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Tax treatment of services

activities. Defining specific types of services is a difficult task that can be addressed, if necessary, at a later stage of the Subcommittee's work.

3. OVERVIEW OF THE EXISTING PROVISIONS OF THE UN MODEL DEALING WITH SERVICES

5. This part of the note provides a brief description of all of the provisions of the Model that deal with income derived from services. This survey is intended to be as comprehensive as possible. It is also intended to identify the allocation of the right to tax between the residence country and the source country with respect to various types of services. In the next section of the note the provisions dealing with services will be analyzed in more detail to determine the conditions under which source countries are entitled to tax income from services and the limitations, if any, on source country taxation.

3.1 Articles 5 and 7 – Business Profits

6. Under Article 7, income from services rendered in a contracting state (the source country) by an enterprise resident in the other contracting state may be taxed in the source country only if the enterprise carries on business in the source country through a permanent establishment (PE) in the source country. If the enterprise carries on business through a PE in the source country only the profits that are attributable to the PE or attributable to other similar activities carried on through the PE (a limited force of attraction rule) are taxable by the source country. It is generally accepted that the source country tax under Article 7 is limited to tax on the net profits of the nonresident enterprise.

7. A PE is defined in Article 5 to mean

3.2 Article 8 – Shipping, Inland Waterways Transport, and Air Transport

8. Under Article 8, profits from international shipping and air transportation and inland waterways transport are taxable exclusively by the country in which the enterprise has its place of effective management. However, as an alternative, profits from international shipping activities in a country may be taxed in that country if the activities are more than casual. In this case Article 8(2) (alternative B) provides special rules for the allocation of the profits between the source and residence countries and the calculation of the source country tax.

3.3 Article 14 – Independent Personal Services

9. Under Article 14, income from professional services or independent activities derived by a resident of one state is subject to tax by the other state in two circumstances:

1. if the resident has a fixed base in the other state that is regularly available to the resident for the purpose of performing the activities. In this case, which is similar to Article 7, only the income attributable to the fixed base is taxable by the source country.

2. if the resident's stay in the source country lasts for 183 days or longer in the aggregate in any 12 month period. In this case only the income from activities performed in the source country are taxable by the source country.

3.4 Article 15 – Dependent Personal Services

10. Under Article 15, income from employment (dependent personal services) derived by a resident of one state from employment exercised in the other state may be taxed in that other state (the source country). Such income may also be taxed by the country in which the employee is resident but the residence country must provide relief for the source country tax in accordance with Article 23. However, employment income is exempt from tax in the source country if

1. the employee is present in the source country for periods not exceeding in the aggregate 183 days in any 12 month period, and

2. the remuneration is not paid by an employer resident in the source country or borne by a PE or fixed base that a nonresident employer has in the source country.

11. The conditions for exemption from source country tax in Article 15(2) demonstrate a concern about tax base erosion. If the remuneration paid by the employer is deductible in computing income for purposes of the source country's tax base (either because the employer is a resident of the source country or because the employer is a nonresident with a PE or a fixed base in the source country), the remuneration derived by the employee is taxable by the source country even if the employee is present in the

source country for only a very short period. In these situations the only condition for source country tax is the exercise of employment activities in the source country.

3.5 Article 16 – Director's Fees and Remuneration of Top-Level Managerial Officials

12. Under Article 16, fees derived by nonresident directors and salary, wages, and other remuneration derived by nonresident senior managers of a company resident in the source country may be taxed by that country. Such income may also be taxed by the country in which the directors or managers are resident but that country must provide relief for the source country tax in accordance with Article 23. The only condition for source country tax under Article 16 is the residence of the company. It is not necessary for the fees or remuneration to be derived from activities performed in the source country by the directors or managers.

3.6 Article 17 – Artistes and Sportspersons

13. Under Article 17, income derived from personal activities as an entertainer or sportsperson exercised in a country may be taxed by that country. This right to tax

TABLE

Type of Income from Services	Conditions for Source Country Tax
Business profits	• permanent establishment and income attributable to PE • services performed in the source country for more than 6 months (to be changed to 183 days or more) for the same or a connected project
Construction and related services	• construction project at a fixed place in the source country that lasts more than 6 months
Insurance	• collection of premiums or insurance of risks in the source country other than through independent agents

4. ASSESSMENT OF THE PROVISIONS OF THE UN MODEL DEALING WITH INCOME FROM SERVICES

19. Based on the review of the various provisions of the UN Model dealing with services in the previous section, this section contains an assessment of these provisions in accordance with several factors. The purpose of this assessment is to identify the underlying principles for the taxation of income from services under the UN Model.

