Law and Business Review of the Americas

Volume 18 | Number 1 Article 4

2012

International Initiatives for Reconciling the Sovereign Right to Tax with Free Trade in Services

Gabriel Gari

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*Dr. Gabriel Gari**

I. INTRODUCTION

UNTIL recently, most services were either non-tradable or traded subject to physical proximity, requiring the commercial presence of the foreign supplier in the territory of the consumer. Over the last twenty years, the development of a whole new range of information technologies, the emergence of new business models organized on a global scale, and a wave of deregulation across countries have fueled an exponential growth of cross-border trade in services, where the service is supplied "over the wire" by a provider in country A to a consumer in country B. This revolutionary event uncovered a series of conflicts between domestic tax rules and trade in services that undermine the neutrality of consumption taxes towards international trade and create problems of double or non-taxation that discourage trade. It soon became apparent that a disparate range of domestic tax systems, designed under the assumption that most services were non-tradable, was failing to provide the consistency, predictability, and transparency that the global service economy needed to continue to flourish, thereby prompting industry associations to lobby policy makers to address the matter.[1]

The General Agreement on Trade in Services (GATS)[2] provided the multilateral trading system with its first set of multilaterally negotiated and legally enforceable rules covering international trade in services. Yet, the GATS deals with tax rules only to the extent that they violate the principle of non-discrimination between like services and service suppli-

* Dr. Gabriel Gari is a Senior Lecturer in International Economic Law at Queen Mary, University of London.

1. *See, e.g.*, INT'L CHAMBER OF COMMERCE, DEFICIENCIES IN VALUE ADDED TAX (VAT) SYSTEMS 1-5, 10 (Mar. 5, 2004) *available at* www.iccwbo.org/home/statements_rules/statements/2004/180-467rev4.pdf (policy statement prepared by the Task Force on Indirect Tax Systems); *NASSCOM Probe: Key Recommendations On Direct And Indirect Taxes*, NASSCOM NEWSLINE No. 51 (Jan. 2006), *available at* http://epi.nasscom.in/Nasscom/templates/NormalPage.aspx?id=11085.
2. *See generally* General Agreement on Trade in Services [GATS], Apr. 15, 1994, Marrakesh Agreement Establishing the World Trade Organization, Annex 1B, 1869 U.N.T.S. 183.

ers.[3] GATS provisions do not encroach upon the sovereign right of its members to develop their own tax policies and administrative rules to raise revenues in a fair and equitable way.[4] Hence, it is necessary to look beyond GATS for mechanisms designed for ensuring that the sovereign right to tax can be exercised in a manner that does not distort trade in services. This paper provides a brief overview of the conflict between free trade in services and taxes on services, and looks at the initiatives sponsored by the Organisation for Economic Co-operation and Development (OECD) to deal with this problem. Section two looks at the problems related to consumption taxes on cross-border service transactions and the OECD International VAT/GST Guidelines.[5] Section three looks at the problems related to direct taxes levied over profits made by service suppliers and the OECD Model Tax Convention on Income and on Capital.

II. CONSUMPTION TAXES

A. PROBLEM

In theory, consumption taxes such as the Value Added Tax ("VAT") should be neutral to taxable business with the burden of the tax falling on final consumption by the end-consumer of goods and services.[6] This can be achieved by allowing firms to deduct the tax on the purchases incurred in the process of operating their business activities (input tax) and offset that tax against the tax they normally collect on their own sales (output tax).[7] In practice, however, there are many circumstances where the VAT ends up being a cost for businesses, for example, when a business incurs VAT on expenses in a foreign country that does not provide for a refund mechanism or when it is too costly for the business to follow the refund procedure.[8] Also, many countries exempt specific activities such as health care, education or cultural services from VAT, preventing the supplier from deducting the VAT on their purchases linked to the provision of these services.[9] In these circumstances, also known as "input taxed activities," the supplier has little choice but to absorb the VAT, which

