# Class #9 (March 5). Income from Services

Please read and consider:

1. Articles 15-20 of the OECD Model Treaty and 14-20 of the UN Model Treaty and the U.S. Model Treaty. Refer to the Commentary (or Technical Explanation) to these model treaties as needed in answering the questions below.

2. McIntyre, *Employment and Personal Services Income* (attached).

3. Article 5, Para. 9, U.S.-Canada Tax Treaty (attached).

4. Treasury Department, *Technical Explanation of Article 5, Para. 9, U.S.-Canada Tax Treaty* (attached).

5. The following Notes and Questions.

## Notes and Questions

1. The OECD Model Treaty limits the right of the source country to tax income derived from the performance of personal services in the country by residents of the other country. These limitations on source jurisdiction are contained in Articles 15-20. In addition, the taxation of business income from the performance of professional services is limited by Articles 5 (PE) and 7 (Attribution of Income to a PE). The UN Model Treaty addresses the issue of professional services in Article 14, which the OECD deleted from its model in 2000. The particular rules limiting source jurisdiction in the model treaties vary, depending on the nature of the services performed, the identity of the payer, and the nature of the compensation (salary or pension). In general, the limitations are intended to simplify administration and to facilitate international commerce without causing either of the contracting states to forgo a disproportionate amount of tax revenue.

2. Article 14 of the UN Model Treaty and former Article 14 of the OECD Model Treaty exempt professionals and other independent contractors who are resident in one contracting state from taxation on income derived from the performance of personal services in the other contracting state unless they perform these services through a "fixed base" located in the latter state. In effect, Article 14 extends to professionals the same type of exemption that is afforded under Article 7 to residents of a contracting state who earn business profits in the other contracting state but do not have a permanent establishment there. As under Article 7, only the profits of the professional that are properly attributable to the fixed base are taxable in the source state. Individuals entitled to the exemption provided by Article 14 may be subject to withholding in the source country. In such circumstances, they must assert their treaty rights by making a claim for refund of the taxes withheld. The OECD Model Treaty now treats professionals under Article 5 and 7.

3. The new U.S.-Canada treaty amends Article 5 by adding a new paragraph 9 to provide for a replacement within that article for Article 14. Is that new rule effective? What difference does it make from having the old Article 14? Do the exceptions for preliminary and auxiliary activities apply to paragraph 9?

*Professional Services*

4. L is a lawyer who resides and generally works in Country X. L has a client, YCo, that engages in business in both Country X and Country Y. YCo has a contract dispute in Country Y that involves the laws of Country X. L is asked to consult with YCo's lawyer in Country Y with respect to the dispute. L travels to Country Y, where he remains for three weeks. He stays at a hotel and works out of the law office of YCo's lawyer. Country X and Country Y have entered into a tax treaty based on the UN Model Treaty. Under the law of Country Y, L is taxable on the fee he receives for the legal services performed in Country Y. Is L protected from taxation in Country Y by the tax treaty?

5. K is a professional ice skater who resides in Country A. She travels to Country B to perform in an ice show at a large arena, for which she is paid 40,000. K remains in Country B for three days and has no other contacts with Country B during the year. Country A and Country B have entered into a tax treaty based on the UN Model Treaty. Can K claim an exemption from tax in Country B under Article 14 (Independent Personal Services) of the treaty?

6. T is a resident of Country D. She is a partner in ABC, an international accounting firm. One of ABC's clients, DCo, has its headquarters in Country D and has a branch office in Country E. ABC has offices in Country D and Country E. T travels to Country E to consult with the staff at ABC's branch office in that country. She spends two weeks in Country E. During that period, she spends most of her time at DCo's branch office. She also makes use of an office maintained by ABC in Country E. T is taxable in Country E under its domestic tax laws. Country D and Country E have an income tax treaty based on the UN Model Treaty. Is T protected from taxation in Country E under the treaty?

7. G is an architect who is resident in Country G and has his office in Country G. G is awarded a contract by MCo to design a building to be constructed in Country M, which is contiguous to Country G. G prepares the plans in his office in Country G and sends the plans electronically to MCo. Employees of MCo deal extensively with G by telephone. They frequently work interactively with G by computer through a hookup over the telephone lines. G occasionally sends blueprints electronically to MCo through a satellite link. G is not physically present in Country M for any part of the taxable year. Under the domestic tax laws of Country M, MCo is required to withhold 20 percent of the fee payable to G as a tax. Country G and Country M have entered into a tax treaty based on the UN Model Treaty. As a result of that treaty, is G entitled to a refund of the tax withheld?

8. H is a resident of Country A and has a vacation home in Country B. He is a skilled heart surgeon. While on vacation in Country B, H is asked to perform an emergency operation on a local resident who is suffering from a defective heart. H performs the surgery at the local hospital and is paid a fee of 10,000 under the patient's medical insurance program. Country A and Country B have entered into a tax treaty based on the UN Model Treaty. Is H protected from taxation in Country B under that treaty?

*Employees*

9. An employee who is resident of a contracting state and performs services for his employer in the other contracting state is exempt from tax in the source state under Article 15 of the OECD Model Treaty if the employee has been present in the source state for no more than 183 days in any 12-month period; the employer paying the remuneration is not a resident of the source state; and the remuneration is not borne by the employer's PE or fixed base in the source state. Note that the exemption is unlimited as to amount. Thus, an employee making a very large salary in the source state may be exempt under Article 15.

10. E is an employee of ACo, a publishing company. ACo is a resident of Country A and has its headquarters there. E resides in Country B and works out of his home. E receives book manuscripts from ACo, edits them, and returns them to ACo, typically in electronic form, by modem or common carrier. He converses extensively with ACo employees by telephone and sends and receives documents by modem between his home in Country B and ACo's headquarters in Country A. E does not travel to Country A as part of his employment. ACo deducts the salary paid to E in computing its income taxable in Country A. In accordance with the domestic tax laws of Country A, ACo withholds 20 percent of the salary payments made to E. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. Is E exempt from tax in Country A and entitled to a refund of the taxes withheld?

