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Tax consequences of the digitalized economy

THE TAXATION OF FEES FOR TECHNICAL, MANAGERIAL AND CONSULTANCY SERVICES IN THE DIGITAL ECONOMY WITH RESPECT TO ART 12A OF THE 2017 UN MODEL[1]

Summary

This secretariat paper addresses the history of the Committee's work on fees for technical services and considers the extent to which:

- It sheds some light on possible approaches to the broader question of taxation rules for the digital economy that might prove to be effective or ineffective;
- It highlights some of the tensions and differences likely to arise in examining taxation rules in the digital economy; and how they might be most successfully accommodated; and
- It demonstrates that some issues not addressed in the context of that work may need to be addressed in any broader consideration of taxation and the digital economy.

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Introduction

Evolution of Article 12A on fees for technical services

The UN Committee of Experts on International Cooperation in Tax Matters (the "Committee") has dealt with issues on the taxation of income from technical, managerial, consultancy and other similar services ("technical services") within the UN Model especially since 2008.[2] In its eight session in 2012 the majority of members agreed in principle (by majority vote) on the inclusion of a new article dealing with the taxation of fees for technical services. A draft proposal for an article on fees for technical services was presented at the ninth session of the Committee in 2013 by Ms. Kana, coordinator of the former Subcommittee on Tax Treatment of Services (the "Subcommittee").[3] Based on the draft article and commentary prepared by the consultant of the Subcommittee Mr. Arnold, a draft article and draft commentary on the taxation of "fees for technical services" was presented.[4] The twelfth session of the Committee resulted in the final approval of the text and the commentary of the new article on the taxation of fees for technical services.[5] Although some tidying up of language was done at the thirteenth and fourteenth sessions, the new article on "fees for technical services" will be assigned article 12A in the 2017 UN Model .[6] Finally, minor changes in the new article 12A and its commentary have been made at the fourteenth session of the Committee.[7]

Nature of "fees for technical services"

2. The term "fees for technical services" is defined as payments in consideration of technical, managerial and consultancy services. Hereby the rendering of services must include the application of specialized knowledge, skill or expertise or the transfer of knowledge, skill or expertise other than royalties in the meaning of article 12 (3) of the UN Model. [8] According to article 12 (3) of the UN Model 2011, the term "royalties" includes 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, commercial or scientific equipment or for information concerning industrial, commercial or*

[2] UN, Committee of Experts on International Cooperation in Tax Matters, Secretariat *Note - Recent Work of the Committee on Tax Treatment of Services*, E/C.18/2013/CRP.17 (2013), at 2 et seq.

[3] UN, Committee of Experts on International Cooperation in Tax Matters, *Report on the ninth session*, E/2013/45-E/C.18/2013/6 (2013), paras. 56 et seq.

[4] UN, Committee of Experts on International Cooperation in Tax Matters, *Note from the Coordinator of the Subcommittee on Tax Treatment of Services: Draft Article and Commentary on Technical Services* E/C.18/2014/CRP.8 (2014).

[5] UN, Committee of Experts on International Cooperation in Tax Matters, *Report on the twelfth and thirteenth sessions*, E/2016/45-E/C.18/2016/7 (2016), para. 43.

[6] Result of the thirteenth session of the Committee, see E/2016/45-E/C.18/2016/7, UN, Committee of Experts on International Cooperation in Tax Matters, *Report on the twelfth and thirteenth sessions*, E/2016/45-E/C.18/2016/7 (2016), para. 41.

[7] UN, Committee of Experts on International Cooperation in Tax Matters, *Report on the fourteenth session*, E/2017/45-E/C.18/2017/3 (2017), paras. 31 et seq.

[8] UN, Committee of Experts on International Cooperation in Tax Matters, *Revised Commentary on Article 12A – Fees for Technical Services,* E/C.18/2017/CRP.1 (2017), para. A 62.

scientific experience". While the definition of "royalties" includes the use of, or the right to use, property, "technical services" are performed independently of any transfer of (immaterial) property.

3. It is often hard to distinguish payments on royalties, on the one hand, from fees for technical, managerial and consultancy services on the other. Technical, consulting and managerial services are not covered by the definition of "royalties" in article 12 (3) of the UN Model 2011. Those payments give rise to practical difficulties. The following criteria might be considered to make a distinction between royalties and service fee payments:[9]

- On the basis of a service contract, the service provider obliges himself to provide services in consideration for a certain payment to the other party of the contract with the use of special knowledge, skill or expertise. In general, a service contract involves a higher level of expenditure by the service provider than a know-how contract. The service provider might need to reimburse his employees, make expenses on research, designing, testing and also associated payments to possible subcontractors.

- Under a know-how contract, one party usually imparts the other party to use his knowledge and experience on his own account. The special know-how and experience remain undisclosed to the public. The providing party usually does not play a part in the result of the application of his know-how and experience and is also not liable to the result of its use.

- Mixed contracts (e.g. franchising), include the transmission of know-how and the rendering of services. Not only know-how and experience are transmitted to the other party of the contract, but also (technical) services providing for technical assistance and in certain cases financial assistance or supply of goods as ancillary activities. The whole amount of consideration agreed by the parties to the contract should be split up appropriately to the transmission of know-how and expertise and services, on the basis of the information contained in the contract. However, if one part of the contract is by far the principal purpose of the contract and the other part is only of ancillary and unimportant character, the whole amount of consideration should be attributed to the principal part.

4. In the case of technical assistance and technical services, the service provider does not transmit industrial, commercial or scientific experience (know-how). The service provider uses his know-how to develop a specific solution for a customer. According to the Commentaries to the OECD and UN Models, services in the nature of technical assistance should not be considered as royalties, as consideration paid for pure technical assistance relates to the provision of services to the customer with the use of know-how and not to the transmission of

[9] See *UN Model Double Taxation Convention between Developed and Developing Countries: Commentary on Article 12*, para. 12 (2011); –OECD Model Tax Convention on Income and on Capital: *Commentary on Article 12*, para. 11.1 (2014).

know-how as such.[10] From a practical perspective, no discernible difference may be found between technical assistance and technical services in a strict sense.[11]

5. The technical aspect of services and assistance generally includes consulting on "technical" issues. Consulting activities might relate to the training of technical personnel for a certain period of time to instruct the personnel on the operation of a plant, construction site or mine. In contrast hereto, the transmission of know-how, e.g. the documentation on the construction of a plant or a mine may not be regarded as an independent service but rather the transmission of know-how as such.

6. Some tax treaties also cover technical assistance connected to intellectual property under article 12 on the taxation of royalties. By applying the concept of article 12 of the UN Model 2011, managerial services cannot be understood as "technical" services in a strict sense. Traditionally, the term "technical" should be applied to "engineering sciences" or "applied and industrial science", excluding social sciences, commercial managerial activity and professional services, e.g. managers, lawyers and doctors.[12]

7. "Consulting" services have to be distinguished from the transmission of industrial, commercial or scientific experience, which would be qualified as royalties. The consultant does not "transmit" know-how, but rather uses industrial, commercial or scientific experience as a tool for giving advice to his customer. The consultant is liable for the service as such, which means for the use of "know-how" as a tool. In contrast to the consultant, the vendor of know-how sells the tool as such and not the solution.[13] Therefore, payments for opinions given by engineers, advocates or accountants shall be seen as payments given in consideration for the rendering of services, rather than the transmission of know-how.

8. Advice rendered electronically, e.g. electronic communication with technicians or for accessing a trouble-shooting database, such as a database providing users of software non-confidential information on frequently asked questions through computer-networks should, in the view of the commentary to the OECD and UN Models, be considered as the rendering of services.[14]

9. As technical, managerial and consultancy services cannot be regarded as royalties (unless specifically addressed in the Article) and are therefore not covered by article 12 of the UN and the OECD Models, many tax treaties explicitly cover the taxation of technical, managerial and consultancy services.[15] One of the principal purposes to widen the scope of article 12 of the UN Model or include a separate article on the taxation fees for technical,

[10] Para. 12 *UN Model: Commentary on Article 12* (2011); para. 11.4 *OECD Model: Commentary on Article 12* (2014).
[11] M. Valta, *Article 12*, in *Klaus Vogel on Double Taxation Conventions*, para. 180 (E. Reimer & A. Rust eds., 4th edition, Kluwer 2015).
[12] M. Valta, *supra* n. 11, para. 185 with further references.
[13] M. Valta, *supra* n. 11, para. 103.
[14] Para. 12 *UN Model: Commentary on Article 12* (2011); para. 11.4 *OECD Model: Commentary on Article 12* (2014).
[15] See e.g. Japan – Pakistan Income Tax Treaty (2008) Art 13; Chile – Malaysia Income Tax Treaty (2004) Art 14.

managerial and consultancy services is the extension of source country taxing rights, especially in cases in which no PE exists in the source state.

Challenges and opportunities on taxation of "technical" services in the digital economy

10. Organizational structures of MNEs have changed as means and speed of telecommunication have improved and have become more important as digitalization in general has increased. The rise of the digital economy raises fundamental issues about a balanced allocation of taxing rights between the source state and the residence state. The traditional concept of permanent establishment as a fixed place of business has arguably become redundant in a digitalized economy, as corporations do not need any workforce to generate very significant income in the source state very quickly. Additionally, MNEs do not necessarily establish a fixed place of business in the source state as digital means allow them to furnish cross-border services or distribute products without any physical facility in the source state. As a result, taxing rights may not be attributed appropriately under tax treaties, as many current tax treaties strongly preserve residence taxation. Business profits may only be taxed by the source state, if a PE of an enterprise is located in the source state.[16]

11. Under the current rules of the UN Model, source country taxation is limited to cases where a resident of the other contracting state has a PE or a fixed base in the source country or if a resident of the other contracting state stayed in the source state for a specific period of time. With the inclusion of article 12A into the UN Model 2017, the Committee of Experts decided to strengthen preservation of source country rights with the aims of a "fair" allocation of taxing rights between residence and source states and prevention of base erosion of the tax base in the source state originating from the deductibility of expenses for fees for technical services.[17]

12. The concept of "permanent establishment" was first established in the nineteenth century in the German states with the German term "stehendes Gewerbe" which would be translated as "a trade with a fixed place of business".[18] The term permanent establishment[19] was further used in non-tax law and codified in Prussian tax law in 1891 in the present tax sense.[20] On 21 June 1899 the Austro-Hungarian Empire and Prussia signed a tax treaty which was the first one using the term "Betriebsstätte", which is the German translation for "permanent establishment". According to the provisions of this tax treaty, business profits arising in the state where the permanent establishment is located, shall be taxed in that state.[21]

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[16] See para. 2 *OECD Model: Article 7* (2014); *UN Model: Article 7* (2011).
[17] UN, *supra* n. 8, at A 7 et seq.
[18] A. Skaar, *Permanent Establishment – Erosion of a Tax Treaty Principle*, at 72 with further references (Wolters Kluwer 1991).
[19] In German: "Betriebsstätte".
[20] J.F. Avery Jones et al., *The Origins of Concepts and Expressions Used in the OECD Model and their Adoption by States*, Bulletin for International Taxation, at 233 (2006).
[21] M. Kobetsky, *International Taxation of Permanent Establishments*, at 110 (Cambridge University Press 2011).

