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PROPOSED ADDITION TO THE COMMENTARY ON ARTICLE 12: FEES FOR INCLUDED SERVICES

Summary

When Article 12A on fees for technical services was debated, a minority of the Committee Members were of the view that there was no need to have a new Article and argued that countries that wish to have greater taxing rights with respect to fees for technical services could do so by including in their treaties an alternative version of Article 12 of the United Nations Model Convention that would allow Contracting States to impose tax on fees for services that are closely connected to the transfer of the use of, or the right to use, property producing royalties.

The majority of the Committee Members did not share that view, pointing out that the alternative version of Article 12 was inappropriate for most developing countries because of its limited scope and difficult and complex application. It was agreed however, that countries that wish to consider an alternative to new Article 12A should consider the alternative provision set out in paragraphs 25 to 27 of the Commentary on Article 12A. The present note had already been agreed on by the Committee but due to some editing work, a few paragraphs have been redrafted, and appear in color-highlight. The Subcommittee is seeking a final approval on those changes before incorporation in the updated UN Model.

Add after paragraph 21 of the Commentary on Article 12

22. As discussed in Section A. General Considerations of the Commentary on Article 12A, a minority of the members of the Committee was opposed to the inclusion of Article 12A in the United Nations Model Convention. Those members of the Committee considered that it would be preferable for countries that wish to have greater taxing rights with respect to fees for technical services to include in their treaties an alternative version of Article 12 of the United Nations Model Convention that would allow Contracting States to impose tax on fees for services that are closely connected to the transfer of the use of, or the right to use, property producing royalties. This alternative version of Article 12 is set out and discussed in paragraphs 24 to 52 below.

23. However, a majority of the members of the Committee were of the view that the alternative version of Article 12 is inappropriate for most developing countries because of its limited scope and difficult and complex application. Instead, the majority of the members of the Committee suggested that countries that wish to consider an alternative to Article 12A should consider the alternative provision set out in paragraphs 25 to 27 of the Commentary on Article 12A under which a Contracting State would be entitled to tax any income from services provided in that State and any fees for any services paid by payers in that State to closely related persons outside that State irrespective of whether those services are provided inside or outside that State.

Fees for Included Services

24. Countries that wish to tax fees for technical services, but are concerned about the scope of Article 12A may consider an alternative version of Article 12. Under this alternative approach, the definition of “royalties” in Article 12, paragraph 3 would be amended to include “fees for included services” and two new paragraphs would be added to Article 12.

25. Article 12, paragraph 3 would read as follows:

3. The term “royalties” as used in this Article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial or commercial or scientific equipment or for information concerning industrial, commercial or scientific experience, and fees for included services as defined in paragraphs 4 and 5 of this Article.

26. Article 12, paragraphs 4 and 5 would read as follows:

4. For the purposes of this Article, “fees for included services” means payments of any kind to any person in consideration for the rendering of any technical or consultancy services (including through the provision of technical or other personnel) if such services:

(a) are ancillary and subsidiary to the application or enjoyment of the right, property or information for which a payment described in paragraph 3 is received; or

(b) make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design.

5. Notwithstanding paragraph 4, “fees for included services” does not include payments:

(a) for services that are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of property;

(b) for services that are ancillary and subsidiary to the rental of ships, aircraft, containers or other equipment used in connection with the operation of ships or aircraft in international traffic;

(c) for teaching in an educational institution or for teaching by an educational institution;

(d) by an individual for services for the personal use of an individual;

(e) to an employee of the person making the payments or to any individual or individuals for professional services as defined in article 14 (Independent Personal Services).

Paragraphs 4, 5 and 6 of Article 12 would be renumbered as paragraphs 6, 7, and 8 respectively.

27. Article 12 includes only certain technical and consultancy services. The term "technical services" in this context means services requiring expertise in a technology. Consultancy services in this context means advisory services. The categories of technical and consultancy services are to some extent overlapping because a consultancy service could also be a technical service. However, the category of consultancy services also includes an advisory service, whether or not expertise in a technology is required to perform it.

28. Under paragraph 4 of the alternative version of Article 12, technical and consultancy services are considered included services only to the extent that: (1) as described in subparagraph 4(a), they are ancillary and subsidiary to the application or enjoyment of a right, property or information for which a royalty payment is made; or (2) as described in subparagraph 4(b), they make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design. Thus, consultancy services which are not of a technical nature cannot be included services under subparagraph 4(b).