4.1 Types of services covered

20. The provisions of the UN Model deal comprehensively with all types of services. However, the treatment accorded to different types of services varies enormously. Several specific types of services, such as government service, employment, pensions, shipping and air transportation, are given special treatment in separate articles of the Model. In contrast, Article 7 deals with business profits generally and includes income from services in certain circumstances.

21. The different treatment of various types of income from services under the UN Model raises difficult issues of qualification. For example, if services are considered to constitute the carrying on of a business, the source country is authorized to tax the income from such services only if, in general, the business is carried on through a PE or a fixed base in the source country. On the other hand, if the services are performed by an employee or an entertainer or sportsperson, the source country is entitled to tax the income from such services simply if the activities take place in the source country.

22. In general, it would be desirable to minimize the qualification issues arising from the different treatment of various types of services. This objective can be achieved by reducing the number of types of income from services dealt with in the UN Model or by minimizing the differences in treatment among the various types of services. It must be recognized, however, that the different treatment of different types of services may be justified. The Subcommittee's work provides an opportunity to ensure that the special treatment of any particular type of income from services is clearly justified.

4.2 Allocation of jurisdiction to tax income from services

23. The fundamental purpose of all of the provisions of the UN Model dealing with services is to allocate the right to tax the income from such services between the residence country and the source country. Three basic allocation patterns are discernible:

1. the right to tax can be allocated exclusively to the residence country (for example, income from in froTw(ic)4.j5 TDpping and air trf ifferent types ofi.01213.-17.jvvar81

employee is paid by an employer resident in the source country or by a nonresident place "within a Contracting State," under Article 15 the employment must be "exercised in the other Contracting State," and under Article 17 an artiste's or sportsperson's personal activities must be "exercised in the other Contracting State." Moreover, under Article 14(1)(b) only the income derived from a nonresident's "activities performed in that other State" are subject to tax in that state.[2] In certain limited circumstances – remuneration of directors and top-level managers and government service – a source country is entitled to tax if the payer is a resident company or the government of the source country even if the services are not performed in the source country. These provisions should be regarded as exceptions to the general principle that only income from the services performed in the source country are subject to tax by that country.[3]

4.5 Basis of source country taxation permitted

30. Once the income subject to source country taxation has been determined, the computation of the amount of income subject to tax by the source country is a matter for the domestic law of the source country. However, in certain limited circumstances the UN Model prescribes that the source country tax cannot exceed the tax on the net income derived by the nonresident. This is the case with respect to income from services taxable under Article 7 and, arguably at least, Article 14. All other types of income from services, such as employment, entertainment and sports activities, and government services, can be taxed by the source country without any limit; for example, the gross income may be subject to a final withholding tax at a fixed rate.

5. UNDERLYING PRINCIPLES FOR SOURCE COUNTRY TAXATION OF INCOME FROM SERVICES UNDER THE UN MODEL

5.1 Introduction

31. The preceding review of the provisions of the UN Model dealing with services does not reveal any clear underlying principles that might be used to guide a revision of those provisions. The provisions differ significantly depending on the type of services involved, without any apparent justification. They differ as to the threshold requirement for source country taxation, the income subject to source country taxation, and the basis of source country taxation (net or gross). Thus, the existing provisions of the UN Model appear to represent a hodgepodge of *ad hoc* rules that lack any clear rationale.

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or performing any services there. The use of the report by the client in Country Y or the payment for the consultant's services, which would ordinarily be deductible by the client in Country Y, could arguably be seen as justification for the taxation of the consultant's fee by Country Y. Both the UN and the OECD Models reject this as a basis for source country taxation.

2 Even under Article 14(1)(a) income attributable to a fixed base that a nonresident has available in a country is likely to be restricted to income derived from activities in the source country that are connected to the fixed base.

