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# Taxation and Non-Discrimination: A Reconsideration

Hugh J. Ault

*Boston College Law School, [hugh.ault@bc.edu](mailto:hugh.ault@bc.edu)*

Jacques Sasseville

*Organisation for Economic Co-operation and Development, [jacques.sasseville@oecd.org](mailto:jacques.sasseville@oecd.org)*

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## ***Taxation and Non-Discrimination: A Reconsideration***

### **1. Introduction**

In 2005, the OECD launched a project on Taxation and Non-Discrimination, and asked a working group composed of tax officials from its Member countries to present a report on this issue at the end of 2006. The report of the working group was released as a Discussion Draft in May 2007,<sup>1</sup> and its conclusions were ultimately incorporated in the 2008 update to the OECD Model.

That Report focused exclusively on issues related to the interpretation and application of the current provisions of Art. 24 (Non-discrimination) of the OECD Model. It recognized, however, that some issues require a more fundamental analysis of the issue of non-discrimination and taxation, which could lead to changes to Art. 24. It was agreed that such work would benefit from the input of experts with different backgrounds and perspectives. As a result, an invitational seminar on fundamental aspects of the issue of taxation and non-discrimination was organized and held on 14-15 April 2008. The seminar was hosted by the International Tax Center Leiden (the Netherlands) under the auspices of the International Network on Tax Research (INTR) and in cooperation with the OECD.

The objective of the seminar was to allow an in-depth discussion of policy issues related to the application of the non-discrimination principles to taxation. While covering issues on non-discrimination generally, the seminar also focused on what lessons might be derived for bilateral tax conventions from the jurisprudence of the European Court of Justice (ECJ) on the relationship between tax measures and the four freedoms provided for by the EC Treaty. While not formally articulated as matters of non-discrimination, the analysis of these cases may be potentially helpful in re-examining the role of non-discrimination in bilateral tax relationships.

The general purpose of the discussion on specific areas in the seminar was to suggest options for changes to the OECD Model, including, but not limited to, Art. 24 on non-discrimination.

For each specific area to be examined, contributors were invited to examine the possibility of new or amended rules, having regard to the following principles:

- such new or amended treaty rules should ensure greater cross-border neutrality, so as to promote the most efficient allocation of resources and thereby maximize global welfare;
- these rules should not substantially alter the existing allocation of taxing rights (the purpose of the seminar is not to review how taxing rights are allocated under the provisions of tax treaties);

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\* Professor of Tax Law at Boston College Law School and Senior Advisor to the Centre for Tax Policy and Administration, OECD. The author can be contacted at [hugh.ault@bc.edu](mailto:hugh.ault@bc.edu).

\*\* Head of Tax Treaty Unit, OECD. The author can be contacted at [jacques.sasseville@oecd.org](mailto:jacques.sasseville@oecd.org).

1. OECD Centre for Tax Policy and Administration (CTPA), "Application and Interpretation of Article 24 (Non-Discrimination)", Public discussion draft, 3 May 2007, available online from <http://www.oecd.org/dataoecd/59/30/38516170.pdf>.

- these rules should not require countries to achieve substantially greater harmonization of their tax systems, and
- these rules should not unduly affect a country's ability to exercise the taxing rights allocated to it.

The concept of cross-border neutrality that is referred to in the preceding paragraph has traditionally been analysed from the perspective of capital export neutrality and capital import neutrality. Capital export neutrality ideally requires that the combination of the tax systems of the two countries that conclude a tax treaty provides no tax advantage or disadvantage for a resident of one country to invest at home rather than in the other country. Capital import neutrality ideally requires that all investments in a country bear the same marginal tax regardless of the residence of the investor. Thus, under capital import neutrality, the combination of the tax systems of the two countries that conclude a tax treaty should provide no tax advantage or disadvantage, with respect to an investment in one of the countries, for a non-resident investor when compared to a resident investor.

Absent a complete harmonization of tax systems (clearly an unrealistic option at this point in time), it is not possible to achieve both capital export neutrality and capital import neutrality. Taking into account the existing allocation of taxing rights provided for by tax treaties based on the OECD Model, which often allows both source and residence taxation of the same income, capital export neutrality and capital import neutrality in relation to tax treaties will essentially depend on issues related to non-discrimination and relief of double taxation. As regards foreign income of a resident, full capital export neutrality would require that that income be taxed by the country of residence at the same time as domestic income (i.e. no deferral) and that that country provide full credit against the domestic tax liability for the tax paid in the state of source (refunding the excess foreign tax if necessary). As regards domestic income of non-residents, full capital import neutrality would require that the country of source tax the domestic income of residents and non-residents in exactly the same way and that there be no additional tax levied in the country of residence.

The existing treaty non-discrimination rules are essentially pursuing a capital import neutrality policy: the underlying objective of Art. 24(3), (4) and (5) is to ensure, in some areas, that the country where an investment is made treats similarly resident and non-resident investors. In other words, the kind of neutrality that treaty non-discrimination is concerned with is neutrality in the taxation, by the country of source, of residents and non-residents. While capital import neutrality will not be fully achieved if the country of residence collects additional tax on the income that the country of source taxes without any discrimination, this simply reflects the fact that tax treaties do not make a choice between capital export neutrality and capital import neutrality and allow both the credit and exemption systems for the elimination of double taxation. The country of residence can indeed decide to also tax the foreign income of its residents that may be taxed in the country of source, but this is acceptable from a treaty perspective as long as the country of residence relieves any double taxation through a credit (a capital export neutrality policy<sup>2</sup>) or decides to exempt such income from residence taxation (a capital import policy).

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2. Full capital export neutrality, however, will not be achieved to the extent that the country of residence does not give a credit for (in effect, refund) the part of the tax levied by the country of source that exceeds its own tax. However, it would be unrealistic to expect countries to use domestic tax on domestic income to refund taxes levied by another country. Full capital export neutrality will also not be achieved to the extent that the country of residence does not tax foreign income at the same time as domestic income.

One objective of neutrality that guided the discussion of treaty non-discrimination rules during the seminar was therefore essentially neutrality in the taxation, by the country of source, of income of residents and non-residents.

Neutrality in the taxation, by the country of residence, of domestic and foreign income of its residents – which is required for capital export neutrality – raises different issues and is also related to relief of double taxation. Clearly, the relief of double taxation is a necessary prerequisite for capital export neutrality and is covered by the existing treaty rules. But nothing in existing treaty rules ensures that foreign and domestic income must be treated similarly by the residence country. For example, a country could provide a lower rate for domestic income than for foreign income, without violating any existing treaty rules. This leads to the question of whether the scope of treaty non-discrimination rules should be extended to cover cases where the country of residence, whilst eliminating double taxation, would tax the foreign income of its residents more heavily than their domestic income. Since countries could, and sometimes do, achieve the same result through preferential taxation of domestic income, this is related to the issue of subsidies for domestic investment, which take the form of both direct grants and tax subsidies.

Outside the European Union, which has state aid rules, there is currently very little international restriction on the granting of either direct or tax subsidies. The WTO Agreement on Subsidies and Countervailing Measures merely prevents subsidies related to domestic production or exports. That agreement applies to direct tax measures (e.g. it was used to strike down the US foreign sales corporation (FSC) regime and its successor, the extraterritorial income exclusion (ETI) regime). Since there is no general globally applicable discipline with respect to other forms of subsidies, it would seem difficult to extend the tax neutrality concept to cover preferential taxation (i.e. tax subsidies). The seminar therefore did not focus on tax subsidies (so-called positive discrimination), although it was recognized that the case of ring-fenced regimes raised issues that do not arise in the case of direct subsidies.

On the other hand, there may be situations which cannot be characterized as involving subsidies, where the residence country applies structural rules to situations involving foreign income and foreign taxpayers which are stricter than those applied to an exclusively domestic situation. The identification of those situations and the possible extension of existing non-discrimination rules to such situations was another issue which was dealt with in the seminar.

