

*Angharad Miller*

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# Taxing Cross-Border Services

Current Worldwide Practices  
and the Need for Change

IBFD DOCTORAL SERIES

37

# Taxing Cross-Border Services: Current Worldwide Practices and the Need for Change

## Why this book?

The tradability of services cross border has increased vastly since the provisions in the OECD and UN Model Tax Conventions were first developed. This book examines the factors used in these Models to connect an enterprise with the tax jurisdiction of a state for the purposes of allocating the tax base arising from cross-border enterprise services. It questions whether these factors produce an allocation of taxing rights which is acceptable to both multinational enterprises and tax authorities, in terms of satisfying any debt of economic allegiance and limiting base erosion. The connecting factors used, such as permanent establishment and location of the customer, are examined from theoretical and empirical standpoints: if they are considered acceptable, they should be found to be in widespread use, both in the domestic laws of states and in the network of bilateral double tax treaties.

The analysis reveals that most treaties do not follow the OECD Model with respect to cross-border enterprise services. Whilst many follow the UN Model in some respects, the provisions adopted lack a sound theoretical basis, and the use of a time threshold for source state taxation is a poor proxy, both for measuring any debt of economic allegiance to the source state and for measuring the degree of base erosion suffered by the source state. These two findings suggest that a fresh approach is needed. A proposal is offered which uses a better proxy for establishing the right of the source state to tax and which strives to produce an equitable division of the tax base. The proposal suggests an administrative mechanism which can be used even by states with poorly developed tax administrations.

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## Introduction

*Services represent the fastest growing sector of the global economy and account for two thirds of global output, one third of global employment and nearly 20% of global trade.<sup>1</sup>*

The value of world trade in services exports was estimated at USD 4.2 trillion in 2011.<sup>2</sup> According to Pascal Lamy, former Director-General of the World Trade Organization,<sup>3</sup> more than half of annual world foreign direct investment flows are in services and the growth in international trade in services has been more rapid than that in world production and merchandise trade. Whereas international services trade was once predominantly comprised of transport services, this is no longer the case.

As Lamy notes, modern business cannot function competitively without efficient services such as telecoms, transport, logistics, computing, accounting and legal services. Neither can it function properly without access to low-cost, high-quality financial services. An efficient service sector underpins other sectors of an economy by ensuring the provision of transport and communications and, through the existence of a well-developed financial services sector, the channelling of finance to those industries most likely to succeed. This thesis examines the allocation of taxing rights over income and profits arising from the provision of cross-border enterprise services for the purposes of direct taxation.

The term “enterprise services” is used to denote services performed by businesses, whether corporate or non-corporate. International services may be delivered in many forms. It is sometimes necessary for natural persons to cross physical borders in order to deliver or consume the service; however, other services can be delivered remotely. In some cases, production and consumption must take place simultaneously, e.g. repair of machinery. Thus some forms of trade in services differ significantly from trade in goods.

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1. WTO, *Services: Rules for Growth and Investment* (2012) <[http://www.wto.int/english/thewto\\_e/whatis\\_e/tif\\_e/agrm6\\_e.htm](http://www.wto.int/english/thewto_e/whatis_e/tif_e/agrm6_e.htm)> (accessed 10 Dec. 2012).

