

# Tax Representation



## TAXREP 12/07

### OECD PUBLIC DISCUSSION DRAFT ON THE TAX TREATY TREATMENT OF SERVICES – PROPOSED COMMENTARY CHANGES – ICAEW TAX FACULTY WRITTEN COMMENTS SUBMITTED IN FEBRUARY 2007

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## INTRODUCTION

1. This is the written response of the ICAEW Tax Faculty to the Public Discussion Draft published on 8 December 2006 by OECD on the Tax Treaty Treatment of Services.
2. Details about the ICAEW Tax Faculty are set out at Appendix 1.
3. The OECD Public Discussion Draft is available on the OECD website at <http://www.oecd.org/dataoecd/2/20/37811491.pdf>.
4. The main purpose of the Discussion Draft is to put forward a proposal which would extend the taxing rights of some countries (source based countries) in respect of services provided in those countries by non resident service providers when the level of provision does not constitute a permanent establishment in the country, by reference to the current definition of permanent establishment.
5. The OECD proposal is explained in the Discussion Draft as follows:

‘...[OECD] has proposed changes to the Commentary on Article 5 that reflect its conclusion that the current provisions of the OECD Model Tax Convention are appropriate to deal with services, that discuss the various reasons that support that conclusion, that present the views of States that do not agree with that conclusion and that suggest an alternative provision that these States could use to secure more taxation rights with respect to services but that would follow the above principles that source taxation should not extend to services performed outside the territory of a State, should apply only to the profits from these services rather than to the payments for them and should only be allowed if there is a minimum level of presence in a State.’

## DETAILED COMMENTS

6. We believe that there is a need for greater certainty for international businesses and individuals as to when services performed in another jurisdiction give rise to taxation in that country. The current situation is unsatisfactory as, other than the UN Model, there is no guidance for countries that have agreed under a bilateral treaty to tax services performed in their state by residents of the other contracting state. We do not think the UN Model Commentary gives sufficient or appropriate guidance to properly define the taxing rights of the source state either in terms of scope or quantum.
7. Whilst we understand the desire of the OECD to improve the current situation, we are very concerned that the current proposal should not have the effect of encouraging an extension of taxing rights to countries (source based countries) in respect of services provided in that country by non resident service providers when the level of provision does not constitute a permanent establishment in the country, by reference to the current definition of permanent establishment. The permanent establishment threshold is well-known and accepted worldwide and a point of reference to fiscal administrations and to taxpayers operating in a global business environment.

8. Further, given the need for greater certainty, we are also concerned that there is no definition of services used in the proposal and while the term can be defined in a bilateral treaty by reference to the domestic law of the relevant states there could well be mismatches which would lead to double taxation.
9. The countries which advocate source-based taxation of services currently rely on a system of withholding to collect the tax and this withholding is generally on the gross amounts paid. This is at odds with the proposed Commentary, which at paragraph 42.19 states that, with a few limited exceptions, tax should be on the net profit. We have two main concerns with this proposal. Firstly, many of the countries advocating such an approach are developing countries with poorly resourced tax administrations and we are concerned that such countries may lack the capacity to appropriately attribute the profit using OECD principles. Secondly, a related issue is that many of such countries also apply a force of attraction rule in computing business profits and so may try to tax related services not actually performed in their jurisdiction.
10. The proposal put forward in the discussion draft cannot be fully evaluated until more information is provided as to how the proposal would work in practice. The issues which need to be clarified include the legislative and administrative application, the attribution of profits, intermediate funding of refundable withholding tax, the threat of the creation of market barriers and possible unequal treatment of resident and non-resident service providers. In addition to potential non-discrimination issues under Article 24 of the OECD Model Tax Convention, this last issue could also cause problems in the context of European Union Member States where the EC Treaty, and the judgments of the European Court of Justice (ECJ), make it clear that taxpayers must be treated in the same way when they are, objectively, in a similar situation and there can be no discrimination against non residents as compared with residents. Indeed, the ECJ's recent (15 February 2007) judgment partly against Germany in the *Centro Equestre da Leiria Grande Lda* case (C-345/04) held that the German rule whereby a non-resident entertainer could only claim a deduction for (directly connected) expenses if they amounted to more than 50 per cent of the local source income was, being restrictive (and arbitrary), held to be contrary to the EC treaty freedom to provide services cross-border (Article 49 EC).
11. Once all this additional information has been provided then the current proposal can be properly evaluated to see if it meets the laudable goal of providing greater certainty as to when services can be taxed in a source state. If the proposal were ever to be introduced we would support the proposed conditions that would have to be satisfied in respect of the services income that a source country can tax namely:
  - The taxation should not extend to services performed outside the source country territory;
  - The taxation should be dependent on a minimum level of presence in the source country (time period and relative level of income); and
  - The taxation should apply only to profits and not to gross amounts payable for services provided and that the profits attributed to the PE should be computed in accordance with OECD principles and not based on any 'force of attraction' approach.

12. As mentioned above we have a concern that developing countries may not have the tax capacity to actually attribute profits in accordance with Article 7 to a services PE, which is one reason why they currently tax on a gross basis. Our view is that these countries should be encouraged to move from the gross to the net profit basis but it is also incumbent on the OECD countries to ensure that they are in a position to be able to attribute only an arm's length amount of profits to the services PE.

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**WHO WE ARE**

1. The Institute of Chartered Accountants in England and Wales ('ICAEW') is the largest accountancy body in Europe, with more than 128,000 members. Three thousand new members qualify each year. The prestigious qualifications offered by the Institute are recognised around the world and allow members to call themselves Chartered Accountants and to use the designatory letters ACA or FCA.
2. The Institute operates under a Royal Charter, working in the public interest. It is regulated by the Department of Trade and Industry through the Accountancy Foundation. Its primary objectives are to educate and train Chartered Accountants, to maintain high standards for professional conduct among members, to provide services to its members and students, and to advance the theory and practice of accountancy, including taxation.
3. The Tax Faculty is the focus for tax within the Institute. It is responsible for tax representations on behalf of the Institute.