11. F is an employee of XCo. Both F and XCo are resident in Country X. XCo has an office in Country Y at which F works. F commutes each day across the border and back to his home in Country X. He is paid a salary of 50,000 by XCo. He also receives the free use of an automobile, which he uses to commute between Country X and Country Y. Country Y imposes income tax on F with respect to the salary and the use of the automobile, which its tax officials value at 6,000. Country X and Country Y have entered into a tax treaty based on the OECD Model Treaty. Is F protected from taxation in Country Y on the salary income or the fringe benefit under the treaty?

12. Q is a resident of Country A and an employee of ACo, which has its headquarters in Country A and a branch office in Country B. Typically, Q works at ACo's headquarters, but on occasion he travels to Country B to assist the branch office. During the first four months of the current taxable year, Q was assigned to ACo's branch office in Country B. In the prior year, Q did not visit Country B at all. ACo pays Q 150,000 for his work in Country B. This amount is charged to headquarters as an expense and is not deducted by ACo in computing the income of its PE in Country B. Under the domestic tax law of Country B, Q is subject to tax on the income earned in Country B. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. Is Q entitled to any relief under the tax treaty?

13. XCo is a resident of Country X. It has a wholly-owned subsidiary, YCo, that is resident in Country Y. XCo sends E, its employee, to provide some technical assistance to YCo. It charges YCo a fee of 50,000 for the services, which is an appropriate arm's length price. E is a salaried employee, who earns 100,000 per year. He spends 90 days in Country Y providing assistance to YCo. Under the domestic tax law of Country Y, E is taxable on 25,000 of his salary. Country X and Country Y have entered into a tax treaty based on the OECD Model Treaty. Is E entitled to any relief under the tax treaty?

*Directors*

14. The limitations on source jurisdiction in Articles 14 and 15 of the OECD and UN treaties do not apply to directors' fees. Under Article 16 of those treaties, directors' fees are fully taxable in the state where the company paying the fees is resident. Paragraph 1 of the OECD Commentary suggests that the purpose of the provision is to avoid the practical problems of determining the place where the services of a director are performed. The UN Model Treaty also allows the source state to tax remuneration paid to "an official in a top-level managerial position".

15. SCo is the wholly-owned subsidiary of PCo. PCo is resident in Country A and SCo is resident in Country B. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. D is an employee of PCo and a member of the board of directors of SCo. SCo and PCo both conduct the annual meetings of their boards of directors in Country H, a tax haven country, during the first week of February, when the weather in County A and Country B is typically cold and unpleasant and the weather in Country H is balmy. D is paid 10,000 by SCo as a director's fee for participation in the February meeting. Under the domestic tax laws of Country B, D is taxable on the payment. Can D obtain relief under the tax treaty?

16. D and E are individuals who are residents of Country A. They are the owners of SP, an entity formed under the laws of Country B. SP is a "limited liability company" which is treated as a partnership under the domestic tax laws of both Country A and Country B. D is referred to in the charter of SP as a "director" of SP, and he performs the supervisory functions usually associated with the director of a corporation. Under the domestic tax laws of Country A and Country B, however, D is characterized as the managing partner of SP. D is paid a fee of 10,000 by SP, which SP characterizes as a director's fee. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. D claims that the payment of 10,000 is a fee for professional services within the meaning of Article 14 of the treaty. Country B claims that it is a director's fee within the meaning of Article 16 of the treaty. How should the amount be treated?

*Artists and Sportsmen*

17. Article 17 of the OECD and UN Model Tax Treaties provide that artistes and sportsmen are not entitled to the exemption from source jurisdiction that is provided to certain individuals performing services in the source state under Articles 14 and 15. This less favorable treatment of artistes and sportsmen probably reflects the unwillingness of the source state to forgo taxation of the very large payments that artistes and sportsmen sometimes receive from making a brief appearance in the source state. In addition, source states probably feel quite confident that most artistes and sportsmen will continue to perform in their country notwithstanding the prospect of taxation.

In some cases, the fees received by a foreign artiste or sportsman may be insufficient to justify the imposition of tax in the source country. To avoid creating a tax barrier to cultural and athletic exchanges, some countries allow artistes and sportsman earning moderate fees to qualify for an exemption under both Articles 14 and 17. The tax treaty between Canada and the United States, for example, provides that Article 17 does not apply if the total remuneration received, directly or indirectly, by the artiste or sportsman is less than 15,000 dollars (Canadian or American, as the case may be).

On April 23, 2010, the OECD issued a discussion draft of proposed changes in the Commentary under Article 17. The Commentary, as revised, would make, *inter alia*, the following points:

- Article 17 can apply to an amateur who wins a monetary sports prize or a person who is not an actor but who gets a fee for a once-in-a-lifetime appearance in a television commercial or movie.
- The activities of an entertainer or sportsman do not include only the appearance in an entertainment or sports event in a given State but also, for example, advertising or interviews in that State that are directly or indirectly related to such an appearance.

See OECD, DISCUSSION DRAFT ON THE APPLICATION OF ARTICLE 17 (ARTISTES AND SPORTSMEN) OF THE OECD MODEL TAX CONVENTION (2010).

18. Is a chess player resident in one contracting state, who earns prize money from a tournament in the other state, covered by Article 14 or Article 17?

19. N is a movie actor and a resident of Country A. GMG Studios is a company that makes movies and is also a resident of Country A. It hires N to star in a movie it is making. Some portion of the movie is shot in Country B. The remaining portion of the movie is shot at GMG's studio in Country A. To make the movie, N spends six weeks in Country B. He is paid a total salary of 1 million by GMG studios. Country B determines that 300,000 of the fee relates to services performed by N in Country B. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. Is N entitled to protection from tax under Article 14 of the treaty or is taxation of the payment to N governed by Article 17?

