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Department of Policy and Business Practices

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

Dear Mr Lennard,

During the Ninth Session of the UN Committee of Experts in Tax Matters ("UN Committee") it was decided that a separate article on technical services would be included in the UN Model Convention. The International Chamber of Commerce (ICC), as the world business organization speaking with authority on behalf of enterprises from all sectors in every part of the world, upon request of the UN Committee provided its initial observations on such a potential article in its letter of 29 August 2014. Following the deliberations at the Tenth Session of the UN Committee in October 2014, ICC greatly values the opportunity to now respectfully share its further comments on the taxation of technical services in the context of the ongoing dialogue within the UN Committee.

ICC acknowledges that many difficulties can be identified with regard to the taxation of 'technical services' under international tax and treaty law. For example, some countries have recognized income from technical services as 'other income' under Article 21 and thus not subjected this income under Article 7 ('business income') under which scope it should fall. Other countries have stretched the interpretation of Article 12 and argued a withholding tax on technical services by considering these services as royalties. Furthermore, some treaties in force already specifically address the taxation of technical services by applying different definitions – either of a wider or a narrower scope.

A model for an article on the taxation of technical services may help to overcome some of the challenges since it might lead to a more consistent international treatment of technical services. However, even taking these potential positive effects into account, ICC identifies important negative consequences which would

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significantly outweigh the potential benefits:

a) *Administrative efforts:* Depending on how a withholding tax on technical services is designed, the administrative burden for companies and service recipients will increase significantly;
b) *Increased tax burden:* As described in more detail in section 3 below, a withholding tax will increase the tax burden for many cross border businesses;
c) *Trade barriers:* The increased administrative and the increased tax burden will clearly constitute a new barrier to international trade;
d) *Weakening of the Permanent Establishment (PE) concept for business income:* For almost a century, the core principle for taxing business' income has been the PE-principle as established in Article 7.The withholding tax on income from technical services means carving out an important portion of business income from the scope of Article 7 and thereby cutting the clear link to a PE and further weakening the respective principle.
e) *Difficulties in defining the scope:* As described in more detail in section 2 below, it will be challenging to define the scope of a new article and its implementation will inevitably lead to further problems.
f) *Imbalanced allocation of taxation rights:* If withholding tax applies independently of whether the services are performed in the source country or outside the source country, it is difficult to justify the taxation at all compared to the existing balanced allocation of taxation rights;
g) *Inconsistency with the OECD/BEPS project with regard to value creation:* ICC notes that many UN Members are actively engaged in the G20 mandated OECD/BEPS project which is based on the concept of securing taxing rights of countries with regard to the value created in those countries. It is evident that the value of technical services is created in the country in which the services are performed. ICC notes that the UN would deviate from the general direction in which the BEPS project is developing if the UN Committee would grant a more extensive taxing right for the so-called 'source' country merely based on the fact that person using those services is a resident of the so-called 'source' country.

Countries wishing to impose a gross basis tax based on the location that a service is consumed could also consider adopting a destination based VAT/GST which might be a better alternative. This would be in line with international norms and would not distort the generally accepted international norm that services are sourced where the activities giving rise to services are performed. Some of the countries that are promoting the expanded taxation of fees for technical services have origin based consumption taxes. If the country where the services are performed – the origin country – applies the destination principle for VAT purposes, then because neither the VAT nor the income tax systems mesh, there could be double non-taxation in the VAT systems and double taxation in the income systems. A better outcome would be to mesh the systems – destination based consumption tax and origin based income tax – such that a single level of taxation would be applied in both cases and both the country of origin and the country of destination have a portion of the taxing right. Based on the concerns raised above, ICC has identified three key issues which would need careful attention in determining a constructive way forward with regard to a possible new article:

- The nexus requirements for technical services to be subjected to the new article;
- The scope of such a new article (i.e. the definition of “technical services”);
- The rate for a gross based withholding tax.

1) Nexus requirements for technical services to be subjected to the new article

A fundamental question is whether the technical services have to be performed in the ‘source’ country to allow for ‘source’ taxation or if the tax would apply to any payments for technical services borne by a resident or a PE in the ‘source’ country. In this respect, ICC strongly believes that there is no basis for a ‘source’ country to impose tax on services that are performed outside of its borders. In this case, the ‘source’ country is the jurisdiction in which the services are actually performed, not the jurisdiction in which the services are received or consumed (cf. e.g. Article 5, 14 and 17 of the UN Model Convention). The value of the services is created by performing them; all the costs which are triggered by performing the services (wages, equipment, leases etc.) do diminish the tax base in the country in which the services are performed and not in the country of the service recipient. It is apparent that the country of residence of the service provider has no rationale to give up some of its taxation rights on the income generated by the service provider. As explained above, if a country wishes to tax the services based on the residence of the consumer, the more appropriate tax is a consumption tax. ICC sees no reason to deviate from these fundamental principles in relation to technical services in a model tax treaty.