3. *See id.* arts. II, XVII (GATS mandates its members to negotiate disciplines on subsidies, but so far no agreement has been reached on this front).
4. *See* Leslie B. Samuels, *Treatment of Tax Measures Under International Trade and Investment Agreements: The GATS Compromise*, 102 AM. SOC'Y INT'L L. PROC. 51, 53-55 (2008) (provides an explanation of the GATS Tax Carve-Out).
5. *See generally* ORG. FOR ECON. CO-OPERATION & DEV. [OECD], INTERNATIONAL VAT/GST GUIDELINES (Feb. 2006) [hereinafter VAT/GST GUIDELINES], *available at* http://www.oecd.org/dataoecd/16/36/36177871.pdf (in Feb. 2006 the OECD Committee on Fiscal Affairs (CFA) launched a project aimed at providing guidance for governments on applying Value Added Taxes and Services Tax to cross-border trade, developing the OECD VAT/GST Guidelines).
6. *Id.*
7. *See id.* at 2, 7.
8. OECD, VAT/GST RELIEF FOR FOREIGN BUSINESSES: THE STATE OF PLAY 4-5, 8 (Feb. 2010) [hereinafter VAT/GST STATE OF PLAY], *available at* http://www.oecd.org/dataoecd/18/52/44560750.pdf (presented by the Committee on Fiscal Affairs).
9. *See* VAT/GST GUIDELINES, *supra* note 5, at 9.

increases the cost of the service and makes the supplier less competitive *vis a vis* suppliers from jurisdictions where such exemption is not in place.[10]

VAT should also be neutral towards international trade.[11] This characteristic, also known as external neutrality, means that it should not be more advantageous or disadvantageous to consume domestic goods or services over goods or services originating in another jurisdiction as a result of VAT.[12] External neutrality can be achieved by use of the "destination principle."[13] "Under this principle, goods and services are zero rated when leaving one jurisdiction and are taxed at importation in another jurisdiction. In this way, it makes no difference whether goods or services are obtained domestically or from abroad; the domestic VAT rate will always apply."[14] The problem is that the destination principle is not consistently applied across the board. Some countries apply an "origin principle" instead of the "destination principle."[15] In this case, "tax accrues to the jurisdiction from which a supply is made . . . [i.e.] exports would be taxed at the rate applicable in the jurisdiction of exportation and imports would not be taxed."[16] The problem arises when trade occurs between countries that apply different principles: "[a] supply from a jurisdiction that operates an origin principle to a jurisdiction that operates a destination principle would result in double taxation . . . [whereas a] reverse of this scenario would result in double non-taxation."[17]

The origin principle can also create significant distortions between like service suppliers competing for a foreign market because services purchased from a jurisdiction without a VAT or with a low VAT rate would be at a significant advantage over services purchased from jurisdictions that apply higher rates.[18]

Take the Uruguayan case. In this country, the tax regime provides that the VAT shall be levied on the circulation of goods, the provision of services within the national territory, and on the effective introduction of goods into the country regardless of where the contract has been concluded and the domicile, residence, or nationality of those involved in the operation.[19] It is further stipulated that the VAT shall not be levied on

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10. VAT/GST STATE OF PLAY, *supra* note 8, at 8.
11. VAT/GST GUIDELINES, *supra* note 5, at 2.
12. *See* OECD, PUBLIC CONSULTATION ON DRAFT GUIDELINES FOR CUSTOMER LOCATION 2 (2010) [hereinafter PUBLIC CONSULTATION], *available at* http://www.oecd.org/dataoecd/19/63/44559751.pdf (presented by Working Party No 9 on Consumption Taxes), at 2.
13. *See id.*
14. *Id.*
15. *See id.*
16. *Id.*
17. *Id.* at 3.
18. *See id.* at 2.
19. *See* Texto Ordenado de la Dirección General Impositiva [Inland Revenue Compilation of Tax Rules], *as amended*, Titulo 10: Impuesto al Valor Agregado [Title 10: Value Added Tax] (Uru. 1996), *available at* http://www0.parlamento.gub.uy/otrosdocumentos/todgi/1996/dgit10.htm.

the export of goods.[20] With respect to the export of services, it is provided that the VAT shall not apply on those service exports expressly identified by the Executive Power.[21] The difference between the VAT regime applicable to the export of goods as compared to that applicable to the export of services is significant. For goods, any export is exempted from VAT by a statutory provision.[22] For services, by contrast, the statute does not exempt exports from VAT, but delegates on the Executive the power to decide, on a case-by-case basis, whether the export of the service should be exempted from VAT or not.[23]

So far, there is a long list of services whose exports have been exempted from VAT by an express administrative decision from the Executive Power.[24] Among the list of exempted services there are typical offshore services such as call center services, data processing services, market research, and public opinion services.[25] But the need for an express administrative decision for a tax exemption is extremely inefficient in light of the constant development of new economic activities, particularly in the service sector.