20. B is a world-renowned orchestra conductor and a resident of Country B. He is hired by CCo, a resident of Country C, to conduct the National Orchestra in Country C. B is paid 100,000 for his services. In addition, he is promised a royalty of 5 percent of the gross sales from the compact disc (CD) made from the performance. The CD is sold in Country C and throughout the world. Under the domestic laws of Country C, B is subject to tax on the 100,000 fee and on the portion of the royalty that relates to sales of the CD in Country C. Country C and Country B have entered into a tax treaty based on the OECD Model Treaty. B claims that he has provided professional services and is exempt from tax on the 100,000 fee. He also claims that the royalty payments from CD sales in Country C are taxable only by Country B. Country C claims that all of the amounts constitute income derived by an entertainer within the meaning of Article 17 and are fully taxable by Country C under the treaty. Who should win?

21. X is rock music star and a resident of Country X. He enters into a contract with BCo, a resident of Country B, to perform a concert at a football stadium in Country B. He is to receive a 200,000 nonrefundable down payment and 60 percent of ticket sales. The 200,000 payment is made and X reserves time in his schedule for the concert. Ticket sales, however, are slow, and BCo decides to cancel the performance. BCo withheld tax of 40,000 on the payment to X in accordance with the domestic tax laws of Country B. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. X claims that the payment is exempt from tax because it is a payment for professional services within the meaning of Article 14, and he has no fixed base in Country B. Country B claims that the payment relates to an artistic performance within the meaning of Article 17 and is not protected by the treaty. Who should win?

22. A is a highly-ranked boxer and a resident of Country A. B is the world champion and a resident of Country B. The managers for both fighters arrange for a title match, to be held in Country B. A has established a personal services company, ACo, that is resident in Country A. ACo enters into a contract to supply A as an opponent in the boxing match in exchange for 30 percent of the gross revenue from ticket sales and television receipts. ACo and A enter into an employment contract under which ACo agrees to pay A a salary of 1 million and A agrees to participate in the boxing match on behalf of ACo. The fight takes place, and ACo receives 15 million. In accordance with its arrangement with A, ACo pays 1 million to A. Country B imposes a withholding tax on the payments to ACo of 20 percent, in accordance with its domestic tax laws. It also notifies A that he is subject to tax on the 15 million. Under the domestic tax laws of Country B, the tax authorities may look through a personal service company and tax the shareholder when the personal service company has been established for the primary purpose of avoiding tax.

Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. A concedes that he is taxable on the 1 million paid to him by ACo but denies that he is taxable on any additional amount because he only earned 1 million in income in Country B. ACo claims to be exempt from tax in Country B under Article 7 (Business Profits) of the treaty because it does not have a PE in Country B. What result?

*Pensions*

23. Article 18 (Pensions) of the OECD and UN Model Treaties generally provide that pensions paid to a resident of a contracting state are to be taxed only in that state, even if some or all of the services performed by the recipient of the pension were carried out in the other contracting state. This rule simplifies the taxation of pensions that are payable as the result of services performed in many countries over several years. In such circumstances, it would often be impossible to accurately determine what portion of a pension was due to the performance of services in a particular country. It would also be difficult to collect the tax due if the pension was paid by a nonresident company.

The residence-only rule has not achieved full support from OECD member countries. One reason is that the rule is inconsistent with the general rule applicable to income from services, which typically gives substantial rights of taxation to the source country. In the typical case, a pension is additional compensation for personal services. In principle, therefore, it should be taxable in the country where the services were performed. Another reason for objection to the residence-only rule is that it may foster international tax avoidance, especially when the residence state exempts its residents from tax on their foreign source income.

Many governments have wanted to reserve the power to tax pensions that are paid to their former employees. Article 19 (Government Service) generally provides that the residence-only rule is not applicable to pensions paid by a contracting state as a result of services performed on its behalf unless the recipient of the pension is both a resident and a national of the other contracting state. Under this rule, a former government servant of a contracting state who retires to a country having a tax treaty with that state would not be exempt from source taxation unless he became a citizen of the state in which he resides.

In addition, many governments want to reserve the right to tax pensions that they pay to nonresidents under a general welfare or social security program. Taxing such pensions is not difficult administratively, and it does not create the problems for multinational companies that are associated with source taxation of private pensions. Paragraph 2 of the OECD Commentary to Article 18 suggests that contracting states might adopt explicit treaty language to clarify that states are free to tax payments made under social security legislation. The OECD Commentary (paragraph 8) also notes with apparent approval that many countries have entered into bilateral social security ("totalization") agreements that avoid double taxation of social security pensions.

As an alternative to source taxation of pensions, the source state might tax nonresident employees on the amounts contributed to a pension fund on their behalf. Taxation of these amounts might be achieved directly, or it might be achieved indirectly by denying employers a deduction for their contributions to employee pension funds. According to the Commentary to Article 18, taxation of pension contributions could interfere significantly with the normal operations of multinational companies, making it more difficult for them to recruit employees to work abroad. The OECD has not been successful, however, in achieving a consensus on the proper treatment of pension contributions. The Commentary (paragraph 11) has suggested language that might be included in bilateral treaties that would provide, in general, that nonresident employees making contributions to a pension fund would obtain the same tax benefits typically provided to resident employees in comparable circumstances. This effort by the OECD is clearly a work in progress.

24. After working in Country A for ACo for 20 years, B retires from ACo and becomes a resident of Country B. ACo is resident in Country A. During the time he worked in Country A, B was a resident of Country A and paid income taxes to Country A. B receives a pension of 1,000 per month from ACo. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. Is B taxable by Country A on the pension he receives from ACo?

25. F, a resident of Country F, worked for FCo, also a resident of Country F, for over 25 years. During that period, FCo frequently sent F to Country G to work out of FCo's permanent establishment there. F was taxable in Country G for the portion of his remuneration charged to the books of FCo's permanent establishment in Country G. F retires and receives a pension of 2,000 per month from FCo. About 30 percent of the pension relates to work that F performed for FCo in Country G. Country F and Country G have entered into a tax treaty based on the OECD Model. Is Country G entitled to impose tax on any portion of the pension payments that F receives from FCo?