The Austro-Hungarian Empire and Prussia tax treaty also included several examples of what types of establishments may constitute a permanent establishment for tax treaty purposes.[22]

13. The concept of a PE is a means to attribute business profits between the residence and the source state. Discussions on the attribution of business profits are based on the economic allegiance (link) of a taxable person to the residence and the source state. The concept of economic allegiance has first been established in 1922. It is based on factors intending to measure the existence and extend of economic relationship between the income of a person or the person and a particular state.[23] Based on the 1923 proposal of the League of Nations Committee of Experts, economic allegiance should be based on the following four factors: 1) origin of wealth (source), 2) location of wealth (situs), 3) the place of enforcement of rights of wealth, 4) residence or domicile (place of consumption).[24]

14. It was the League of Nations which started to work on a model provision on the taxation of business profits borne by a permanent establishment in its draft bilateral treaty in 1927.[25] The draft business profits article defined the term “permanent establishment” in a very broad sense, as not only “*real centres of management*, […] *branches*, *factories*, *agencies*, *warehouses*, *offices*, *depots*” but also “*affiliated companies*” were regarded as permanent establishments.[26] The notion of “affiliated companies” was deleted from the PE definition in article 5 of the 1928 General Meeting´s draft convention.

15. The draft article on business profits was at that time a success for source states as it was a deviation from the general principle of residence state taxation established by the Committee of Experts.[27] The source state should have been allowed to tax profits attributable to a permanent establishment carrying on business within its territory. At the end of the 1920s international trade was mainly focused on trade of tangible goods. As a consequence enterprises operating at that time were required to have business operations in the source state. In order to conduct business in the source state, offices, sales facilities and storage facilities were needed which provide the source state´s tax authority with the ability to enforce its tax law.[28] The first model treaty meeting especially the needs of developing countries was the 1943 Mexico Model. The draft of this model was a result of two meetings of the Subcommittee of the League of Nations Fiscal Committee in Mexico City in 1940 and 1943. The Subcommittee was predominantly composed of representatives of least developed Latin-American countries, aiming at increasing state revenue. In the light of the consideration that both conferences in

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[22] J.F. Avery Jones et al., *supra* n. 20 at 234: “[…] *Branch offices, factories, storage facilities, offices, purchase and sale facilities and other business establishments used for the performance of standing enterprises by the entrepreneur himself, business partners, authorised agents or other permanent agents*.”

[23] W.H. See, *The Territoriality Principle in the World of the OECD/G20 Base Erosion and Profit Shifting Initiative: The Cases of Hong Kong and Singapore – Part I*, Bulletin for International Taxation, at 51 (2017).

[24] Economic and Financial Commission, *Report on Double Taxation Submitted to the Financial Committee* (1923).

[25] Report presented by the Committee of Technical Experts on Double Taxation and Tax Evasion, *Double Taxation and Tax Evasion* (1927).

[26] M. Kobetsky, *supra* n. 21, at 122 et seq.

[27] M. Kobetsky, *supra* n. 21, at 125.

[28] M. Kobetsky, *supra* n. 21, at 125 et seq.

Mexico City were mainly attended by representatives of least developed countries, the result of a more source based draft model was not a surprise.[29]

16. The PE principle was reintroduced by the Fiscal Committee in London in 1946. According to the 1943 Mexico Model an enterprise is liable to tax in the source state if it carries out not only “isolated or occasional transactions” in that state.[30] In comparison to the 1943 Mexico Model, the 1946 London Model required the existence of a PE, in the sense of a fixed place of business, to tax business profits generated in the source state.[31] The general nature of a PE had to been drawn from the list of PE examples in the Mexico and London draft Models as the 1946 London Model lacked a general definition of a PE.[32] However, article 5 para 1 of the Protocol to the 1946 London Model gives a definition of the term “permanent establishment”. Two conditions must be met for an establishment to be regarded as “permanent establishment”: Firstly, it must be a” fixed place” of business and secondly that fixed place needs to contribute to business earnings.[33]

17. The Fiscal Committee of the League of Nations stated the view that taxing profits generated by an enterprise in the source state was extremely difficult without the existence of a PE.[34] This is especially true in the light of the view that a PE should have been regarded as an independent enterprise with the same or similar activities functioning at least on similar conditions.[35] Books and accounts are kept separately for each establishment as it were an independent enterprise. The obligation to hold and report accounts on the profits of the enterprise and its assets generated in the source state helped the source state´s tax administration to tax the income generated within their territory. As regards the digital economy enterprises do not need any assets or personnel in the source state to conduct business therein. No physical presence is given in the source state and therefore also no accounts and reports on the activities in the source state are maintained by the non-resident enterprise in the source state. Without the existence of accounts, reports and assets in the source state, exchange of financial information from the source to the residence state will become increasingly important. Especially in the area of cross-border services, rendered with digital means, payments will flow from a bank account of the payer (in the source state) to another bank account of the payee (in the residence state). Only by deviating from the traditional PE-concept in the digital economy, the source state will be attributed a taxing right, as the mere existence of a bank account in the source state will not constitute a permanent establishment therein.

18. Deviations from the PE concept may be found in articles 10, 11, 12, and 17 of the OECD and UN Models.[36] Articles 10, 11 and 12 of both Models distribute the right to withhold

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[29] A. Skaar, *supra* n. 18, at 88.
[30] League of Nations, *London and Mexico Model Tax Conventions – Commentary and Text*, C.88.M.88.1946.II.A (1946) at 13.
[31] A. Skaar, *supra* n. 18, at 90.
[32] A. Skaar, *supra* n. 18, at 91.
[33] League of Nations, *supra* n. 30, at 14.
[34] League of Nations, *supra* n. 30, at 14.
[35] League of Nations, *supra* n. 30, at 17 et seq.
[36] See e.g. A. Cordewener, *Article 17*, in *Klaus Vogel on Double Taxation Conventions*, para. 13 (E. Reimer & A. Rust eds., 4th edition, Kluwer 2015)

a certain percentage of the gross amount of distributed dividends, interest and royalties to a resident of one of the contracting states.[37]

19. Article 17 of both Models constitutes rules on the taxation of artists and sportspersons. According to article 17 (1), activities performed by artists and sportspersons shall be taxed in the state of performance. As this is not an exclusive taxing right, the residence state of the artist or sportsperson still retains the right to tax the income of the performance. To avoid taxation in the source state, artists and sportspersons established so called “star-companies”.[38] Payments for the performance of the artist or sportsperson were made to before mentioned companies who paid a small salary to the artist or sportsperson and retained the remaining remuneration. Before the introduction of article 17 (2) in the OECD Model 1977 those payments could not have been taxed in the state of source, which is the state of performance, as the remuneration for the performance was paid to another person than the artist or sportsperson. Remuneration for the performance would have been taxed as business profits according to article 7 (1) of the models which provides that business profits shall be exclusively taxed in the residence state of the enterprise unless the profits are attributable to a PE. If profits are attributable to a PE, those profits may also be taxed in the source state. As no PE was established in the state of performance the remuneration for the performance of the artist or sportsperson which was paid to a “star-company” was solely taxed in the residence state (in most cases low tax jurisdiction) of the company. Although the performance and therefore the economic value was created in the source state the sole taxing right was distributed to the residence state. The outcome was an inappropriate allocation of taxing rights between the source and the residence state.

20. Although the initial purpose for the insertion of article 17 (2) was to counter abuse the outcome results in an appropriate allocation of the business profits of the enterprise without the criterion of a PE. There are only two requirements: Firstly, the performance must be made in the state of source. Secondly, the payment must be made to the company who factually benefited (beneficial owner) from the payment made. Similarly, article 12A also focuses on the payer – payee relationship (and the place of value creation) and not on the establishment of a PE. In the case of article 12A of the UN Model 2017, taxation shall take place in the state of residence of the payer which is most often also the place of consumption of the service. Accordingly, articles 17 (2) and 12A overlap in those cases in which the performance/service of the non-resident performer/service provider was made in the source state and the payer of the remuneration is a resident of that state.

21. As already mentioned, the digital economy enables businesses to render cross-border services without physical but digital presence in another state. Therefore it is hard to determine in which state the economic activity is *de facto* exercised. The digital economy is especially present in today´s day-to-day business. However, questions on the basis of exercising economic activity through digital means, resulting in an attribution of taxing rights between the residence and the source state, were already discussed in the late 1950s by the OEEC with regards to the taxation of directors´ fees. The OEEC recognized the problematic of determining the place in

[37] The UN Model distributes a higher percentage on the distributed passive income to the source state.

[38] See para. 11.1 *UN Model: Commentary on Article 17* (2011).

which the director exercises his activity, in the second half of the 1950s.[39] Especially considering modern information and telecommunication technologies enabling conferences, meetings and other ways of correspondence to be held without physical presence of the director in a contracting state, an attribution of taxing rights to the state in which the activity is exercised may often be difficult to determine. Therefore, the OEEC decided to attribute a taxing right preferentially to the state of residence of the respective company, of which the director is a member of the board of directors. The OECD adopted the approach of the OEEC to its Model Convention in 1963. Since then, the article on the taxation of directors´ fees in the OECD Model basically remained unchanged. The commentary on article 16 on the OECD Model 2014 also recognizes that "*it might sometimes be difficult to ascertain where the services are performed*".[40] As the UN Model reproduces article 16 (1) of the OECD Model, it also views the respective parts of the commentary on the OECD Model as relevant for the interpretation of article 16 (1).[41]

22. In the case that services are rendered through digital means, the PE concept and the application of the 183 days rule in article 14 (1) (b) of the UN Model 2011 might not be appropriate any more as rules resulting in an appropriate attribution of taxing rights between the residence and the source state. As in the case of article 16 (1) the OEEC, OECD and UN decided to omit the inclusion of a state-of-activity rule requirement. Taxation in the source state, which is the state of residence of the company concerned, is possible without any physical presence of the taxpayer therein. A director might only be physically present in a third state using digital means (e.g. meetings, conferences) to exercise his activities. Although only digitally present in the state of residence of the company, the source state has a taxing right on the directors´ fees according to article 16 (1) of the UN and the OECD Models.

23. Article 16 (1) of the OECD and the UN Models is not the only example for a deviation from the physical presence concept. Also article 12A of the UN Model 2017 does not require any physical presence of the service provider for the attribution of a taxing right to the source state. Article 12A of the UN Model focuses on the payer-payee relationship and attributes a taxing right to the residence state of the payer. Also in the case of services rendered by using modern means of telecommunication and information technologies, different types of services are rendered without any physical presence in one of the contracting states. Similar questions as in the case of article 16 (1) of the UN and OECD Models arise. It is hard to determine in which state the service is actually exercised. A non-resident service provider might actually only be digitally and not physically present in the source state while rendering the demanded services. Under the current rules, focusing on physical presence in the source state, taxation of the non-resident service provider in the source state would not be possible, although value was created in the source state by the rendering of services through digital presence.

24. The rising digital economy enables (and perhaps requires) a rethinking of traditional concepts, based on physical presence in one of the contracting states. The inclusion of article 12A in the UN Model 2017 is a step further to challenging and rethinking those traditional

[39] OEEC Fiscal Committee, *The Elimination of Double Taxation: 2nd Report* (1959), Article IX.
[40] Para. 1 *OECD Model: Commentary on Article 16* (2014).
[41] Para. 2 *UN Model: Commentary on Article 16* (2011).

concepts and might lead to further discussions on renovated concepts leading to an appropriate attribution of taxing rights in the digital economy.

Bilateral and unilateral measures to tax "technical services"

25. Developing countries often include a provision on the taxation of technical services in the article on the taxation of royalties. By 2012, 134 of 1586 examined tax treaties included an autonomous article on the taxation of technical services.[42] Most of these tax treaties define technical services in a broader sense, which means that they also include managerial and consultancy services within their scope of application. Additionally, fees for (in)dependent personal services are mostly excluded from the scope of the fees for technical services article in the above examined treaties. Such clauses seem to be increasingly popular among developing countries and we expect the number of treaties including such clauses, despite likely negotiation resistance from some treaty partners, to increase.