3 The treatment of income derived from insurance under Article 5(6) of the UN Model may be considered as another exception although it is unclear whether insurance services are provided in the country in which the insurer is located or the country in which the risk insured is located.

32. In this section of the note, an attempt is made to determine whether the fundamental inconsistencies in the treatment of income from the various types of services are justified, and if so, why. If the inconsistencies are not justified, they should be reduced or eliminated. If the inconsistencies are justified, then it must be determined if the rationale for the special treatment of a particular type of service should be applied to other types of services. At the conclusion of this section an attempt is made to identify the principles for the taxation of income derived from services that should be generally applicable even though exceptions to those general principles may be recognized in certain limited circumstances.

5.2 Government service

33. Article 19 is based on the principle that the country paying the salary, wages, other remuneration, or pension should have the exclusive right to tax the income. As the Commentary on Article 19 (paragraph 2) indicates, the principle of exclusive taxation by the paying country is based on international courtesy and the Vienna Conventions on Diplomatic and Consular Relations. The Vienna Conventions justify an exception for taxation by the non-paying country where the services are performed in that country by an individual who is a resident or national of that country. The special treatment of government services is generally accepted and justified. Because the underlying rationale for the exclusive source country taxation of amounts in respect of government service is based on international courtesy, the rationale is not applicable to any other types of income from services.

5.3 Pensions and social security payments

34. Article 18A(2) and 18B(2) give exclusive taxing rights to the country paying social security benefits. The rationale for this treatment is that the “payments involved are wholly or largely financed out of the tax revenues of the source country.” (Paragraph 4 of the Commentary on Article 18.) This rationale for exclusive source country taxation is clearly justified.[4] It appears to be unique and is not applicable to other types of income from services.

35. Other private pensions in respect of past employment are taxable only by the country in which the recipient is resident (Article 18A(1)) or by both the residence country and the country in which the payer is resident or has a PE (Article 18B(2)). The rationale for source country taxation of pensions is not completely clear. First, it can be argued that a pension is a form of deferred compensation for employment services performed in the source country that should be taxed in the same manner as employment income. Second, for developing countries, pension payments may represent a substantial net outflow because, *vis à vis* developed countries, the flows of pension payments are unlikely to be reciprocal. These two rationales are mentioned in the Commentary on

[4] As the Commentary notes, however, this rationale does not apply where the social security benefits are financed largely by private contributions.

40. The principle underlying Article 16 is not articulated in the Commentary of either the OECD Model or the UN Model. The principle is obviously not the location of the performance of the services by the directors or managers because there is no requirement in Article 16 that the services must be performed in the country in which the company paying the amounts is resident. As a practical matter, it might be difficult to determine where the services of directors or top-level managers are performed and it is probably reasonable to assume that ordinarily such services would be performed primarily in the country in which the paying company is resident. Further, the company paying the fees or remuneration is likely to claim a deduction for such amounts in computing its income tax liability in its country of residence. Since the tax base of the country in which the paying company is resident is eroded by the deduction of the payments, that country should be entitled to tax the payments. This base-erosion rationale for Article 16 is more convincing than the justification set out above, viz., that the country in which the paying company is resident to tax the fees or remuneration is a proxy for the place where the services are rendered. The base-erosion principle applies wuen

Where the employment is exercised;

The period of physical presence of the employee in the source country; and

Who pays or bears the cost of the employee's remuneration.

47. If the employee is paid by a resident of the source country or the employee's remuneration is borne by a permanent establishment or fixed base of the employer in the source country, the source country is entitled to tax the employment income. In this regard, Article 15 is similar to Article 16. The underlying principle that justifies source country tax is the erosion of the source country's tax base as a result of the deduction of the employee's remuneration by the employer. As a result, the source country is entitled to tax the employment income irrespective of how much the income is or how long the employee spends working in the source country. Although there are compliance problems for nonresidents who are employees in a country for short periods (the necessity to file returns in the source country and claim foreign tax credits in the residence country), these problems are not considered to be sufficient to outweigh the source country's claim to tax.[8] In this situation, the enforcement of source country tax on employment income is handled by requiring the resident employer or nonresident employer with a PE or fixed base in the source country to withhold from the remuneration paid to the employee.