26. In general, governments are reluctant to give up by treaty the right to tax their own employees. Article 18 (Pensions) and Article 19 (Government Service) generally reserve the right to the payer government to tax amounts paid as remuneration for services performed for the government, including pension payments made for prior services. However, if the services are rendered in the other country by an individual who is both a resident and citizen of that country, only that country is entitled to tax the income.

27. X is employed by Country X in its embassy in Country Y. She is paid an annual salary by Country X of 20,000. X is a longtime resident and citizen of Country Y. Country X imposes an income tax on X with respect to her wages of 20,000. Is X entitled to claim protection under the tax treaty between Country X and Country Y, which is based on the OECD Model Treaty?

28. X is a citizen and resident of Country X. He works in Country A's embassy, which is located in Country C, a country contiguous to Country X. Country A imposes an income tax on the salary that its embassy pays to X. Country A and Country X have entered into a tax treaty based on the OECD Model Treaty. Is X taxable in Country A?

29. Country A provides tax relief to its residents by granting them a credit for foreign income taxes paid to its treaty partners. A is a resident and citizen of Country A who is employed by Country B's tax department as a computer specialist. The tax rate in Country B is lower than the tax rate in Country A. Country B imposes tax on A. Country A also imposes tax on A, but grants A a credit for the taxes paid to Country B. Country A and Country B have entered into a tax treaty based on the OECD Model Treaty. Is A taxable by Country A?

*Students*

30. Article 20 of the OECD and UN Model Treaties provides that a student who is resident in a contracting state and travels to the other contracting state in pursuit of his or her studies is not taxable on the amounts received to support these studies. The exemption from source country tax extends to amounts received for tuition fees and maintenance. In many cases, this exemption may result in the student's receiving the amounts tax-free if the amounts are not taxable under the domestic tax laws of the country where the student formerly lived. Indeed, the exemption continues to apply even if the student gives up residence in that country. Business apprentices may also qualify for the special treatment.

31. X is a resident of Country X. He moves to Country Y to undertake graduate studies in chemistry at a university located in Country Y. X subsequently becomes a resident of Country Y. X receives financial assistance from the university, including a waiver of tuition fees and a stipend to pay for his room and board in return for assisting the teaching staff of the university in conducting its laboratory courses. Under the domestic tax laws of Country Y, X is taxable on the financial assistance received from the university. He claims that he is exempt from tax under Article 20 of the tax treaty between Country X and Country Y, which is based on the UN Model Treaty. Country Y claims that X is not entitled to treaty benefits because he is not a resident of Country X and the payments received were for services performed in Country Y. Who should win?

32. ABC is an international accounting firm headquartered in Country X. It sends some of its new employees to Country Y to work for six months in its branch office in Country Y. The purpose of sending the employees to Country Y is for them to obtain training and experience in the accounting practices of Country Y. The employees are paid their normal salaries, which is enough for them to live in a comfortable style in Country Y. Country Y imposes tax on the employees under its domestic tax laws on the portion of their salaries paid for services conducted within Country Y. Are the employees taxable in Country Y?

# Employment and Personal Services Income

Michael J. McIntyre (2004, revised 2007)

All U.S. income tax treaties limit the right of the source country to tax income derived from the performance of personal services in the country by residents of the other country. These limitations on source jurisdiction are contained in Articles 14–20 of the U.S. Model Treaty (2006). The particular rules limiting source jurisdiction vary, depending on the nature of the services performed, the identity of the payer, and the nature of the compensation. In general, the limitations are intended to simplify administration and to facilitate international commerce without causing either of the Contracting States to forgo a disproportionate amount of tax revenue. In the absence of treaty protection, a person performing personal services in the United States generally would be taxable under the rules applicable to income effectively connected with a U.S. trade or business, although some exemptions are also available under the Code.

Section 1, below, describes the limited exemption for individuals who are resident of one Contracting State and work in the other Contracting State as an employee. Section 2 addresses the limited exemption for independent contractors. Section 3 addresses issues relating to government employees, entertainers, students, and several other categories of individuals. The treatment of individuals receiving pensions is addressed in section 4.

## 1. Income from Employment

Under Article 14 (formerly Article 15) of the U.S. Model Treaty (2006), an employee who is a resident of a Contracting State and performs services for his employer in the other Contracting State generally is exempt from tax in the source state for a taxable year if three tests are met.

- *First*, the employee must have been present in the source state for no more than 183 days in a 12-month period beginning or ending within the taxable year.
- *Second*, the employer paying the remuneration must not be a resident of the source state.
- *Third*, the remuneration must not be "borne by" the employer's PE or fixed base in the source state.

Remuneration is "borne by" the employer's PE if the amount of the compensation is deductible, directly or indirectly, in computing the taxable income attributable to that PE. The point of the rule is to prevent the source state from suffering a double loss in revenue—once from giving up the right to tax the personal services and then again by losing the right to tax income derived by a PE from those services.

In applying the 183-day rule, the United States takes the position that a day counts if the individual is physically present in the United States for any part of the day.[1] Apparently, the United States intends to follow the OECD Commentary and not count any day that the

[1] Rev. Rul. 56-24, 1956-1 C.B. 851.

individual was present in the United States because he was prevented by illness from leaving.[2] Similarly, days in transit between two points outside the United States apparently do not count.[3]

The exemption of Article 14 applies to salaries, wages and other remuneration earned by an individual from dependent personal services. Article 14 does not take priority over other treaty articles affecting personal services. For example, compensation received by an athlete that would be exempt under Article 14 may be taxable under Article 16 (Artistes and Sportsmen).

