respect to its marketing and to ensure that Dco's communications department understands and complies with the worldwide marketing strategy.

8.15 In that case, Cco's business includes the management of the world-wide marketing activities of the group and X's own services are an integral part of that business activity. While it could be argued that an employee could have been easily hired by Dco to perform the function of advising the company with respect to its marketing, it is clear that such function is frequently performed by a consultant, especially where specialised knowledge is required for a relatively short period of time. Also, the function of monitoring the compliance with the group's worldwide marketing strategy belongs to the business of Cco rather than to that of Dco. The exception of paragraph 2 of Article 15 should therefore apply provided that the other conditions for that exception are satisfied.

8.16 *Example 3:* A multinational owns and operates hotels worldwide through a number of subsidiaries. Eco, one of these subsidiaries, is a resident of State E where it owns and operates an hotel. X is an employee of Eco who works in this hotel. Fco, another subsidiary of the group, owns and operates an hotel in State F where there is a shortage of employees with foreign language skills. For that reason, X is sent to work for 5 months at the reception desk of Fco's hotel. Fco pays the travel expenses of X, who remains formally employed and paid by Eco, and pays Eco a management fee based on X's remuneration, social contributions and other employment benefits for the relevant period.

8.17 In that case, working at the reception desk of the hotel in State F, when examined in light of the factors in paragraph 8.11, may be viewed as forming an integral part of Fco's business of operating that hotel rather than of Eco's business. Under the approach described in paragraphs 8.3 to 8.6 above, if, under the domestic law of State F, the services of X are considered to have been rendered to Fco in an employment relationship, State F should then logically consider that Fco is the employer of X and the exception of paragraph 2 of Article 15 would not apply. Also, under the other approach described in paragraphs 8.7 and 8.8, State F could consider that the employer, for purposes of the exception of paragraph 2 of Article 15, is not Eco and that the exception therefore does not apply.

8.18 *Example 4:* Gco is a company resident of State G. It carries on the business of filling temporary business needs for highly specialised personnel. Hco is a company resident of State H which provides engineering services on building sites. In order to complete one of its contracts in State H, Hco needs an engineer for a period of 5 months. It contacts Gco for that purpose.

Gco recruits X, an engineer resident of State X, and hires him under a 5 month employment contract. Under a separate contract between Gco and Hco, Gco agrees to provide the services of X to Hco during that period. Under these contracts, Gco will pay X's remuneration, social contributions, travel expenses and other employment benefits and charges.

8.19 In that case, X provides engineering services while Gco is in the business of filling short-term business needs. By their nature the services rendered by X are not an integral part of the business activities of his formal employer. These services are, however, an integral part of the business activities of Hco, an engineering firm. In light of the factors in paragraph 8.11, State H could therefore consider that, under the two approaches described in paragraphs 8.3 to 8.8 above, the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.

8.20 *Example 5:* Ico is a company resident of State I specialised in providing engineering services. Ico employs a number of engineers on a full time basis. Jco, a smaller engineering firm resident of State J, needs the temporary services of an engineer to complete a contract on a construction site in State J. Ico agrees with Jco that one of Ico's engineers, who is a resident of State I momentarily not assigned to any contract concluded by Ico, will work for 4 months on Jco's contract under the direct supervision and control of one of Jco's senior engineers. Jco will pay Ico an amount equal to the remuneration, social contributions, travel expenses and other employment benefits of that engineer for the relevant period, together with a 5% commission. Jco also agrees to indemnify Ico for any eventual claims related to the engineer's work during that period of time.

8.21 In that case, even if Ico is in the business of providing engineering services, it is clear that the work performed by the engineer on the construction site in State J is performed on behalf of Jco rather than Ico. The direct supervision and control exercised by Jco over the work of the engineer, the fact that Jco takes over the responsibility for that work and that it bears the cost of the remuneration of the engineer for the relevant period are factors that would support the conclusion that the engineer is an employment relationship with Jco. Under the two approaches described in paragraphs 8.3 to 8.8 above, State J could therefore consider that the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that state.