In this regard, ICC also emphasises that the wider the definition of the term ‘technical services’ is phrased, the more problematic the challenges will become (see also below in section 2). For ‘simple’ services there is no imbalance between developing and developed countries, just as no such imbalance exists for many ‘higher’ services. The argument that payments for services erode the tax base in the country of the service recipient, would disregard the fact that the service recipient orders the service because it provides him with a benefit. Without the service rendered to him the service recipient would have to perform the activity himself and, therefore, directly bear the related costs of performing those activities. From an economic perspective, this means that the service recipient will only purchase the services when it proves more efficient to do so or when he will not be able to perform the services himself. In the first case there is no apparent base erosion because the tax base is even protected against the higher cost of having the service recipient perform the service-activities himself. Consequently, this rule creates a disincentive to the purchase of services from outside the jurisdiction and protects local service providers despite the higher cost. Such a protectionist impact seems unavoidable but is certainly highly undesirable. Tax rules should neither be used as a disguised restraint of trade nor indirectly have these consequences.

In the second case – the purchaser cannot perform the service itself – there is a scenario comparable to that of Article 12 indicating that there is an imbalance between developing and developed countries though this might not be true in many areas. However, there is still a significant difference between the base case for Article 12 and fees for technical services. In the context of granting licences intangible property is used and the specific usage (granting the licence) does not result in any direct costs since the cost for the intangible property has already been carried by the licensor when the respective intangible property was created. After the creation the intangible property can be used as often and by as many licensees as desired. This situation is evidently different for technical services since performing them is not an intangible, but actually a very tangible transaction. There is only one service recipient and the performance of the services itself results in costs. This is a significant difference from the transactions covered by Article 12 and in ICC's view clearly demonstrates that the taxing right for income from technical services should belong with the country in which the services are performed.

2) The scope of a new article

It is evident that interpretations of the definition of technical services vary. ICC believes it is imperative to clearly define a 'service' and, consequently, in which cases those services would qualify as being 'technical' in nature. Without such a clear understanding double taxation and disputes will inevitably increase. In this context, and as elaborated upon below, ICC advocates for a narrow definition of the term 'technical services' to ensure that a possible new article would fit seamlessly into the framework of the UN Model Tax Convention without overlapping with other articles in a way that would give rise to conflicting interpretations and disputes. In this regard, ICC would also like to underline that the risk of double taxation and increasing disputes constitutes a severe obstacle to cross border trade and investment.

Narrow definition: When considering an appropriate definition of 'technical services', ICC recommends a precise and specific definition. A broad definition can be found in some Double Tax Conventions (e.g. in the one between India and Germany: "services by technical or other personnel"). ICC believes that this is in fact not truly a definition since it is formulated so broadly that it would effectively cover all services. While as a practical matter covering all services would avoid conflicting interpretations, such a rule would further weaken the principle of PE based taxation and would extend beyond the aim of taxing technical services in the source country. Furthermore, any definition of technical services in this context raises a fundamental question about the essence of the service PE contained in Article 5(3) (b): why would a time threshold be required to justify the taxing right of a source country under the PE concept if another Article grants a taxing right for services with no regard to any such requirements? Any definition, moreover, needs to avoid conflicting interpretations and should be aligned with the definition of 'royalties' under Article 12 to prevent the same function from being subject to both definitions – potentially confronting the taxpayers with double or multiple levels of taxation. The US – India Income Tax Treaty definition of technical services ("included services") was specifically designed to capture services that were most difficult to distinguish from royalty transactions and could serve as a useful model.

'Service': ICC believes that services ought to be clearly differentiated from transactions in which the ownership of tangible or intangible property (i.e. the title) is transferred. Services should also be differentiated from transactions which entitle the other party to use or benefit from a certain tangible or intangible property. This distinction would need to be properly addressed in order to prevent a sales transaction, the lease of property or the licensing of IP to be considered as 'services' which would inevitably lead to discussions on whether Article 6, 7, 12, 13 or the new article on technical services should apply to those transactions/activities. The desired and imperative differentiation might be achieved by linking the understanding of a service to the 'personnel performing' this service: this would demonstrate that a service is a specific activity and its core characteristic is the performance of that activity.