Participants in the seminar included academics, tax advisors, government officials and members of the OECD Secretariat. Short background notes on the various issues which were the focus of the seminar were provided to the participants and are set out below along with a brief summary of the discussion at the seminar. Individual papers dealing with specific topics were also prepared and are presented in this article.

## **2. Background Notes**

### ***2.1. Treatment of dividends***

The underlying assumption for this session was that non-discrimination rules of tax treaties should pursue the economic objective of cross-border neutrality so as to promote the most efficient allocation of resources and thereby maximize global welfare. That assumption is

particularly important in the case of cross-border dividends, as their tax treatment will be a main factor in determining the after-tax return on investment.

Since total neutrality with respect to cross-border dividends would require the harmonization of the tax systems of the state of source and the state of residence, it is not a practical option. One could argue, however, that the objective of non-discrimination should be to ensure that, as far as possible, the state of source treats similarly dividends paid to its residents and non-residents. Translating this principle into practical legal rules is, however, extremely difficult. Though the issues come up somewhat differently in the context of the ECJ, some of those decisions may be relevant in a bilateral context.

### *2.1.1. Dividends: allocation of taxing rights under tax treaties*

Tax treaties provide that the state of source has the prior right to tax the business profits attributable to a permanent establishment of a non-resident company (Art. 7). The state of residence has the right to tax the worldwide profits of any resident enterprise, such as a subsidiary, subject to providing relief from double taxation to the part of these profits that is taxable in other countries (Arts. 7 and 23).

Art. 10 (Dividends) applies with respect to the distribution of a domestic company's profits. It recognizes that the state of source has a prior claim to tax the distributions but that the right is limited to:

- 5% in the case of direct dividends (i.e. those paid to a company holding more than 25% of the capital of the paying company); and
- 15% in the case of portfolio dividends.

The result of these rules is that if a non-resident taxpayer (individual, company, partnership) carries on business through a branch, tax treaties give an unlimited right to tax the branch profits to the state of source. If a non-resident taxpayer (individual, company, partnership) carries on business through a local company, tax treaties give to the state of source an unlimited right to tax the profits of the local company plus a limited right to an additional tax on distributed profits (while the OECD Model does not deal specifically with branch taxes, a number of tax treaties provide that the limited tax that the state of source may apply to direct dividends may also be applied to branch profits).

One could of course question the policy rationale for allowing any additional right to tax dividends. If the state of source has the right to tax the profits of a local company, should that not be enough? That, however, is not really an international tax question; it is the familiar issue of the relationship between the corporate tax and the shareholder tax. The domestic laws of most countries provide for some level of shareholder tax and the amount of shareholder tax levied on dividends was probably higher when the treaty rules applicable to dividends were first designed. Since most countries entering into tax treaties have either a classical or a partial-relief system, it is not surprising that tax treaties allow for the source taxation of dividends. Also, because of the wide variations and frequent changes in domestic laws on this issue (e.g. the United States has gone from a full classical system to 15% shareholder tax in 2003; many European countries have been moving from imputation systems to partial-relief systems as a result of ECJ decisions), the safest approach when negotiating a treaty that is intended to apply for a long period of time is to allow a country the right to tax dividends paid by its resident companies.

Ideally, in the case of portfolio dividends, one would want the tax payable on dividends paid to non-resident shareholders to be the same as that levied on resident shareholders. For practical reasons, however, the correct determination of the deductible expenses related to the investment and the ability to pay of non-residents has historically been considered impossible to determine: the treaty compromise has therefore been to limit the source country right to tax to 15% of the gross amount of the dividend.

In the case of dividends paid to companies that own more than 25% of the capital of the paying company (i.e. direct dividends), however, the analysis is more complex. The domestic laws of most countries recognize that there is a need to avoid multiple levels of corporate tax and, therefore, that the shareholder tax should not be payable as long as profits are not distributed to non-corporate shareholders.

Treaties recognize that situation but also acknowledge that in a purely domestic context, the shareholder tax would be payable when the receiving company ultimately pays a dividend to an individual shareholder. For that reason, the traditional treaty compromise has been to allow the state of source to levy tax at a rate limited to 5% of the gross amount of direct dividends.

One can certainly question whether the traditional compromise is a good approximation. A more detailed analysis could be done (e.g. by looking at the average dividend pay-out ratio of multinational companies and at the present value of the shareholder tax that should ultimately be collected by the state of source), but the answer would still end up being an arbitrary rate. One should note, however, that the EU Parent-Subsidiary Directive, the traditional approach of the Netherlands, and the US and Australian recent treaty practices suggest that many OECD countries now consider that exempting direct dividends from any source taxation is a better approach.

### *2.1.2. Dividends: relief of double taxation in the state of residence*

Taxation of corporate profits is divided between the tax on the profits levied at the level of the company and the tax on the dividends levied at the level of the shareholder. The foreign tax credit mechanism provided for in Art. 23 of the OECD Model, however, does not expressly recognize the tax levied at the level of the company for the purposes of relief of double taxation on the dividends. This is discussed in Paras. 49-52 of the Commentary on Art. 23, which leave that issue open:

These provisions effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. [...] The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. [...] In the end, it appeared preferable to leave States free to choose their own solution to the problem.

If, in a purely domestic context, the shareholder taxation on the dividend does not take account of the tax paid by the company, it is difficult to argue that, in a cross-border context, a resident shareholder should be entitled, in his country of residence, to relief for the corporate tax paid by the foreign company. In the case of domestic intercorporate dividends, however, many tax systems relieve economic double taxation and it is therefore logical to ask

whether treaties should not provide for the same relief for cross-border dividends. It is, however, technically complex to provide relief for the underlying corporate tax paid by a foreign company and countries that do so only do it in the case of substantial intercorporate shareholdings (e.g. 10% or more).

### 2.1.3. ECJ decisions on these issues

The ECJ has rendered a number of decisions on the application of the fundamental freedoms to the taxation of dividends (see also the Communication of the European Commission on dividend taxation of individuals in the Internal Market, COM(2003) 810). A main objective of the session was to examine whether some of the rules that indirectly emerge from these decisions provide a better approach to the taxation of cross-border dividends and could be incorporated into practical non-discrimination rules for tax treaties, taking into account the existing treaty rules for allocation of taxing rights.

The following are some of the ECJ cases and issues that seem relevant:

- *Athinaiki Zithopiia AE* (C-294/99) (see also *Epson Europe BV* (C-375/98)): should a tax imposed on the company on its distributions be treated the same way as a tax on dividends for the purposes of tax treaty limitations (this is especially relevant for systems such as those of Estonia and Chile, which levy higher taxes on distributed profits)?
- *Bosal* (C-168/01) (see also C-439/07 with respect to the 95% deduction rule applicable in Belgium): should expenses that are deductible with respect to investments in domestic shares that give rise to exempt dividends be similarly deductible with respect to investment in foreign shares that give rise to exempt dividends?
- *Manninen* (C-319/02) (see also *Meilicke* (C-292/04), *Lenz* (C-315/02), *Verkooijen* (C-35/98), and *Commission v. Greece* (C-406/07)): should the benefit of an imputation system or partial relief system provided to residents with respect to domestic dividends be extended to foreign dividends received by residents?
- *Test Claimants in the FII GLO* (C-446/04): if a country exempts domestic intercorporate dividends from corporate income tax, should it similarly exempt from corporate income tax dividends received by a domestic parent company from a foreign subsidiary?
- *Denkavit* (C-170/05) and *Amurta* (C-379/05): if a country exempts domestic intercorporate dividends from any withholding tax, should it similarly exempt from withholding tax dividends paid by a domestic company to a foreign company? In particular, should it exempt dividends paid to a foreign company also if the withholding tax otherwise due can be credited in full against the corporate income tax payable by the foreign company in accordance with the provisions of either its domestic law or the applicable tax treaty?
- *Metallgesellschaft Ltd* (C-397/98) (see also *Test Claimants in Class IV of the ACT Group Litigation* (C-374/04)): if a country exempts domestic intercorporate dividends from payment of an equalization tax that is part of its imputation system, should it similarly exempt dividends paid by a domestic company to a foreign company?
- *Bouanich* (C-265/04): should the treatment of share repurchases (or liquidations) be the same for resident and non-resident shareholders? Should it be considered to be discrimination to treat a share repurchase as a capital gain for a resident but as a dividend for a non-resident?

