General Report

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This is a shortened version of the general report. A full version is available on the secured part of the IFA website.

Summary and conclusions

When in 1993 the general reporter to the IFA Congress in Florence reported on the subject non-discrimination (ND) in international taxation, he concluded that this principle, which surely has its role within international tax relationships, is not always properly taken into consideration. Furthermore, the rules expressing this principle gave rise to many unanswered questions of interpretation and many uncertainties. It is the task of this report to discuss 15 years later, on the basis of 31 branch reports, the current status of article 24 of the OECD model convention (MC) and double taxation conventions (DTCs) and on recommended interpretations and/or changes needed to improve the legal certainty, coherence, and effectiveness of the ND principle taking into account new developments at the crossroads of international taxation.

The study starts with the historical footprint of the MC provision and its current interpretation problems, set out notably in the 2007 OECD discussion draft, and the case law of national jurisdictions. Both point to a strict interpretation and envisage the need for improvement and upgrading of the current ND principle.

The report goes on to study the ND principles in other systems of cross-border taxation, specifically national (constitutional) law, bilateral commercial treaties, regional trade agreements, world trade agreements and treaties in human rights and personal freedoms. The branch reports point to an increasing interest and many new developments in this area since 1993. Two expert reports deal in particular with fiscal ND principles and related case law under the World Trade Organization (WTO) and European Community (EC) treaties. The study explains how these developments and experience with other ND concepts and new case law have contributed to a general awareness of the need for more coherence, effectiveness, legal certainty and convergence. In particular it focuses on the legalistic and conceptual problems involved in upgrading the current version of article 24 MC/DTCs. It thus points to the limits of new interpretation and new OECD commentaries and to the need for language changes. While this is a long-term project, new commentaries may be an interim step, even though this step may not be very fruitful in terms of improving the concept itself.

The prospect of changes also raises a more substantive conceptual issue. What should the recommended standards be? Which international tax system should be the role model? Any recommended version is likely to be controversial either for governments or international market participants, being either too aggressive or too soft in its proposed changes. Specifically a version inspired by the case law of the European Court of Justice (ECJ), being the engine of tax integration, may be deemed too aggressive and unacceptable from a DTC perspective, unless it is properly reduced to a bilateral treaty frame and content. The general reporters therefore propose, for OECD/Committee of Fiscal Affairs (CFA) action, a composite version consisting of a first paragraph providing an overarching principle of direct ND and a second paragraph listing the two present cases of prohibited indirect tax discrimination but open for cherry-picking of further cases by mutual agreement.

One thing has become clear since the 1993 IFA general report: the search for a coherent and convergent ND principle is definitely under way.

1. A new look at a traditional principle: today and tomorrow

ND in an international tax perspective is not a new theme for IFA. The 1993 IFA Congress in Florence dealt with *Non-discrimination rules in international taxation* on the basis of a general report submitted by Professor Adonnino.[1] On the basis of 26 branch reports, the general reporter in 1993 described the status of ND principles applied in the different legal systems of international taxation, and focused in particular on the ND provision in bilateral DTCs following article 24 of the OECD MC.

So why this new report on the same subject hardly 15 years later?

According to the findings of the 1993 general reporter and the branch reporters, the ND principles operative at that time were unsatisfactory:

> "This report shows that such principle, which surely has its role within international relationships, is not always taken into consideration. Furthermore, the rules expressing this principle give rise to many questions of interpretation and many uncertainties … It is noteworthy that decisions of the Courts, explanations of Administrations and comments of doctrine on this issue are always expressed in very general terms and, therefore, not in a precise way … They [the numerous interpretation problems of article 24 MC] have been underlined by all the national reporters who have dealt with them. An author entitled his work 'Non-discrimination – now you see it, now you don't' and points out, quoting another author, that, as admirable as the ND concept sounds, the ramifications of this section are probably more uncertain than those of any other article."[2]

At the same time, the general reporter referred to signals that a better understanding and application of ND in international taxation might be forthcoming, even as he couched that prospect in rather cautious and reserved terms:

> "As yet the problems of discrimination have not received the proper attention, although recently some competent studies have discussed them and Administrations and Courts of some countries have started to take decisions on the situations reported."[3]

Now, 15 years later, the time has come to draw a new picture of ND at the crossroads of international taxation, following up on the 1993 report and pursu-

[1] P. Adonnino, General Report, IFA Congress Florence 1993, *Cahiers*, vol. 73b.

[2] *Ibid.*, p. 36, referring to S. Goldberg, "Non-discrimination – now you see it, now you don't", *The Club*, September 1991.