26. The wording and scope of the article on the taxation of fees for technical services differs among the treaties and depends to a large extent on the tax treaty policy of the respective countries. The new UN provision may help to bring more consistency to the drafting and administration of such clauses. The following section should give an overview of country practice on the taxation of "technical services" not only from the treaty perspective but also from a perspective of the corresponding national law.

Angola

27. Service fees paid to non-resident entities are subject to a withholding tax with a tax rate of 6.5 %. Tax will be imposed and withheld if the services are provided in Angola or paid by Angolan entities. In case of double taxation on income of a non-resident taxpayer, no relief can be granted as there are no treaties in force.[43]

Brazil

28. Most of Brazilian tax treaties include a specific provision on the taxation of technical services in their protocols. According to this specific provision, payments of any kind for technical services rendered in one of the contracting states shall be taxed as royalties.[44] Exceptions are to be found in the tax treaties with Austria, Finland, France, Japan and Sweden.[45] The tax rate negotiated in Brazil´s tax treaties for the taxation of royalties provides in most tax treaties for a 15 % withholding tax rate. The Federal Revenue Service of Brazil

[42] J. de Goede, *The Treatment of Services in Tax Treaties*, Bulletin for International Taxation, at 33 et seq. (2012).
[43] M. Graca, *Portuguese-Speaking African Countries: Same Background, Different Solutions*, Bulletin for International Taxation, at 719 (2016).
[44] E.g. Brazil – Netherlands Income Tax Treaty Protocol (1990), para. 5: "*It is understood that the provisions of paragraph 3 of Article 12 shall apply to payments of any kind received as a consideration for the rendering of technical assistance and technical services*.".
[45] S.A. Rocha, *Brazil´s Treaty Policy*, Bulletin for International Taxation, at 336 et seq. (2017).

issued an Interpretative Declaratory Act in 2014[46] for the interpretation of technical services and technical assistance, with or without technology transfer, based on Brazil´s tax treaty protocols. According to Brazil´s tax legislation, the term "technical services" shall be defined in a broad sense, which means that not only technical services in a strict sense are covered by this definition but any service requiring specialized skills.[47] According to the Federal Revenue Service, technical services means the execution of services requiring a specialized technical knowledge or administrative assistance or consultancy, performed by independent professionals or with employment relationship or, also, automated with clear technological content. Fees for technical services, technical assistance, administrative and similar services derived by a non-resident are subject to a 15 % or, if the payment is made to a person resident in a "tax haven", 25 % withholding tax in Brazil.[48]

<u>Chile</u>

29. Payments for services provided by non-resident service providers in Chile are generally taxed with a tax rate of 35 %.[49] However, payments for engineering or technical work are as well as payments for professional or technical services exempt from tax in Chile, if they are similar as the services named by the Customs export list and therefore qualified as exports from Chile. In case that the services are not included in the list, the gross amount paid for those services is subject to a withholding tax rate of 15 % or 20 %, if the payment is made to a payee or beneficiary, resident of a state named in the list of tax havens.[50]

30. The application of most of Chile´s tax treaties would result in source taxation only if a physical presence in the form of a permanent establishment is given in Chile, as article 7 on business profits, which is construed after the UN and OECD Models, is applicable. So only if the payments for services rendered in Chile are attributable to a permanent establishment of the non-resident taxpayer in Chile, source taxation will take place. It is notable that the service PE constituted in article 5 of Chile´s tax treaties deviates on two major issues from the respective provision of the UN Model 2011. Firstly the service PE provision of Chile´s tax treaties does not refer to the "same or connected project" which means that the time threshold of the service PE provision is also applicable if the enterprise provides services in general not limited to connected projects. Secondly, Chile does not limit the applicability of the service PE provision to individuals having an employee relationship with the enterprise rendering the services. However, Chile limits the applicability of source taxation to services rendered in Chile. If the services are rendered outside of Chile, source taxation will not take place.[51] By

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[46] RFB Interpretative Declaratory Act No. 5 of June 16, 2014.

[47] S.A. Rocha, *supra* n. 45, at 337.

[48] L.F. de Moraes e Castro & A.L. Moraes do Rego Monteiro, *Qualification of Services Under Double Tax Treaties in Brazil: Open Issues After Iberdrola case*, Intertax, at 55 (2017).

[49] J. Escudero & I. Gepp, *Cross-border outsourcing – issues, strategies and solutions - Chile*, in *IFA Cahiers 2014*, at 220 (2014).

[50] A.B. Baraona, *Chile – Corporate Taxation – Country Analyses*, IBFD (accessed 9 October 2017), at 7.3.4.4.2; and the same, Amendments by Law 20,956/2016 clarified, IBFD (accessed 9 October 2017).

[51] S. Benedetto & L. Kana, *Enterprise services – Chile*, in *IFA Cahiers 2012*, at 192 (2012).

2012 fees for technical, consultancy and managerial services were not specifically subject to tax in Chile´s tax treaties, except the tax treaty concluded with Malaysia.[52]

India

31. Fees for technical services are treated differently among India´s tax treaties. Most of the tax treaties concluded by India include a provision on the taxation of fees for technical services with a very broad scope.[53] This scope includes fees paid in consideration of services of managerial, technical or consultancy nature, except services provided by an employee to its employer.[54] Not only payments made by the employer to the employee for services provided by the employee but also payments made for independent services of technical, managerial or consultancy nature are not included in some "fees for technical services provisions" of India´s tax treaties.[55] Some of India´s tax treaties also include a "make-available" clause. According to the "make-available" clause, fees for technical and consultancy services may only be taxed, if those services "*make available technical knowledge, experience, skill, know-how, or processes, or consist of the development and transfer of a technical plan or technical design*".[56]

32. Of special interest for the taxation of technical services on the basis of a tax treaty provision is the introduction of India´s "Equalization Levy" on 29 February 2016. The Indian "Equalization Levy" was introduced with an objective of tax neutrality between enterprises conducting business through different business models or residing within or outside the taxing jurisdiction and is a tax deducted from considerations made for "specified services" to "specified persons". [57] Services covered by the "Equalization levy" are online advertisement, provision of digital advertising space or any other service aiming on online advertisement, including any other services notified by the Indian government in this regard.[58] The consideration must be paid to service providers who are not resident in India and not having a permanent establishment in that state.

33. The Indian government adopted this option to address the tax challenges of the digital economy and to provide greater certainty and predictability in its taxation. Before the introduction of the equalization levy, payments for the above mentioned online services were not subject to tax under the Indian Income Tax Law.

Indonesia

[52] Chile – Malaysia Income Tax Treaty (2004) Art 14.
[53] J. Pal, *Taxation of Fees for Technical Services: An Analysis of Indian Tax Treaties and Their Journey Through the Courts*, Asia-Pacific Tax Bulletin, at 3.2 (2017).
[54] See e.g. India – Germany Income Tax Treaty (1995) Art 12 (4).
[55] See e.g. India – France Income Tax Treaty (1992) Art 13 (4), India - Malaysia Income Tax Treaty (2012) Art 13 (3).
[56] See e.g. India – USA Income Tax Treaty (1989) Art 12 (4) (b).
[57] See M. Agrawal, *India at the Forefront in Implementing BEPS-Related Measures: Equalization Levy in Line with Action 1*, International Transfer Pricing Journal, at 324 (2016).
[58] A. Mehta, *"Equalization Levy" Proposal in Indian Finance Bill 2016: Is It Legitimate Tax Policy or an Attempt of Treaty Dodging?* Asia-Pacific Tax Bulletin, at 2 (2016).

34. Service fees paid to non-resident companies are generally taxed as business profits under Indonesian tax treaties. Therefore, the source state may only have a taxation right on service fees, if a permanent establishment is established in the source state. However, Indonesia negotiated provisions on the taxation of service fees in a few tax treaties. Such provisions are found in the tax treaties with Germany, Luxembourg, Papua New Guinea, Pakistan, Switzerland, Venezuela and Zimbabwe.[59] Indonesia agreed with Germany and Luxembourg to tax fees for technical services the same way as royalties.[60] The technical services definition in these treaties includes any service of managerial, technical or consultancy nature rendered in the payer´s resident state.

35. Indonesia´s tax treaties with Pakistan, Papua New Guinea, Switzerland and Zimbabwe include an autonomous article on the taxation of services. The wording and scope of the article used in the tax treaties differ from each other. Article 13 (3) of the tax treaty with Zimbabwe also includes services of administrative nature to the definition of "technical fees" paid for services. Whereas "technical fees" should be taxed under the tax treaties with Papua New Guinea and Zimbabwe, the terms "fees for technical services" in the tax treaty with Pakistan and "payments for services" for services of any kind shall be taxed under the tax treaty with Switzerland.[61]

36. Indonesia imposes a 20 % withholding tax on service fees paid to non-residents.[62] Up to 2009 no withholding tax was applied on service fees according to DGT Circular Letter SE-03/PJ.101/1996,[63] if the non-resident taxpayer did not have a permanent establishment in Indonesia. However, in 2009 the before mentioned regulation has been revoked and no respective law has been put in place instead.

Japan

37. Under Japan´s tax treaties fees for technical services are generally taxed by the application of the article on the taxation of business profits. However, Japan included a provision on the taxation of fees for technical services in two of their tax treaties, i.e. India and Pakistan. Fees for technical services are taxed as passive income under these treaties. Whereas a provision on the taxation of fees for technical services may be found in the article on the taxation of royalties under the Japan-India tax treaty[64], Japan´s tax treaty with Pakistan[65] includes a separate article on the taxation of fees for technical services which by their definition also include managerial and consultancy services. Those provisions were most probably

[59] P.L. de Ridder, *Taxation of Cross-Border Dividends, Interest, Royalties and Service Fees*, Asia-Pacific Tax Bulletin, at 4.1 (2013).

[60] See Indonesia – Luxembourg Income Tax Treaty (1993) Art 12; Germany – Indonesia Income Tax Treaty (1990) Art 12.

[61] See Indonesia – Papua New Guinea Income Tax Treaty (2010) Art 13; Indonesia – Zimbabwe Income Tax Treaty (2001) Art 13; Indonesia – Pakistan Income Tax Treaty (1990) Art 13; Indonesia – Switzerland Income Tax Treaty (1988) Art 13.

[62] See PWC, Indonesian Pocket Tax Book 2017: https://www.pwc.com/id/en/pocket-tax-book/english/ptb-2017.pdf (accessed 9 October 2017), at 32.

[63] See DGT Circular Letter SE-03/PJ.101/1996 issued on 29 March 1996.

[64] See India – Japan Income Tax Treaty (1989) Art 12 (4).

[65] See Japan – Pakistan Income Tax Treaty (2008) Art 13.

included in those treaties on the request of India and Pakistan, as taxation of fees for technical services is a key issue of both countries tax policy.

Malaysia

38. Malaysia introduced a withholding tax on payments for technical, management and other services. Those payments are, if made to a non-resident, subject to a 10 % withholding tax on the gross amount paid.[66] The Finance Act 2017 enables Malaysia`s tax authorities to impose a withholding tax on service fees even if the services are performed outside of Malaysia. The Internal Revenue Board of Malaysia (IRB) takes a very broad view on "technical advice assistance or services". The IRB interprets the term "technical" connected only to advice and not to assistance or services, which means that assistance and services of all kind are included in the scope of the new provision. Income, received and derived by non-residents for the rendering of assistance or services are subject to a withholding tax irrespectively of the source of income and also if a permanent establishment is created in Malaysia or not.