48. If the employee is paid by a nonresident employer and the remuneration is not borne by the employer's PE or fixed base, if any, in the source country, the base-erosion principle does not apply. Instead, the source country is entitled to tax only if the employee is present in the source country for more than 183 days in any 12-month period beginning or ending in the fiscal year. This threshold requirement is based exclusively on the physical presence of the employee in the source country. The fundamental idea seems to be that if the employee spends more than half of the year in the source country, that country is entitled to tax. If, however, the employee spends half or less than half of the year in the source country, only the residence country is entitled to tax the employment income. The primary advantage of this physical presence test is its simplicity. It is relatively easy to determine whether a person is present in a country or not.

49. The threshold for source country taxation of employment income could be framed differently. For example, the source country could be entitled to tax any employment income derived from employment exercised in the source country. In effect, all employment income would be taxed like employment income derived from resident employers or nonresident employers with a PE or fixed base in the source country. This approach would present serious enforcement difficulties where there is no resident employer to withhold the tax from the employment income. Another approach would involve using a threshold based on days of employment rather than days of presence. It would be somewhat more difficult to determine the days of employment. Also, there does not appear to be any clear advantage to adopting a threshold based on the days of employment, in light of the fact that the presence test is well accepted and applied in a

8 It is notable that, to my knowledge, very few countries have *de minimis* exemptions for nonresident employees in their domestic law.

consistent manner by most countries. Arguments can be made that a days-of-employment threshold is more appropriate than a days-of-presence threshold because presence in the source country by an employee for a purpose unrelated to employment is not relevant to a source country's right to tax income from employment. Moreover, a days-of-employment threshold would be consistent with the threshold for income from services under Article 5(3)(b). It would be inconsistent, however, with the days-of-presence threshold in Article 14(1)(b). Overall, in my opinion, the case for changing to a days-of-employment threshold is not convincing especially for developing countries.

50. Consideration could be given to introducing into Article 15(2) an alternative threshold based on the days of employment in the source country. The exemption in Article 15(2) would apply only if the employee was present in the source country for 183 days or less and performed the duties of employment in the source country for less than a certain number of days (for example, 90 days which, assuming a 5-day work week, would represent approximately 4 ½ months). Such a combined threshold makes sense only if a similar combined threshold is adopted for purposes of Article 5(3)(b) and Article 14(1)(b). Such a combined threshold would obviously impose additional administrative burdens on the tax authorities and for this reason cannot be recommended.

51. Another issue with respect to the threshold for employment income is whether the period of presence should be reduced to 120 days or 90 days. There is no clear justification for any particular number of days. The period should be based on a balancing of the source country's right to tax income arising in or having its source in its territory and the compliance and administrative difficulties in collecting the tax. The administrative difficulties in collecting the tax appear to be the same whether the period is 183 days or some shorter period. Obviously, a shorter period would give increased taxing rights over employment income to source countries. If the period of presence for purposes of Article 15 is reduced, the threshold periods for purposes of Articles 5(3)(b) and 14(1)(b) should be reduced in parallel fashion to maintain some measure of consistency. The thresholds for Articles 5(3)(b) and 14(1)(b) are discussed below.

5.7 Service businesses

52. The two general provisions of the UN Model dealing with income derived from services are Article 7 dealing with business profits and Article 14 dealing with professional and independent personal services. Such income is taxable by the source country only if:

1. The taxpayer has a PE or fixed base in the source country and the income is attributable to the PE or fixed base;

2. In the case of professional and independent personal services, the taxpayer "stays" (i.e., is present) in the source country for 183 days or more in any 12-month period beginning or ending in the year and the income is derived from services performed in the source country;

Commentary to give countries the choice of using a days-of-presence or a days-of-work threshold.[9]

57. In any case, the key issue is whether the existing thresholds – 183 days of presence or 183 days of work — are still appropriate or whether they should be reduced. According to the Commentary on Article 7 of the OECD Convention at paragraph 9 and noted at paragraph 9 of the Commentary on Article 7 of the UN Model, "it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights." Therefore, the fundamental policy issue is, at what point can an enterprise of one state be considered to be participating sufficiently in the commercial and economic life of another state to justify taxation of the enterprise by that other state. A threshold of 183 days of either presence or work can be argued to be appropriate because it is consistent with the 6-month minimum time requirement for a PE.