Related activities: ICC notes that those activities that are part of the main transaction – although they might be considered a 'technical service' if rendered on a stand-alone basis – should not be carved out. Otherwise many activities, such as the first training on equipment sold or a test run of such equipment could be subjected to the new article on technical services.

'Technical': Some interpretations of 'technical services' seem to disregard the component 'technical' which de facto would bring all services within the scope of a new article. ICC respectfully advocates for a narrow scope of a new article to bring it in line with other articles allowing for taxation at 'source' such as Article 12. At the same time ICC notes that there is a clear link between defining the term 'technical' in a wider or narrower sense and the nexus requirement for those services to be at all subjected to 'source' taxation (see also section 1 above). The fact that a balanced allocation of intangible property between countries is lacking is a reason to tax royalties at source. This is particularly the case between developing and developed countries. It should therefore be noted that without the right to tax royalties at source, the tax base of developing countries would inevitably be decreased by the deductible royalty payments whilst the right to tax those royalties would be in the developed countries. However, the situation for services is different. For many services there is a more or less balanced allocation between countries (e.g. civil works). For others there might even be a hub in developing countries (e.g. call centers, software programming, certain back-office hubs). Only for those activities that are closely related to specific know-how or highly technical expertise there might still be a centre of gravity in the developed countries. ICC therefore sees an advantage in limiting the scope to services, which "*make available technical knowledge, experience, skill, know-how or processes, or consist of the development and transfer of a technical plan or technical design*" – a definition found in Article 12(4) of the Double Tax Convention between India and the United States, with an accompanying memorandum of understanding containing numerous examples that have been helpful in guiding correct interpretations of the provision.

Exclusion from Other Characterizations: To prevent inevitable overlaps between Articles, and consequently a risk for increased double taxation, it would be desirable to include language that would provide clarity that Characterization of an activity as a service subject to domestic withholding would eliminate any other basis of taxation under domestic law or treaty provision.

3) Rate for a gross based withholding tax

The UN Model Tax Convention allows for gross based withholding taxes in a variety of cases. While the Model itself does not contain any fixed rates but rather leaves those rates to be negotiated between the treaty partners, the commentary to the UN Model does set specific ranges – e.g. for direct investment dividends between 5% and 15% and for portfolio dividends between 15% and 25%. The commentary only indicates the range for interest found in existing treaties, which is 0% to 25%, and explicitly mentions that no consensus could be reached on an introduction of a ceiling of 10%. There are two rates: a standard percentage rate and a reduced percentage rate. With regard to royalties the commentary addresses the challenges of determining an appropriate withholding tax rate because the net profit will in many cases amount to only a small fraction of the gross royalties given that the bases for royalties are cost intensive patents and developments.

In this context, technical services are comparable to royalties as they almost always involve a material portion of cost to render the services: cost of labor, technical equipment employed in the rendering of the services, travel, administrative (including overhead) and so on. A good indication for the net profit can be found in certain profit-level indicators which are used by financial authorities to verify profits declared. Depending on the different services the profitability may range somewhere between 5% to 15% before tax. Statistics for German Enterprises for 2013 show a profit margin of 12.8% for knowledge-based services, 6.7% for construction services and 4.8% for other services. A high-level search in AMADEUS[1] demonstrates a median EBITDA margin between 5% and 12% for various types of (knowledge based) services (see annex 1 for the search results). EBIT margins are at a median between 3% and 8%.Consequently, even the services with a high know-how component and required expertise, generally only generate a limited net profit before tax.