29. Subparagraph 4(a) of the alternative version of Article 12 refers to technical or consultancy services that are ancillary and subsidiary to the application or enjoyment of any right, property, or information for which a payment described in paragraph 3 is received. Thus, subparagraph 4(a) includes technical and consultancy services that are ancillary and subsidiary to the application or enjoyment of intangible property for which a royalty is received under a license or sale as described in paragraph 3, as well as those ancillary and subsidiary to the application or enjoyment of industrial, commercial, or scientific equipment or information concerning industrial, commercial, or scientific experience for which a royalty is received under a lease as described in paragraph 3.

30. Subparagraph 4(a) is consistent with the interpretation of the definition of "royalty" that is set forth in paragraph 12Above (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention). The inclusion of subparagraph 4(a) in the text of a bilateral treaty is particularly beneficial to countries that have concerns about relying only on the interpretation in paragraph 12Above (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention). Provisions identical or substantially similar to paragraph 4(a) of the alternative provision are found in several existing bilateral tax treaties concluded by developing countries.

31. In order for a service fee to be considered "ancillary and subsidiary" to the application or enjoyment of some right, property, or information for which a payment described in paragraph 3 is received, the service must be related to the application or enjoyment of the right, property, or information. In addition, the predominant purpose of the arrangement under which the payment of the service fee and such other payment are made must clearly be the application or enjoyment of the right, property, or information described in paragraph 3. The question of whether the services are related to the application or enjoyment of the right, property, or information described in paragraph 3 and whether the predominant purpose of the arrangement is such application or enjoyment must be determined by reference to the facts and circumstances of each case. Factors which may be relevant to such determination (although not necessarily controlling) include:

- the extent to which the services in question facilitate the effective application or enjoyment of the right, property, or information described in paragraph 3;

- the extent to which such services are customarily provided in the ordinary course of business arrangements involving royalties described in paragraph 3;

- whether the amount paid for the services (or the amount which would be paid by parties operating at arm's length) is an insubstantial portion of the combined payments for the services and the right, property, or information described in paragraph 3;

- whether the payment made for the services and the royalty described in paragraph 3 are made under a single contract (or a set of related contracts); and

- whether the person providing the services is the same person as, or related to, the person receiving the royalties described in paragraph 3 (for this purpose, persons are considered related if their relationship is described in Article 9 (Associated Enterprises) or if the person providing the services is doing so in connection with an overall arrangement which includes the payer and recipient of the royalties.

32. To the extent that services are not considered ancillary and subsidiary to the application or enjoyment of some right, property, or information for which a royalty payment under paragraph 3 is made, the fees for such services shall be considered "fees for included services" only to the extent that they are described in subparagraph 4(b) of the alternative version of Article 12.

33. The following paragraphs provide examples to clarify the types of services intended to be included within the scope of the definition of “fees for included services” and the types of services that are not intended to be included in that definition. These examples are intended to be illustrative rather than exhaustive.

34. **Example 1:**

A manufacturing company resident in State R grants rights to a company resident in State S to use manufacturing processes in which the manufacturer has exclusive rights by virtue of process patents or the protection otherwise extended by the law of State R to the owner of a process. As part of the contractual arrangement, the manufacturer agrees to provide certain consultancy services to the State S company in order to improve the effectiveness of the latter's use of the process. For example, such services include the provision of information and advice on sources of supply for materials needed in the manufacturing process, and on the development of sales and service literature for the manufactured product. The payments for these services do not form a substantial part of the total consideration payable under the contractual arrangement.

35. The payments described in Example 1 are fees for included services. They are ancillary and subsidiary to the use of a manufacturing process protected by law as described in paragraph 3 of the alternative version of Article 12, because the services are related to the application or enjoyment of the protected process and the granting of the right to use the process is clearly the predominant purpose of the arrangement. Because the services are ancillary and subsidiary to the use of the manufacturing process, the fees for these services are considered fees for included services under subparagraph 4(a) regardless of whether they are covered in subparagraph 4(b). As explained in paragraph 30 above, while this result is consistent with the interpretation of the definition of “royalty” that is set forth in paragraph 12Above (quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model Convention), countries can make this result explicit by including subparagraph 4(a) in the text of the treaty provision.