58. On the other hand, where nonresident service providers are paid by residents of a country or nonresidents with a PE in the country, base erosion considerations would seem to justify a lower or no threshold for source country tax, as is the case for employment income and income from entertainment or sports activities. Compliance and administrative enforcement considerations would not appear to be significantly greater for independent service providers than for employees. Many countries impose an obligation to withhold on residents and nonresidents with a PE in the country making payments to nonresidents for services rendered.

59. In summary, there is no compelling reason to reduce the threshold for source country taxation of services to less than 183 days. By the same token, there is no compelling reason not to reduce that threshold to 90 or 120 days. In my view, if a resident of one country spends 90 days working in another country, the resident is participating sufficiently in the economic life of that other country to justify that country exercising its jurisdiction to tax the income derived from the services performed in its territory. Perhaps the 183-day threshold should be left unchanged in Articles 5, 14, and 15, but the Commentary could be revised to allow countries to agree to a lower threshold in their bilateral treaties in appropriate circumstances. For example, for countries for which the flow of cross-border services is reciprocal, a higher threshold may be more appropriate than for countries for which the flow is disproportionate. Typically, the flow of cross-border services will be disproportionate between developed and developing countries.

60. The 2008 Update to the OECD Model added to the Commentary on Article 5 (paragraph 42.23) an alternative services PE rule that countries may include in their treaties. This alternative provision was included in recognition of the fact that some countries wish to exert taxing rights with respect to income from services performed in

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9 As noted above, these alternative thresholds should be reasonable approximations of one another. Therefore, it would not be appropriate to use the same time period (e.g. 183 days) for both thresholds.

their territories in circumstances where the taxpayer does not otherwise have a PE in the source country. The alternative OECD provision builds on the provision of Articles 5(3)(b) and 14(1)(b) of the UN Model and reads as follows:

> "Notwithstanding the provisions of paragraphs 1, 2 and 3, where an enterprise of a Contracting State performs services in the other Contracting State

country tax is possible under Articles 5(3)(b)

67. The justification for the 6-month period is set out in the Commentary on Article 5:

> … the goal of the treaty is to promote international trade and development, and the idea behind the time limit is that business enterprises of one

the rules in Article 7. One of these rules (Article 7(3)) is that deductions must be allowed for expenses incurred by the enterprise in earning income attributable to the PE. This rule can be justified by reference to common sense and principles of fairness and neutrality. In most circumstances, earning income from business activities, including services, involves substantial expenses. If the deduction of relevant and appropriate expenses is not allowed, a nonresident enterprise might be subject to excessive taxation by the source country. Such excessive taxation would seriously discourage cross-border trade and investment, contrary to the fundamental goal of tax treaties. The denial of deductions to nonresident service providers would also constitute discrimination against such nonresidents, contrary to the principle in Article 24(3).[14]

75. The requirement to tax only net income makes it more difficult for a source country to collect tax on nonresident service providers. A source country cannot collect its tax through a final gross-basis withholding tax with the ob

Article 7 currently. The fact that nonresident artistes and sportspersons are present in a source country for what may be very short periods does not justify taxing such persons on a gross basis. As long as amounts paid to such persons can be subjected to withholding at source, in principle, those persons should be entitled to file returns and pay tax on a net basis.

6. SUMMARY OF GENERAL PRINCIPLES FOR THE TAXATION OF SERVICES UNDER THE UN MODEL

78. This section of the note summarizes what I consider to be the general principles that apply to the taxation of income derived from services. These general principles should guide any revisions of the provisions of the UN Model. Although these principles are generally applicable, they are subject to several exceptions for certain types of services (for example, government service and remuneration of directors and top-level managers).

6.1 Source principle

79. A source country should be limited to taxing income from services performed in the source country. Income from services performed outside the source country should not generally be taxable by the source country. To the extent that services are performed in a country there is a clear nexus between the income from those services and that country which justifies that country's right to tax the income. Moreover, the performance of services in the country will generally require the presence of individuals in the country for that purpose. The presence of those individuals will provide the source country with the opportunity to gather information and enforce its tax. Article 16 (Director's Fees and Remuneration of Top-Level Managerial Officials) and Article 18 (Pensions) constitute exceptions to this general principle. These exceptions are justified because they are limited and represent situations in which it is very difficult to determine where the services are performed or in which the services are performed in different countries.