2. WTO, *Press Release: World Trade 2011, Prospects for 2012* (2012).

3. J.A. Marchetti & M. Roy (eds.), *Opening Markets for Trade in Services* (Cambridge University Press 2008), p. xix.

It might reasonably be assumed that all the tax rules on international services one could possibly want would be found in the Model Tax Conventions,<sup>4</sup> but this is not so. Provisions covering international transport services and the services of sportspersons and entertainers are well established, but provisions governing the allocation of income and profits from services in general are not specifically dealt with in the text of the OECD Model Tax Convention (hereinafter OECD Model). The allocation of taxing rights over business profits of a non-resident are dealt with in article 5 of the OECD Model. Article 5 sets out two thresholds before a host state may tax the business profits of a non-resident: either there must be a fixed place of business or the non-resident must have a dependent agent in the territory of the taxing state. If either of these thresholds is breached, then the non-resident is said to have a permanent establishment (hereinafter PE) and the net profits attributable to the PE may be taxed by the host state. No matter how substantial the profits earned by a non-resident from the provision of services in a state, so long as there is neither a fixed place of business nor a dependent agent, the host state has no taxing rights over that service provider. The Commentary on the OECD Model<sup>5</sup> offers some optional wordings relating to services for article 5. The United Nations Model Tax Convention (hereinafter UN Model) has always included provision for a services PE, effectively a third threshold which does not require a fixed place of business or a dependent agent. However, this Model is less widely used than the OECD Model. The OECD Model, the leading Model, defines the right to tax business profits of non-residents primarily by the existence of a fixed place of business for a certain length of time, a concept developed in an era when the way non-residents earned business profits in the territory of a host state was via the setting up of premises and the presence there of personnel. Arnold, who has been advising the UN on the 2011 update of the UN Model, has this to say:

In my view, the fixed-place-of-business threshold, i.e. PE or fixed base, that applies to the source country taxation of business profits generally is clearly insufficient for income from services. That threshold was adopted at a time when most cross-border business activity involved the manufacture or production and sale of goods. In a modern economy, cross-border services are much more important. Such services can often be performed without the need for any fixed place of business and the country in which services are performed

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4. OECD, *Model Tax Convention on Income and on Capital* (2010), Models IBFD; United Nations, *Model Double Tax Convention between Developed and Developing Countries* (2011), Models IBFD.

5. *OECD Model* (2010).

should have the right to tax the income from those services in certain circumstances where there is no PE in the country.<sup>6</sup>

Those developing the OECD Model and its antecedents were responding to growth in international trade in goods and could not reasonably have foreseen the changes in the patterns, and the expansion, of international trade made possible by improvements in transport and communications. However, developments in international tax have tended to shadow developments in international trading practices: anti-haven legislation was developed starting with US Subpart F in the 1960s in response to the growth in the use of tax havens. As another example, the OECD Commentary on Article 5 was expanded significantly in 2005 in response to the growth in e-commerce, which led to the OECD's policymakers being much exercised by the question of whether or not inanimate physical assets, of themselves, could be regarded as a fixed place of business.<sup>7</sup> International trade in services, though, is not a particularly novel development: trade flows of services were significant in comparison to flows of goods throughout the 20th century. What has been changing with respect to international services in recent decades is the scale of international trade and the advent of supranational efforts to liberalize international trade in services.<sup>8</sup> In the light of these changes, it may be expected that, in future, the OECD Model will undergo development to take account of international trade in enterprise services. The policy of the OECD has traditionally been to resist changes to the text of the OECD Model and to amend and expand the Commentary to accommodate the performance of services by non-residents within the concept of the fixed place of business<sup>9</sup> and by providing the suggested wording for an optional services PE. There are signs that the OECD's Base Erosion and Profit Shifting initiative<sup>10</sup> (BEPS) may result in changes to this

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6. B.J. Arnold, *The Taxation of Income from Services under Tax Treaties: Clearing up the Mess – Expanded Version*, 65 Bull. Intl. Taxn. 2 (2011), Journals IBFD.

7. OECD Ctr. for Tax Policy and Admin., *The Tax Treaty Treatment of Services: Proposed Commentary Changes Public Discussion Draft*, 8 Dec. 2006 to 16 February 2007 (OECD 2006).

8. The General Agreement on Trade in Services (GATS) entered into force in January 1995 following the Uruguay round of negotiations of the WTO: while the GATS does not impose liberalization measures in respect of services trade, it provides a framework within which countries can enter into bilateral or multilateral agreements for the liberalization of trade in services. WTO, *General Agreement on Trade in Services* (WTO 15 Apr. 1994).

9. OECD Ctr. for Tax Policy and Admin., *OECD Model Tax Convention: Revised Proposals Concerning the Interpretation and Application of Article 5 (Permanent Establishment): 19 October 2012 to 31 January 2013* (OECD 2012).

10. OECD Ctr. for Tax Policy and Admin., *Addressing Concerns Related to Base Erosion and Profit Shifting* (OECD 2013).

strategy. However, this initiative is aimed at curbing “tax planning strategies that exploit gaps and mismatches in tax rules to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid”,<sup>11</sup> whereas this study is concerned principally with the effect on the division of the tax base between states caused by the general expansion of cross-border service trade rather than by the deliberate tax minimization strategies employed by MNEs that are the focus of the BEPS initiative.