36. **Example 2:**

A manufacturing company resident in State S produces a product that must be manufactured under sterile conditions using machinery that must be kept completely free of bacterial and other harmful deposits. A company resident in State R has developed a special cleaning process for removing such deposits from this type of machinery. The State R company enters into a contract with the State S manufacturing company under which the former will clean the latter's machinery on a regular basis. As part of the arrangement, the State R company leases to the State S company a piece of equipment which allows the State S company to measure the level of bacterial deposits on its machinery in order for it to know when cleaning is required.

37. In Example 2, the provision of cleaning services by the State R company and the lease of the monitoring equipment are related to each other. However, the predominant purpose of the arrangement is clearly the provision of cleaning services. Thus, although the cleaning services might be considered technical services, they are not “ancillary and subsidiary" to the rental of the monitoring equipment. Accordingly, the cleaning services are not "included services" within the meaning of subparagraph 4(a) of the alternative version of Article 12.

38. Subparagraph 4(b) of the alternative version of Article 12 refers to technical or consultancy services that make available to the recipient technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design to such person. The services described in subparagraph 4(b) differ from the services described in subparagraph 4(a) of the alternative version of Article 12 in that any service that does not make technology available to the person acquiring the service is excluded. Generally speaking, technology will be considered "made available" to a person if that person is enabled to apply the technology through the provision of the services. The fact that the provision of the service may require technical input by the person

providing the service does not mean, by itself, that technical knowledge, skills, etc., are made available to the person purchasing the service. Similarly, the use of a product that embodies technology does not mean, by itself, that technology is made available to the recipient of the services.

39. Categories of services that typically involve either the development and transfer of technical plans or technical designs, or making technology available as described in subparagraph 4(b) of the alternative version of Article 12, include:

engineering services (including the subcategories of bioengineering and

aeronautical, agricultural, ceramics, chemical, civil, electrical, mechanical, metallurgical, and industrial engineering);

architectural services; and

computer software development.

The manner through which the services are provided is irrelevant to the characterization of the payments as fees for included services.

40. Under subparagraph 4(b) of the alternative version of Article 12, technical and consultancy services could make technology available in a variety of settings, activities and industries. Such services may, for example, relate to any of the following areas:

bio-technical services;

food processing;

environmental and ecological services;

communication through satellite or otherwise;

digital networking;

energy conservation;

exploration or exploitation of mineral oil or natural gas;

geological surveys;

scientific services; and

technical training.

41. **Example 3:**

A manufacturing company resident in State R has experience in the use of a process for manufacturing wallboard for interior walls of houses which is more durable than standard wallboard products. A company resident in State S wishes to produce this product for its own use. It rents a plant in State S and contracts with the State R company for the use of the process and for sending experts to State S to show engineers employed by the State S company how to produce the more durable wallboard. The experts supplied by the State R manufacturer work with the employees of the State S firm for a few months.

42. According to the principles set out in paragraph 12Above (quoting paragraphs 11.1, 11.3 and 11.4 of the Commentary on Article 12 of the OECD Model Convention), in Example 3, payments for the use of the wallboard manufacturing process would be characterized as payments for "know-how," and thus are taxed as royalties, while the payments by the State S company to show its engineers how to produce the more durable wallboard would be characterized as business profits. However, under subparagraph 4(b) of the alternative version of Article 12, the payments for the services of the experts supplied by the State R manufacturer would be fees for included services. The services are of a technical or consultancy nature; they have elements of both types of services. The services make available to the State S company technical knowledge, skill, and processes. Therefore, the payments are fees for included services under subparagraph 4(b) of the alternative version of Article 12.

43. **Example 4:**

A manufacturing company resident in State R operates a wallboard fabrication plant outside State R. A company resident in State S enters into a contract with the State R company to produce wallboard for the State S company at that plant for a fee. The State S company provides the raw materials, and the State R manufacturer fabricates the wallboard in its plant, using advanced technology.

44. In Example 4, the payments under the contract to the State R manufacturer would not be fees for included services under the alternative version of Article 12. Although the State R company is performing a technical service, no technical knowledge, skill, etc., is made available to the State S company, nor is there any development and transfer of a technical plan or design. The State R company is merely performing contract manufacturing services for the State S company.