6.2 Threshold principle

80. A source country should be entitled to tax income from services only if the nonresident service provider is present or works in the source country for a substantial period. Such a threshold facilitates cross-border trade in services by reducing the compliance burden for taxpayers whose presence and activities in the source country are limited. The threshold should be based on a days-of-presence threshold or possibly a combined days-of-presence and days-of-work threshold.

81. An exception to this threshold requirement for entertainment and sports activities is difficult to justify. Other than the amount of revenue that can be earned in a short period by big-name stars, there is no relevant difference between entertainment and sports activities and other services. If a threshold based on days-of-presence or days-of-

work is rejected, a monetary threshold should be added to Article 17. Moreover, Article 17 should be expanded to deal with more types of high-value services.

6.3 Base-erosion principle

82. The base-erosion principle supports source country taxation of income from services derived by nonresidents if the payments for the services are deductible against the tax base of the source country. This principle is the basis for the taxation of employment income by the source country if the employer is a resident of the source country or has a PE or fixed base in the source country. Theoretically, the principle could be applied much more broadly. The broader the application of this principle, however, the more it conflicts with the threshold principle described above. Thus, it is a question of which principle should prevail with respect to particular types of services. Under the existing provisions of the UN Model, the threshold principle is clearly the dominant one since the base-erosion principle applies only to certain employment income, director's fees, and remuneration of top-level managers.

6.4 Enforcement principle

83. In principle, jurisdiction to tax income from services should be allocated to a source country only if the tax can be effectively and efficiently collected. This general principle does not mean that jurisdiction to tax income from services should not be allocated to developing countries that have difficulty taxing income derived from services performed by nonresidents. It means that jurisdiction to tax such income should not be allocated to source countries if, even with efficient tax administration, the tax would be impossible or extremely difficult to collect.

6.5 Net basis taxation principle

84. In general, income should be taxed on a net basis unless the expenses incurred to earn the income are negligible or the nature of the income requires taxation on a gross basis as the only effective means of collecting the tax. Although the principle of net basis taxation is advanced here as a general principle, it is restricted to Article 7 and perhaps Article 14 of the existing provisions of the UN Model. In my opinion, net basis taxation devE3.7 ay op2n7

7. FEES FOR TECHNICAL AND OTHER SIMILAR SERVICES

86. Both the UN Model and the OECD Model make a distinction between business income and investment income. Income from services performed in a country that is taxable under Article 7 or (arguably) 14 is taxable on a net basis; any expenses incurred in earning the income are deductible in computing the amount of income subject to tax. Tax is usually levied on business profits by an assessment process whereby nonresidents file annual tax returns reporting their gross revenues and deductible expenses and tax is assessed on the reported amounts subject to verification and adjustment by the tax authorities. In contrast, the gross amount of investment income, such as dividends, interest, and royalties, derived by nonresidents from sources in a country is subject to a withholding tax that cannot exceed a specified percentage of the gross amount of the payment. The withholding tax is often a final tax that eliminates the need for nonresidents to file tax returns, but also prevents them from deducting relevant expenses and paying tax on net income.

87. This distinction between business and investment income is a fundamental part of the structure of the UN and OECD Models. Both Models provide for business profits derived by nonresidents to be taxed on a net basis and prohibit countries from imposing discriminatory taxation on nonresidents. In contrast, tax treaties usually restrict source country taxation of dividends, interest, and royalties to a fixed percentage of the gross amount of the payment.

88. The distinction between business and investment income is problematic with respect to technical and other similar fees for services. If such fees are paid to a nonresident by a resident of the source country or a nonresident with a PE or fixed base in the source country, the fees will generally be deductible in computing the income of the payer and reduce the source country's tax base. If the nonresident receiving the fees does not have a PE or fixed base in the source country, the amounts will not be taxable by the source country under Article 7 or 14. If the amounts qualify as royalties under Article 12, they would be deductible but would be taxable by the source country at a flat rate (established through bilateral negotiations) on the gross amount of the payment. However, fees for technical and other services are not included in the definition of royalties in Article 12(3) because that definition is limited to payments for the use of, .9(e[()definitio15 TD.