The following case is illustrative of the disadvantages of this system. A company that provided translation services to clients residing abroad consulted the tax authorities whether their exports were exempted from VAT or not.[26] Unsurprisingly, the tax authority concluded that such activity was not exempted from VAT because there was no express decision from the Executive that had provided for such exemption.[27] The negative consequences of this tax regime for Uruguayan service suppliers *vis a vis* like service suppliers from jurisdictions that apply the "destination principle" is apparent.

Even if all countries followed the "destination principle," there would still be difficulties relating to its application. As the OECD notes, it is relatively simple to apply the destination principle to trade in goods:

> Exports are relieved from VAT and the VAT incurred on their production and distribution prior to export is credited through the usual system of input tax deduction within the supply chain. The final exporter receives a credit for the input tax incurred on their purchase but the sale of those goods to the customer in the second jurisdiction

20. *See id.*
21. *See id.*
22. *See id.*
23. *See id.*
24. *See* Registro Nacional de Leyes, Decretos, y Otros Documentos de la República Oriental del Uruguay (Rep. Nac.) Decreto 220/998, art. 34, (Uru. 1990) (as amended by Decreto 391/007, art. 1 and Decreto 386/000).
25. *See id.*
26. *See* Consulta No 4702, DIRECCIÓN GENERAL IMPOSITIVA [INLAND REVENUE] (Dec. 28, 2007) (Uru.), http://www.dgi.gub.uy/wdgi/hgxpp001?6,4,40,O,S,0,PAG;CONC;40;16;D;9859;1;PAG;,.
27. *See id.*; *see also* James A.Whitelaw, *La Exportación de Servicios y el IVA. Estado Actual de la Cuestión*, INFORMES 2008 (Camara Nacional de Comercio y Servicious del Uruguay, Montevideo, Uru.), Feb. 8, 2008, at 1 (citing Consulta No 4702, *supra* note 27).

is free of VAT. When the goods enter the importing jurisdiction they are subject to the VAT regulations in that jurisdiction and any tax is imposed at the appropriate rate under that jurisdiction's VAT regime. This ensures that imported goods are subject to the same tax regime as domestically produced goods.[28]

But it is much more complex to apply the destination principle to the cross-border supply of services. Because of their intangible nature, services cannot be subject to customs controls that can confirm their exportation, and no customs controls can impose VAT at importation. The place where services are consumed is not always obvious and the use of proxies (*e.g.* recipient's residence or permanent/fixed establishment, the physical place of performance, or the place of use and enjoyment) is not consistent among countries.

In short, the lack of internationally agreed principles on the application of consumption taxes such as VAT to international trade in services results in a number of inefficiencies and inconsistencies such as double taxation (*e.g.* when the supplier is subject to the origin principle and the consumer is subject to the destination principle), unintentional non-taxation, (*e.g.* when the supplier is subject to the destination principle and the consumer is subject to the origin principle) and distortion of competition (*e.g.* both the supplier and the consumer are subject to the origin principle, but the VAT rate in the supplier's jurisdiction is lower than that applicable in the consumer's jurisdiction).[29] The scale of the problems is magnified both by the exponential growth of cross-border trade in services and the expansion of consumption taxes.[30] This environment is detrimental for the development of a global service economy and, in particular, for the offshore industry that operates entirely on a cross-border basis.