- *Avoir fiscal* (270/83) and *Saint-Gobain* (C-307/97): should permanent establishments of foreign enterprises be treated like resident shareholders with respect to dividends that they receive? In particular, should permanent establishments of foreign enterprises be entitled to the same tax treaty benefits that are available to resident shareholders?
- *Orange European Smallcap Fund NV* (C-194/06): should the preferential treatment of dividends received by domestic investment funds with domestic investors be extended to domestic investment funds with foreign investors? Should the differential treatment of dividends received by domestic investment funds from different foreign companies be considered to be discrimination?
- *Kerckhaert and Morres* (C-513/04): is it sufficient to provide for the same treatment of domestic dividends and foreign dividends in the hands of resident taxpayers, irrespective of the tax treatment in the other country?

## **2.2. Personal allowances, deduction of personal expenses and tax rates applicable to non-residents**

Like other sessions, this session started from the assumption that the economic objective of cross-border neutrality should be the ultimate goal of tax treaties' non-discrimination provisions. That objective should only be pursued, however, to the extent that the non-discrimination rules do not substantially affect the allocation of taxing rights under other treaty provisions and may be practically applied.

Some of the main differences found in the domestic laws of many countries between the treatment of residents and non-residents relate to personal allowances, the deduction of personal expenses and tax rates. There may also be differences with respect to domestic and foreign income in determining the personal allowances, the deduction of personal expenses and tax rates applicable to residents. This raises the issue of whether non-discrimination rules that would achieve a closer approximation in the treatment of residents and non-residents, as well as domestic and foreign income, should or could be achieved in these areas.

### *2.2.1. The relevant principles of tax treaties*

Since personal allowances and progressive rates seek to take account of the ability to pay of taxpayers, domestic law usually restricts their application to taxpayers that are subject to the most comprehensive liability to tax. The ability to pay of these taxpayers can be effectively measured by taking into account their income from all sources. This is not the case for non-residents, as the source country will only tax certain types of domestic income derived by them.

A difficult issue, however, arises where most of the income of a resident of one country is derived from another country – in that case, the personal allowances in the country of residence may be of no or limited benefit, whereas the fact that personal allowances are not available in the state of source puts the taxpayer at a clear disadvantage unless he is subjected to a lower rate of tax.

The deduction of personal expenses, such as maintenance payments or pension contributions, gives rise to the same issue but, in addition, raises the problem of a possible mismatch between the deduction of the payment and its ultimate taxation. This is especially problem-

atic for pension contributions: whilst allowing the deduction of contributions for a resident may be considered to be merely a deferral of tax, since the pension paid to that resident will be taxed (unless there is a change of residence), a deduction granted to a non-resident is more likely to constitute a tax exemption in the state of source.

While some bilateral treaties deal with these issues, the OECD Model generally does not extend the benefit of personal allowances and personal deductions to non-residents (see, however, Paras. 31-65 of the Commentary on Art. 18, which include an alternative provision that ensures the deductibility of pension contributions paid by non-residents in some circumstances). Art. 24(3), which generally ensures that the taxation on permanent establishments of foreign enterprises is not less favourable than the taxation of domestic enterprises, includes the following express exclusion:

This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

Another aspect of the issue of non-discrimination with respect to personal allowances and personal deductions is to what extent these should be allocated to foreign income in the case of a resident. If that resident does not get the benefit of a pro rata part of the personal allowances/general deductions in the country of source, is it appropriate to reduce the benefit of the personal allowances/general deductions in the country of residence by allocating them to the foreign income, which may be exempt or not taxed because of a foreign tax credit? This issue is discussed in Paras. 39-43 of the Commentary on Art. 23, where the conclusion is that “[i]n view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique.”

Since the application of progressive rates of taxation only makes sense if the overall ability to pay of the taxpayer can be measured, it is not surprising that tax treaties do not require that rates applicable to residents and non-residents be the same. One exception is that applicable to the profits attributable to a permanent establishment of a non-resident: in that case, Art. 24(3) requires that taxation not be less favourable than that on a domestic enterprise. Para. 56 of the Commentary on Art. 24 confirms that this requires the application of the same rate of tax, but suggests that if the rates are progressive, the state of source could determine the applicable rate by reference to the worldwide profits of the non-resident (the discussion focuses on progressive rates applicable to companies, as most permanent establishments belong to companies rather than to individuals):

When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way.

Of course, depending on how the profits of the whole company are taken into account, if a similar policy were followed by multiple states in which a company had permanent establishments, the result could be a higher aggregate tax burden than if all of the company's worldwide profits were taxable in any one state, so in that sense even this approach may fail to achieve neutrality.

### 2.2.2. ECJ decisions on these issues

The ECJ has rendered a number of decisions on the issues of personal allowances, rates of taxation and various personal deductions. These decisions follow an approach radically different from that of tax treaties, as they generally consider that non-residents should be entitled to personal allowances, personal expenses and rates of tax applicable to residents, at least if almost all the income of the non-resident arises from the state of source.

The following are some of the ECJ cases and issues that seem relevant:

- *Turpeinen* (C-520/04): should it be considered to be discrimination to subject pension payments to non-residents to a flat withholding tax which, in certain cases, is higher than the tax which that taxpayer would have had to pay if he/she had been a resident?
- *Gerritse* (C-234/01): should it be considered to be discrimination to levy a withholding tax on non-resident entertainers at a lower uniform rate deducted at source, whilst the income of residents is taxed according to a progressive table including a tax-free allowance?
- *Schumacker* (C-279/93) (see also *Wallentin* (C-169/03) and *Meindl* (C-329/05)): these cases have held that where a non-resident derives most of his income from a country, that country should grant to that non-resident personal allowances that are available to residents. The fact that the rate applicable to the non-resident on the income that is taxable in the country of source may be lower than the rate applicable to residents of that country is not a justification for that country not granting these allowances.
- *Wielockx* (C-80/94): this case has held that where a non-resident derives most of his income from a country, that country should grant to that non-resident the same right to deduct pension contributions that is available to residents regardless of how taxing rights are allocated on pension payments.
- *Gschwind* (C-391/97): should the benefit of the joint assessment for married couples be given to non-residents?
- *Asscher* (C-107/94): (progressive) income tax rate applied to a non-resident taxpayer should be determined without regard to any income the taxpayer derives from (foreign) sources in respect of which he is not subject to tax in the source country.
- *D* (C-376/03): for the purposes of wealth tax, should it be considered to be discrimination to deny non-residents who hold the major part of their wealth in the state where they are resident entitlement to the allowances which it grants to resident taxpayers?
- *De Groot* (C-385/00): is foreign income being discriminated against if personal allowances of a resident are allocated proportionally to domestic income and foreign income so that part of the personal deductions, such as the deduction of alimony payments made to a former spouse, are allocated to income that is not taxed in the residence country under the exemption method?
- *Ritter-Coulais* (C-152/03) (see also *Lakebrink* (C-182/06) and *Renneberg* (C-527/06)): it was held in this case that, for the purposes of determining the taxable income of non-residents in the source state or in the computation of the rate of tax applicable to them, the non-residents should be able to claim rental income losses (negative income) incurred in

their state of residence through the use of their house located there for their own needs as if that house had been located in the state of source.

- *Blanckaert* (C-512/03): should a non-resident who derives only investment income from a country and who does not pay any social security contributions in that state be entitled to an income tax credit for contributions to a national social security scheme in that country in the calculation of his taxable income there when a resident who also derives only investment income and pays no social security contributions would be entitled to such a credit?
- *Jundt* (C-281/06): it was found incompatible with the freedom to provide services for a country to restrict an income tax exemption granted for part-time teaching activities to teaching activities performed in universities established in that country.