90. This result is difficult to justify where the services provided by the nonresident constitute carrying on a business in the source country. The fundamental scheme of the UN Model is that business profits from services are taxable by a source country only if the nonresident has a PE or fixed base in the source country. Otherwise the profits are taxable exclusively by the residence country. Moreover, if the income derived by a nonresident is qualified as royalties rather than business profits, source country tax is limited to a fixed percentage of the gross amount of the royalty payments. Therefore, allowing unlimited source country taxation of fees for technical services as other income under Article 21 is inappropriate. Earning fees from the performance of technical services typically involves significant expenses. Therefore, any source country tax should be imposed on a net basis or should be limited if imposed on the gross amount of the payments.

91. In principle, business profits should be taxable on a net basis at the applicable rates imposed by the source country. If a nonresident's economic connections with a country do not meet or exceed a minimum threshold, the country should not tax the nonresident's business profits derived from the country. However, there seems to be widespread recognition that source countries should be entitled to tax interest, royalties, and technical fees that constitute business profits even in the absence of a PE. The concern is that the source country should tax these amounts on a net basis. If a nonresident derives interest, royalties, technical fees or other similar amounts that do not form part of the nonresident's business profits, it is appropriate, in my opinion, for the source country to tax the amounts up to a ceiling, as established in Articles 11 and 12 of the UN Model. Source country tax in these situations can be justified by reference to the base erosion principle.

92. This result could be achieved by amending the UN Model in a variety of ways. First, Article 21 could be amended to provide that source country taxation of fees for technical and other similar services performed in the source country cannot exceed 15% (or a percentage established by bilateral negotiations) of the gross amount of the fees. The primary difficulty with this approach is that it would require a definition of technical and other similar services. Second, a new article could be added to the UN Model authorizing the source country taxation of fees derived by a resident of one state from the performance of technical and other similar services in the other state. The source country tax would be limited to 15% (or a percentage established by

14 and the fixed-base requirement should be deleted. Even if those recommendations are accepted, Article 14 should be further revised along the lines of the OECD alternative services provision, with modifications in accordance with other recommendations in this note (for example, the deletion of the same or a connected project requirement).

2) The adoption of a combined threshold based on both days of presence and days of work in the source country for purposes of Articles 5(3)(b), 14(1)(b), and 15(2) should be studied.

3) The adoption of a shorter time threshold (90 or 120 days) for purposes of Articles 5(3)(b), 14(1)(b), and 15(2) should be considered.

4) The same or a connected project requirement should be deleted from Article 5(3)(b).

5) The 6-month time frame threshold for construction and related activities should be changed to 183 days, and possibly be reduced to 90 or 120 days, or left up to bilateral negotiations. The possible deletion of the requirement to treat each project separately should be considered, especially if the same or a connected project requirement in Article 5(3)(b) is deleted. It might be useful to survey the provisions of existing treaties to determine how many treaties already use a threshold of less than 6 months or 183 days for construction and other activities.

6) Several changes to the provisions of Article 17 dealing with entertainment and sports activities should be considered:

   a) Article 17 could be revised to apply only to entertainment and sports activities engaged in by independent individuals or enterprises. As a result, income from such activities derived by employees would be dealt with under Article 15.

   b) The scope of Article 17 could be expanded to include other high-value services.

   c) A monetary threshold could be added to Article 17 in order to exclude from source country taxation taxpayers earning relatively small amounts from entertainment or sports activities performed in the source country.

   d) Article 17 could be revised to require source country taxation on a net basis or, if taxation on a gross basis continues to be allowed, to limit source country tax to a fixed percentage (to be agreed on through bilateral negotiations) of the gross revenue derived from the source country.

7) The provisions of the UN Model or Commentary should be revised to permit source country taxation of income from technical and other similar services provided in the source country, especially if those services are provided by a

nonresident to an associated enterprise in the source country. A first step in the work on this issue might be to canvass the existing provisions of bilateral treaties dealing explicitly with technical services. This