B. Remedies

Acknowledging that the lack of international "rules of the game" leads to uncertainties, double taxation or non-taxation, the OECD launched a project in February 2006 aimed at providing guidance for governments on applying VAT to cross-border trade in services.[31] The objective is to develop an agreed upon set of framework principles and a series of guidelines for translating the framework principles into a set of workable rules on consumption taxation applicable to cross-border transactions on services.[32]

The two principles that have been agreed upon so far deal with the

28. Public Consultation, *supra* note 12, at 3.
29. *See* VAT/GST Guidelines, *supra* note 5, at 3, 7.
30. *See id.* at 2 (the OECD notes that consumption tax revenues' contributions to countries' tax revenues in OECD countries typically account for one-fifth of total tax revenue.).
31. *See id.* at 3.
32. *See id.*

place of taxation and the impact of consumption taxes on business.[33] They are inspired by the Ottawa Framework Conditions for e-commerce taxation and their aim is to ensure that transactions are taxed only once in a single, clearly defined jurisdiction, and that VAT remains neutral to taxable business.[34]

The principle related to the place of taxation stipulates that "for consumption tax purposes internationally traded services and intangibles should be taxed according to the rules of the jurisdiction of consumption," but provides no guidance about appropriate proxies to determine appropriate definitions of consumption.[35] In 2010, a new document was issued with guidelines on proxies to determine the jurisdiction of consumption for business-to-business supplies.[36] The document, which is currently under public consultation, stipulates that "[f]or business-to-business supplies, the jurisdiction in which the customer is located has the taxing rights over internationally traded services or intangibles."[37]

According to this principle, "the supplier makes the supply free of VAT in its jurisdiction but retains the right to full input tax credit (subject to clearly legislated exceptions in that jurisdiction) on inputs related to making such international supplies."[38] The document stipulates that the supplier "need[s] to identify and be able to demonstrate who their customer is in order to make the supply free of VAT because the customer is located outside the supplier's jurisdiction."[39] The document also stipulates that the tax administration where the supplier is located may require the supplier "to produce evidence that the customer is a business and that this business is located in another jurisdiction," but to minimize compliance burdens on the supplier, it recommends tax administrations "provide businesses with clear guidance on the evidence they require."[40] An important guideline to this effect stipulates that "the identity of the customer is normally determined by reference to the business agreement."[41]

The document recommends that the customer be liable to account for any tax due and suggests the adoption of the reverse-charge mechanism (sometimes referred to as "tax shift" or "self-assessment") to this effect where that is consistent with the overall design of the national consumption tax system. Under this procedure, the customer is typically required to declare the VAT due on the supply received from the overseas supplier as output tax on the relevant VAT return. The customer is then entitled to input tax deduction to the extent allowed under the rules of its jurisdic-

33. *See id.* at 7-8.
34. *See id.* at 8; OECD, *Electronic Commerce: Taxation Framework Conditions*, at 4, 7 (Oct. 8, 1998), *available at* http://www.oecd.org/dataoecd/46/3/1923256.pdf (report presented by the Committee on Fiscal Affairs).
35. VAT/GST GUIDELINES, *supra* note 5, at 9.
36. *See* PUBLIC CONSULTATION, *supra* note 12, at 8.
37. *Id.*
38. *Id.*
39. *Id.* at 11.
40. *Id.* at 15.
41. *Id.* at 8.

tion. If the customer is entitled to full input tax credit in respect of this supply, it may be that local VAT legislation does not require the reverse charge to be declared on the local VAT return. The document encourages tax administrations to make businesses "aware of the need to account for any tax on 'imported' services and intangibles from their suppliers in other jurisdictions" and recommends the application of the domestic rate applicable to the nature of the service involved.[42]

As noted by the public consultation document, the reverse-charge mechanism is beneficial in several ways:

> First, the tax authority in the jurisdiction of consumption can verify and ensure compliance since that authority has jurisdiction over the customer. Secondly, by shifting the compliance burden from the supplier to the customer, it minimizes compliance costs since the customer has full access to the details of the supply and avoids unnecessary burdens on suppliers, which should not be required to be identified for VAT or account for tax in the customer's jurisdiction. Thirdly, the administration costs for the tax authority are also lowered because the supplier is not required to meet tax obligations in the customer's jurisdiction (*e.g.* VAT identification, audits, which would otherwise have to be administered, translation and language barriers, etc.). Finally, it reduces the revenue risks associated with the collection of tax by non-resident suppliers, whether or not that supplier's customers are entitled to deduct the input tax.[43]

