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TAXATION OF CROSS-BORDER TRADE IN SERVICE: A REVIEW OF THE CURRENT INTERNATIONAL TAX LANDSCAPE AND THE POSSIBLE FUTURE POLICY OPTIONS

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1. Introduction

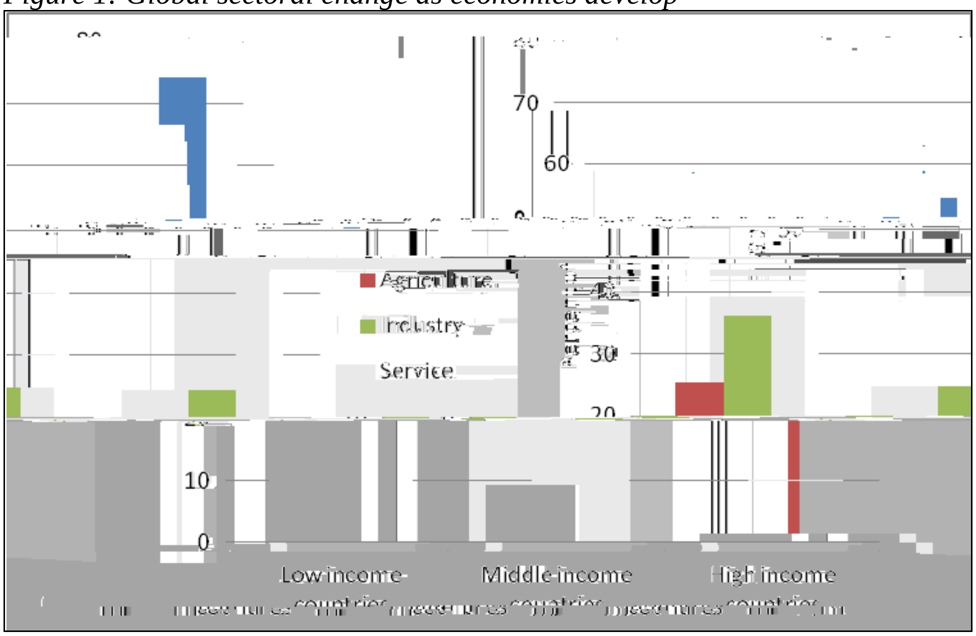
The service sector currently accounts for approximately 70% of the world's Gross Domestic Product ("GDP").[1] Following the development of today's highly integrated and globalised economy, growth in the cross-border trade in services now exceeds growth in the cross-border trade in goods.[2] Given the magnitude of the global trade in services it is imperative that tax authorities ensure that income from trade in services is taxed efficiently, effectively and equitably.

The aim of this report is to review the curren

2. Importance of the service industry

The service industry is a major component of today's global economy. As we see income per capita rising, the agricultural sector typically loses its importance, giving way first to a rise in the manufacturing industry then finally a rise in the service industry. These two shifts are commonly referred to as industrialization and post-industrialization. Once these incomes continue to increase, people's needs become less material and they begin to demand further services for example in health, education and entertainment.[4] As shown in Figure 1 below, high income countries can attribute the lion's share of their GDP to the service sector with only a very small portion from the Agricultural sector.

Figure 1: Global sectoral change as economies develop

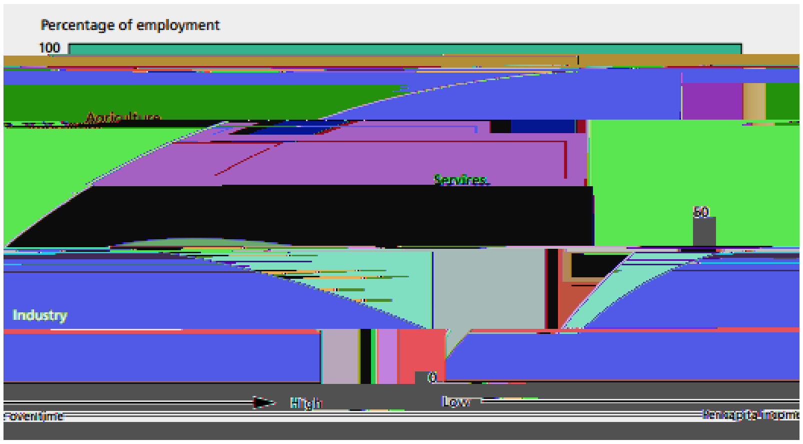


Source: Compiled by the author with data from the World Bank, *Data p2i(m)11.r*

Figure 4: Growth in the global service sector in Developed Countries

The shift towards the service sector also creates a shift in how labour is deployed across the economy. As the service sector require less mechanisation, employment in the service sector continues to grow while employment in agriculture and industry declines as technology continues to improve which in turn increases labor productivity (Figure 6). Eventually the service sector replaces the industrial sector as the dominant sector of the economy.[5]