39. Many Malaysian tax treaties include an article on the taxation of "technical fees" for "any services of a technical, managerial or consultancy nature".[67] Certain tax treaties that Malaysia concluded restrict the right to tax fees for services in above mentioned way. Fees for services rendered outside of Malaysia are not subject to withholding tax under the treaties with Singapore and Spain. The treaties concluded by Malaysia with Australia and Turkmenistan do not consider fees for services being subject to a withholding tax at all.[68]

Mozambique

40. Income from dividends, interest, royalties and fees for services are subject to withholding tax with a tax rate of 20 %, if these types of income arise from a Mozambique source. This is for example the case, when a Mozambique resident entity or a non-resident entity with a permanent establishment in Mozambique makes a payment to a non-resident entity without a permanent establishment in Mozambique for above mentioned types of income.[69] A reduced tax rate is applicable for telecommunication and international transportation services and leasing of vessels for the purpose of fishing and cabotage activities and also leasing and maintenance of aircraft.[70] At the time of writing this article, Mozambique had concluded tax treaties with Botswana, India, Italy, Macau, Mauritius, Portugal, South Africa, the United Arab Emirates (UAE) and Vietnam but none of these tax treaties include a provision on the taxation of fees for technical, managerial or consultancy services.

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[66] Section 109B of Malaysia's Income Tax Act (ITA).
[67] See e.g. Malaysia – Singapore Income Tax Treaty (2004) Art 13 (2).
[68] P. Nathan, *Withholding tax for services performed outside Malaysia – clarifications issued*, IBFD (accessed 9 October 2017).
[69] M. Graca, *supra* n. 43, at 720.
[70] M. Graca, *supra* n. 43, at 720.

Saudi Arabia

41. The Saudi-Arabian Income Tax Law provides for a withholding tax on service fees for the rendering of technical, consultancy and other services. Fees paid to non-resident service providers for technical services rendered in Saudi-Arabia are subject to a 5 % withholding tax if the fee is paid to an unrelated party. However, if the technical service fees are paid to a related party, a 15 % withholding tax is applicable. A withholding tax also applies, if the non-resident service provider does not establish any physical presence in Saudi-Arabia. Taxation without physical presence is enabled by article 6 of the By-Laws which deems a service to be performed in Saudi-Arabia, if the service is carried out fully or partially in Saud-Arabia, which also includes remotely performed services without physical presence.[71]

42. Non-resident service providers may seek relief from the withholding tax on technical service fees based on article 7 of Saudi-Arabia´s tax treaties which is basically a reproduction of article 7 of the OECD Model. Business profits of a non-resident service provider may therefore be only taxed in Saudi-Arabia, if he carries on business through a permanent establishment in Saudi-Arabia. If the non-resident service provider exceeds the 183 days presence threshold constituted under the service PE provision[72] in Saudi-Arabia´s tax treaties. As modern digital means enable companies to provide services without a physical presence in the source state, the service PE time threshold will most often not be exceeded and taxation in the source state will not take place according to tax treaty law.

43. However, Saudi Arabia´s tax administration (DZIT) is in favour of a broad interpretation of the service PE provision. Accordingly, physical presence in Saudi-Arabia is not required to trigger the application of Saudi Arabia´s tax treaties service PE provision. This view is not in line with the OECDs view on the application of the PE provisions.[73] The OECD views physical presence as a requirement to establish a fixed place of business in a state, which by itself is a requirement to establish a permanent establishment therein.[74]

44. Nevertheless, the DZIT applies the service PE concept also in cases where no physical presence is established in Saudi-Arabia. By applying the “virtual” service PE concept, services rendered abroad may also result in the existence of a service PE in Saudi-Arabia, if:

- the non-resident service provider renders services in Saudi-Arabia and
- those services have a duration of more than six months.[75]

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[71] V.A. Gidirim, *Saudi Arabia - Taxation of Foreign Multinational Enterprises Conducting Business in and with Saudi Arabia*, Bulletin for International Taxation, at 231 et seq (2016).

[72] Saudi Arabians service PE provision is based on article 5 (3) (b) of the UN Model.

[73] See e.g. para. 42.2 *OECD Model: Commentary on Article 5* (2014): “[…] *an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that web site is concerned*.” and para 42.4 *OECD Model: Commentary on Article 5* (2014): “*Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed*.”.

[74] See para. 2 *OECD Model: Commentary on Article 5* (2014).

[75] V.A. Gidirim, *supra* n. 71, at 231 et seq.

South Africa

45. A withholding tax on royalties in South Africa also includes, according to section 49B of the South African Income Tax Act, the rendering or undertaking of any assistance or service in connection with the application or utilization of scientific, technical, industrial or commercial knowledge or information. The tax rate applicable for the source taxation of these services is 15 % on the royalty paid to a non-resident taxpayer. Tax exemptions or reduced tax rates are possibly applicable if the respective tax treaty provides for them.

46. Proposed legislation on the taxation of "service fees", which included fees for technical, managerial and consultancy services, was abolished by January 1 2017. It was planned to tax fees for before mentioned services on a tax rate of 15 %, if they were paid to non-resident service providers. Certain exceptions should have been established for non-resident individuals in case certain conditions were met. Instead of legislation on the taxation of non-resident service providers for "service fees", South Africa introduced reporting obligations on arrangements for the rendering of specific services. An obligation to report a service arrangement to South African revenue authorities arises, if a non-resident service provider is physically present in South Africa for the purpose of rendering services of consultancy, construction, engineering, installation, logistical, managerial, supervisory, technical or training nature.[76] However, those kind of service arrangements are only reportable, if the fees are anticipated to exceed ZAR 10 million ($ 747,000) in aggregate.[77] In case that the parties to the arrangement fail to stick to the reporting obligation, a penalty may be fined to both contracting parties.

47. South Africa adopted provisions from the UN Model as well as the OECD Model in its tax treaties. Also a model tax convention has been developed within the Southern African Development Community (SADC). The SADC Model consists of a mix of provisions taken from the UN Model and the OECD Model with some deviations. A specific feature of the SADC Model is an article on the taxation of "technical fees". However, South Africa decided to make a reservation on this article to not use it in its tax treaties.[78] As a result, South Africa will probably also not be keen to include an article on the taxation of fees for technical services in the future with developing as well as developed countries.

Uruguay

48. Five of Uruguay's tax treaties include a specific provision on the taxation of fees for technical services.[79] The tax treaties with Chile (2016) and Vietnam (2013) include a separate article on the taxation of fees for technical services, which is similar but not identical to article

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[76] S. Gilmour, *South Africa: The spectre of withholding tax on service fees finally laid to rest*, International Tax Review 2017: http://www.internationaltaxreview.com/Article/3665499/South-Africa-The-spectre-of-withholding-tax-on-service-fees-finally-laid-to-rest.html (accessed 9 October 2017).

[77] S. Gilmour, *supra* n. 76.

[78] J. Hattingh, *South Africa – Corporate Taxation – Country Analyses*, IBFD, at 7.4.1.1 (accessed 9 October 2017).

[79] Chile – Uruguay Income Tax Treaty (2016); Uruguay – Vietnam Income Tax Treaty (2013); United Arab Emirates – Uruguay Income Tax Treaty (2011); India – Uruguay Income Tax Treaty (2011); Hungary – Uruguay Income Tax Treaty (1988).

12A of the UN Model 2017 in its wording and structure.[80] Fees for technical services are taxed by the application of the article on royalties in Uruguay´s tax treaties with the United Arab Emirates (2011), India (2011) and Hungary (1988).[81] The term "fees for technical services" is defined as "*payments of any kind* […] *as consideration for managerial or technical or consultancy services"*.[82] Except of some exceptions like publicity and advertising-related services, the treaty definition of "fees for technical services" is also covered by its respective provision of domestic law. Fees for technical services derived by Uruguayan non-residents in Uruguay for IRAE (Impuesto a las Rentas de las Actividades Económicas)[83] and IRPF (Impuesto a las Rentas de las Personas Físicas)[84] payers are, under national law, subject to a withholding tax of 12%.[85]

Taxation of technical services under the UN Model 2011

Business profits derived from services provided by enterprises: Articles 5 and 7 of the UN Model 2011

49. Article 7 of the UN Model 2011 constitutes rules on the taxation of business profits. The article on the taxation of business profits is also applicable for services, rendered by an enterprise in the other contracting state (source state). The residence state has an exclusive taxing right on the business profits originating in the source state. The source state only has a taxing right, if the enterprise carries on business in the source state through a permanent establishment and the profits are attributable to the permanent establishment. Also, other business activities may be taxed in the source state, if the activities are of similar nature as those "effected" through the permanent establishment.[86] Also the limited force of attraction rule constituted in article 7 (1) (b) of the UN Model 2011 allows the source state to tax profits from sales of goods or merchandise effected in that state and similar to those sold through the permanent establishment. The limited force of attraction rule is intended to serve as an anti-avoidance rule.[87]

50. To ensure that profits attributable to a permanent establishment in the source state are determined in accordance with the arm´s length principle[88], two assumptions need to be made:[89]

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[80] Chile – Uruguay Income Tax Treaty (2016) Art 14bis; Uruguay – Vietnam Income Tax Treaty (2013) Art 13.
[81] See United Arab Emirates – Uruguay Income Tax Treaty (2011) Art 12; India – Uruguay Income Tax Treaty (2011) Art 12; Hungary – Uruguay Income Tax Treaty (1988) Art 12.
[82] See e.g. Chile – Uruguay Income Tax Treaty (2016) Art 14bis (3); India – Uruguay Income Tax Treaty (2011) Art 12 (3) (b).
[83] Personal Income Tax.
[84] Income Tax on Economic Activities.
[85] R. B. Correa, *Uruguay's Treaty Policy*, Bulletin for International Taxation, at 152 et seq. (2017).
[86] Para. 1 (a) and (c) *UN Model: Article 7* (2011).
[87] B.J. Arnold, *The Taxation of Income from Services*, Papers on Selected Topics in Protecting the Tax Base of Developing Countries, at 17 (2013).
[88] See *UN Model: Article 9* (2011).
[89] Para. 2 *UN Model: Article 7* (2011).

- The profits attributed to the permanent establishment are expected to be earned as it were a separate legal entity engaged in the same or similar activities under the same or similar conditions,
- dealing wholly independently with the enterprise of which it is a part of.

51. Any expenses incurred for business purposes of the permanent establishment are deductible expenses to determine the profits of a permanent establishment in the source state, whether they are incurred in the source state or a third state.[90] Article 7 (3) of the UN Model 2011 also explicitly excludes certain payments (royalties, fees for services or other similar payments) made by the permanent establishment to its head office or any other part of the enterprise from the calculation of attributable profits to the permanent establishment. As a result, article 7 of the UN Model 2011 attributes net profits to a permanent establishment, computed in accordance with the arm´s length principle.[91]

52. As already mentioned, the source state will only be granted a taxing right on business services, if a permanent establishment of the non-resident taxpayer is located in the source state and profits are attributable to the permanent establishment. According to article 5 (1) of the UN Model 2011, a permanent establishment is a fixed place of business through which the business of an enterprise is wholly or partly carried on. State practice has shown that a permanent establishment generally does not exist if the place of business was maintained for less than six months in a contracting state.[92] However, no general rule on a certain time threshold is established in the UN Model 2011 to determine a permanent establishment to exist in one contracting state. Exceptions, requiring a certain time threshold, are only found in the provision on the construction PE[93] and the service PE[94].