### **2.3. Recognition of group of companies (e.g. transfer pricing, corporate reorganizations and transfer of losses)**

The extent to which tax systems take account of the relationship between related companies creates particular issues for tax treaties. In this area, the objective of neutrality – which would generally require the same treatment of resident and non-resident companies and investors – will often conflict with the need to preserve the tax treaty allocation of taxing rights.

This session considered possible changes that could be made to tax treaty non-discrimination rules to achieve greater neutrality with respect to situations where domestic law recognizes groups of companies. Such changes, however, should be practical and should not substantially affect the existing treaty principles for the allocation of taxing rights with respect to business profits, dividends and capital gains. A main focus of the session was to examine whether and to what extent EU law (e.g. the Merger Directive and decisions rendered by the ECJ with respect to provisions related to groups of companies) could provide useful lessons in this area.

#### *2.3.1. Recognition of groups of companies under tax treaties*

Tax treaties are based on the separate-entity and arm's length principles. Thus, for tax treaties, each company is a separate person regardless of who owns its shares. This is expressly recognized in Art. 5(7), which clarifies that the fact that a company is a subsidiary of another company does not, in itself, make either company a permanent establishment of the other.

Subject to a few exceptions, tax treaties do not take into account the relationship between two companies or between a company and its shareholders. The two main exceptions<sup>3</sup> are:

- the provisions of Art. 9, which confirm that countries can adjust the profits of associated enterprises to deal with non-arm's length transfer pricing and provide for a corresponding adjustment; and
- Art. 10(2)(a), which provides for a lower rate (5%) of tax on direct dividends, i.e. dividends paid to a company that holds at least 25% of the capital of the paying company.

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3. Other possible exceptions are Arts. 11(6) and 12(4), which deal with interest and royalties that exceed what would have been paid absent a special relationship between the payer and the beneficial owner of the income, and Art. 13(4), which authorizes the source country to tax capital gains on shares deriving more than 50% of their value directly or indirectly from immovable property located in that country.

The Commentary on the OECD Model also includes a number of references to groups of companies. These are primarily related to anti-abuse measures (see the provisions to prevent the use of conduit or base companies that are included in the Commentary on Art. 1) and the treatment of intercorporate dividends.

The approach of tax treaties must be contrasted with that of the domestic laws of many states, which recognize that within a single economic unit, such as a multinational enterprise, the separate-entity principle may sometimes be inappropriate and which, for that reason, include specific rules either to prevent tax avoidance (e.g. thin capitalization rules, CFC rules, etc.) or to prevent excessive or inappropriate taxation (e.g. consolidation, exemption of intercorporate dividends, corporate reorganization rules, etc.).

The session discussed whether such rules, if found in domestic law, should apply equally to resident and non-resident companies and permanent establishments, rather than whether such rules should be required in countries that do not have them.

### *2.3.2. Application of existing non-discrimination rules*

As already mentioned, there are two different categories of domestic rules dealing with groups of companies: those aimed at preventing tax avoidance and those aimed at preventing excessive or inappropriate taxation. The issue of cross-border discrimination presents itself differently in the two categories. In the case of rules aimed at preventing tax avoidance, the issue is primarily whether rules that only apply in cross-border situations should be considered discriminatory; in the case of rules aimed at preventing excessive or inappropriate taxation, the issue is rather whether it is discriminatory not to extend the application of the domestic rules to cross-border situations.

#### *2.3.2.1. Domestic rules to prevent tax avoidance*

One aspect of the treatment of groups of companies is the extent to which domestic anti-abuse rules that apply primarily to situations involving non-resident companies that are part of a group raise non-discrimination issues. This would be the case, for instance, with transfer pricing and thin capitalization rules.

In these cases, the different treatment of resident and non-resident companies seems to be justified by the need for each country to effectively enforce the taxing rights that are recognized by the treaty. Since concerns about transfer pricing and thin capitalization do not typically arise with respect to transactions involving two resident companies, there seems to be a valid policy justification for restricting the application of such rules to cross-border situations.

One issue, however, is whether the current drafting of Art. 24 is adequate in this regard. For instance, not all domestic thin capitalization rules comply with Art. 24(4) as currently drafted. Also, while that position has been rejected in the May 2007 discussion draft and the resulting changes to the Commentary on Art. 24, it has been argued that Art. 24(5) could prevent the application of thin capitalization or transfer pricing rules between a resident subsidiary and a non-resident parent (or between a resident subsidiary and a non-resident sister company commonly owned by a non-resident parent) if these rules did not also apply in a similar situation involving a resident subsidiary and a resident parent (or a resident subsidiary and a non-resident sister company commonly owned by a resident parent).

### 2.3.2.2. Domestic rules to deal with excessive or inappropriate taxation

While some commentators have argued that the existing non-discrimination rules of Art. 24(3) and (5) of the OECD Model could be interpreted as extending to non-resident companies the application of domestic rules allowing for consolidation, transfer of losses or tax-free transfers between resident companies, this approach is not followed in the Commentary.

Regardless of the respective merits of these different interpretations of existing law, the question raised during the seminar was whether and to what extent domestic rules dealing with groups of companies should, as a matter of policy, be extended to non-resident companies. Several situations must be distinguished.

In general, since treaty allocative rules restrict a country's right to tax non-resident companies, it seems clear that it would not be possible to simply extend such domestic rules to non-residents without a substantial loss of tax revenues. To take a simple example, whilst it may make sense for a country to allow consolidation or the transfer of profits between two resident companies that are part of the same group because both companies are fully subject to tax in that country, it would not seem appropriate for that country to allow consolidation or the transfer of profits between a resident and a non-resident companies if the result would be that income that is taxable in that country could effectively be transferred to the non-resident company, in the hands of which it would become non-taxable under the provisions of the treaty.

It may be, however, that some domestic rules concerning groups of companies could be partially extended to non-residents with some adaptations or under certain conditions. In the above example, there would seem to be no policy reason why a country that allows the transfer of profits between two related resident companies should not at least allow the permanent establishment of a non-resident company to transfer its profits to a related resident company (the reverse situation of a transfer of profits from the resident company to the permanent establishment is more problematic, as it could trigger a potential loss of dividend withholding tax). Similarly, allowing the transfer of profits or losses between two resident subsidiaries of a non-resident parent company would not necessarily disturb the allocative rules of treaties.

Another approach could be to design treaty rules that would extend to non-residents the benefit of a country's domestic rules applicable to groups of companies, while preserving the taxing rights of that country. Assume, for example, that a country allows resident companies to make tax-free asset-for-share exchanges with related resident companies. It could rightly be concerned that allowing such exchanges with a related non-resident company to be tax-free would allow the resident company to avoid capital gains taxation on a transfer of assets (such as portfolio shares) outside the group by first transferring these assets to a foreign related company, which would subsequently sell the assets to a third party. A possible solution, however, could be to design a treaty rule that would extend the application of the domestic rule to a transfer to a related non-resident company, but only as long as the country is allowed to subsequently tax any capital gain arising from a subsequent transfer of these assets outside the group. In both cases, however, it would be necessary to consider the possible double taxation implications of either current or deferred taxation.