45. **Example 5:**

A firm resident in State S owns inventory control software for use in its chain of retail outlets throughout State S. It expands its sales operation by employing a team of employees to travel around the countryside selling the company's wares. The company wants to modify its software to permit the sales force to access the company's central computers for information on what products are available in inventory and when they can be delivered. The State S firm enters into a contract with a State R computer programming firm resident in State R to modify its software for this purpose. In fulfilling the terms of the contract, the State R firm transfers the modified software to the State S firm.

46. According to the principles set out in paragraph 12Above (quoting paragraph 14.3 of the Commentary on Article 12 of the OECD Model Convention), in Example 5, the payments by the State S firm for the modification of computer software would be characterized as business profits. However, under subparagraph 4(b) of the alternative version of Article 12, the payments are fees for included services. The State R company [performs/provides] a technical service to the State S company, and it transfers to the State S company the technical plan (i.e., the computer program) that it develops.

47. **Example 6:**

A vegetable oil manufacturing company resident in State S wants to produce a cholesterol-free oil from a plant which produces oil containing cholesterol. A company resident in State R has developed a process for refining cholesterol out of the oil. The State S company contracts with the State R company to modify the extraction formulas which it owns and uses to eliminate the cholesterol, and to train the employees of the State S company in applying the new formulas.

48. According to the principles set out in paragraph 12Above (quoting paragraphs 11.1, 11.3 and 11.4 of the Commentary on Article 12 of the OECD Model Convention), in Example 6, payments for the modification of the cholesterol extraction formula as well as the payments for the training in the use of the new formulas would be characterized as business profits. However, under subparagraph 4(b) of the alternative version of Article 12, both payments by the company resident in State R are fees for included services. The services are technical, and the technical knowledge is made available by the manufacturing company to the State S company through the training of its employees to apply the modified formulas.

49. **Example 7:**

A company resident in State R engaged in manufacturing vegetable oil has mastered the science of producing cholesterol-free oil and wishes to market the product worldwide. It enters into a contract with a marketing consulting firm resident in State S to do a computer simulation of the world market for such oil and to advise it on marketing strategies.

50. The payments in Example 7 would not be fees for included services under the alternative version of Article 12. The State S company is providing a consultancy service to the manufacturing enterprise in State R, which involves the use of substantial technical skill and expertise. It is not, however, making available to the State R company any technical experience, knowledge or skill, etc.; nor is it transferring a technical plan or design. The State S consulting firm is providing commercial information to the State R manufacturing company through the service contract. The fact that the consulting firm used technical skills and expertise in order to perform the services and provide the commercial information to the State R manufacturing company does not make the service a technical service within the meaning of subparagraph 4(b) of the alternative version of Article 12.

51. **Example 8:**

A hospital established in State S purchases an X-ray machine from a manufacturer resident in State R. As part of the purchase agreement, the manufacturer agrees to install the machine, to perform an initial inspection of the machine in the hospital, to train hospital staff in the use of the machine, and to service the machine periodically during the usual warranty period (2 years). Under an optional service contract purchased by the hospital, the manufacturer also agrees to perform certain other services throughout the life of the machine, including periodic inspections and repair services, advising the hospital about developments in X-ray technology, which could improve the effectiveness of the machine, and training hospital staff in the application of these new developments. The cost of the initial installation, inspection, training, and warranty service is relatively minor as compared with the cost of the X-ray machine.

52. In Example 8, the initial installation, inspection, and training services performed for the hospital in State S and the periodic services provided during the warranty period are ancillary and subsidiary, as well as inextricably and essentially linked, to the sale of the X-ray machine because the usefulness of the machine to the hospital depends on this service, the manufacturer has responsibility to service the machine during the warranty period, and the cost of the services is a relatively minor component of the contract. Therefore, under subparagraph 5(a) of the alternative version of Article 12 the payments received by the manufacturer are excluded from the definition of fees for included services, regardless of whether they would otherwise be covered by subparagraph 4(b). However, neither the post-warranty period inspection and repair services, nor the advisory and training services relating to new developments are "inextricably and essentially linked" to the initial sale of the X-ray machine. Absent the alternative version of Article 12, these payments would constitute business profits. However, under the alternative version of Article 12, the payments for the training of the hospital staff on the application of new developments in X-ray technology are covered by paragraph 4(b) and as such, may be taxed as fees for included services.