The principle related to the impact on business stipulates that "the burden of value added taxes themselves should not lie on taxable businesses except where explicitly provided for in legislation."[44] The objective of this principle is to ensure that only end-consumers bear the economic costs of the tax, whereas the tax remains neutral to taxable business.[45] It is acknowledged that in exceptional circumstances countries may legitimately place a value added tax burden on businesses for policy reasons (health care, education, culture) because the tax base of the output is difficult to assess (i.e. many financial services), or when the "input tax relates to purchases that are not wholly used for furtherance of taxable business activity."[46] It is suggested, however, that these exceptions "should be clear and explicit within the legislative framework for the tax."[47]

The OECD work on the application of VAT to international trade in services has just started. Clearly, more work needs to be done to improve the current international consumption tax environment applicable to cross-border trade in services, avoiding inconsistencies and inefficiencies that hold back the development of the global service economy and, in

42. PUBLIC CONSULTATION, *supra* note 12, at 15.
43. *Id.* at 16.
44. VAT/GST GUIDELINES, *supra* note 5, at 9.
45. *Id.*
46. *Id.*
47. *Id.*

particular, the offshore industry. With respect to the jurisdiction of taxation, the OECD is committed to further developing special rules to ensure that international neutrality is maintained. Further work is also necessary to minimise the circumstances where businesses incur irrecoverable VAT other than those resulting from express VAT exemptions adopted for public policy reasons.

III. CAPITAL AND INCOME TAXES

A. Double Taxation Problem

In the context of a globalized world with increasing mobility of goods, services, capital, and persons across national boundaries, it is not unusual for a business or an individual who is a resident in one country to make a taxable gain (earnings, profits) in another. This person may find that she is obligated by domestic laws to pay tax on that gain locally and pay again in the country in which the gain was made. International juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical periods.[48] Cross-border investment would be seriously impeded if there were danger that the returns on such investment would be taxed twice. The same could be said about the exchange of goods and services, technology, and persons.

The harmful effects of double taxation are so well-known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relations between countries.[49] The service sector is particularly vulnerable to the double taxation problem. Most frequently, service providers need to establish a commercial presence in the territory where the consumer is located in order to be able to reach their customers in the same way local service providers do.[50] In the absence of an agreement between home and host countries, there is a risk that the profits made by the service suppliers' permanent establishments in the host country may be taxed both by the home and host country. The advent of new opportunities for cross-border trade in services complicates matters even further. When a company located in one country is profiting from activities made in another country without even having a permanent establishment in the host country, it is even more likely that the tax authorities from both the country where the company is registered and that from the country where the

48. OECD, *Commentary on the Articles of the 2010 Model Income and Capital Tax Convention,* at 7, (June 22, 2010) [hereinafter *Convention Commentary*].
49. *See generally id.*
50. The WTO Secretariat estimates that the commercial presence mode of supply accounts for 50% of world trade in services flows, while 35% corresponds to cross-border supply, 10-15% to consumption abroad, and 1-2% presence of natural persons. *See* World Trade Organization [WTO], *International Trade Statistics 2005,* (Aug. 31, 2005), *available at* http://www.wto.org/english/res_e/statis_e/its2005_e/its2005_e.pdf.

profit is made will seek to collect taxes on the profits made, leading to double taxation.

For example, while the exporting company pays taxes in its country of origin, the tax authorities from the destination country may require resident payers to report, and possibly withhold tax on, payments to non-residents for services performed in their territory.[51] In fact, export-led industry organizations have actively been denouncing in international forums that requesting residents to apply a withholding tax to the payment for services supplied by non-residents effectively acts as a non-tariff barrier to trade in services.[52]

B. Remedies

In order to protect their individuals or companies against the risk of being taxed twice where the same income is taxable in two states, the OECD has devoted a significant amount of effort in encouraging its members and non-members to enter into bilateral tax agreements.[53] To this end, the OECD has developed a Model Tax Convention on Income and on Capital.[54] The main purpose of the convention is to avoid double taxation by allocating taxing rights between the resident and source countries and by requiring the former to eliminate double taxation where there are competing taxing rights.[55] There are close to 350 bilateral tax agreements between OECD member countries and over 1,500 worldwide.[56] Most bilateral tax agreements between non-OECD members follow both the principles and the detailed provisions of the OECD Model.[57]