The exemption provided under Article 14 of the U.S. Model Treaty (2006) is unlimited in amount. Thus, an employee making a very large salary in the source state may be exempt under Article 14. A few U.S. tax treaties, however, limit the maximum benefit. For example, the U.S. treaty with Canada does not allow the exemption if the remuneration exceeds $10,000.[4]

### 2. Independent Personal Services

Many U.S. tax treaties, typically in Article 14, provide an exemption under some circumstances for professionals and other independent contractors[5] who work temporarily outside their home country. The U.S. Model Treaty (2006) deleted old Article 14 and renumbered the following articles accordingly. The proposed protocol to the U.S./Canada treaty provides in Article 5 that an enterprise otherwise not having a PE in a Contracting State will be treated as having one under conditions similar to the rules of former Article 14.

To qualify for benefits under Article 14 of the typical U.S. tax treaty, an individual must be some type of independent professional who is resident in one Contracting State and is deriving income in the other Contracting State from the performance of personal services. In addition, the individual must not have a "fixed base" located in the latter state that is regularly available to him. In effect, Article 14 extends to professionals the same type of exemption that is afforded under Articles 5 and 7 to residents of a Contracting State who earn business profits in the other Contracting State. A fixed base and a PE are nearly but not completely synonymous.

One complicating issue in interpreting the term "fixed base" is whether the various rules defining a PE in Article 5 of the U.S. and OECD models are carried over to Article 14. For example, can an individual performing independent services have a fixed base in a country on account of the activities of its dependent agents? Does a permanent office that would not constitute a PE because it is used only for purchasing and activities of an auxiliary nature nevertheless constitute a fixed base? Questions of these types have led commentators to suggest that independent services income should be taxed as business income. That result is now

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[2] *Technical Explanation of* U.S. Model Treaty (2006), Article 14(2), p 48. See OECD Commentary on Article 15, para. 5.

[3] Id.

[4] The $10,000 limit is measured inthe currency of the exempting state. See also U.S./Jamaica treaty, Art. 15(2)(b) (limiting the exemption to $5,000).

[5] Under the U.S./Czech Republic treaty, Art. 14(2), "the term 'personal services' includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants."

achieved in the OECD and U.S. Model Treaties. The UN retained Article 14 in its 2001 revision but is now considering changes in that article.[6]

The exemption provided in Article 14 ought to be limited to individuals—a result reached by the U.S. Treasury Department in its prior model treaty. It should not extend to companies or other juridical persons. Presumably a company that is resident in one Contracting States and engaged in business in the other Contracting State without having a fixed base therein would be eligible for exemption under Article 5 in that other Contracting State.

A few U.S. tax treaties do not grant the benefits of Article 14 to individuals who are present in the source country for an extended period. For example, the U.S./New Zealand treaty denies the benefit to individuals present in the source state for more than 183 days in any consecutive twelve-month period.[7]

The following two examples, taken from the Treasury Department's Technical Explanation to the 1996 U.S. Model Treaty, illustrate what it means for an individual to have an office or other fixed base "regularly available" to him. In the first example, a partner in a U.S. law firm that has offices in Canada has access to the Canadian offices whenever she goes to Canada on business. That partner has a fixed base in Canada for purposes of Article 14 of the U.S./Canada tax treaty regardless of how frequently she conducts business in Canada or whether she ever uses the office available to her. In the second example, an individual has no office in Canada but occasionally rents a hotel room to serve as a temporary office while conducting business in Canada. That individual would not be considered to have a fixed base regularly available to her.[8]

## 3. Specially Treated Earners of Personal Services Income

Several categories of individuals earning income derived from the performance of personal services are treated specially under U.S. tax treaties. Section 3.1 summarizes the treaty rules applicable to government employees. The special rules for athletes, entertainers, and other performers are addressed in section 3.2. Section 3.3 describes the rules applicable to students, trainees, and teachers under some U.S. tax treaties. Section 3.4 addresses the treaty rules relating to pension distributions.

### 3.1. Government Employees

A government typically is reluctant to give up by treaty the right to tax its own employees. Article 19 of the U.S. Model Treaty (2006) generally reserves the right to the payer government to tax amounts paid out of public funds as remuneration for services performed for the government, including pension payments made for prior services. If the services are rendered in the other country by an individual who is both a resident and citizen of that country, only that

[6] Under the UN Model Treaty, professionals and other persons performing independent services generally may be taxable whether or not they have a fixed base if they are present in the country for more than 183 days of the taxable year or if their compensation is deductible in the source country.

[7] See also U.S./Greece treaty, Art. X (must be present less than 183 days and compensation must not exceed $10,000 to qualify); U.S./Czech Republic treaty, Art. 14 (individual's stay must not exceed 183 days).

[8] *Technical Explanation of* U.S. Model Treaty (1996), Art. 14(1), para. 200

country is entitled to tax the income. The rules of Article 19 override exemptions that might otherwise be available under Articles 14, 15, 16, or 20.[9]

### 3.2. Athletes, Artists, and Entertainers

Article 16 of the U.S. Model Tax Treaty applies to "entertainers and sportsmen." The comparable provision is labeled Article 17 in the OECD and UN models and in many U.S. tax treaties. Those treaties typically use the term "artistes" instead of "entertainers". In general, an "artiste" is a skilled entertainer or performer. For treaty purposes, the term also includes artists, musicians, and other accomplished practitioners of the fine arts.[10] The term "sportsmen" is also a broad, generic term that includes men and women involved in athletic endeavors[11] and other competitive activities, including chess.[12] It does not include trainers and support staff.

It is not good news to be covered by Article 17 of the OECD and UN Model Treaties. Its main effect is to remove the exemption from source jurisdiction that individuals performing services in the source state might otherwise have enjoyed under Articles 5/7 and 14. This less favorable treatment of entertainers and sportsmen probably reflects the unwillingness of the source state to forgo taxation of the very large payments that artistes and sportsmen sometimes receive from making a brief appearance in the source state. In addition, source states probably feel quite confident that most artistes and sportsmen will continue to perform in their country notwithstanding the prospect of taxation.