53. For the application of the UN Model on technical, managerial and consultancy services rendered in one of the contracting states, the provision on the service PE is of major importance. If a non-resident furnishes services in a contracting state, a permanent establishment will be deemed to exist, if the enterprise renders services through its employees or personnel for more than 183 days within a period of 12 months for the same or connected project.[95] Especially in digital economy the application of the service PE provision seems to be a disadvantage for developing countries. New business models evolved in today´s digital age. Enterprises increasingly conduct business through digital means, which means that less or no personnel is needed to furnish services in another state. A service PE will only exist in a state, if personnel will be used to furnish services within a specific period of time (183 days within 12 months). If, however, no personnel is used or the time threshold will not be met, because of the use of digital means, a service PE will not be deemed to exist under the current service PE provision. As a result, the source state will not be attributed a taxing right on business services according to article 7 in connection with article 5 (3) (b) of the UN Model 2011.

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[90] Para. 3 *UN Model: Article 7* (2011).
[91] B.J. Arnold, *supra* n. 87, at 18.
[92] Para. 6 *UN Model: Commentary on Article 5* (2011).
[93] Para. 3 (a) *UN Model: Article 5* (2011).
[94] Para. 3 (b) *UN Model: Article 5* (2011).
[95] Para. 3 (b) *UN Model: Article 5* (2011).

Income from independent personal services – Article 14

54. Article 14 of the UN Model 2011 constitutes rules on the taxation of professional services and other activities of independent character. Aforementioned activities are subject to tax in the source state, if the following conditions are met:

- The individual established a fixed base, which is regularly available to him in the source state, or
- the individual is present in the source state for a period of at least 183 days within a period of 12 months.

55. The term "professional services" is defined in article 14 (2) and especially includes independent scientific, literary, artistic, educational or teaching activities. Additionally, independent activities of physicians, lawyers, engineers, architects, dentist and accountants are covered by the definition of "professional services".

56. In case that the individual established a fixed base in the source country, only the income attributable to the fixed base is subject to tax in the source state. The attributable income may also include income from services performed outside the source state.[96] In contrast hereto, if the individual resident does not have a fixed base in the source country, but is present therein for at least 183 days within 12 months, only the part of the income earned in the source state through rendering independent services therein, is taxable in the source state.[97]

57. Basically, the term "fixed base" in article 14 (1) (a) of the UN Model 2011 is regarded as having the same meaning as "fixed place of business" in article 5 (1) of the UN Model 2011.[98] However, some states take the view that differences in meaning exist between those two terms.

58. In order to establish a fixed base in the sense of article 14 (1) (a) of the UN Model 2011, the threshold requirements constituted in article 5 of the UN Model have to be met. A threshold requirement for a fixed place of business is insufficient in today's digital economy. The concept underlying the existence of a threshold requirement was developed at a time, where the manufacturing, production and sale of goods were of crucial importance. In today´s digital economy cross-border services through digital means become increasingly important. As already mentioned in this paper, those kinds of services can be rendered without the need of a fixed place of business in the source state. The source stateshould have a right to tax an appropriate amount of the service fees paid to the resident of the other contracting state.

59. Article 14 (1) (b) of the UN Model 2011 constitutes a 183 days threshold in which the individual has to be present in the source state in order for a taxing right to exist for the source state. Contracting states are free to deviate from this threshold and are also free to decide if they want to apply the 183 days threshold in article 14 (1) (b) of the UN Model 2011 to working days or days of presence in the source state. As physical presence in the source state will most

[96] Para. 1 (a) *UN Model: Article 14* (2011).
[97] Para. 1 (b) *UN Model: Article 14* (2011).
[98] B.J. Arnold, *supra* n. 87, at 20.

often not be needed, especially as the individual might render professional services through digital means,[99] it will be in the interest of the source state to (re)negotiate the physical presence threshold to retain certain taxing rights.

Other Income – Article 21

60. Article 21 (1) of the UN Model 2011 attributes an exclusive taxing right to the residence state on items of income not covered by other distributive rules of the UN Model. However, paragraph 1 shall not apply in cases where business is carried out through a permanent establishment or independent personal services are rendered through a fixed base in the source state by a resident of the other contracting state.[100] In those cases, article 7 or 14 shall apply. Article 21 (3) of the UN Model 2011 grants a taxing right to the source state for items of income not mentioned in the other distributive rules, but arising in that state.

61. The only requirement for source taxation that article 21 (3) of the UN Model 2011 sets, is that the income must have its "source" in the source state. Domestic law determines the issue, whether income is "sourced" in a state.[101]

Taxation of "technical services" under Art 12A of the UN Model 2017

Object and Purpose

62. Developed countries usually take an export-oriented view. Income should be attributed to the state in which the production factors for income generation are located. This approach does not consider the consumer market, in which the goods are sold or the services are rendered (demand side). The right to tax a certain type of income would only be attributed to the source state, if a sufficient economic nexus between the taxpayer or the income as such and the source state can be demonstrated.[102] In this context the concept of a permanent establishment with a minimum time threshold was developed in order to get a sufficient nexus.

63. On the basis of the discussion on the allocation of taxing rights between source and residence state, the question on the erosion of the tax base of the source state plays a key role. Even without the existence of a permanent establishment in the source state, taxation in the source state might be justified by the application of the base-erosion principle. Fees for technical, managerial and consultancy services paid to non-resident taxpayers might be deductible against the tax base of the source state. To counter base erosion in the source state some developing countries are of the opinion that payments made in connection to the

[99] Especially scientific, educational, teaching services but also services rendered by lawyers, accountants and architects.
[100] Para. 2 *UN Model: Article 21* (2011).
[101] See para. 9 *UN Model: Commentary on Article 21* (2011).
[102] J.F. Bianco & R.T. Santos, *A Change of Paradigm in International Tax Law: Article 7 of Tax Treaties and the Need to Resolve the Source versus Residence Dichotomy*, Bulletin for International Taxation (2016).

rendering of technical, managerial and consultancy nature should be taxed in the state where those payments arise.[103]

64. The OECD BEPS Action Plan did not raise the issue of base erosion and profit shifting through deduction of service fees. However, developing countries are large importers of technical, managerial and consultancy services. There is often a lack of administrative capacity to limit base erosion of the tax base originating in the deductibility of payments made to a non-resident taxpayer in the source state by the application of domestic or international anti-avoidance rules.[104] In this respect, the inclusion of article 12A of the UN Model 2017 in the respective tax treaty might be a means to counter base erosion in the source state. It grants the source state the right to tax the gross amount of above mentioned payments by means of a withholding tax. The source state will be granted a taxing right without the need of existence of a permanent establishment of a non-resident taxpayer in that state. As article 12A of the UN Model 2017 does not require any physical presence in the country of the recipient of the service it enables the source state to tax services which are conducted through modern telecommunication and digital means. "Digital" services falling within the scope of article 12A of the UN Model 2017 are especially services that involve the application of specialized knowledge, skill or expertise by the service provider in the field of technical, management or consultancy services and do not include routine, standardized services (specialized consulting services through the internet).

65. Fees for technical, managerial and consultancy services are usually deductible against the tax base of the source state if the payer is a resident of that state or a non-resident with a permanent establishment or fixed base therein. However, before the introduction of article 12A, the residence state of the payer was not able to tax the fee for before mentioned services. Non-taxation of fees for technical, managerial and consultancy services in the state of the payer of the fee may especially lead to base erosion within a multinational group as those fees may be used to shift profits from a profitable group company member to another group company member in a low-tax jurisdiction. The paying group company member could deduct the service fee in the source state and therefore reduce its taxable base. The group company member receiving the service fee in the low tax jurisdiction will increase its profits but those profits may only be subject to a low or no tax rate. Even if fees for technical, managerial and consultancy services are taxable under the domestic law of the source state, current tax treaty rules generally restrict the possibility of the source state to tax before mentioned fees. Article 12A will, in this respect, help to encounter situations of tax avoidance. This is especially important for developing countries with limited administrative capacity to counter abusive situations with general (GAAR) or specific (SAAR) anti-avoidance rules in domestic law and the respective tax treaty.

General characteristics

[103] UN, *supra* n. 8, at A 12 et seq.
[104] UN, *supra* n. 8, at A 10.
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66. The inclusion of article 12A in the UN Model 2017 will lead to a significant change in the allocation of taxing rights of income from technical, managerial and consultancy services. As already noted, current rules of tax treaty law only allow for source taxation in case of business services, if a company establishes a permanent establishment or a fixed base in the source state. The UN and the OECD Models establish high (time) thresholds that must be met for a permanent establishment to exist in the source state.[105] In contrast to the rules in the previous UN Model and the OECD Model, article 12A of the UN Model 2017 does not establish any time threshold for the taxation of fees for technical, managerial and consultancy services. From a practical point of view, the inclusion of article 12A in a tax treaty is a feasible and desirable solution. The deletion of thresholds avoids the need to count the working days and to deal with the interpretation as to what are (un)connected projects.[106]

67. Article 12A imposes, in contrast to article 7 (business profits) and article 14 (independent personal services), a withholding tax on the gross amount of service fees paid by a resident of one contracting state to a resident of the other contracting state at a rate, negotiated by both contracting states.

68. A contracting state is entitled to tax fees for technical, managerial and consultancy services, irrespective of whether before mentioned services are performed in the state of the payer or in a third state. In contrast hereto, article 15 (employment income) and article 17 (artists and sportspersons) of the UN Model 2011 attribute a taxing right to the source state only if the employment is exercised/the performance is performed in the source state.

69. Article 12A focuses on the payer – payee relationship. It also applies where the recipient of the service fee is different from the non-resident service provider, if the recipient is a resident of the other contracting state.[107] However, fees for technical, managerial and consultancy services must arise in one of the contracting states and not in a third state. [108]

70. In contrast to articles 10 (dividends) and 11 (interest), which do not apply to dividends paid by a company resident in a third state or interest arising in a third state, article 12A applies to fees for technical, managerial and consultancy services paid by company resident in a third state. However, this consideration only applies, if fees for technical, managerial and consultancy services are borne by a permanent establishment or fixed base in one of the contracting states and the permanent establishment is assigned to the resident of the third state.[109]

71. The structure of article 12A is similar to article 11 (interest) and article 12 (royalties). Nevertheless, certain conceptual issues differentiate these before mentioned articles from each other. Fees for technical, managerial and consultancy services only fall within the scope of article 12A, if the non-resident service provider renders services of specialized knowledge,

[105] Para. 3 (b) *UN Model: Article 5* (2011).
[106] B. Moreno, *The Taxation of Technical Services under the United Nations Model Double Taxation Convention: A Rushed – Yet Appropriate – Proposal for (Developing) Countries*? World Tax Journal, at 281 (2015); The phrase "for the same or a connected project" is included in article 5 (3) (b) of the 2011 UN Model but has been deleted and is not included in article 5 (3) (b) of the 2017 UN Model.
[107] UN, *supra* n. 8, at A 39
[108] UN, *supra* n. 8, at A 41
[109] UN, *supra* n. 8, at A 41

skill or expertise on behalf of a client or transfers knowledge, skill or expertise to the client different from the definition of “royalties” in article 12 (3) of the UN Model 2017. [110] Services of a routine nature that do not meet the aforementioned requirements are out of the scope of article 12A.