Chapter I of the Model Convention determines its scope of application.[58] The Convention applies to all persons who are residents of one or both of the Contracting States[59] and applies to taxes on income and on capital imposed on behalf of a Contracting State.[60] Chapter II provides definitions of relevant terms including, inter alia "resident," "permanent establishment," and "competent authority."[61] Chapters III and IV allocate taxation rights over income and capital between the Contracting States and specify the mechanisms for the elimination of international

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51. *Convention Commentary*, *supra* note 48, at 114.
52. Dewang Mehta, President, NASSCOM, Address at the WTO Information Technology Symposium: Non-Tariff Trade Barriers in IT Trade: Experience of India, (July 16, 1999), *available at* www.wto.org/english/tratop_e/inftec_e/mehta.ppt.
53. *See Centre for Tax Policy and Administration, OECD*, http://www.oecd.org/about/0,3347,en_2649_33747_1_1_1_1_1,00.html (last visited May 14, 2010).
54. *Id.*
55. *Id.*
56. *Id.*
57. *Id.*
58. OECD, *Model Income and Capital Tax Convention*, art. 1 (June 22, 2010) [hereinafter *Model Income and Capital Tax Convention]*.
59. *Id.* art. 1.
60. *Id.* art. 2.
61. *Id.* ch. II.

juridical double taxation.[62] Articles 6 through 21 determine, with regard to different classes of income, the respective right to tax of the state of source and of the state of residence, and Article 22 does the same with regard to capital.[63]

There are certain types of income and capital that may be taxed without any limitation in the state of source (*e.g.* income from immovable property situated in that state, profits of a permanent establishment situated in that state, income from the activities of artists and sportsmen exercised in that state).[64] Likewise, other types of income and capital may be subject to limited taxation in the state of source (*e.g.* dividends and interests).[65] Finally, there are certain type of income and capital that are taxable only in the state of residence of the taxpayer and therefore may not be taxed in the state of source (*e.g.* royalties, private sector pensions, gains from the alienation of shares or securities, etc.).[66]

Chapter V deals with the methods for the elimination of double taxation.[67] When the income or capital may, in accordance with the Convention, be taxed with or without limitation in the state of the source, the state of the residence has the obligation to eliminate double taxation.[68] This can be accomplished by the exemption method (income or capital that is taxable in the state of source is exempted in the state of residence) or the credit method (income or capital that is taxable in the state of source is subject to tax in the state of residence, but the tax levied in the state of source is credited against the tax levied by the state of residence on such income or capital).[69]

Chapter VI deals with other issues including non-discrimination, exchange of information between competent authorities for the prevention of tax evasion and money laundering, assistance between competent authorities in the collection of taxes and dispute resolution procedures for resolving conflicts of interpretation of the Convention.[70]

Finally, Chapter VII includes provisions about entry into force and termination. For each Article in the Convention, there is a detailed commentary that is intended to illustrate or interpret its provisions, which are drafted by experts appointed to the Committee on Fiscal Affairs by OECD member countries.[71] The commentaries are of great relevance in the application and interpretation of the Convention and in the settlement of any dispute.

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62. *Id.* ch. III-IV.
63. *Id.* arts. 6-22.
64. *Id.* arts. 6-22.
65. *Id.*
66. *Id.*
67. *Id.* ch. V.
68. *Id.*
69. *Id.*
70. *Id.* ch. VI.
71. *Id.* ch. VII.

