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The “other” tax club more ought to follow, part 2

Johann Müller (International tax professional) · Monday, October 26th, 2015

So what were the other discussions at the UN from 19 to 23 October this year? One of the main topics is the continuing work on a withholding tax on technical services. The reason for developing countries is simple: it is a simple, effective way to protect the local tax base and prevent BEPS through technical service fees.

It is obvious that developing countries are tired of seeing their tax bases eroded through management fees, engineering services, legal services and the like. One can therefore understand the desire to claw back a part of those losses through a withholding tax. However, considering the fact that profit margins on services may sometimes be large, but often very slim (think transfer pricing on low value adding services), one can also understand the concern of business that withholding taxes on gross service fees can easily outstrip profit margins, thus leading to double taxation. A low withholding tax rate will obviously alleviate the chances of double taxation, but it will leave a bad aftertaste for source countries in the case of highly profitable services and in cases where the residence country also gets to tax the high cost base itself. E.g. RCo in R provides engineering services of 100 to SCo in S. RCo employs engineers in R and pays them 90 so RCo’s profit is 10. If S levies 15% withholding tax on the service fees (15), RCo is (100 – 90 – 10) 5 out of pocket. However S’s overall tax base got eroded by 100, whereas R’s aggregate tax base suffered no erosion at all (RCo has a pre-tax base of 10 and the engineers of 90). So S may wonder why it should be limiting its withholding taxes, to prevent double taxation.

Besides being concerned about withholding taxes on services, one also has to bear in mind the interaction of this work with the work on service PE’s under article 5, paragraph 3, letter b, of the UN Model Convention discussed in my previous post, the ongoing work of the UN on royalties for the use of equipment (2 documents) and the view of some UN countries that corporations are covered by article 14 as well. With this many articles, potentially overlapping, the general UN rule may well become: gross withholding tax on services lasting less than 183 aggregated days; and net taxation on services lasting 183 aggregated days or more.

In the end though, it will depend on which of these articles get adopted into actual bilateral treaties and the here the rule is most likely to be: the more extreme the article, the less likely it is to ever see any incorporation.

An interesting side discussion arose with regard to services in the offshore sector. The discussion covered the scope of the convention with regard to the geographic area covered and article 7. Imagine oil company R in state R extracting oil on the continental shelf of state S, but outside state S's territorial waters (> 12 nautical miles from the coast) (see here for a definition of terms).

If I understand the discussion correctly, there are basically two schools of thought. Under the first, only the source country can tax if there is a treaty which defines the geographic scope of the source country as only including its territorial waters (but not the continental shelf); the underlying thought being that what falls outside the geographic scope of article 3 falls outside the treaty (including article 7). Further, off course no country would dream of giving taxing rights on its minerals away (and any treaty partner arguing the contrary, cannot do so in good faith – pacta sunt servanda).

The second school of thought runs as follows.

1. Is there a tax treaty between S and R?
    1. If not, then one would assume that both states can tax, but it would be up to State R to provide double tax relief under its national law.
2. If there is a treaty, does it contain a definition of the geographic reach of state S?
    1. If not, then article 7 applies and only state R can tax, unless Company R has a PE in state S under the treaty.
    2. If there is a geographic definition which covers state S including its territorial waters only, then article 7 applies and only state R can tax, even if Company R fulfils the remaining PE definition under the treaty on the continental shelf outside the territorial waters. I.e. article 7 is not limited by the application of article 3.
    3. If there is a geographic definition which covers state S including the continental shelf, then article 7 applies and only state R can tax, unless Company R has a PE in state S under the treaty.

So, under 2.b, state S cannot tax company R, if state S is only defined to include its territorial waters, even if company R has a fixed place of business outside of state S's territorial waters, but on top of its continental shelf. This is because RCo is an enterprise of state R under article 7, paragraph 1 ("enterprise of a contracting state"); article 3 paragraph 1, letter c ("enterprise of a contracting state") and article 4 ("enterprise carried on by a resident of state R"). Article 1 defines the scope of the convention: it applies to all residents, regardless of whether they are inside or outside the geographic scope of the "other contracting state" of the convention: it is not limited by the geographic definition of the other state in article 3. So – some would say perversely – the limitations put on the geographic area under article 3 do limit the taxing rights of the source state to PE's within its territorial waters only and gives exclusive taxing rights to PE's on the continental shelf outside those territorial waters.

Obviously such a line of thinking would make any country which forgot to put a continental shelf clause into a treaty very nervous and the Committee of Experts will work on a wording preventing the effect of the second line of thinking being applied to old treaties, if possible.

Regardless of which stream of thought is the right one, it is refreshing to see the UN so strongly upholding the guardian function of article 7, as I defended in a previous blog. One can only wish that the OECD has done more of this in the BEPS action plan as well. It will be a grave mistake to erode this function.

A last blog of mine on this meeting will be published later this week, together with the impressions of a few participants.

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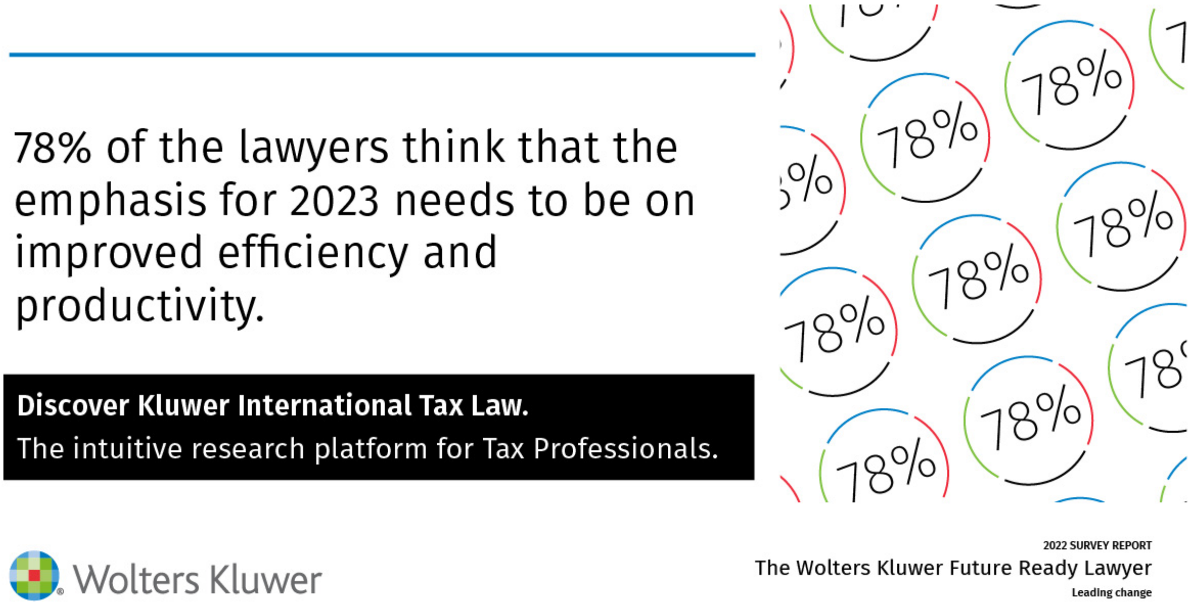

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