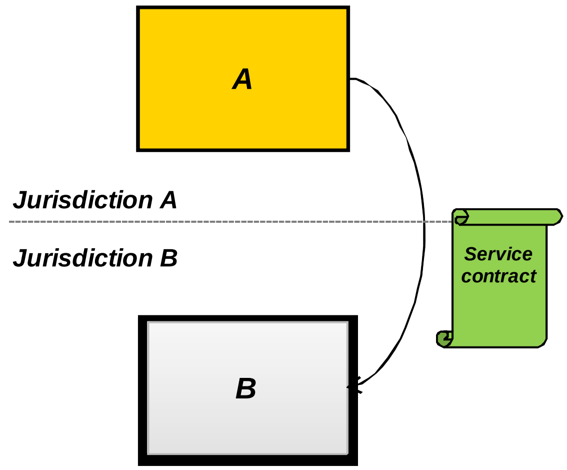
Figure 6: Changing structure of employment by sector



Source: Tatyana P. Soubbotina and Katherine A. Sheram, *Beyond Economic Growth: Meeting the Challenges of Global Development*, The World Bank, 2000 at page 51.

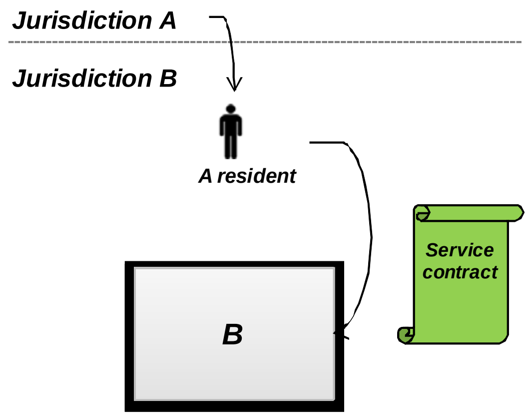
5 SOUBBOTINA, Tatyana, P., and SHERAM, Katherine, A., "Beyond Economic Growth: Meeting the Challenges of Global Development", The World Bank, 2000 at page 51

3.1.1. Mode 1 – Cross-border supply: A provides services to B



In Mode 1 only the service crosses the border. The delivery of the service can take place, for example, through telecommunications (telephone, fax, television, Internet, etc.), or the sending of documents, disks, tapes, etc.[7]

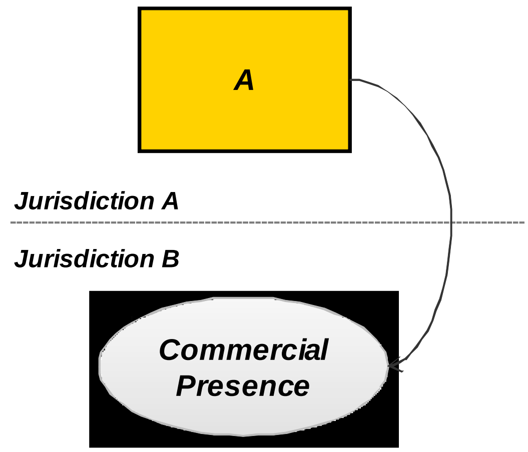
3.1.2. Mode 2 – Consumption abroad: B provides services to A resident in jurisdiction B



In Mode 2 an individual consumer has moved temporarily into the foreign State where the service provision is made, and that individual is a resident of the home State. For example, medical treatment and language courses taken abroad are being provided services under this mode of supply.[8]

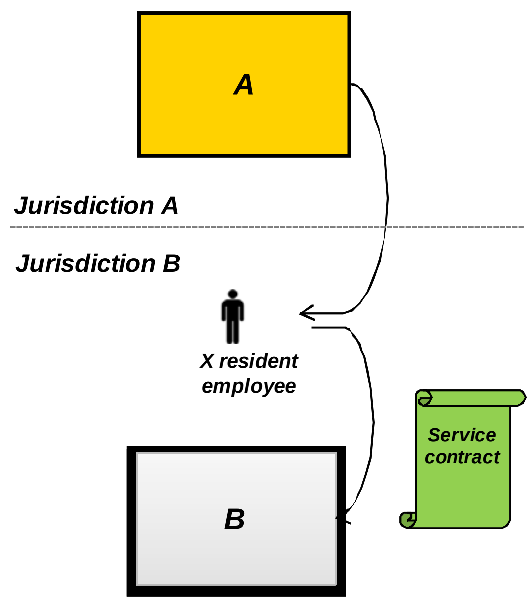
[7] Ibid.
[8] Ibid.