Since domestic rules applicable to groups of companies and related taxpayers vary considerably between countries and change over time, it would seem extremely difficult to design spe-

cific treaty rules that would achieve that purpose. A generic solution granting some degree of discretion to the tax authorities may be the best that could be achieved. The prototypical example of that approach is Art. XIII(8) of the Canada–United States treaty, which provides that:

Where a resident of a Contracting State alienates property in the course of a corporate or other organization, reorganization, amalgamation, division or similar transaction and profit, gain or income with respect to such alienation is not recognized for the purpose of taxation in that State, if requested to do so by the person who acquires the property, the competent authority of the other Contracting State may agree, in order to avoid double taxation and subject to terms and conditions satisfactory to such competent authority, to defer the recognition of the profit, gain or income with respect to such property for the purpose of taxation in that other State until such time and in such manner as may be stipulated in the agreement.<sup>4</sup>

It should be acknowledged, though, that the scope of that provision is quite limited, as it deals primarily with cases of timing mismatches in the recognition of gains; in other words, it effectively applies only in cases where the initial transfer of the asset in question is potentially taxable at that time by *both* contracting states (e.g. as might be the case for certain real property interests or stock in real property corporations) and only one state would allow deferral of the tax under its domestic law. It may be possible to design a rule of broader application that would cover a larger category of provisions applicable to groups of companies. For example, a more broadly designed provision would be needed to deal with the arguably more typical case where the initial transfer of the asset is potentially taxable only by one contracting state, and where the transferor would have enjoyed deferral in that state if the transfer had been made to a resident transferee but does not enjoy such deferral if the transfer is made to a non-resident. A main issue, however, would be whether such a practical rule could be designed without granting discretionary powers to each country.

### 2.3.3. ECJ decisions on these issues

The ECJ has rendered a number of decisions on the application of the fundamental freedoms with respect to domestic provisions related to the taxation of groups of companies. The Parent-Subsidiary and the Merger Directives also deal with groups of companies. A main objective of the session was to examine whether some of the rules that indirectly emerge from these decisions and directives provide a better approach to a non-discriminatory treatment of groups of companies under tax treaties, taking into account the existing treaty rules for the allocation of taxing rights.

The following are some of the ECJ cases and issues that seem relevant:

- *Futura Participations* (C-250/95): should it be considered discriminatory if losses incurred by a non-resident company can be carried forward only insofar as they are economically connected to a permanent establishment and subject to the condition that the company keeps and holds separate accounts relating to that establishment in the year in which the losses arose and which comply with the relevant tax accounting rules?
- *ICI* (C-264/96): should it be considered discriminatory to deny a resident holding company the benefit of consortium relief for losses incurred by resident subsidiaries if the majority of its subsidiaries are resident in other states?

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4. Somewhat similar provisions can be found in the United States–Mexico and United States–Spain treaties.

- *X AB and Y AB* (C-200/98): should it be considered discriminatory to deny tax relief in respect of intra-group transfers between resident companies if the transferee company is owned by two or more non-resident companies which are resident in different states?
- *X and Y* (C-436/00): should it be considered discriminatory to deny resident taxpayers deferral of tax due on capital gains derived from the alienation of shares if either the transferee company itself is resident in another state or its shareholder is a company which is resident in another state?
- *CLT-UFA* (C-253/03): should it be considered discriminatory to deny a non-resident company the benefit of a reduced corporate income tax rate which is applicable to resident companies upon distribution of their profits and imputed to their shareholders to avoid economic double taxation of those profits?
- *N* (C-470/04): should it be considered discriminatory to tax unrealized capital gains inherent in shares or other assets only if they are transferred abroad, e.g. to a different part of the same enterprise carried on by a non-resident company?
- *Marks & Spencer* (C-446/03): should the group relief rules of a country which allow transfers of losses from a resident subsidiary to a resident parent, be extended to allow the transfer of losses from a non-resident subsidiary to a resident parent, and if so, under what conditions?
- *Oy AA* (C-231/05): where domestic rules allow a transfer of profits from a resident subsidiary to a resident parent for tax purposes, should it be considered discriminatory not to allow a similar transfer of profits from a resident subsidiary to a non-resident parent? (In this decision, it was held that such an extension should not be required under the fundamental freedoms as to do otherwise would undermine the allocation of taxing rights between the two countries.)
- *AMID* (C-141/99): should it be considered to be discriminatory to require that a resident corporation first apply domestic losses realized in a given year against profits from its foreign permanent establishments for that year instead of applying these losses against domestic profits for a subsequent year?
- *Leur-Bloem* (C-28/95): should it be allowable, for purposes of determining whether cross-border share-for-share exchanges satisfy the Merger Directive's criterion of having been made for "valid commercial reasons", to consider whether they were made for the attainment of a purely fiscal advantage, such as horizontal offsetting of losses?

#### **2.4. Withholding taxes**

Clearly, withholding taxes that are applied exclusively to non-residents or that are final taxes only for non-residents do not meet the objective of neutrality between domestic and foreign taxpayers. Such withholding taxes are typically applied to passive income, such as dividends, interest, rents, royalties and pensions. They may also be levied, however, on certain types of active income, in particular payments for services (e.g. to non-resident subcontractors and entertainers). The main issue that the participants were invited to discuss was whether, as regards the types of income with respect to which taxing rights are granted to the state of source, there are practicable alternatives that would offer the same treatment, or a better approximation of the same treatment, of domestic and foreign taxpayers.

#### 2.4.1. *Withholding taxes and tax treaties*

The provisions of the OECD Model do not expressly refer to withholding taxes. This is consistent with the overall approach of allocating taxing rights between the contracting states without specifying the manner in which these rights should be exercised. For example, Arts. 10 and 11, which allow source taxation of dividends and interest, merely provide a limit, expressed as a percentage of gross payments, that any tax levied by the state of source should not exceed; they do not indicate how such taxes should be determined or collected. A number of paragraphs of the Commentary confirm that approach; for instance, Para. 18 of the Commentary on Art. 10 reads as follows:

Paragraph 2 lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.

The OECD Model also allows states to first levy taxes that treaty provisions do not authorize, provided that these taxes are subsequently reimbursed to the taxpayer. Para. 26.2 of the Commentary on Art. 1, however, recognizes the difficulties that such a refund system can create:

A number of Articles of the Convention limit the right of a State to tax income derived from its territory. As noted in paragraph 19 of the Commentary on Article 10 as concerns the taxation of dividends, the Convention does not settle procedural questions and each State is free to use the procedure provided in its domestic law in order to apply the limits provided by the Convention. A State can therefore automatically limit the tax that it levies in accordance with the relevant provisions of the Convention, subject to possible prior verification of treaty entitlement, or it can impose the tax provided for under its domestic law and subsequently refund the part of that tax that exceeds the amount that it can levy under the provisions of the Convention. As a general rule, in order to ensure expeditious implementation of taxpayers' benefits under a treaty, the first approach is the highly preferable method. If a refund system is needed, it should be based on observable difficulties in identifying entitlement to treaty benefits. Also, where the second approach is adopted, it is extremely important that the refund be made expeditiously, especially if no interest is paid on the amount of the refund, as any undue delay in making that refund is a direct cost to the taxpayer.

#### 2.4.2. *Justification for withholding taxes*

The policy justifications for withholding taxes that are applied exclusively to payments to non-residents seem to be essentially based on administrative concerns related to the determination and collection of tax. Since a non-resident taxpayer will typically have little or no connection with the country of source apart from the right, asset or temporary performance generating the income, withholding at the time of payment has often been found to be the only realistic approach for the source country to collect its tax.

Since the verification of business or investment expenses is more difficult for a non-resident than for a resident, the tax that is withheld as a percentage of the payment is typically a final tax in the case of non-residents. This has the additional advantage of facilitating the application of the foreign tax credit in the state of residence: since the source tax is finally determined at the time of the payment, it can more easily be taken into account at the (later) time of filing an annual tax return in the state of residence.

Rates of final withholding tax on payments to non-residents are almost always lower than those applicable to residents. This reflects a trade-off between a simple and effective collec-

tion of tax and a fairer approximation of the tax that would have been payable if the taxpayer had been a resident. A main issue for discussion is whether that trade-off is still the best approach in policy terms, having regard to the evolution in cross-border assistance between tax administrations, particularly as regards exchange of information and assistance in the collection of taxes.

#### 2.4.3. ECJ decisions on these issues

The ECJ has rendered a number of decisions on the issue of withholding taxes. In many of these decisions, the Court has relied on the existence of a Directive concerning mutual assistance in the field of direct and indirect taxation to rule that the application of withholding taxes restricted to non-residents was not an acceptable approximation of the tax levied on residents.

