INTERNATIONAL CHAMBER OF COMMERCE
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Department of Policy and Business Practices

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Subject: ICC's perspectives on the taxation of technical services

Dear Mr Lennard,

During the Eighth Session of the UN Committee of Experts in Tax Matters ("UN Committee") it was decided that a separate article on technical services would be included in the UN Model Convention. The International Chamber of Commerce ("ICC"), as the world business organization, values the opportunity to engage in an on-going constructive dialogue with the newly appointed UN Committee and is pleased to respond to the Committee's request to provide observations and comments of the wider business community on the taxation of technical services.

ICC understands that several UN Member States believe that the division of income between "source" and "residence" countries is currently inequitable and needs to be rebalanced in favour of "source" countries. In the context of fees for technical services, the UN has identified two possible approaches to increase "source" country taxation. First, the permanent establishment (PE) definition could be broadened. Second, a gross basis withholding tax could be imposed on fees for technical services. However, ICC is concerned that either of these approaches has the potential to significantly increase global double taxation if the "source" jurisdictions take a unilateral approach to adopting new rules. In particular, gross basis withholding taxes may be imposed in the absence of net earnings. In such a case, the "source" country taxes will not be creditable in the country of residence. The potential for double taxation may discourage foreign direct investment in countries that assert the right to tax fees for technical services. Therefore, ICC strongly calls for a coherent multilateral framework that would allow for a consistent approach on the taxation of technical

services by all countries. In this regard, ICC would applaud increased synergy between the UN Committee of Experts in Tax Matters and the work currently conducted by the Organization for Economic Co-Operation and Development (OECD), mandated by the G20, on Base Erosion and Profit Shifting (BEPS).[1]

ICC believes that every tax treaty should always reflect a balance in the competing interests of the potential treaty partners. This is especially true for the UN and OECD Model Tax Conventions as the world standard for both developed and developing countries. Given the wide variety of UN Member States, States will understandably seek to recalibrate this balance to fit their specific circumstances. The international business community, represented by ICC, fully supports a balanced split of taxation rights among UN Member States. However, ICC would like to emphasize that it is not the potential rebalancing of competing interests by a possible change to the UN Model Tax Treaty that might have direct and indirect material consequences for world trade and direct investments. In the view of the business community, it always has been and still is the inadequately working dispute resolution mechanism that triggers double taxation and, therefore, negatively impacts direct investments and global economic growth and wealth. ICC, therefore, strongly recommends that dispute resolution mechanisms (including MAP) should be addressed.

1. A new Article on technical services

ICC would like to take this opportunity to comment on the two possible different approaches for the UN Committee's work on technical services. The first approach would be to adopt a new Article that grants taxing right to the "source" country on a net basis, provided that a certain minimal-days threshold is met. This approach would essentially establish a PE in the country where technical services are "consumed" if the provider of the technical services was present in the "source" jurisdiction for the pertinent period of time, presumably this would have to be some period of time less than the 183 days which already triggers a PE for any services under the UN Model. This would be regardless of the existence of an office or other indicia of a PE under traditional rules. The second approach would be to adopt a new Article that grants taxing rights to the "source" country on a gross basis, generally imposed through withholding, with no time or monetary threshold for the imposition of the tax. In the case of a gross basis tax, there is also the question of whether the technical services need to be performed in the "source" country.

It is ICC's perspective that business services, should be subject to net taxation under the principles contained in Articles 5 and 7 of the UN Model and the threshold contained in Article 5(3)(b). Source taxation related to services contained in these Articles is already a stretch for business, especially in view of the broad interpretation of these Articles by some countries. Accordingly, in ICC's view, broadening the definition of a PE by introducing a deemed technical services PE, may mean giving up the core of the PE concept contained in

[1] Specifically, in its communiqué dated 22-23 February 2014, the G-20 stated, in ¶ 9 as follows: "We are committed to a global response to Base Erosion and Profit Shifting (BEPS) based on sound tax policy principles. Profits should be taxed where economic activities deriving the profits are performed and where value is created."

Article 5 of the UN Model and would lead to a huge increase in compliance burden for business (e.g. registration obligations, financial reporting etc.). Regardless of the PE threshold, net taxation is always preferable to gross basis taxation.

If nevertheless "source" taxation rights for a specific category of services such as technical services are to be expanded, there are a variety of issues that must be addressed.