The divergence between the types of international trade directly catered for in the text of the OECD Model as it reads at 2014 and the types of international trade now taking place has led to a plethora of diverse provisions concerning trade in services in double tax treaties. While the UN Model services PE is often adopted, so too are provisions permitting taxation of income from services on a gross, as opposed to a net, basis. This divergence is referred to in the BEPS Report:

The international common principles drawn from national experiences to share tax jurisdiction may not have kept pace with the changing business environment.<sup>12</sup>

### 1.1. Research objectives and research questions

The objective of this thesis is to analyse the treatment of enterprise services within the OECD and UN Models in the light of the treatment of non-resident services providers under the domestic law of states and under the double tax treaties entered into by states in order to form a view as to the adequacy of the treatment of cross-border trade in enterprise services in the OECD and UN Models. The principal research question asked is:

*Are the provisions found in the texts of the Models adequate and appropriate to deal with the scale of and the forms of present-day cross-border trade in enterprise services?*

An important subsidiary question is whether or not the treatment of enterprise services in the Models may be explained by looking at the historical context of them and at historic patterns of world trade.

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11. OECD Ctr. for Tax Policy and Admin., *About BEPS*, <<http://www.oecd.org/tax/beps-about.htm>> (accessed 10 Sept. 2014).

12. *Supra* n. 10 at p. 1.

“Adequate” is used in the sense of:

Fully satisfying what is required: quite sufficient, suitable or acceptable in quality or quantity.<sup>13</sup>

“Appropriate” is taken to mean:

Specially fitted or suitable, proper.<sup>14</sup>

To answer these questions, three primary sources are used:

- (1) National statistics on flows of trade in goods and services from the inception of the Models to the present day.
- (2) The provisions in the domestic law for taxation of non-resident service providers in a selection of countries.
- (3) A comprehensive survey of treaty practices with respect to enterprise services.

The conclusions on the principal research question will be strongly influenced by two factors: Do double tax treaties (DTTs) follow the text of the OECD Model with respect to the treatment of income from services? To the extent that they do not, are the positions adopted in individual treaties likely to engender a favourable climate in which cross-border trade in services can flourish?

If it is found that the OECD is failing to provide leadership in the allocation of profits from cross-border services, then the implications for service providers and the OECD itself will need to be considered.

Having considered these questions the thesis will then formulate proposals for changes to the text of the OECD Model with respect to enterprise services.

### 1.1.1. The scope of the research

There are many pressing and interesting issues in the field of the taxation of services. This thesis is principally concerned with the division of rights between states over the direct tax base arising from cross-border enterprise services; thus indirect taxation is beyond the scope of this thesis. Equally, the thesis does not examine the mechanics of attribution of profits from services.

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13. Oxford English Dictionary.

14. Id.

## 1.2. Thesis outline and methodology

Chapter 2 considers the definition of services and the importance of the definitions adopted in the GATS. If trade in services is not significant relative to trade in goods, then a lack of explicit provision for services in the Models may be considered appropriate. This chapter goes on to present some factual material on the changing patterns of world trade in order to provide a firm foundation for the belief that cross-border trade in services has grown considerably since the OECD Model was first developed and that such trade is continuing to grow. The material presented is drawn mainly from primary statistical sources produced by international organizations and by the governments of the United States and the United Kingdom, but also makes use of some appropriate secondary sources.

Chapter 3 examines the theoretical underpinnings of source-state taxation of the profits of non-resident service providers. A historical analysis is conducted into the theory of jurisdiction to tax, focusing on the benefits principle, the principles of economic and political allegiance, and that of base erosion. This historical analysis is then applied to the taxation of non-resident service providers, drawing distinctions between the reliance placed on source-state resources by traditional forms of cross-border trading and cross-border trade in services. Conclusions are drawn as to whether or not source-state taxation of non-resident service providers is justified.

Chapter 4 traces the history of the treatment of services in both the OECD and the UN Models in order to form conclusions as to the reasons for the present-day treatment, or lack of it, in the text of the Models. The history of the OECD Model is well documented and so no attempt is made at a comprehensive history of the Model. Rather, this analysis seeks to establish whether or not the omission of specific provisions on trade in services in the OECD Model was the result of reasoned analysis based upon known patterns of international trade. The reasons for the inclusion of a services PE in the UN Model are explored, as is the historical treatment of the distinction between services and royalties.