In principle, Article 17 should apply to celebrities capable of commanding high appearance fees who are famous without reference to athletic skill or artistic talent. For example, a lawyer who gained notoriety in a spectacular criminal case might command a high fee for making a public speech. The case for taxing that individual in the source country is essentially the same as the case for source taxation of sportsmen and artistes. The language of Article 17 is not easily stretched, however, to cover such cases.

To avoid creating a tax barrier to cultural and athletic exchanges, the U.S. Model Treaty (2006) allows artistes and sportsmen earning moderate fees to qualify for an exemption under both Articles 14 and 15. The dollar limit in the model is $20,000 (raised from $10,000 in the prior model). For example, the tax treaty between Canada and the United States provides that Article 17 does not apply if the total remuneration received, directly or indirectly, by the artiste or sportsman is less than $15,000 (Canadian or American, as the case may be).[13] The dollar

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[9] Under the saving clause, included in all U.S. tax treaties, the United States generally retains the right to tax its citizens without regard to those treaties.

[10] See U.S./Czech Republic treaty, Art. 18(1) (defining, by implication, an artiste as "an entertainer, such as a theater, motion picture, radio, or television artiste, or a musician").

[11] See OECD Commentary on Article 17, para. 5 (including in the definition "golfers, jockeys, footballers, cricketers and tennis players, as well as racing drivers").

[12] Id., para. 6 (including income derived from billiards and snooker, chess, and bridge tournaments).

[13] Most treaties are scrupulously reciprocal in their treatment of the two Contracting States. The granting of a larger or small exemption for Canadians working in the United States than for Americans working in Canada (depending on the exchange rates) is an anomaly.

limits vary considerably from treaty to treaty.[14] A person earning income above the cap is taxable on the full amount of the income, including the amount below the cap.

### 3.3. Students, Trainees, and Teachers

Article 20 of the U.S. Model Treaty provides that a student who is resident in a Contracting State and travels to the other Contracting State to enroll in an education program is not taxable on the amounts received to support his studies.[15] The exemption from source country taxation extends to amounts received from outside the source country for tuition fees and maintenance. Only full-time students at accredited educational institutions may qualify. In many cases, the residence country also may exempt some or all of the income under its rules for scholarships, resulting in a full exemption from taxation for the student. For example, a U.S. student studying in Canada on scholarship may enjoy a dual exemption because he would be exempt from tax in Canada under Article XX of the U.S./Canada tax treaty and exempt in the United States under Code section 117.[16]

In contrast to most treaty rules, the exemption for students from a Contracting State continues to apply even if the student gives up residence in that Contracting State. This rule protects students who become residents of the source country under a days-present test from losing the benefit of the exemption. A few treaties extend the exemption, with a cap, to income that students derive from the performance of personal services in the source country.[17]

Business apprentices and trainees present in the source state for full-time training may also qualify for an exemption for amounts paid for their maintenance, education, or training. Under the U.S. Model Treaty (2006), the exemption period may not exceed one year, and the exempt amount cannot exceed $9,000.[18]

Many U.S. treaties provide benefits to teachers and researchers, although the U.S. Model Treaty (2006) does not include such a provision. A typical provision exempts teachers and researchers on the remuneration they receive for their teaching or research activities. To qualify

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[14] See U.S./Austria treaty, Art. 17(1) (threshold of $20,000); U.S./Barbados treaty, Art. 17(1) (threshold of $250 per day or total of $4,000); U.S./Czech Republic treaty, Art. 18(1) (threshold of $20,000); U.S./Denmark treaty, Art. 17(1) (threshold of $20,000); U.S./France treaty, Art. 17(1) (threshold of $10,000); U.S./India treaty, Art. 18(1) (threshold of $1,500); U.S./Israel treaty, Art. 18(3) (threshold of $5,000); U.S./Mexico treaty, Art. 18(1) (threshold of $3,000); U.S./Netherlands treaty, Art. 18(1) (threshold of $10,000); U.S./South Africa treaty, Art. 17(1) (threshold of $7,500); U.S./Sweden treaty, Art. 18(1) (threshold of $6,000); U.S./Thailand treaty, Art. 19(1) (threshold of $3,000).

[15] OECD Model Treaty (2005), Art. 20, provides similar exemptions.

[16] The U.S./Canada treaty, Art. XXIX(3)(b), includes a saving clause that allows the United States to impose its tax on students otherwise exempt under Article XX (Students) of the treaty if they are U.S. citizens or U.S. residents having a green card.

[17] U.S./China treaty, Art, 20(c) (cap of $5,000); U.S./Germany treaty, Art. 20(4) (cap of $5,000 and 4-year limit on period); U.S./Pakistan treaty, Art. XIII(1)(a) (cap of $5,000).

[18] See, e.g., U.S./Czech Republic treaty, Art. 21(2) (maximum period 12 months, cap of $8,000 on compensation); U.S./Germany treaty, Art. (maximum period 4 years, annual cap of $5,000); U.S./Ireland treaty, Art. 20 (maximum period 1 year, unlimited compensation); U.S. Switzerland treaty, Art. 20 (unlimited period, unlimited compensation); U.S./Thailand treaty, Art. 22 (maximum period 12 months, cap of $7,500 on compensation).

for the exemption, an individual typically must be temporarily in the source country for the purpose of teaching at a university or other educational institution or engaging in scholarly research at such an institution.[19]

### 3.4. Pensions

Under Article 17 of the U.S. Model Treaty (2006), pension distributions and similar remuneration paid to a resident of a Contracting State may be taxed only in that Contracting State. In addition, the residence state is not permitted to tax the distributions to the extent they were taxed prior to the distribution in the other Contracting State. In effect, the residence state must provide for recovery of cost basis. The effect of the residence-of-recipient rule is to give tax jurisdiction to the residence state even if some or all of the services performed by the recipient of the pension were carried out in the other Contracting State.