The following are some of the ECJ cases and issues that seem relevant:

- *Denkavit* (C-170/05) and *Amurta* (C-379/05): if a country exempts domestic intercorporate dividends from any withholding tax, should it similarly exempt from withholding tax dividends paid by a domestic company to a foreign company?
- *Bouanich* (C-265/04): should it be considered to be discrimination to treat a share repurchase as a capital gain (subject to normal tax on the gain only) for a resident but as a dividend (subject to withholding tax on the gross payment) for a non-resident?
- *Turpeinen* (C-520/04): should it be considered to be discrimination to subject pension payments to non-residents to a flat withholding tax which, in certain cases, is higher than the tax which that taxpayer would have had to pay if he/she had been resident?
- *Commission v. Belgium* (C-433/04): should it be considered to be discrimination to oblige main contractors who use non-resident subcontractors not registered in a state to withhold 15% on the payment for the services rendered and to make the main contractor jointly and severally liable for the tax owed by the subcontractors?
- *ELISA* (C-451/05): should it be considered to be discrimination to levy a tax at a fixed rate of the commercial value of immovable property which only applies to non-residents who do not reside in countries with which there is a treaty allowing an effective exchange of information?
- *Gerritse* (C-234/01) (see also *Scorpio* (C-290/04) and *Centro Equestre* (C-345/04)): should it be considered to be discrimination to levy a withholding tax on non-resident entertainers at a lower uniform rate deducted at source whilst the income of residents is taxed according to a progressive table, including a tax-free allowance?

#### 2.5. Non-discrimination and anti-abuse rules

Since residents are normally subject to the most comprehensive form of taxation, whereas non-residents are only subject to tax – often at a reduced rate – on certain types of domestic income, there are circumstances in which there are incentives to shift to non-residents income that would normally accrue to residents. This shifting is particularly easy to achieve between related parties.

For that reason, domestic tax laws include a number of anti-abuse rules that apply exclusively to transactions involving non-residents. For instance, controlled foreign company (CFC) rules deal with the use of non-resident base or conduit companies; foreign investment funds (FIF) rules seek to prevent residents from deferring and avoiding tax on investment income through the use of non-resident investment funds; thin capitalization rules may apply to restrict the deduction of base-eroding interest payments to related non-residents; transfer pricing rules may prevent the artificial shifting of business profits from a resident to a non-resident; and exit or departure taxes may prevent the avoidance of capital gains tax or tax on pension payments through a change of residence before the realization of a treaty-exempt capital gain or pension receipt.

Even if the underlying assumption is that the economic objective of cross-border neutrality should be the ultimate goal of tax treaties' non-discrimination provisions, it would seem inappropriate to conclude that any anti-abuse rules that apply exclusively to transactions involving non-residents should be considered to be discriminatory. Here the difference in situation between the resident and non-resident taxpayer would clearly justify some difference in treatment as far as anti-abuse rules are concerned. The main issue to be discussed during the session was therefore how and to what extent non-discrimination rules should allow for the application of anti-abuse rules and what limits should be imposed on those rules by the non-discrimination principle.

#### 2.5.1. *Anti-abuse rules and tax treaties*

Clearly, where there is a conflict between provisions of domestic law and those of tax treaties, the provisions of tax treaties are generally intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*", which is incorporated in Art. 26 of the Vienna Convention on the Law of Treaties. Thus, if the application of domestic anti-abuse rules had the effect of increasing the tax liability of a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail, at least for the purposes of public international law.

The current limited non-discrimination provisions of Art. 24 already raise difficulties with the application of some domestic anti-abuse rules. For instance, some thin capitalization rules, to the extent that they apply only to interest paid to non-residents, could constitute a violation of Art. 24(4), which generally requires that payments to non-residents be deductible under the same conditions as similar payments to residents. While that paragraph includes a specific exception allowing the application of domestic rules that conform to the provisions of Art. 9(1), 11(6) or 12(4), these paragraphs refer to arrangements that would not be entered into by arm's length parties and would therefore not justify the application of rules that are based on a different basis (e.g. a thin capitalization rule based on a debt-to-equity ratio without a safe harbour for arm's length debt).

Art. 24(5), which prevents discrimination of companies based on whether or not their capital is foreign-owned, does not include a similar specific exception. This may be explained by the fact that Art. 24(4) was included in the OECD Model in 1977, after drafting issues arising from the 1963 draft had been identified. However, since Art. 9(1) specifically authorizes the application of domestic law rules that have the effect of adjusting the profits of associated enterprises according to the arm's length principle, it seems reasonable, when reading Art. 24(5) in the context of the whole OECD Model, to conclude that a similar exception applies to the non-discrimination rule of that paragraph.

2.5.2. *ECJ: recognition of the prevention of abuses as an acceptable restriction to the fundamental freedoms*

The ECJ was quick to recognize that the prevention of abuse could constitute a justification for derogating from the fundamental freedoms (see, for instance, *ICI* (C-264/96)). It took a few cases, however, before a clearer formulation of that justification emerged (see also the recent Communication from the European Commission on the application of anti-abuse measures in the area of direct taxation – COM/2007/785).

The current position of the ECJ is that for an anti-abuse rule to be an acceptable restriction to a fundamental freedom, “the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory” (*Cadbury Schweppes*, Para. 55).

The ECJ, however, does not accept rules that go beyond what is strictly necessary to attain that objective. This, in effect, only justifies anti-abuse rules that require “the consideration of objective and verifiable elements in order to determine whether a transaction represents a purely artificial arrangement, entered into for tax reasons alone” (*Test Claimants in the Thin Cap Group Litigation* (C-524/04), Para. 82). Anti-abuse rules that meet that condition must also, however, meet a proportionality requirement: their effect must not go beyond what is needed to eliminate the abuse (see *Test Claimants in the Thin Cap Group Litigation*, Para. 83).

The ECJ therefore seems to reject any form of anti-abuse rules applicable to arrangements involving non-residents that would not be based on a case-by-case analysis aimed at determining whether the arrangements are tax-motivated.

The following are some of the ECJ cases and issues that seem relevant:

- *Columbus Container Services BVBA & Co.* (C-298/05): should it be considered discriminatory to apply a domestic-law switch-over rule that provides for a switch from the exemption method to the credit method with respect to income of a foreign permanent establishment that would have been subjected to CFC rules if the permanent establishment had been a subsidiary?
- *Test Claimants in the Thin Cap Group Litigation* (C-524/04) and *Lankhorst-Hohorst* (C-324/00): should it be considered to be discriminatory for a country to have thin capitalization rules that do not allow taxpayers to show that there is a commercial justification for the arrangement or, even if they do, that recharacterize interest beyond what would not have been paid at arm’s length? For example, should a thin capitalization rule that is based on a debt-to-equity ratio be considered to be discriminatory?
- *Cadbury Schweppes* (C-196/04): should CFC rules be considered to be discriminatory to the extent that they only apply to profits derived by non-resident controlled companies? Should the answer to that question depend on whether the taxpayer is allowed to escape the application of these rules by showing, “on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives [the] controlled company is actually established in the [foreign country] and carries on genuine economic activities there”?

- *Commission v. Belgium* (C-522/04): should it be considered to be discriminatory for a country to trigger a deemed payment of pensions upon a change of residence by a taxpayer?
- *X and Y* (C-436/00): should it be considered to be discriminatory to disallow, in order to prevent abuse, the application of rules allowing a tax-free transfer of shares to a company if the transferor is a foreign company or a resident company controlled by a foreign company?
- *Hughes de Lasteyrie du Saillant* (C-9/02): should departure taxes be considered to be discriminatory if they do not require the tax authorities to demonstrate abusive purpose for the change of residence in each case (compare *N* (C-470/04))?

**2.6. Should discriminatory tax measures be dealt with through tax treaties, trade and investment agreements or both?**

The seminar finally examined whether the prevention of discrimination towards cross-border activities should primarily or exclusively be dealt with in tax treaties or whether it should also be dealt with in trade and investment agreements, having regard in particular to the dispute resolution mechanisms of both types of instruments.