Chapter 5, recognizing that treaty practices are strongly influenced by the domestic laws of the states negotiating treaties and having input to the Models, presents an analysis of the provisions concerning non-resident service providers in the domestic laws of a selection of states. Given that the text of the OECD Model makes no mention of services in article 5, it might be expected that no distinction is made in the domestic laws of states between taxation of non-residents on income from trade in goods and trade



in services. The chapter also enquires into the source rules adopted for taxation of services income and into state practices concerning the levying of withholding tax (WHT) on payments made to non-residents in respect of services. If the domestic laws of many states in respect of taxation of cross-border services differ from the Model treatment, this may support a conclusion that the Model provisions are inappropriate.

Chapter 6 presents the results of an extensive survey of the provisions for enterprise services contained in all full double tax treaties in force where an English or French translation was available as at August 2012. This chapter supplies the principal evidence as to whether DTTs follow the Model with respect to the taxation of cross-border services. Taken together, chapters 5 and 6 reveal that there are widespread differences in the treatment of income from services and they provide a rich data seam that forms the basis for the analyses in the remaining chapters.

Chapter 7 examines whether the basic PE rule, the “fixed place of business” test, is capable of being used to determine the existence of a PE in the case of non-resident service providers. Is this rule adequate and appropriate for determining the allocation of profits from cross-border services? A critique is offered of the changes to the Commentary on Article 5 of the OECD Model, which have been made and which are proposed, to facilitate an interpretation of the fixed place of business test in a way which would permit a source state to find that a service provider has a PE, even where that service provider does not have its own premises in the source state. This chapter includes an assessment of the proposals for alteration of article 5 contained in the BEPS initiative.

Chapter 8 considers whether the services PE provisions in the Commentary to the OECD Model, the text of the UN Model and also that in the Fifth Protocol to the US-Canada treaty constitute an adequate and appropriate means of dealing with the allocation of the tax base from cross-border services. The temporal threshold in article 14 of the UN Model is also analysed. Problems in interpretation are examined, as are difficulties in determining whether a temporal threshold has been breached. More fundamentally, this chapter questions whether a temporal threshold is a good proxy for establishing whether any debt of economic allegiance is owed to the host state. The BEPS proposals for tackling artificial avoidance of breaching of the service PE thresholds are considered.

Chapter 9 builds on this analysis of the services PE provisions as they stand and questions the principles underlying them. Source rules for allocation

of the tax base arising from cross-border services are analysed. Place of performance is often assumed to be the source rule, but the review of state domestic law in chapter 5 and a review of some case law suggests that place of performance may not be the most appropriate rule. Some source rules can only be operated by means of levying WHT. WHT levied on the gross amount of payments for services may, at best, lead service providers to inflate their price and, at worst, lead to service providers withdrawing from particular markets altogether. No provisions exist in any of the Models for WHT on payments for enterprise services, yet the practice is quite widespread, either through explicit treaty provisions or through a failure to interpret article 7 as covering profits from services and is mooted in the BEPS work on the topic of the digital economy as a possible means of restoring taxation revenues to the market jurisdiction.<sup>15</sup> The questions posed in this chapter are whether or not the OECD has established that place of performance possesses the necessary theoretical underpinnings to be the source rule for services income and whether the widespread imposition of WHT on services income, despite being contrary to the Models, indicates a fundamental failure of the Models with respect to services. The planned introduction of a new article on WHT on services payments in the UN Model is examined.

Chapter 10 presents conclusions based on the data generated and the issues analysed in the thesis. The role of the OECD Model in developing tax treaty policy is critically examined and conclusions on the principal research question are offered, as well as an assessment of the proposals within the BEPS initiative that are relevant to the taxation of cross-border services. The chapter puts forward a proposal for a new method of allocating the tax base with respect to cross-border enterprise services that might be incorporated into the OECD and UN Models.

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15. OECD Ctr. for Tax Policy and Admin., *Addressing the Tax Challenges of the Digital Economy* (OECD 2014).

**Notes**

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