72. Although article 12A defines the term “fees for technical services”, no definition for the term “services” exists, similar to other articles of the UN Model that deal with the taxation of services. The term “services” should be interpreted very broadly. The ordinary meaning of the term “services” implies that it generally includes activities “*carried on by one person for the benefit of another person in consideration of a fee*”.[111] A treaty autonomous interpretation in accordance with the articles 31 to 33 Vienna Convention on the Law of Treaties (VCLT) should take precedence over an interpretation of the term “services” within national law. Difficulties in respect of the interpretation may arise in relation to the application of other distributive rules of the UN Model.[112] The inclusion of a complete list of services covered by article 12A would be a feasible solution but is accompanied with a “risk” of narrowing the scope of “fees for technical services”.

73. Article 12A attributes a taxing right to the residence state of the payer of the fees for technical, managerial and consultancy services. However, it is not an exclusive taxing right. Also the residence state of the person receiving the fee has a right to tax those fees. The residence state of the payer of the service fees has a taxing rate on a gross basis at a rate which has to be negotiated by the contracting states. [113]

74. Fees for technical, managerial and consultancy services are deemed to arise in one contracting state, if the payer is a resident of one of the contracting states or a non-resident that carries on business in that state through a permanent establishment or a fixed base, which bears the fees.[114] The aforementioned service fees are deemed not to arise in the residence state of the payer, if the payer has a permanent establishment or fixed base in the other contracting state or a third state and the service fees are borne by the permanent establishment or fixed base. In this case the service fees are deemed to be more closely related to the state in which the permanent establishment or fixed base is established. As a result, the residence state of the payer does not have any taxing right in this situation.

75. Article 12A (3) constitutes certain exceptions of fees not covered by this article. Payments to employees by employers, payments for teaching in or by an educational institution and payments by an individual for services for personal use of an individual person, are excluded from the scope of article 12A. It is considered that these kinds of payments do not

[110] UN, *supra* n. 8, at A 62.
[111] UN, *supra* n. 8, at A 83 et seq.
[112] *UN Model: Articles 7, 12, 14, 21* (2011).
[113] UN, *supra* n. 8, at A 1.
[114] B.J. Arnold, *The UN Committee of Experts and the UN Model: Recent Developments*, Bulletin for International Taxation, at 132 (2017): “*The precise wording of Article 12A (5) is that the obligation to pay the fees for technical services must be connected with the permanent establishment or fixed base of the payer and the fees are borne by the permanent establishment or fixed base. This wording is generally accepted to mean that the* ***fees must be deductible in computing the profits of the permanent establishment or fixed base***.”; Article 12A para 5 refers to national law as the profits of the permanent establishment or fixed base have to be computed (in correspondence with national law).

cause any tax base erosion in the state in which the fees for technical, managerial and consultancy services arise, as they are usually not deductible for tax purposes.[115] Therefore, the aforementioned payments are excluded from the scope of article 12A.

Relationship to other distributive rules

76. As service fees (in general) may fall within the scope of other distributive rules of the UN Model, depending on the circumstances in each case and the interpretation of the articles of the UN Model, the relationship between article 12A and other distributive rules has to be clarified:

- Professional and other independent services covered by the scope of article 14 of the UN Model 2017 are taxable by a contracting state only, if the non-resident service provider has a fixed base in that state or stays in that state for 183 days or more in any 12-month period. Such services may often be covered und article 12A of the UN Model. Therefore, article 12A (2) constitutes that article 12A applies "notwithstanding" the application of article 14. However, article 12A (4) explicitly states that article 12A does not apply, if the beneficial owner of the service fees performs independent personal services in the contracting state in which the fees arise through a fixed base (or permanent establishment)[116] in that state and the technical, managerial or consultancy services are effectively connected with the fixed base (or permanent establishment).[117] Article 12A (4) provides that in this case article 14 of the UN Model shall apply instead of article 12A.
- Regarding the relation between article 7 of the UN Model 2017 on the taxation of business profits and article 12A, paragraph 6 of article 7 of the UN Model 2017 provides that the provisions of article 12A shall prevail. Article 12A (2) takes precedence in relation to article 7 because of article 7 (6).[118]
- Payments falling within the scope of articles 15, 18 and 19 of the UN Model 2017 are explicitly excluded from the application of article 12A.[119] As a result, there is no overlap between article 12A and articles 15, 18 and 19.
- Article 12A does not apply to fees for technical services to which the articles 8 (shipping, inland waterways transport and air transport), 16 (directors' fees and remuneration of top-level managerial officials) and 17 (artistes and sportspersons) of the UN Model 2017 apply, as article 12A (2) is subject to the provisions of articles 8, 16 and 17.[120]

[115] UN, *supra* n. 8, at A 72.
[116] See para. 10 *UN Model: Commentary on Article 14* (2011).
[117] UN, *supra* n. 8, at A 35.
[118] UN, *supra* n. 8, at A 48.
[119] Para. 3 *UN Model: Article 12A* (2017).
[120] UN, *supra* n. 8, at A 36.

- Many developing countries[121] take the view that remuneration derived from technical services or technical assistance should be included in article 12 (royalties) to safeguard taxation at source. Some states also take the view that "information concerning industrial, commercial or scientific experience" includes certain services covered by the scope of article 12 and also that the provision of brain-work and technical services is covered by this wording, and therefore payments related to such services are generally taxable under article 12.[122] However, according to article 12 (3) of the UN Models, royalties are payments for the use of, or the right to use, intellectual property, equipment or know-how (information concerning industrial, commercial or scientific experience). Royalties involve the use of, or the right to use, intellectual property, equipment or know-how. The rendering of services does not necessarily include the transfer of intellectual property or know-how or experience to the customer. In case of so called "mixed-contracts", an enterprise is transferring intellectual property or know-how together with the furnishing of services. In those cases, the remuneration has to be split up and taxed separately on the one hand by the application of article 12 on the transfer of intellectual property or know-how and on the other hand by the application of article 12A for the furnishing of services to the customer.

Article 12A and the digital economy

77. New business models create a digital presence in the market jurisdiction, where economic value is created. Creating a digital without a physical presence gives opportunities of base erosion and profit shifting (BEPS) as current rules of (inter)national tax law require physical presence in the market jurisdiction. BEPS may occur by fragmenting physical operations in a way to avoid taxes. It is common that companies conduct services through a remote location at a distance far from the market jurisdiction with minimal use of personnel. Economic value is effectively arising in the market jurisdiction to which the services are addressed but may only be taxed by the residence state as no permanent establishment is established in the market jurisdiction and therefore no required nexus under current (inter)national taxation rules. Although the consideration paid for the services rendered by a non-resident of the market jurisdiction may not be taxed in that state, they may be conducted as business expenses by the payer of the consideration, resident in the market jurisdiction. In those situations the tax base of the payer of the consideration will be lowered resulting in (tax) base erosion in the market jurisdiction.

78. States[123] have started to introduce certain unilateral and bilateral measures to tax fees for technical services originating in the source state. Those unilateral measures also include provisions affecting the taxation of fees for managerial, technical and consultancy services, which are covered by article 12A of the UN Model 2017.

[121] E.g. Argentina, Brazil, Gabon, Ivory Coast, Philippines, Thailand, Tunisia, Vietnam.
[122] UN, *supra* n. 8, at A 5.
[123] E.g. Australia, China, India, Israel, Italy and the UK.

79. The OECD recognized that base erosion may occur by the use of modern information and communication technologies and released a report on "Addressing the Tax Challenges of the Digital Economy" (BEPS Action 1) in 2015.[124] BEPS Action 1 addresses the new tax challenges in terms of value creation in the market jurisdiction through a marketable location established by the use of digital products and services, application of related source taxation rules and VAT/GST aspects in relation to cross-border supply of digital goods and services.[125] One of the measures recommended by the OECD was, countering BEPS issues arising in the digital economy by the introduction of a withholding tax on digital transactions.[126]

80. The OECD did not consider that base erosion and profit shifting might occur in the source state, through the deductibility of service fees paid to non-residents. The UN on the other hand will introduce article 12A on the taxation of fees for technical services in the UN Model 2017. Although article 12A does not specifically address the issue of BEPS in the digital economy, it does address BEPS in the source state, resulting from the deductibility of service fees paid to non-residents. Especially in the digital economy, corporations can avoid taxation in the source state by using digital means. An appropriate balance of attribution of taxing rights is no longer guaranteed by the application of the current rules on international taxation. The current PE-concept might not be suitable for the digital economy, as services are rendered with the use of digital means and therefore without (almost) any workforce or fixed place of business in the source state. Alternative indicators for the determination of significant presence are needed. Article 12A might serve as a means to resolve issues concerning the attribution of taxing rights in the digital economy. Technical, managerial and consultancy services are often provided with the use of digital means and only with digital presence in the source state. The UN already addressed the issue of a rapidly changing business environment in modern economies and the resulting rendering of cross-border services without physical presence in the source state with the introduction of article 12A in the UN Model 2017.[127] Cross-border services are based on different business models, as the online retailer model, social media model, the subscription model and the collaborative platform model.[128] Services based on those models have in common that they may be rendered to international customers without physical presence in the state of the customer. The recipients of the services receive the (digital) service in consideration for a fee. Fees are charged for connecting seller and buyer (online retailer model), advertisement (social media model), for subscription (subscription model) or on each digital transaction (collaborative platform model).

81. An appropriate allocation of taxing rights requires a redefinition of the traditional PE concept based on physical characteristics. The application of thresholds different from physical presence in a state was proposed by academics and the OECD.[129] A new nexus could be

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[124] OECD, *Addressing the Tax Challenges of the Digital Economy – Action 1: 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project.

[125] OECD, *supra* n. 124, at para. 3.

[126] OECD, *supra* n. 124, at para. 274.

[127] UN, *supra* n. 8, at A 2.

[128] European Commission, *A Fair and Efficient Tax System in the European Union for the Digital Single Market*, COM(2017) 547 final, at 5.

[129] See e.g. P. Hongler & P. Pistone, *Blueprints for a New PE Nexus to Tax Business Income in the Era of the Digital Economy,* White Papers IBFD, at 10 and 14 (2015).

established by deeming a PE to exist in the digital economy, based on a monthly user base, revenue earned through "digital" business in the market country or number of contractual relationships in the market country.[130] As a result a new paragraph might be inserted in article 5 of the OECD and the UN Model by deeming a PE to exist based on one of the aforementioned criteria for purely digitalized transactions of goods or services. These new nexus criteria proposals relate in their structure to the service PE constituted in article 5 (3) (b) of the UN Model 2011 and the service PE option in the commentary on Article 5 of the OECD Model 2014[131], as the "digital" PE concepts also do not require any physical fixed place of business in the source state.

82. Potential amendments of article 5 (4) of the OECD Model 2014 and article 5 (4) of the current UN Model could be made to face the challenges of the digital economy. Article 5 (4) of the OECD and the UN Models covers certain circumstances which are deemed to not be regarded as a PE, including the use of facilities solely for the purpose of maintenance of a stock of goods for storage, display, merchandise or processing by another enterprise, for purchasing goods or merchandise or collecting information or any other activities of auxiliary or preparatory character.[132] These activities do not constitute core activities of a business but are rather of an auxiliary or preparatory character to carry on the core business activity of a company in another state. However, deletions of certain provisions of the article or article 5 (4) as such might only be of limited effect in the digital economy, as those changes only address business models that require at least some physical presence in the source state, by example a warehouse.[133] The deletion of article 5 (4) or parts of it would not be a suitable solution for the taxation of technical, managerial or consultancy services rendered through digital means.