For example, if gross revenue from a service were 100 with costs of 81.2., the service provider would have income of 12.8. If this were taxed at 30%, the after tax profitability would amount to 8.96 (100-81.2 = 12.8 x.30 = 8.96).. At a withholding rate of e.g. 15% on the gross amount the service provider would actually end up at an after tax loss (100-(81.2 + 15) = (2.2)). At a rate of 10% the service provider would have no chance to credit this tax, but would have to deduct it as cost and end up with 2.8% profit before tax and an after tax profit of 1.96%. This would be the case despite the fact that it concerns services with a relatively high profitability. The services which only yield lower profits of around 5% would be lossmaking at any rate equal or higher than 5%. There are two possible outcomes in this scenario. First, the

[1] AMADEUS is an European database containing the publicly available financial information of European enterprises. AMADEUS is often used to perform arm’s length margin analyses for transfer pricing purposes.

service provider would no longer be able to provide the service into the country imposing the withholding tax and would effectively be put out of business if the rate exceeds 1.5% (which would be the maximum to be creditable against a tax of 30% in the country of residence of the service provider). Second, the cost of the service would be passed on to the consumer of the service.[2] The examples above clearly illustrate that the withholding tax rate has to be set with the outmost caution and should be limited by a strict ceiling.

Another potential solution to the problem described above would be to include a profit based cap for the withholding tax: if the company is able to demonstrate that the profit from its service activities does not exceed a certain margin a relief from withholding tax would be granted.[3] This option would combine a system which in principle is administratively simple – such as the gross based withholding tax – with a means to resolve those cases if the taxpayer makes an additional effort to substantiate the profit level for the respective services. It should not be forgotten that taxpayers will do this calculation regardless: if confronted with a gross based withholding tax taxpayers have to make sure that they do not end up with a loss after tax: if the taxation would lead to a loss for the service provider the service provider would simply stop providing the services. This would give the withholding tax on technical services a flavor of protectionism - a result no country or business desires in a globalized economy.

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

Respectfully submitted.

Your sincerely,

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Chair, ICC Commission on Taxation

[2] This is more likely if alternative providers are not available in the jurisdiction of consumption, which is why the withholding tax effectively protects local service providers and therefore functions as a trade barrier.
[3] For countries which are participating in the G20 mandated OECD/BEPS project and agree to the principles set forth in the low-value intra-group services draft as ultimately adopted, any gross basis withholding tax should not apply, at a minimum, in situations covered by that draft.

ANNEX 1: Results high-level AMADEUS margin search with respect to various knowledge based services

Industry Category	**NACE code (AMADEUS)**	**EBITDA Margin % 2013**	**EBIT Margin % 2013**
C33 - Repair and installation of machinery and equipment	NACE 33	5,923	3,901
J61 - Telecommunications	NACE 61	8,6165	4,4855
J62 - Computer programming, consultancy and related activities	NACE 62	7,827	4,5995
K66 - Activities auxiliary to financial services and insurance activities	NACE 66	11,403	7,5675
M69 - Legal and accounting activities	NACE 69	8,327	5,073
M70 - Activities of head offices; management consultancy activities	NACE 70	6,617	3,857
M71 - Architectural and engineering activities; technical testing and analysis	NACE 71	8,232	4,843
M72 - Scientific research and development	NACE 72	8,3055	4,352
M73 - Advertising and market research	NACE 73	5,1385	3,063
M74 - Other professional, scientific and technical activities	NACE 74	7,368	4,64
N80 - Security and investigation activities	NACE 80	5,388	3,032
N82 - Office administrative, office support and other business support activities	NACE 82	6,074	3,389
Q86 - Human health activities	NACE 86	10,4175	7,1045
S95 - Repair of computers and personal and household goods	NACE 95	5,542	3,4555

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ICC is the world business organization, whose mission is to promote open trade and investment and help business meet the challenges and opportunities of an increasingly integrated world economy. Founded in 1919, and with interests spanning every sector of private enterprise, ICC's global network comprises over 6 million companies, chambers of commerce and business associations in more than 130 countries. ICC members work through national committees in their countries to address business concerns and convey ICC views to their respective governments. The fundamental mission of ICC is to promote open international trade and investment and help business meet the challenges and opportunities of globalization. ICC conveys international business views and priorities through active engagement with the United Nations, the World Trade Organization, the Organisation for Economic Co-Operation and Development (OECD), the G20 and other intergovernmental forums.

The ICC Commission on Taxation promotes transparent and non-discriminatory treatment of foreign investment and earnings that eliminates tax obstacles to cross-border trade and investment. The Commission is composed of more than 150 tax experts from companies and business associations in approximately 40 countries from different regions of the world and all economic sectors. It analyses developments in international fiscal policy and legislation and puts forward business views on government and intergovernmental projects affecting taxation. Observers include representatives of the International Fiscal Association (IFA), International Bar Association (IBA), Business and Industry Advisory Committee to the OECD (BIAC), Business Europe and the United Nations Committee of Experts on International Cooperation in Tax Matters.