3.1.3. Mode 3 – Commercial presence: A provides services to B



In Mode 3 the service supplier establishes its commercial presence in another country, for example, through a branch or subsidiary. For example, banking services supplied by a subsidiary of a foreign bank.[9]

3.1.4. Mode 4 - Presence of natural persons: A provides services to B



4. Review of the current tax landscape

4.1. International tax agreements

The purpose of a tax treaty is to strengthen the ability of jurisdictions to impose taxes fairly and effectively on taxpayers engaged in cross-border trade and investment (and, thus, to facilitate cross-border trade and investment).[12]

There are various Articles that deal with the taxation of services income. For example, under Article 7 (the Business Profits Article) where a foreign taxpayer is resident in a State which has a tax treaty with the other State in which services are being performed, such taxpayer will generally only be taxable under the Business Profits Article where it is taken to have a permanent establishment (“PE”) in that other State, or under a royalty Article where relevant. Where taxation is possible under more than one Article of a treaty the more specific will generally apply.

4.2.2. Permanent establishment Article

The UN Model Convention has a definition of PE to strengthen source State taxation, which is generally in the interest of developing nations. For example, a PE within that model tax treaty is defined to include independent agents in some circumstances, as well as the performance of services that last longer than 183 days:

> Article 3. The term "permanent establishment" also encompasses:
>
> "… (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned."

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.[13]

Historical reports of the UN's Ad Hoc Group of

a) through an individual who is present in that other State for a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50

4.4. *Multilateral tax treaties - Andean Pact and potential OECD action*

4.4.1. Background

The Andean Pact is a multilateral tax agreement between Colombia, Bolivia, Ecuador and Peru signed in 1971 and updated in 2005.

The genesis of the Andean Pact was in the formation of the Latin American Free Trade Association (LAFTA). In 1959, the Secretariat of the Economic Commission for Latin America had stated that "there are grounds for asserting that a common market could be established, within which development would be more rapid than if the market were not organized, not only in Latin America as a whole, but in each of the individual countries of the region."[17]

The Treaty of Montevideo was signed by Argentina, Brazil, Chile, Mexico, Paraguay, Peru and Uruguay in 1960, establishing LAFTA. They were soon joined by Bolivia, Colombia, Ecuador and Venezuela. The countries were classified according to their level of economic development and less developed countries were given preferential treatment to promote development. However, this classification failed to recognise the presence of an intermediate level of medium level developed countries which were distinct from the lesser developed countries and the three more developed countries, Argentina, Brazil and Mexico. It was this failure coupled with the slow progress in LAFTA which led the medium level developed countries and two of the lesser developed countries (Bolivia and Ecuador) to form the Andean Pact.[18]

4.4.2. Source taxation approach

The Agreement is different to the OECD or UN

finances and conduct their affairs without being constrained by geography or national boundaries.
The modern global economy differs from the environment within which many of our traditional sourcing rules were developed in many respects[26]:

- A substantial amount of international trade consists of services and intangible products.
- A physical presence may no longer be required for the conduct of business.
- Intangible assets are of vital economic importance.
- Communications are instantaneous.
- Capital is highly mobile internationally.
- People are highly mobile.

Under these conditions, in many cases a fixed place of business is not required to carry out substantial business activity. In particular, businesses in the service sector do not have to incorporate a subsidiary or open a branch to service customers in another country; they can simply send employees to work temporarily at the client's site in that country. Further, contracts can be structured to minimize the risk of creating a fixed place of business by ensuring that the business has limited control over the client's premises. For example, contracts can specify that agents or employees of the business do not have a general right of access to the client's premises (for instance, by requiring special identification tags and authorizations) and that the client has the ultimate discretion in terms of providing space (instead of contractually providing dedicated space). Steps can also be taken to ensure that the client's premises are not identified as a place of business of the non-resident.

The issue of how States should respond to the global service-based economy then arises. As services are able to be provided absent the physical presence of the service provider, a situation akin to that of the importing and exporting of tangible and intangible goods appears to result. As such, any modifications to the way in which the modern service industry is brought to tax should be consistent with more traditional approaches taken to the taxation of mobile goods (i.e. through a focus on commercial activity rather than attempting to price market access).