[3] *Ibid.*, pp. 19–20. One of these studies is that of K. Van Raad, *Non-discrimination in International Tax Law,* Kluwer (1986), who notes on pp. 3–4: "The volume of legal writing on non-discrimination in international taxation and the number of court cases dealing with the subject is still limited. This is partly due to the obscurity in which the legal provisions pertaining to the subject remained for long. Still, among those who were aware of the existence and scope of treaty non-discrimination clauses, many seem to prefer alternative legal routes for pursuing their aims, apparently fearing the ramifications of these clauses not fully fathomed yet."

ing the issues that it left open. We will first look into the origins and current interpretations of article 24 MC and make an evaluation of the ND principle laid down in it. We will then draw the broader picture of ND principles in national and other international tax systems and look for trends and convergences. This search will lead us to direct our special attention to the ND principle in the tax case law of the ECJ (which was hardly available at the time of the 1993 report), looking for features that may suggest a more efficient and structured version of article 24 MC. We will conclude that the search for a coherent and modern ND principle and for more convergence of ND principles at the crossroads of international taxation is under way.

To bring this task to a satsifactory conclusion, we received 31 branch reports dealing with the detailed directives that we submitted to the branch reporters. They offer a wealth of information and analysis at the national level. We also received two expert reports dealing with the ND principles applied in ECJ case law and in WTO agreements. While it is not possible to consider in this general report all relevant aspects covered in those reports, we are sure that the readers and the panel members participating in the debate on this topic at the 2008 IFA Congress in Brussels will find them as interesting and instructive as we did.

2. The current status of article 24 MC (and DTCs)

2.1. The long shadow of the past

This section deals with the involvement of the OEEC/OECD in the drafting of the ND MC clause found in most DTCs. It starts with a reference to the clauses in the prior involvement of the League of Nations. It included in its MC of Mexico 1943 (article XV) and that of London 1946 (article XVI) a broadly worded clause comparing the taxation of a resident of one state with that of a resident or a national of the other (source) state.[4] In the real world of bilateral tax treaty practice, these clauses had very little impact as they were either not included in the conventions or included on the basis of nationality only.[5]

The specific issue of "tax discrimination on grounds of nationality or similar grounds" was formally put on the agenda of the Fiscal Committee, which the OEEC Council established in 1956 and which delegated the work to its Working Party no. 4 (WP4), chaired by the Dutch government delegate and Professor Van den Tempel. On the basis of circular letters to and written reactions from government delegates, WP4 prepared successive reports in 1957 which later found their way into the nationality, permanent establishment and foreign control discrimination provisions of the 1963 OECD MC. The deductibility discrimination clause was added in the 1977 MC. The ND provision was included as such or in

4 J. Avery Jones, "The non-discrimination article in tax treaties", *ET*, 1991, p. 311.

5 F. Oberascher, "Das Staatsangehörigendiskriminierungsverbot des Art. 24 OECD-MA in einer historischen Längsschnittanalyse", in Lang, Schuch and Staringer (eds.), *Die Diskriminierungsverbote im Recht der Doppelbesteuerungsabkommen*, Linde 2006, pp. 65–68.

modified wordings in most DTCs between OECD member states and also non-member states.[6]

It is instructive for our further critical review of the current clause to look into the WP4 discussion of the issues and of the formulation that was ultimately retained. WP4 found out from the reactions to its circular questionnaire that, in the DTC practice of most members of the League of Nations (and in particular that of the United Kingdom), the prohibition was based on nationality. The concern of government delegates related to the impact of a change that would widen the scope of application of the ND prohibition and by the same token restrict their own national tax systems, policies and practice.

What lessons can be drawn from this historic record of the provision currently laid down in article 24 MC? Evaluating the activities of WP4 in the years 1956–8, Lang recognized two forces at work in the original formulation. On the one hand, he pointed to the inspired action on the part of the members of WP4 and in particular of Van den Tempel as Chairman of the Fiscal Committee. This resulted in the successful extension of the ND clause to cases of permanent establishment and of foreign ownership. On the other hand he noted the concern of government delegates that ND rules would curtail the field of action of their national legislators, the better common denominator for them being that the ND rules would have a limited effect or would be effective only *vis-à-vis* third countries. The fact that the decision making power in an international organization like the OEEC was exclusively in the hands of government representatives turned out to be detrimental for the outcome in terms of legal protection. Taxpayers' interests were only represented at the time of the formal ratification of the bilateral treaty, when the *de facto* decision at the level of WP4 and the Fiscal Committee had already been taken.[7]

The historical footprint of article 24 MC (not intended to be fully effective because that would be more work and trouble for national governments) is important for its current interpretation and critical evaluation in the context of our study.