83. Criteria for a new "digital" nexus would potentially ring-fence certain digital transactions. Additionally, the treatment of corporations relying on both digital and physical presence and also the interaction with traditional PE concepts on which also the distributive rules in tax treaties rely, remain uncertain if a "digital" PE might be introduced.[134] Therefore, any changes made to the existing PE provisions need to be tested with regard to their ability of fitting into the framework of already existing tax treaty structures. As *Blum* pointed out, questions arise on the possible effects of a deemed "digital" PE on the attribution of business profits. Would it be possible to attribute intangibles to the "digital" PE? Would it be therefore possible to attribute royalties to the "digital" PE?[135]

84. A withholding tax on "digital" transactions (services), which was also proposed by the OECD and the European Commission,[136] avoids the difficult task of agreeing on a uniform definition and interpretation of the "digital economy", "digital" nexus and its related

[130] See e.g. P. Hongler & P. Pistone, *supra* n. 129, at 25.
[131] Para. 42.21 et seq. *OECD Model: Commentary on Article 5* (2014).
[132] Para. 4 (a) to (f) *UN Model: Article 5* (2011).
[133] D. Blum, *Permanent Establishments and Action 1 on the Digital Economy of the OECD Base Erosion and Profit Shifting Initiative – The Nexus Criterion Redefined?* Bulletin for International Taxation, at 316 with further references (2015).
[134] M. Olbert & C. Spengel, *International Taxation in the Digital Economy: Challenge Accepted?* World Tax Journal, at 16 (2017).
[135] D. Blum, *supra* n. 133, at 321.
[136] European Commission, supra n. 128, at 5.

transactions and also enhances the collectability and enforceability of a tax on "digital" transactions of goods or services.

85. *Baez/Brauner* proposed how a withholding tax might be incorporated in the OECD Model. In the authors opinion, a new article 7 (4) might be inserted which specifically focuses on enterprises (B2B) and the payer-payee relationship.[137] Only B2B transactions should be included in the scope of this provision due to easier collection of taxes and less burdensome application of a withholding mechanism in contrast to B2C transactions.[138] Similarly article 12A of the UN Model 2017 focuses on the payer-payee relationship and constitutes a withholding tax on payments made by a resident of one contracting state to a payee of the other contracting state.

86. A withholding tax on B2C relationships, would ensure neutral taxation between different forms of commerce. However, a crucial question arises: Who would have to withhold the tax? In this respect, the OECD proposes to require financial institutions involved in payments from "digital" transactions to withhold the taxable amount.[139] Such a proposed withholding requirement would be imposed and enforced by the national tax authorities in accordance with national law. The tax authorities might face challenges in tax collection when a financial institution of a third-state is involved. Third-state financial institutions neither have a connection to the residence state of the service provider nor to the source state. Even if a customer is a resident of the source state to which the services are provided he may have a bank account issued by a financial institution resident in an uninvolved third state. Bilateral rules need to be established between the residence state of the financial institution and the law enforcing state in assistance on the collection of taxes and exchange of information as sovereignty rights of the residence state of the financial institution are affected. Additionally, questions on tax liability might arise where the taxpayer and the financial institution have no legal connection to each other and were merely "mixed" together by the choice of the (online) payment service option of the customer.[140]

87. The application of article 12A of the UN Model 2017 might be a solution to a "fair" allocation of taxing rights in the digital economy. As already mentioned in this paper, article 12A does not require any physical presence of the non-resident service provider in the source state. The rendering of services in another contracting state through digital means will be treated by itself as sufficient engagement and therefore as sufficient "nexus" in that state. Fees for technical, managerial and consultancy services rendered with the use of digital means will

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[137] See A. Baez & Y.Brauner, *Withholding Taxes in the Service of BEPS Action 1: Address the Tax Challenges of the Digital Economy*, White Papers IBFD, at 23 et seq (2015): „*Payments made by an enterprise of a Contracting State or by a permanent establishment situated in a Contracting State may be taxed in that State. The tax so charged shall not exceed: (a) 10 per cent of the gross amount of the payments if the payee is an enterprise of the other Contracting State or a permanent establishment situated therein duly registered with the first-mentioned Contracting State for the purposes of this paragraph; and (b) 15 per cent of the gross amount of the dividends in all other cases. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this tax, including specified exemptions for non-base eroding and other similar payments*."

[138] A. Baez & Y.Brauner, *supra* n. 137, at 16 et seq.

[139] D. Blum, *supra* n. 133, at 324 with further references.

[140] See e.g. D. Blum, *supra* n. 133, at 324.

be taxed in the state of residence of the payer if the recipient of the fee is a resident of the other contracting state. The before mentioned fees are deemed to arise in the residence state of the payer. Therefore, no physical presence needs to be established, neither by the use of workforce nor by a fixed place of business. Services conducted with digital means, are covered by the scope of article 12A if they involve the application of specialized knowledge, skill or expertise by the non-resident service provider and do not include routine, standardized services.

88. Article 12A does not provide for any definition of the term "services". However, the omission of a definition does not need to result in a disadvantage for the application of article 12A in the digital economy. It gives financial authorities more leeway to cover new emerging business models and instruments used by companies in the digital economy. New types of technologies might be developed and classified as services in the future. A "narrow" definition in the tax treaty might result in non-coverage of new types of technologies by article 12A. As a result, omitting the inclusion of a definition of the term "services" creates uncertainty but leaves room for interpretation of future technologies, which might be classified as "services" in the sense of article 12A.[141]

Alternatives to the taxation of "technical services" in the digital economy

89. Instead of including article 12A in their tax treaties, states may alternatively choose to opt for example for one of the following options:[142]

- Reduction of the 183 days´ time threshold in article 5 (3) (b) and article 14 (1) (b) of the UN Models and application of the new time threshold to either only technical services or all kind of services.

90. The period of physical presence constituted in article 5 (3) (b) and article 14 (1) (b) of the UN Models could be reduced to a number which fits both contracting states most. From the perspective of developing countries, a low time threshold should be negotiated in order to increase their taxing right over the services rendered by the non-resident taxpayer. The same applies in respect of professional services of independent character provided in the source state. Modern digital means allow companies to still generate a substantive amount of profits by the furnishing of services in the source state without the use or with shorter presence of personnel therein. Administrative costs and compliance issues remain unchanged, irrespectively of the time threshold negotiated in the tax treaty. However, the major argument to not reduce the 183 days´ time threshold is, to stay consistent with the 6-month time threshold for a fixed place of business established in the commentaries to article 5 of the UN Model.[143] In negotiating a time threshold, the developing country should also be aware of not to insist on a time threshold which is as low as to discourage inbound investments.

[141] See F. Sixdorf & S. Leitsch, *Taxation of Technical Services under the New Article 12A of the UN Model – Improved Taxation or a Step in the Wrong Direction, European Taxation*, at 241 (2017).
[142] See also UN, *Committee of Experts on International Cooperation in Tax Matters, Note on the taxation of services under the United Nations Model Tax Convention*, E/C.18/2010/CRP.7 (2010).
[143] B.J. Arnold, *The Taxation of Income from Services under Tax Treaties: Cleaning up the Mess – Expanded Version*, Bulletin for International Taxation, at 63 et seq. (2011).

- Inclusion of the base erosion conditions of article 15 (2) in article 14. Payments for professional and independent services would be taxed by the source state if they were made by a resident of the source state or borne by a permanent establishment or fixed base of a non-resident in the source state. Negotiating states may decide to apply the revised version of article 14 of the UN Models on either technical or all kind of services.

91. According to article 15 (2) of the UN Models, an exclusive taxing right of the residence state in respect of employment income is dependent from the exercise of the employment in the source state, the days of presence of the employee in the source state and the question of who bears the cost for the remuneration of the employee. Applying those principles to article 14 of the UN Models, would require the independent individual to render services in the source state, being present for 183 days in the source state and the remuneration does not have to be borne by a corporation or PE in the source state to attribute an exclusive taxing right to the residence state. Those criteria have to be cumulatively met; otherwise the source state should have a taxing right if the individual renders services in the source state. However, such a revised provision would still require physical presence of the individual in the source state for a shared taxing right to apply between both contracting states. This alternative is not suitable for the taxation of technical, managerial or consultancy services rendered without any physical presence in the source state.

- Defining income from technical services as “other income” in the sense of article 21 (3) of the UN Models. It would also be possible to add a limitation on source country taxation in article 21 (3).

92. Article 21 (3) of the UN Models constitutes the application of the article on other income that has not been dealt with in the foregoing articles of the UN Model. Usually, fees for technical services would be taxed under articles 7, 12 (if negotiated) or 14 of the respective tax treaty. If by means of interpretation fees for technical, managerial or consultancy services cannot be subsumed under one of these provisions, such fees will be taxed in conformity with national law on the basis of article 21 of the UN Model. The source state is not limited in source taxation on the basis of article 21 (3) of the UN Model.[144] Article 21 (3) of the UN Model does not constitute any threshold requirement. The only requirement that has to be met is that income must arise in the source state. This result cannot be justified in cases where services are rendered for the purpose of carrying on business in the source state. Current rules in the OECD and UN Model require that a PE or fixed base is established in the source state to tax business services. Unlimited taxation of fees for technical, managerial and consultancy services would therefore be inconsistent with the pattern of the OECD and UN Models.

- Taxation of intra-group services by the source state by deeming a subsidiary of a non-resident parent company as a permanent-establishment. Services rendered to and payments made by the subsidiary would be attributable to the permanent establishment and taxable in the source state. Services which are “arm´s length” should be excluded from taxation.

[144] B.J. Arnold, *supra* n. 143, at 65.

93. This measure will counter B2B transactions within a group of companies and covers a great number of cases of BEPS originating in the deductibility of fees for technical, managerial and consultancy services in the source state. However, as this measure only applies to intra-group services, B2B and B2C services between economic actors of two contracting states which are not members of a group of companies are not addressed by this measure. As a result, the narrow applicability of this measure will not lead to a complete coverage of all digitally rendered services.

- Broadening the scope of article 12A of the UN Model 2017 to "fees for services". As a consequence, article 12A would not only apply to fees for technical services but also to other services provided in one of the contracting states. As a result, also routine, standardized services that do not require the application of specialized knowledge, skill or expertise by the non-resident service provider are taxable under article 12A. This is also true for services performed in third states.
- Technical service fees could be considered to arise in a contracting state, if the technical service fees were paid by a resident of one of the contracting states to a resident of the other contracting state and be provided in the residence state of the payer of the technical service fees, or if the payer is a non-resident and technical service fees are borne by a permanent establishment or fixed base in one of the contracting states. As a result, the inclusion of paragraph 6 of article 12A of the UN Model 2017 would not be necessary.
- A new article 7 (4) might be inserted which specifically focuses on enterprises (B2B) and the payer-payee relationship.

94. Instead of the insertion of article 12A, a new paragraph in the article on taxation of business profits might be inserted in the respective tax treaty. A withholding tax focusing only on B2B transactions has the advantages of easier collection of taxes and less burdensome application of a withholding tax in contrast to B2C transactions. Disadvantages might lie in the loss of revenue for the source state and in the loss of tax neutrality.

- The PE definition might be redefined. A new (digital) nexus could be introduced in article 5 of the current UN Model. A PE might be deemed to exist on the basis of a monthly user base, revenues earned through digital transactions in the source state or the number of contractual relationships in the source state.