[26] MCLURE, Charles E. Jr., "Globalization, Tax Rules and National Sovereignty" (2001) vol. 55, no. 8 Bulletin for International Fiscal Documentation 328-41, at page 334 referred to in REID, Marsha, "The New Services PE Provision of the Canada -US Tax Treaty", (2010) vol. 58, no 4, 845 – 96 Canadian Tax Journal at pages 858-9

5. Alternatives / options

We have set out below a discussion of various alternatives which may support existing tax

1. Local Manufacturer – A company manufactures products, which are then on-sold and delivered to local customers. The key contracts, decisions, and risks are held offshore. Through the use of transfer pricing the majority of the income generated through the sale transaction may be booked offshore with only a small margin taxable in the source country.
2. Banking services – An offshore private equity group or investment bank sends its employees to a local country for less than 6 months at a time (i.e. not sufficient to give rise to a service PE under applicable tax treaty) to advise a local third party corporation on a financial transaction (e.g. IPO or M&A activity). In return for these services the private equity group or investment bank receives a service fee which is taxable in the offshore jurisdiction and not subject to tax in the local country.
3. E-commerce business – A company manufactures products offshore, which are then subsequently sold and delivered to local customers by a non-resident entity which does not have a PE in China through an offshore e-commerce platform (such as an online store). The sale transaction is booked entirely offshore and not subject to tax in the local country.

In each of these examples the foreign corporation would have a local subsidiary with employees to support its foreign operations.

5.1.2 Mixed service supplies

- Issuing qualifying guidance that includes approaches similar to the United States 50/50 method, under which one half of the gross income from the sale of goods is considered to be attributable to production activity services in the foreign State and one half is considered to be attributable to sales activity services in the source State.[30]

Adopting an interpretation similar to the 50/50 method may change the way in which the local manufacturer taxpayer at 5.1.3.4 (above) would

5.2 Possible changes to the UN Model Tax Convention

5.2.1 Thresholds changes

- Reduction of the time thresholds in Article 5 (3) (b) and in Article 14 (1) (b) to less than the current 183 days. The new threshold would apply either to all services or solely to technical services.[31]

This approach can be relevant for developing countries as it expands taxing rights over income from business and technical services as for other types of services. However, it will be necessary to define the scope of the income that wio all services or

5.2.3 *Revision of Royalty Article*

- Revision of Article 12 to include technical services related or connected to the transfer of intellectual property. The change could also be included only in the commentary to Article 12 as an alternative provision.[36]

This option would not deal with the issue of technical services specifically; consequently, the provision of Article 12 would be more complex and difficult to understand and implement, as its scope would become wider.[37]

5.2.4 *New Technical Services Article*

- Adding a new article and commentary dealing with income from technical services. While pointing out that some bilateral treaties include such a provision, Professor Arnold raised a number of questions that may need to be answered before going forward with this option: what are the conditions for source country tax; how is the source country going to tax (gross or net basis); and how technical services are defined. It may also be possible to include such provisions in the commentary as an alternative, which is being done by OECD for the provision of technical services related to PE.[38]

This option has the advantage of being more relevant and appropriate. It points out clearly the position of the UN Model Tax Convention. The commentary which goes with the new article relatively simple for non-resident service providers to avoid falling under this aspect of the definition by simply moving from place to place in the source country before the six-month time-threshold is reached.

At the fifth session of the United Nations Committee of Experts on International Cooperation in Tax Matters (the Committee), in 2009, the Subcommittee on Services was established. The Committee's mandate is set out in the following terms:

> "The Subcommittee is mandated to address the issue of the taxation treatment of services in general in a broad way includi

to source-country taxation under Article 7 or Article 14 only if a high threshold in terms of the non-resident's connections to the source country is met (PE, fixed base or a substantial amount of time working or staying in the source country).

The Committee may opt to employ a new article considered to be inappropriately taxed under the current regime, would be limited to the extent that Contracting States do not have domestic taxing rights. For example, without the appropriate mechanisms in place, such as withholding taxes on services income, amounts that are not ordinarily taxable domestically should not become so through the introduction of a new services article.

6. Summary / conclusions

The current international taxation rules on services appear to suffer the following deficiencies:

- Difficulty in identifying and substantiating the nexus between commercial activity and the creation of a taxable presence (i.e. a PE) in the source State. This is particularly evident where certain operations, such as source State support functions, are able to be quarantined within subsidiary entities such as corporate subsidiaries; and
- The ability for foreign enterprises to manipulate generous service PE time thresholds through careful control over personnel movement.

The Committee should remain cautious to ensure that any changes to its approach in respect of taxing services income do not lead to inequitable distortions between the taxation treatment of trade in services and trade in goods. This is particularly true should the Committee consider the inclusion of a new article in the UN Model Tax Convention.

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