2.2. Interpretation and analysis of article 24 MC

Since the text of article 24 MC has not changed since the IFA Congress of 1993 and the OECD commentary to this article has only been slightly modified since 1993 (after a substantial review in July 1992), the purpose of this section of the general report is not to provide an exhaustive analysis of article 24 MC or a critical overview of all the possible issues relating to its application. Reference is made to the 1993 general report for an overview of the various issues that were raised by the branch reporters at that time. The purpose of this section is to give an overview, as well as a brief analysis, of the developments relating to article 24 MC that have occurred after 1993 and that have been referred to in the branch reports.[8]

6 For a good review of WP4 activities, see M. Lang, "Die Arbeiten der OEEC und der OECD zur Schaffung der Diskriminierungsverbote", in Lang *et al.*, *op. cit.*, pp. 33–48.

7 *Ibid.*, pp. 47–48.

8 Para. 2 relating to the application of this article to stateless persons (which is not included in the US MC) is not discussed as this article appears to be of very little use in practice. In order to

It should be noted, however, that almost all branch reporters have indicated that the impact of the ND provision in bilateral tax treaties on the domestic law of their country has been very limited and that there is also little case law relating to its application and interpretation. Nevertheless several branch reports mention an increasing interest in the ND principle in their jurisdiction. This interest may be caused by a substantial increase in the number of DTCs concluded by that state (e.g. since 1993 Mexico has increased its DTCs from 1 to 36), by the introduction of a (new) constitution offering protection against discrimination (e.g. Poland, Russia, Finland, Serbia, South Africa) or by the increase of litigation before the constitutional court which is prepared to apply the constitutional ND principle in tax matters (e.g. Austria, Belgium, France, Luxembourg). The reports of the EEA member states (all 27 EU Member States as well as Norway, Iceland and Liechtenstein) not surprisingly (see below) refer to the growing impact of the ND principle in the EC Treaty in domestic tax law and on DTCs with other Member States, mainly pursuant to the significant development of ECJ case law on this issue after 1993.

The limited impact of the ND provision in DTCs has given rise to new discussions relating to the added value of this provision in some of the branch reports (see Canada, Italy, Luxembourg, Spain). Article 24 MC needs a critical look and new stimulus if it is still to play a significant role in international taxation in the future. This review has already started within Working Party no. 1 (WP1) of the CFA of the OECD upon the initiative of the Business and Industry Advisory Committee to the OECD (BIAC). A first public discussion draft in this respect was issued on 3 May 2007 and made public on the OECD website. In several of the branch reports reference is made to this discussion draft. The views of WP1 (more in particular of its *ad hoc* working group) reflected in the discussion draft are also taken into account in our analysis of outstanding issues. While the discussion draft itself only deals with issues of "application and interpretation of article 24", WP1 also

> "recognizes that some issues … require a more fundamental analysis of the issue of non-discrimination and taxation which could lead to changes of Article 24. It was agreed that such work would benefit from the input of experts with a different background and should constitute a subsequent project. The Working Party will start consultations on this second stage of its work in the next few months."

The terminology that is used in this report makes a distinction between "covert" and "indirect" discrimination, whereas in the discussion draft (and in ECJ tax case law) these two notions have the same meaning. Covert discrimination refers to a situation in which the tax measure concerned discriminates against the protected class of taxpayers, not in explicit terms, but by its practical effect. In other words, the tax measure will in practice mainly affect the protected class. Indirect

cont.

avoid confusion reference will always be made to the relevant number of the paragraphs of article 24 as used in the MC (even if a different numbering is used in another model convention or specific DTC that is being referred to). In accordance with volume limits, the text of the different paragraphs of article 24 MC is not reproduced in this general report.

discrimination refers to a situation in which it is not the protected (foreign) taxpayer himself but a related person who suffers (directly) from the unfavourable tax treatment provided for in the measure concerned. Paragraphs (1) and (3) of article 24 MC can be characterized as provisions against direct discrimination while paragraphs (4) and (5) of article 24 MC offer protection against indirect discrimination.

"Direct nationality discrimination" (in the form of overt nationality or of equivalent personal criteria such as residence of taxpayer) is sometimes distinguished from "indirect discrimination", i.e. not based on nationality or an equivalent *in personam* criterion but on the taxpayer's (internal vs. cross-border) tax situation (*in rem*). This distinction and terminology have a basis in logic (equal treatment vs. restriction based) and will be applied in our proposed new approach to article 24 MC.