1. The Taxation of Services

The Convention allocates taxing rights between the state of residence and the state of source with respect to profits from any kind of economic activity, including services. The general principle on this matter provides that the profits of an enterprise of a Contracting State must be taxable only in that state unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein.[72] If that is the case, then the profits of the enterprise may be taxed in the other state, but only so much of them as is attributable to that permanent establishment.[73]

The Convention does not differentiate between types of activities and thus applies to any kind of enterprise, whether it is a goods manufacturer or a service supplier. Therefore, "profits from services performed in the territory of a Contracting State by an enterprise of the other Contracting State" should not be taxed in the aforementioned state unless they are attributable to "a permanent establishment situated therein."[74] This allocation of taxing rights has been justified by various policy and administrative considerations, in particular by reference to the idea that until an enterprise of one state sets up a permanent establishment in another state, it should not be regarded as participating in the economic life of that state to such an extent that it comes within the taxing jurisdiction of that other state.[75]

In light of the growing opportunities for the cross-border supply of services, some states are becoming "reluctant to adopt the principle of exclusive residence taxation of services" to those services that are performed in their territory, but are not attributable to a permanent establishment situated therein.[76] These states propose changes to Article 7 of the Model Convention in order to preserve the source taxation rights with respect to this type of services.[77] They argue that the business profits are originated in their territory even when the services are not attributable to a permanent establishment located in their territory,[78] they point at domestic tax laws in many countries that follow this principle,[79] and they note that some service businesses do not require a fixed place of business in their territory in order to carry on a substantial level of business activities therein.[80]

The OECD Committee on Fiscal Affairs considered it "important to circumscribe the circumstances" in which states that disagree with the general principle provided by the Convention could, in a bilateral treaty,

72. *Id.* art. 7.
73. *Id.*
74. *Convention Commentary*, *supra* note 48, at 113.
75. *Id.*
76. *Id at 114.*
77. *Id.*
78. *Id.*
79. *Id.*
80. *Id.* at 115.

provide that profits from services performed by a foreign enterprise could be taxed by them even if not attributable to a permanent establishment situated on their territory.[81] In this vein, it is suggested that a state should not have source taxation rights on income derived from the provision of services performed by a non-resident outside that state's territory; that only the profits from services, as opposed to the gross payments for these services, should be subjected to tax; and that for compliance and other reasons, it is not appropriate to allow a state to tax the profits from services performed on their territory in certain circumstances (*e.g.* when such services are provided during a very short period of time).[82]

In spite of the OECD's efforts to support a harmonized criterion, it is clear that the allocation of taxing rights over profits made by a service supplier from country A in country B, but not attributable to a permanent establishment of that service supplier in country B, are far from being resolved. And the growing opportunities for cross-border trade in services suggest that the seriousness of the problem is likely to increase. On the other hand, the international community tougher stance against tax heavens and non-cooperative jurisdictions allows for room to be optimistic. Indeed, the call, if not the outright pressure, by the G20 on all countries across the world to sign information exchange agreements with extensive commitments to exchange information between tax authorities,[83] may contribute, not just to combat tax evasion, but also to avoid double taxation problems, the reason being that one of the main routes chosen by countries to establish information exchange agreements is by adopting the OECD Model Tax Convention on Income and Capital.

IV. CONCLUSIONS

This paper examined the tensions between demands for a freer regulatory environment for trade in services and the need to preserve one of the most precious rights that a state can exercise, i.e. its sovereign right to tax economic activities that occur within its territory. Taxes on the consumption of services should be neutral to taxable business and towards international trade, but in the absence of international coordination such neutrality cannot be achieved, creating input tax costs on businesses, which affect their competitiveness and distort trade flows.

By the same token, in the absence of international coordination, taxes on the profits made by service suppliers create problems of double taxation or non-taxation, which either create barriers to trade in services or undermine the capacity of tax authorities to raise revenues in circumstances where it would be legitimate to do so. The OECD has led the

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81. *Id.*
82. *Id.*
83. G20 Cannes Summit, *Cannes Summit Final Declaration – Building Our Common Future: Renewed Collective Action for the Benefit of All*, para. 35 (Nov. 4, 2011), *available at* http://www.g20.utoronto.ca/2011/2011-cannes-declaration-111104-en.html.

efforts to address these problems both through its International VAT/GST Guidelines initiative and its Model Tax Convention on Income and on Capital. Such initiatives should be welcomed and embraced by the main participants in the global service market. But work remains to be done with respect to services supplied over the wire through electronic means. Crucial interpretative issues such as the definition of the place of supply, the place of consumption and the place where profits are generated by this type of services are in need of further clarification with a view to facilitate a consistent allocation of taxing rights between states.

Comment and Case Note