95. Amendments made to the PE provision need to be tested in regard to their suitability within the framework of existing tax treaty structures, as distributive rules rely on the PE definition in article 5 of the UN Models. As a result, for example several questions on the attribution of business profits will arise, especially whether it would be possible to attribute intangibles to the new "digital" PE? On the other hand, a new nexus approach might be required to ensure taxing rights for the source state as value creation occurs in a modern, digital sense without the establishment of physical presence in the source state. Companies conducting business on the basis of digital business models also receive benefits from the source state,

which are crucial for the business model as such, e.g. supply of energy or infrastructure and enforcement of payments.[145]

- Amendments could be made in respect of article 5 (4) of the current UN Model. Service provider with auxiliary or preparatory activities in the source state would be addressed through this action.

96. Changes in the provision of article 5 (4) of the current UN Model might lead to a taxing right for the source state, as auxiliary activities or other activities of preparatory nature will not be deemed to be excluded from the qualification as a PE in the tax treaty anymore. However, changes of article 5 (4) of the UN Model only affects business models requiring at least some kind of physical presence to support the company's core activities in the source state. A deletion of article 5 (4) or changes in the sub letters of this article would not be a suitable solution if the company´s core activities might be solely rendered through digital means, e.g. technical, managerial or consultancy services not requiring any physical presence in the source state.

Policy implications for developing countries

97. The inclusion of article 12A on the taxation of fees for technical services also faces challenges and opportunities for developing countries:

- Developed countries may be reluctant to include article 12A in their tax treaties with developing countries, because article 12A deviates from the traditional PE concept on the taxation of services which favours residence taxation and gives more leeway to circumvent source state taxation. Developing countries may foreseeably have to negotiate the inclusion of article 12A without major concessions on other taxation issues in the tax treaty.
- The relationship between domestic law and the tax treaty must be examined. As tax treaties allocate taxing rights to the residence and the source state it is up to the state as such to decide if it is willing or able to tax a certain type of income. If there are no provisions in force that allow the taxation of technical services derived by non-resident service providers, then an inclusion of article 12A in the tax treaties of one state is worthless.
- Developing countries need to negotiate a tax rate which is not to excessive to discourage inbound investments. Additionally, the negotiation of a tax rate for the taxation of fees for technical services, which is the same as the tax rate for the taxation of royalties is recommended as it may help to overcome difficulties in the taxation of mixed contracts and may reduce potential conflicts in the application of article 12A.
- Technical services performed in more than two states may lead to multiple taxation of service fees, as the residence state and the states in which the services are performed may tax the income. Tax treaty measures for the relief of double taxation need to be established.

[145] P. Hongler & P. Pistone, *supra* n. 129, at 19 and 22.

- An efficient withholding system with an option to register and file for net taxation should be established.

Efficient withholding system

98. Fees for technical, managerial and consultancy services are taxed on the gross amount of the fee under article 12A. A final withholding tax on a gross basis eliminates the need for source and computational rules.[146] The withholding tax is imposed on the full amount of the service fee paid to the non-resident service provider without the deduction of any expenses, at the time the service fee is paid or shortly afterwards. In the case of net taxation, the income earned by the non-resident service provider is generally subject to the same computational rules as income earned by resident taxpayers. In contrast to developed countries, developing countries usually do not provide for a choice to opt for taxation on a net basis for certain types of service income due to the lack of administrative capacity.

99. Administrative capacity also plays a role in the choice of imposing either a final or a non-final withholding tax on service fees. The majority of developing countries tend to impose a final withholding tax as more administrative capacity than available is needed to administer a non-final withholding tax. A few developing countries, such as India, impose a non-final withholding tax.[147] A non-final withholding tax is levied at the first stage which is creditable against the tax payable by the non-resident in the source state. At a second stage a tax return has to be filed to receive a refund for the excessive withholding tax paid. A non-final withholding tax obliges the non-resident taxpayer as well as the tax administration. A tax return has to be filed and administrative resources have to be provided by the developing countries tax administration to assess the received tax returns and refund amounts withheld in excess of the tax effectively payable in the source state.

100. Whatever choice will be made by the developing country to either impose a (non-)final withholding tax on fees for technical, managerial and consultancy services on a net or gross basis, affects the opportunities of the taxpayer to erode the tax base of the source state. The source state might consider fees for technical, managerial and consultancy services rendered through digital means as being deductible in computing the tax base of the non-resident. A developing country must consider that the domestic tax base will be eroded through the deductibility of service fees paid by either resident taxpayers or non-resident taxpayers with a PE in the source state to non-resident taxpayers. However, if fees for technical, managerial and consultancy services are subject to tax in the source state, the domestic tax base will only be eroded to the difference of the amount from which the tax has been reduced as a result of the deductible service fee and the amount of tax imposed on the non-resident service provider.[148]

101. The imposition of a source withholding tax on fees for technical, managerial and consultancy services will reduce the base eroding character of such payments. The source state

[146] B.J. Arnold, *supra* n. 87, at 9.

[147] See e.g. S. Wagh, *The Taxation of Digital Transactions in India: The New Equalization Levy*, Bulletin for International Taxation, at 550 (2016).

[148] See e.g. B.J. Arnold, *supra* n. 87, at 25.

receives tax revenues from the fee paying resident tax payer in relation to his deductible expenses from services for technical, managerial and consultancy services. Article 12A of the UN Model 2017 is an appropriate tool to reduce the base eroding character of fees for technical, managerial and consultancy services rendered without a physical presence in the source state. However, taxation based on the gross amount of the service fee might be harmful for service recipients in developing countries as gross based taxation might lead to economic distortion and discourage inbound investment flows by grossing up all the costs occurred in relation to the respective service.[149] A final withholding tax on fees for technical, managerial and consultancy services rendered with the use of digital means would be a choice in favour of simplicity and certainty. The withholding tax would be a final one from the perspective of the source state. The residence state would grant a credit for the tax paid in the source state.

102. A tax rate on the withholding tax should be negotiated which is neither too high nor too low in order to ensure an appropriate allocation of income, generated by the taxpayer, between the residence and the source state. The negotiation of the tax rate should be sufficiently high to satisfy its base erosion role but be kept low enough to not discourage cross-border investment or being an incentive for tax evasion. A proposed tax rate of 10 – 15 % would be feasible in order to reach a balanced attribution of taxing rights between the residence and the source state.[150] A higher tax rate of 15 % or more could be applied to payees resident in low or no-tax jurisdictions.

103. Another issue concerning the negotiation of an appropriate tax rate concerns the relation between the tax rate on royalties and the tax rate on "fees for technical services", especially if the negotiated tax rate for fees for technical, managerial and consultancy services is lower than the agreed tax rate on royalties. If the agreed tax rate on "fees for technical services" is (extraordinarily) lower than the one for royalties, a strong incentive might exist to enter into mixed contracts and artificially distribute the consideration received on the basis of the contract. A so called mixed contract is a contract entered by an enterprise providing for both, services and the right to use immaterial property or know-how. Components of the contract might be split up into a larger part taxed under the lower tax rate (technical, managerial and consultancy services) and a smaller part subject to a higher tax rate (royalties). Negotiating a tax rate which is the same for "fees for technical services" and royalties, may help developing countries as potential conflicts resulting from the application of different tax rates might be reduced and scarce administrative resources economically used.

104. A withholding tax will be collected by financial institutions on the gross amount of "fees for technical services" paid to a non-resident, unless the non-resident taxpayer registers in the source state to obtain some form of a taxpayer identification number and opt for net taxation. In either way, with or without a permanent establishment in the source state, registration of the (digital) business would be needed for the tax administration to identify the taxpayer and withhold the tax. The implementation of a registration apparatus is also necessary

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[149] See F. Sixdorf & S. Leitsch, *supra* n. 141, at 241.
[150] A. Baez & Y.Brauner, *supra* n. 137, at 19 et seq.

for a successful information exchange with other states and also to identify non-resident taxpayers who are potentially subject to the withholding tax.[151]

Relief from double taxation

105. The state in which fees for technical, managerial and consultancy services arise has the primary right to tax those payments.[152] In the case of article 12A of the UN Model 2017, fees for such services arise in the residence state of the payer of the fees. Therefore, the residence state of the payee is obliged to eliminate double taxation of those fees. Articles 23 A and 23 B of the OECD and the UN Models establish rules on the elimination of double taxation in cases in which the application of a distributive rule results in a shared taxing right. In order to avoid double taxation, either a credit or an exemption must be granted by the residence state for taxes paid on before mentioned service fees in the source state. In cases in which the residence state applies the exemption method constituted in article 23 A of the UN Model 2017, it is, according to the switchover provision in article 23 A (2), entitled to apply the credit method on article 12A income. [153]

Conclusion

106. Organizational structures of MNEs have changed as digitalization in general increased. The rise of the digital economy fundamentally challenges a balanced allocation of taxing rights between the source state and the residence state. The traditional concept of permanent establishment as a fixed place of business has become redundant in a digitalized economy, as corporations don´t need any workforce to generate income in the source state. Additionally, MNEs do not necessarily establish a fixed place of business in the source state as digital means allow them to furnish cross-border services or distribution of products without any physical facility in the source state. As a result, taxing rights may not be attributed appropriately, as current taxation rules strongly rely on residence taxation.

107. Business profits may generally only be taxed in the source state under tax treaties if a PE of an enterprise is located in the source state. Creating a digital presence for purposes of the business, without a physical presence, gives opportunities of base erosion and profits shifting as current tax treaty rules require physical presence in the market jurisdiction. BEPS may occur by fragmenting physical operations in a way to avoid taxes. It is common for companies to conduct services through a remote location at a distance far from the market jurisdiction with minimal use of personnel. Economic value is effectively arising in the market jurisdiction to which the services are addressed but may only be taxed by the residence state as no permanent establishment is established in the market jurisdiction and therefore no required nexus under current (inter)national taxation rules. Although the consideration paid for the services rendered by a non-resident of the market jurisdiction may not be taxed in that state, they may be conducted as business expenses by the payer of the consideration, resident in the market

[151] A. Baez & Y.Brauner, *supra* n. 137, at 14
[152] Para. 2 *UN Model: Article 12A* (2017).
[153] UN, *supra* n. 8, at A 43.

jurisdiction. In those situations the tax base of the payer of the consideration will be lowered resulting in (tax) base erosion in the market jurisdiction.

108. The application of article 12A of the UN Model 2017 might be a solution to a “fair” allocation of taxing rights in the digital economy. As already mentioned in this paper, article 12A does not require any physical presence of the non-resident service provider in the source state. The rendering of services in another contracting state through digital means will be treated by itself as sufficient engagement and therefore as sufficient “nexus” in that state. Fees for technical, managerial and consultancy services rendered with the use of digital means will be taxed in the state of residence of the payer if the recipient of the fee is a resident of the other contracting state. The aforementioned fees are deemed to arise in the residence state of the payer. Therefore, no physical presence needs to be established, neither by the use of workforce nor by a fixed place of business.

109. Services conducted with digital means, are covered by the scope of article 12A if they involve the application of specialized knowledge, skill or expertise by the non-resident service provider and do not include routine, standardized services. The imposition of a source withholding tax on fees for technical, managerial and consultancy services will reduce the base eroding character of such payments. The source state receives tax revenues from the fee paying resident tax payer in relation to his deductible expenses from services for technical, managerial and consultancy services. Article 12A of the UN Model 2017 is an appropriate tool to reduce the base eroding character of fees for technical, managerial and consultancy services rendered without a physical presence in the source state. A final withholding tax on fees for technical, managerial and consultancy services rendered with the use of digital means would be a choice in favour of simplicity and certainty. The withholding tax would be a final one from the perspective of the source state. The residence state would grant relief for the tax paid in the source state.