One advantage of a residence-of-recipient rule for pensions is that it simplifies the taxation of pensions payable as the result of services performed in many countries over several years. In such circumstances, accurately determining the portion of a pension that was due to the performance of services in a particular country would be extremely difficult. Collecting the tax due on the pension also would be difficult with respect to pensions paid by nonresident companies.

The residence-of-recipient rule has not achieved full support from all OECD member countries.[20] One reason is that the rule is inconsistent with the general rule applicable to income from services, which typically gives substantial rights of taxation to the source country. In the typical case, a pension is additional compensation for personal services. In principle, therefore, it should be taxable in the country where the services were performed. Another reason for objection to the residence-of-recipient rule is that it may foster international tax avoidance, especially when the residence state exempts its residents from tax on their foreign source income.

Many governments, including the United States, typically reserve the right to tax pensions that they pay to nonresidents under a general welfare or social security program.[21] Taxing such pensions is not difficult administratively, and it does not create the problems for multinational companies that are associated with source taxation of private pensions. The United States has entered into bilateral social security totalization agreements with many countries that avoid double taxation of social security payments.[22]

[19] See, e.g., U.S./Germany treaty, Art. 18 (2-year limit); U.S./Italy treaty, Art. 20 (2-year limit); U.S./Netherlands treaty, art. 20 (2-year limit); U.S./Turkey treaty, Art. 20 (2-year limit, and payment must arise outside the source state).

[20] Belgium, Canada, Denmark, Finland, and Sweden reserve the right to tax pensions paid with respect to services performed in their country. OECD Commentary on Article 18 (1997), para. 40-43.

[21] U.S. Model Treaty (2006), Art. 17(2).

[22] See, e.g., "Social Security Agreement between Canada and the United States." March 11, 1981; "Agreement Between the United States of America and the Italian Republic on the Matter of Social Security," May 23, 1973; "Agreement Between the United States of America and Spain on Social Security." September 30, 1986. As of 2007, the U.S. had 21 totalization agreements.

# U.S.-Canada Tax Treaty (2008)

*Article 5, New Paragraph 9*

PERMANENT ESTABLISHMENT

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9. Subject to paragraph 3 [*Ed. ,Construction Site, etc.*] where an enterprise of a Contracting State provides services in the other Contracting State, if that enterprise is found not to have a permanent establishment in that other State by virtue of the preceding paragraphs of this Article, that enterprise shall be deemed to provide those services through a permanent establishment in that other State if and only if:

(a) Those services are performed in that other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period, and, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise consists of income derived from the services performed in that other State by that individual; or

(b) The services are provided in that other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected project for customers who are either residents of that other State or who maintain a permanent establishment in that other State and the services are provided in respect of that permanent establishment.

## DEPARTMENT OF THE TREASURY<br>TECHNICAL EXPLANATION OF<br>THE PROTOCOL<br>AMENDING THE CONVENTION BETWEEN<br>THE UNITED STATES OF AMERICA AND CANADA (2008)

*Paragraph 9 of Article V [Permanent Establishment]*

New paragraph 9 provides a special rule (subject to the provisions of paragraph 3) for an enterprise of a Contracting State that provides services in the other Contracting State, but that does not have a permanent establishment by virtue of the preceding paragraphs of the Article. If (and only if) such an enterprise meets either of two tests as provided in subparagraphs 9(a) and 9(b), the enterprise will be deemed to provide those services through a permanent establishment in the other State.

The first test as provided in subparagraph 9(a) has two parts. First, the services must be performed in the other State by an individual who is present in that other State for a period or periods aggregating 183 days or more in any twelve-month period. Second, during that period or periods, more than 50 percent of the gross active business revenues of the enterprise (including revenue from active business activities unrelated to the provision of services) must consist of income derived from the services performed in that State by that individual. If the enterprise meets both of these tests, the enterprise will be deemed to provide the services through a permanent establishment. This test is employed to determine whether an enterprise is deemed to have a permanent establishment by virtue of the presence of a single individual (i.e., a natural person).

For the purposes of subparagraph 9(a), the term "gross active business revenues" shall mean the gross revenues attributable to active business activities that the enterprise has charged or should charge for its active business activities, regardless of when the actual billing will occur or of domestic law rules concerning when such revenues should be taken into account for tax purposes. Such active business activities are not restricted to the activities related to the provision of services. However, the term does not include income from passive investment activities.

As an example of the application of subparagraph 9(a), assume that Mr. X, an individual resident in the United States, is one of the two shareholders and employees of USCo, a company resident in the United States that provides engineering services. During the 12-month period beginning December 20 of Year 1 and ending December 19 of Year 2, Mr. X is present in Canada for periods totaling 190 days, and during those periods, 70 percent of all of the gross active business revenues of USCo attributable to business activities are derived from the services that Mr. X performs in Canada. Because both of the criteria of subparagraph 9(a) are satisfied, USCo will be deemed to have a permanent establishment in Canada by virtue of that subparagraph.

The second test as provided in subparagraph 9(b) provides that an enterprise will have a permanent establishment if the services are provided in the other State for an aggregate of 183 days or more in any twelve-month period with respect to the same or connected projects for customers who either are residents of the other State or maintain a permanent establishment in the other State with respect to which the services are provided. The various conditions that have to be satisfied in order for subparagraph 9(b) to have application are described in detail below.

In addition to meeting the 183-day threshold, the services must be provided for customers who either are residents of the other State or maintain a permanent establishment in that State. The intent of this requirement is to reinforce the concept that unless there is a customer in the other State, such enterprise will not be deemed as participating sufficiently in the economic life of that other State to warrant being deemed to have a permanent establishment.