1) *Taxation on gross or net basis:* A threshold question is whether taxation is to be on a net or gross basis. There are inevitable expenses associated with any type of service, so that taxation on a net basis is generally preferable[2]. If the tax is to be collected via withholding on the payer, then the "net" vs. "gross" issue could be addressed by treating the withholding tax as merely a collection mechanism. Overpayments of withheld tax should be refundable upon filing of a tax return with information proving the amount of net income. If a true gross basis tax is imposed, then the rate of withholding, as discussed further below, should be very low to reflect the likely existence of significant expenses. Again, ICC stresses the importance of arranging for double taxation relief in this respect as well.

2) *Nexus to the source country:* A fundamental question is whether the technical services are performed in the "source" country or may the tax apply to any payments for technical services borne by a resident or a PE in the "source" country. In this respect, ICC believes strongly that there is no basis for a so-called "source" country to impose tax on services that are performed outside of its borders.[3] The real "source" country in this case is the place where the services are actually performed, not the place where the services are received or consumed (*cf.* e.g. Article 5, 14 and 17 of the UN Model Convention).[4] If a country wishes to tax the services based on the residence of the consumer, the more appropriate tax would be a consumption tax. ICC does not see why one should deviate from these fundamental principles in relation to technical services.

Given that it is the unanimous view of OECD Member States that the source basis taxation is not appropriate for services performed by a nonresident outside that State, it is unlikely that the country where services are performed will give up its right to tax and therefore such a provision is unlikely to serve as an effective model for bilateral agreements. While the UN Model reflects different interests than the OECD Model and different rules are therefore appropriate in some cases, it should be considered if deviating from a rule in the OECD Model that reflects unanimous agreement among OECD member countries will inevitably lead to conflicts in treaty negotiations. Doing so will likely encourage countries to take aggressive unilateral positions (in the absence of a treaty). The adoption of this rule on a

[2] See paragraph 42.19 of the Commentary on Article 5 of the OECD Model, which provides "another fundamental issue on which there is general agreement relates to the determination of the amount on which tax should be levied…only the profits derived from the services should be taxed."
[3] See paragraph 42.18 of the Commentary on Article 5 of the OECD Model, which provides "that all member States agree that a State should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that State.

unilateral basis will increase double taxation, reduce cross-border trade and increase costs for local consumers. To the extent that countries adopt such a rule in their bilateral agreements, it is important that Article 23 (Relief from Double Taxation) be amended to provide effective relief from double taxation. Finally, the position that the source of the income is the location of the consumer is fundamentally inconsistent with the position that many countries are taking on the issue of the return to intangibles in the context of the BEPS discussion. The draft revisions to Chapter VI of the Transfer Pricing Guidelines ("TPG") specify that the returns to intangibles should be allocated by reference to the location of personnel who perform or control the development, enhancement, maintenance, and protection of the intangible. Advocating for this position on intangibles is inconsistent to arguing that the place of performance of services is irrelevant to determining the taxation of those services. This inconsistency needs to be resolved, either the place of performance of profit producing activities is important or it is not. It cannot be important to determine the entitlement to intangible related returns, but at the same time not be important to determine the taxation of services whether technical or otherwise.

2. Definition of technical services

When considering a reasonable definition of "technical services", ICC believes that a precise and specific definition should prevail. A broad definition can be found in some Double Tax Conventions (e.g. in the one between India and Germany: "services by technical or other personnel"). Such a broad definition might help to avoid conflicting interpretations that will inevitably arise from a narrow definition but is also likely to result in a very broad taxation of services that would further weaken the principle of PE based taxation and extend beyond the aim of taxing technical services in the source country.

Furthermore, any definition of technical services in this context raises an inevitable question about the very basic concept of the service PE contained in Article 5(3)(b): why would a time threshold be needed to justify the taxing right of a source country under the PE concept if another Article grants a taxing right for services with no regard to any such requirements? Any definition, moreover, needs to avoid conflicting interpretations and should be aligned with the definition of "royalties" under Article 12 so that the same function cannot fall within both definitions, potentially subjecting the taxpayers to double or multiple levels of taxation.