The non-discrimination provisions of tax treaties cover a limited range of situations with targeted provisions. Various trade and investment liberalization treaties, such as the EC Treaty, the General Agreement on Tariffs and Trade (GATT), the General Agreement on Trade in Services (GATS), the North American Free Trade Agreement (NAFTA) and many bilateral investment and bilateral trade agreements,<sup>5</sup> include more general provisions prohibiting discriminatory treatment that can apply to taxation.

In the 1990s, and in particular during the negotiation of the GATS, the issue of the application of trade and investment liberalization agreements to taxes was the subject of intense discussions between tax officials and trade and investment officials. The view of the tax officials was that if these agreements are too broadly drafted and if tax laws and treaties are not carefully taken into account, the obligations imposed by these agreements may inadvertently have an impact on legitimate tax measures and upset the reasonable expectations and needs of taxpayers and tax authorities. Trade and investment officials, however, argued that taxation may be, and sometimes is, used to discriminate against foreign investment or products and that the general non-discrimination rules of these agreements should apply to all forms of discrimination.

**2.6.1. The treatment of taxes under existing trade and investment liberalization agreements**

The most important multilateral trade agreement is the GATT, which applies national treatment and most-favoured-nation obligations to taxes on products and to taxes applicable to the sale or transfer of products. The GATS, signed at the completion of the Uruguay Round, contains specific provisions relating to taxes. Other multilateral agreements have created specific obligations with regard to taxation. For example, despite the absence of express harmonizing powers for direct taxes (as exist for indirect taxes), EU Member States' national tax sys-

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 5. The bilateral trade agreements can include certain "friendship, commerce and navigation" agreements dating back a century or more.

tems are not excluded from the various “fundamental freedom” provisions of the Treaty. NAFTA imposes national treatment and most-favoured-nation obligations with respect to investment, goods and services – direct taxes<sup>6</sup> are subject to national treatment obligations with respect to trade in goods to the same extent as under the GATT, subject to qualified national treatment and most-favoured-nation obligations with respect to the purchase or consumption of particular services and totally exempt from those obligations with respect to investors and investment (subject to a limited application of the rules on expropriation).

Some multilateral agreements cover trade and investment in particular sectors and impose obligations concerning taxation in the sectors covered. For example, the Energy Charter Treaty contains obligations with regard to taxation in connection with cross-border trade and investment (mostly confined to indirect taxation), but the obligations are limited to measures affecting the energy sector.

Many countries also have an extensive network of bilateral trade agreements and bilateral investment agreements. Some bilateral trade agreements incorporate GATT provisions and GATT principles, and are fairly similar to the GATT in the extent to which (and the manner in which) they apply national treatment and most-favoured-nation obligations to indirect taxes. Other bilateral trade agreements apply a national treatment and most-favoured-nation concept, but not through the incorporation of GATT obligations. Bilateral investment agreements generally do not grant parties to those agreements any treatment, preference or privilege resulting from bilateral or multilateral agreements relating to taxation. Also, many countries, including the United States, exclude taxation from national treatment and most-favoured-nation obligations under bilateral investment agreements.

GATT obligations are of particular importance because they tend to be incorporated into other agreements. Art. III of the GATT requires that national treatment be accorded to internal taxation and regulation. Art. III:1 states that “internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products... should not be applied to imported or domestic products so as to afford protection to domestic production”. More specifically, Art. III:2 provides that “the products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.”

This national treatment obligation with regard to internal taxes has historically been applied only to taxes on products and not to income taxes, in part because indirect taxes on products affect internal consumption to a far greater extent than do direct taxes on the income of foreign producers. One could, however, imagine an example of a consumer incentive provided

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6. The distinction between “direct” and “indirect” taxes is convenient but not always clear. Direct taxes are imposed on the income or wealth of natural persons (that is, individuals) and juridical persons (such as corporations and trusts). Individual and corporate income taxes and taxes on capital or wealth are good examples of direct taxes. Indirect taxes are taxes and duties imposed on the production, extraction, sale, leasing or delivery of goods, and on the rendering of services. They may be levied on the basis of value added, the pre-tax price, or some other characteristic of the good or service and thus are typically passed on in the price charged. Value added taxes, sales taxes, customs duties, and excise taxes are typical indirect taxes.

through the direct tax system that could affect internal consumption in much the same manner as an indirect tax on the product.

Art. I:1 of the GATT contains the most-favoured-nation provisions. It grants to the like products of all GATT contracting parties the benefit of any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country, with respect to inter alia customs duties and charges imposed on import or export and all matters referred to in Art. III:2 and 4. The phrase “all matters referred to in Article [III:2]” gives GATT contracting parties the most favourable treatment granted by a contracting party to any other country with respect to taxes on products. The application of most-favoured-nation obligations to taxes has historically been limited to taxes on products, which are generally excise taxes.

The tax provisions of the GATS gave rise to long and difficult negotiations between tax and trade officials. Three features of the GATS as originally proposed raised particular concerns among tax officials:

- *Most-favoured-nation treatment.* Art. II of the GATS provides generally that each party shall accord to services and service suppliers of any other party treatment no less favourable than it accords to like services and service suppliers of any other country. Tax officials argued that without proper qualification, most-favoured-nation treatment might require any party to extend to all other parties the most favourable benefits granted under any of its bilateral double taxation treaties and agreements.
- *National treatment.* Art. XVII of the GATS provides generally that, subject to certain conditions and in areas identified by the party, each party shall accord to services and service providers of any other party treatment no less favourable than it accords to its own like services and service providers. Tax officials argued that without proper qualification, national treatment obligations might affect the generally accepted practice of making legitimate distinctions between residents and non-residents under domestic tax systems. They also argued that national treatment is broadly dealt with under the non-discrimination articles of bilateral double tax treaties and that an alleged violation of national treatment obligations might therefore give rise to a jurisdictional conflict. They also took the position that if a tax measure is allowed by a bilateral double taxation treaty, it should not be amenable to challenge as a GATS violation.
- *Dispute resolution.* Art. XXII of the GATS provides for consultation among the parties when a dispute under the agreement arises. Art. XXIII of the GATS contains procedures to be followed when a party feels that the actions of another party are not in accord with the agreement. The power to ultimately settle a dispute is given to the Council for Trade in Services (CTS): Art. XXIII provides that disputes arising under the GATS between signatory countries may be referred to the CTS for binding resolution. Tax officials argued that since bilateral double tax treaties contain their own long-established procedure (the MAP) for addressing tax disputes, using the GATS dispute resolution procedures in the area of taxation would allow forum shopping.

These concerns led to the incorporation of special provisions dealing with taxation into the text of the GATS. Art. XIV (General exceptions) of the GATS contains two provisions dealing specifically with tax matters. Measures that are inconsistent with the most-favoured-nation obligation may nonetheless be maintained if they result from an international agree-

ment on the avoidance of double taxation by which the party affording the treatment is bound. Measures that are inconsistent with national treatment may be maintained, provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other GATS members. A lengthy footnote illustrates the broad range of provisions to which this text is intended to apply. In addition, Art. XXII of the GATS as finally adopted provides that Art. XVII (National treatment) may not be invoked under either Art. XXII (Consultation) or Art. XXIII (Binding dispute settlement and enforcement) if the disputed measure falls within the scope of an international agreement between them relating to the avoidance of double taxation. However, if there is disagreement over whether a measure falls within the scope of a tax convention, either party may bring the matter to the CTS, which shall refer the dispute for binding arbitration. A footnote contains the important exception that disputes over the application of a tax convention that exists at the time of entry into force of the Agreement Establishing the WTO may be brought to the CTS only if both parties agree.

#### *2.6.2. The case for applying trade and investment agreements to tax measures*

The relationship between indirect taxes and trade liberalization is easy to understand. Taxes on transfers of goods and services across borders will have an immediate effect on the volume and frequency of those transfers. Because most indirect taxes are reflected in the prices of goods and services, they have a direct and measurable effect on economic activity. For this reason, as already indicated, indirect taxes on goods are subject to the application of many international agreements, including trade and customs treaties.