Assume for example, that CanCo, a Canadian company, wishes to acquire USCo, a company in the United States. In preparation for the acquisition, CanCo hires Canlaw, a Canadian law firm, to conduct a due diligence evaluation of USCo's legal and financial standing in the United States. Canlaw sends a staff attorney to the United States to perform the due diligence analysis of USCo. That attorney is present and working in the United States for greater than 183 days. If the remuneration paid to Canlaw for the attorney's services does not constitute more than 50 percent of Canlaw's gross active business revenues for the period during which the attorney is present in the United States, Canlaw will not be deemed to provide the services through a permanent establishment in the United States by virtue of subparagraph 9(a). Additionally, because the services are being provided for a customer (CanCo) who neither is a resident of the United States nor maintains a permanent establishment in the United States to which the services are provided, Canlaw will also not have a permanent establishment in the United States by virtue of subparagraph 9(b).

Paragraph 9 applies only to the provision of services, and only to services provided by an enterprise to third parties. Thus, the provision does not have the effect of deeming an enterprise to have a permanent establishment merely because services are provided to that enterprise. Paragraph 9 only applies to services that are performed or provided by an enterprise of a Contracting State within the other Contracting State. It is therefore not sufficient that the relevant services be merely furnished to a resident of the other Contracting State. Where, for example, an enterprise provides customer support or other services by telephone or computer to customers located in the other State, those would not be covered by paragraph 9 because they are not performed or provided by that enterprise within the other State. Another example would be that of an architect who is hired to design blueprints for the construction of a building in the other State. As part of completing the project, the architect must make site visits to that other State, and his days of presence there would be counted for purposes of determining whether the 183-day threshold is satisfied. However, the days that the architect spends working on the blueprint in his home office shall not count for purposes of the 183-day threshold, because the architect is not performing or providing those services within the other State.

For purposes of determining whether the time threshold has been met, subparagraph 9(b) permits the aggregation of services that are provided with respect to connected projects. Paragraph 2 of the General Note provides that for purposes of subparagraph 9(b), projects shall be considered to be connected if they constitute a coherent whole, commercially and geographically. The determination of whether projects are connected should be determined from the point of view of the enterprise (not that of the customer), and will depend on the facts and circumstances of each case. In determining the existence of commercial coherence, factors that would be relevant include: 1) whether the projects would, in the absence of tax planning considerations, have been concluded pursuant to a single contract; 2) whether the nature of the work involved under different projects is the same; and 3) whether the same individuals are providing the services under the different projects. Whether the work provided is covered by one or multiple contracts may be relevant, but not determinative, in finding that projects are commercially coherent.

The aggregation rule addresses, for example, potentially abusive situations in which work has been artificially divided into separate components in order to avoid meeting the 183-day threshold. Assume for example, that a technology consultant has been hired to install a new computer system for a company in the other country. The work will take ten months to complete. However, the consultant purports to divide the work into two five-month projects with the intention of circumventing the rule in subparagraph 9(b). In such case, even if the two projects were considered separate, they will be considered to be commercially coherent. Accordingly, subject to the additional requirement of geographic coherence, the two projects could be considered to be connected, and could therefore be aggregated for purposes of subparagraph 9(b). In contrast, assume that the technology consultant is contracted to install a particular computer system for a company, and is also hired by that same company, pursuant to a separate contract, to train its employees on the use of another computer software that is unrelated to the first system. In this second case, even though the contracts are both concluded between the same two parties, there is no commercial coherence to the two projects, and the time spent fulfilling the two contracts may not be aggregated for purposes of subparagraph 9(b). Another example of projects that do not have commercial coherence would be the case of a law firm which, as one project provides tax advice to a customer from one portion of its staff, and as another project provides trade advice from another portion of its staff, both to the same customer.

Additionally, projects, in order to be considered connected, must also constitute a geographic whole. An example of projects that lack geographic coherence would be a case in which a consultant is hired to execute separate auditing projects at different branches of a bank located in different cities pursuant to a single contract. In such an example, while the consultant's projects are commercially coherent, they are not geographically coherent and accordingly the services provided in the various branches shall not be aggregated for purposes of applying subparagraph 9(b). The services provided in each branch should be considered separately for purposes of subparagraph9(b).

The method of counting days for purposes of subparagraph 9(a) differs slightly from the method for subparagraph 9(b). Subparagraph 9(a) refers to days in which an individual is present in the other country. Accordingly, physical presence during a day is sufficient. In contrast, subparagraph 9(b) refers to days during which services are provided by the enterprise in the other country. Accordingly, non-working days such as weekends or holidays would not count for purposes of subparagraph 9(b), as long as no services are actually being provided while in the other country on those days. For the purposes of both subparagraphs, even if the enterprise sends many individuals simultaneously to the other country to provide services, their collective presence during one calendar day will count for only one day of the enterprise's presence in the other country. For instance, if an enterprise sends 20 employees to the other country to provide services to a client in the other country for 10 days, the enterprise will be considered present in the other country only for 10 days, not 200 days (20 employees x 10 days).

By deeming the enterprise to provide services through a permanent establishment in the other Contracting State, paragraph 9 allows the application of Article VII (Business Profits), and accordingly, the taxation of the services shall be on a net-basis. Such taxation is also limited to the profits attributable to the activities carried on in performing the relevant services. It will be important to ensure that only the profits properly attributable to the functions performed and risks assumed by provision of the services will be attributed to the deemed permanent establishment.

In addition to new paragraph 9, Article 3 of the Protocol amends paragraph 6 of Article V of the Convention to include a reference to paragraph 9. Therefore, in no case will paragraph 9 apply to deem services to be provided through a permanent establishment if the services are limited to those mentioned in paragraph 6 which, if performed through a fixed place of business, would not make the fixed place of business a permanent establishment under the provisions of that paragraph.

The competent authorities are encouraged to consider adopting rules to reduce the potential for excess withholding or estimated tax payments with respect to employee wages that may result from the application of this paragraph. Further, because paragraph 6 of Article V applies notwithstanding paragraph 9, days spent on preparatory or auxiliary activities shall not be taken into account for purposes of applying subparagraph 9(b).