A starting point for a definition could be the 1989 Double Tax Convention between India and the U.S. stating that "by technical services, we mean in this context, services requiring expertise in a technology". It should be noteworthy that it is not only the term "technical" which should be clearly defined but also the activity itself, the "service" needs to be precisely specified. To avoid any misinterpretations with regards to the latter, term payments for the usage of tangible and intangible goods should be excluded (because they are rent or royalties) as well as the transfer of ownership in tangible and intangible goods (because a sale should not qualify as a service). This might be best achieved if the understanding of a service is linked to "personnel performing" the service demonstrating that a service is a specific activity having its core component in the mere performance of that very activity. To

specify the nature of the service it might fall short to simply speak of "services performed by technical personnel…" (as in Article 12 of the Double Tax Convention between India and Germany, which extends the definition to "…or other personnel"). Such a wording should only serve as a starting point and would need to be further illustrated as it is the case in Article 13 of the Double Tax Convention between India and the UK (which is closely based on the concept of "fees for included services" in the 1989 Double Tax Convention between India and the United States):

> *"fees for technical services" means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including the provisions of services of technical or other personnel) which:*
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> - *Are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph (3)(a) of this Article is received [trademark, patent, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience]; or*
> - *Are ancillary and subsidiary to the enjoyment of the property for which a payment described in paragraph (3)(b) of this Article is received [use, any industrial, commercial or scientific equipment other than ships and aircrafts in international traffic]; or*
> - *Make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design"*

ICC believes that making the link – ancillary and subsidiary – with the definition of a royalty under the tax treaty helps to clarify the word "technical" in order to avoid that services involving specialized/expertise knowledge be considered as falling into the category of technical services[5]. The Memorandum of Understanding (MOU) which accompanies the 1989 Double Tax Convention between India and the US contained a useful elaboration on the concept of "ancillary and subsidiary" to the application or enjoyment of a right, property, or information for which a royalty is paid, and on the concepts of "making available technical knowledge, experience, skill, know-how or processes" and of "consisting of the development and transfer of a technical plan or technical design". The explanations contained in that MOU have provided very helpful and clear guidance to courts seeking to interpret the scope of the covered services, and ICC recommends that the UN make use of that guidance in developing any special rule providing expanded source taxation of "fees for technical services".

ICC further believes that general head offices' service expenses should explicitly be excluded from any definition.

[5] As it is the case, for instance, under Brazilian domestic law where courts judged that marketing, publicity or even legal consulting qualified as technical services under the definition given by the law (Normative instruction 252/2002).

3. Withholding tax rate

If there is to be a withholding tax mechanism, ICC advises that withholding taxes always shift the risk of double taxation or unreasonably high tax burdens to the taxpayer. For example, a taxpayer earning a 10% pre-tax profit and subject to a gross basis withholding tax of 15% would end up with a post-tax loss of 5% unless it shifted the burden of that tax to the payer. In addition, the gross based withholding tax can only be credited against the tax due in the home country which will be calculated on a net basis. Fees from the performance of technical services involve significant expenses and withholding taxes are most effective for income from activities which do not typically bear significant expenditures. Withholding rates that approach or exceed the normal net profit on transactions often have a tendency to result in a shift of the economic burden of the excessive tax to the pay or of the amount being taxed. In the case of services transactions, this would simply raise the cost of cross-border services to the purchaser of the services in the taxing jurisdiction and would create economic distortions which could inhibit such purchasers' access to the most competitive and efficient services. For these reasons, any gross basis withholding tax should be set at a reasonable level (3% would be a maximum in ICC's view),[6]

4. Placement of the Article

The last issue to be addressed is in which treaty Article the technical service provision should be included. ICC believes that it would be most appropriately placed in Article 7 as an exception to the general principle of PE based taxation or in a separate Article. ICC's concern is that otherwise the new Article might be used to levy withholding taxes on any fee paid from a country. Also, including a clear definition of what services can be subject to withholding taxes in the Article on business profits would clarify that the fees for these services are business profits and not a form of residual income that can be taxed under Article 21.

Including it in the royalty Article would simply give the impression that the concept of "royalty" is being broadened. The royalty Article has to be kept in the defined limits of the UN DTT Model as to include only payments for intangible properties.

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[6] The1999 India report from the "High Powered Committee on 'Electronic Commerce' seemed to favor a 3% withholding tax due to these considerations (at 75-76).

ICC appreciates the opportunity to comment on the technical services issue as it continues to evolve. We hope that our comments will facilitate a constructive way forward.

Respectfully submitted.

Yours Sincerely,

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Chair, ICC Commission on Taxation