Direct taxes are paid by producers or households and are not imposed directly on goods, services and transfers. Direct taxes (such as income taxes) may, however, affect cross-border investment and, indirectly, cross-border flows of goods and services. As explained above, while the application of trade and investment agreements is more limited in the case of direct taxes than in the case of indirect taxes, some provisions of these agreements do apply to direct tax measures.

Some of the main arguments raised at the seminar that may be used to argue in favour of the application of trade and investment agreements to tax measures are:

- Tax treaties are bilateral instruments and the coverage of tax treaties is incomplete (not all countries enter into these treaties). WTO instruments ensure broader coverage and their multilateral nature is more likely to reduce economic distortions.
- The non-discrimination provisions of tax treaties have very limited application and do not guarantee national treatment and most-favoured-nation treatment, which are the cornerstones of the WTO rules.
- Tax treaties lack an effective dispute resolution mechanism. The mutual agreement procedure (at least before the introduction of mandatory arbitration) is merely equivalent to the consultation phase of the WTO-type dispute resolution mechanism (this issue is further discussed below).

### *2.6.3. The case for not applying trade and investment agreements to tax measures*

The main concerns that were raised by tax officials during the negotiation of the GATS and discussed at the seminar were that the basic rules of trade and investment agreements are national treatment and most-favoured-nation treatment, neither of which can be applied without qualification to direct taxes.

Direct taxes are far more affected by national treatment obligations than are indirect taxes. They are also more sophisticated than other taxes imposed on goods, because they are typically imposed on the total income or profits of the taxpayer. It is also easier to avoid direct taxes by moving assets and earnings between taxing jurisdictions that differ in tax rates and tax bases. There are therefore important policy reasons that justify distinguishing between residents and non-residents when imposing direct taxes.

In contrast to the issues raised by national treatment obligations, most-favoured-nation provisions have a smaller impact on domestic tax measures, because domestic law contains few most-favoured-nation derogations. Where, however, most-favoured-nation obligations do apply to direct taxes, the interaction of such provisions with bilateral tax treaties creates substantial difficulties. Bilateral tax conventions, although patterned on generally recognized principles, differ from each other in many respects. These differences result from negotiations through which the contracting states attempt to coordinate their respective source and residence tax rules. By its very nature, the most-favoured-nation principle, if applied to taxation without important restrictions, would extend to all states the most important concessions granted to any other state in the context of these bilateral negotiations.

In some countries, however, domestic law also distinguishes among other countries for valid tax policy reasons. For example, various countries have statutory exemptions for shipping and aircraft income of foreign companies, generally on a reciprocal basis; an implementing agreement may not be required in all countries. The reciprocity requirement is generally considered to be inconsistent with the most-favoured-nation obligation, since it results in a distinction between those countries meeting the conditions for the exemption and those which do not qualify. These provisions do not pursue any trade or investment objective, but are merely intended to simplify the allocation between taxing jurisdictions of income derived from these activities (especially between countries that have not entered into a more comprehensive bilateral tax treaty). Countries may also, as part of the anti-avoidance measures in their tax systems, include provisions targeted at specific other countries (e.g. CFC regimes based on a blacklist and rules imposing specific requirements for the deduction of payments made to residents of certain countries).

It may be argued that the relatively narrow scope of the non-discrimination article of tax treaties reflects the maximum protection against discrimination that has historically been considered to be appropriate in the case of direct taxes. It is difficult to imagine what extension of these rules would meet with general approval among tax officials. One possible area is that of expropriation. Prohibitions against the expropriation of property can be found in a number of international agreements, including some trade and investment liberalization agreements. Taxation measures can be imagined that would be tantamount to the expropriation of property owned by non-residents. There is, however, no internationally agreed definition of expropriatory taxation, and it is not clear where the dividing line between legitimate tax measures and expropriatory taxation lies. Where tax measures have been subjected to

rules on expropriation, specific procedural provisions have sometimes been included to ensure that tax expertise is called upon in determining whether particular measures are expropriatory (e.g. NAFTA).

A further difficulty is the potential conflict between differing definitions of the nationality of enterprises. Art. 3 of the OECD Model provides that a legal person, partnership or association deriving its status as such from the laws in force in a contracting state is a national of that state. Other agreements, however, may determine the nationality of such a legal person by reference to the nationality of its members, associates or shareholders (cf. Art. XXXIV(i) of the GATS), which may create problems of interpretation.

#### *2.6.4. The resolution of disputes concerning non-discrimination rules*

As indicated above, the relative merits of the dispute resolution mechanisms of tax treaties and trade/investment agreements were an important consideration during previous discussions between tax and trade/investment officials. In order to better examine that issue, it is useful to distinguish disputes between two contracting states (state–state disputes) from disputes between a taxpayer and a tax administration (taxpayer–state disputes).

##### *2.6.4.1. Current dispute resolution mechanisms applicable to disputes concerning the non-discrimination article*

Most disputes concerning the application of the non-discrimination article of tax treaties seem to be taxpayer–state disputes. This perception, however, may result from the fact that no independent dispute resolution mechanism exists for the resolution of a state–state dispute. Arguably, the only available mechanism is that of Art. 25(3) (Mutual agreement procedure), which only provides a requirement for the states to “endeavour to resolve” a case without the possibility for one of the states to require an independent resolution of the issue:

The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

Taxpayer–state disputes, on the other hand, may be resolved in two different ways. The most frequently used mechanism is probably the access to domestic courts of the state that applies an allegedly discriminatory measure. The provisions of tax treaties are typically incorporated into domestic law so that taxpayers can directly claim their benefits against tax administrations through domestic litigation.

While one could be somewhat sceptical of a mechanism that relies on the domestic courts of a country to solve a case of alleged discrimination of foreign investors by that country, the fact that tax treaty non-discrimination issues are essentially seen as tax issues between taxpayers and tax administrations means that the risk of courts taking a nationalistic position is usually not a major concern.

Another available mechanism is that of the mutual agreement procedure of Art. 25(1) and (2). While the mutual agreement procedure provisions of most existing tax treaties only require states to “endeavour to resolve” cases presented by taxpayers, the OECD Model has been amended to include a new Art. 25(5) to provide for the mandatory arbitration of issues arising from cases that the states are unable to resolve within 24 months. This new provision,

which will gradually be added to tax treaties, will ensure that if the tax administrations of the contracting states cannot solve through consultation a non-discrimination issue brought by a taxpayer, the issue will be decided by an independent party.

A crucial difference between these two mechanisms (i.e. access to domestic courts and the mutual agreement procedure) is that the mutual agreement procedure requires practically that the tax administration of the state of residence of the taxpayer supports the claim of the taxpayer against the tax administration of the other state. Indeed, if the competent authorities of both states agree that the relevant measure is not in violation of the non-discrimination provisions of the tax treaty, that is the end of the mutual agreement procedure, even if the taxpayer does not agree with that outcome.

#### 2.6.4.2. Dispute resolution mechanisms in international trade and investment agreements

The tax treaty dispute resolution mechanisms applicable to the non-discrimination provisions of tax treaties are therefore very different from those applicable to disputes related to the provisions of trade and investment agreements (including WTO agreements and, in particular, the GATS). Some of these agreements provide exclusively for the resolution of state-state disputes and others provide mechanisms for the resolution of investor-state disputes.

#### 2.6.4.3. Dispute resolution mechanism applicable to the EC Treaty

It is also interesting to refer to the mechanism under which issues involving cross-border tax matters and the fundamental freedoms of the EC Treaty are resolved (essentially access to domestic courts with reference to the ECJ with respect to Community law issues). There are a few examples of disputes that involved alleged violations of both the EC Treaty and the non-discrimination provisions of tax treaties (see, for instance, *Halliburton* (C-1/93), *Royal Bank of Scotland* (C-311/97), *Saint-Gobain* (C-307/97) and *Denkavit* (C-170/05)), and these cases raise interesting issues of forum shopping.