2.2.1. Article 24(1): nationality-based ND

2.2.1.1. Personal scope

The personal scope of this provision is limited to "nationals" of the other contracting state. The last sentence clarifies that, as an exception to the general rule, these nationals must not be a resident of one or both of the contracting states to invoke this provision. However, some countries (e.g. Chile and UK) do require the nationals also to be a resident of one of the contracting states to be entitled to invoke this protection against nationality-based discrimination.

"National" is defined in article 3(1)(g) MC as "(i) any individual possessing the nationality or citizenship of that Contracting State; and (ii) any legal person, partnership or association deriving its status as such from the laws in force in that Contracting State". In the DTCs of some states the personal scope of article 24(1) is generally limited to individuals (e.g. Canada, Peru, France). One will always need to check the specific wording of the provision in the applicable DTC to determine its effective scope of application.[9]

With respect to legal persons, associations and partnerships, reference is made to the laws in force in the relevant contracting state. This reference relates to civil and company law and not to the tax law applied in the contracting state. As has already been pointed out in the 1993 general report the relevant criterion for distinguishing between national and foreign legal persons is not the same in all states. Many of them use the criterion of incorporation, but quite a few apply the place of central management/administration as the relevant criterion. Consequently, if different criteria are applied, a legal person can have a double nationality (e.g. a company incorporated under Dutch law which has moved its place of central management to Belgium). In the event of double nationality (i.e. of each of the contracting states) article 24(1) will have no impact since discrimination based on nationality cannot arise.

Several branch reports (e.g. Denmark) state that if partnerships are considered to be tax transparent in the source state, they cannot invoke article 24(1) MC for

9 The French branch report makes a distinction between five different categories of DTC concluded by France based on the wording of article 24(1).

income tax purposes, even if the partnership itself is considered a national of the other contracting state according to the laws of that state. In such a situation it is the partners of the partnership who can invoke the protection of article 24(1) of the DTC between the source state and the respective states of which they are nationals, with respect to the taxation of their share of the partnership income in the source state.[10] If article 24(6) is included in the relevant DTC, the partnership, even if it is transparent for income tax purposes, can possibly invoke the protection of this provision with respect to other taxes for which it is considered to be the relevant taxpayer (e.g. VAT, customs duties). The application of article 24(1) to partnerships is included in the list of issues enumerated in the annex to the discussion draft which require a more fundamental analysis. The US reporters suggest that the CFA should also consider the issue of application of article 24 as a whole to partnerships that are considered tax transparent in one of the contracting states and opaque (non-transparent) in the other contracting state (so-called "hybrid" entities).

2.2.1.2. Same circumstances

In order to evaluate whether or not a tax measure in the source state could be deemed to be discriminatory in the sense of article 24(1) MC, the national of the other state must be in the same circumstances, both in law and in fact, as the national of the source state. In 1992 it was added to the text of this paragraph that this related in particular to the residence of both categories of taxpayer. In the OECD commentary it is stated that this constitutes a mere clarification and consequently must also be applied in DTCs which do not expressly include this clarification.[11] Since not "nationality" but "residence" constitutes a relevant criterion of distinction for the tax treatment of taxpayers in almost all states, this clarification substantially reduces the impact of this provision, which is confirmed in several branch reports (e.g. Chile, Czech Republic, Germany, Luxembourg, Norway, Spain). In some reports (e.g. Brazil, New Zealand, Russia) reference is made to case law relating to the application of a (higher) withholding tax on dividend, interest or royalty payments to a foreign, non-resident taxpayer where there would be no such withholding tax or a lower withholding tax on payments to a resident taxpayer. In all cases the ND claim of the foreign taxpayer under article 24(1) of the applicable DTC has been rejected since the different tax treatment is based on the different residence of the taxpayer and not on his nationality.

Article 24(1) of the 2006 US MC contains the same clarification relating to the notion "in the same circumstances" as in the OECD MC. However, it is added that, for purposes of US taxation, US nationals who are subject to tax on a worldwide basis are not in the same circumstances as nationals of the other contracting state who are not resident in the USA. This is due to the fact that the USA also subjects its citizens who are no (longer) resident in the USA to income tax on their worldwide income. In both MCs it is the distinction between unlimited and limited income tax liability in the source country which constitutes the justi-

10 See the Swiss report.
11 Apparently this still gives rise to discussion in some states (see branch report of Brazil).

fication for the different tax treatment. In the discussion draft it is proposed to mention this expressly in the new paragraph 4(1) of the OECD commentary.

The very limited practical relevance of article 24(1) not only applies to individuals but also to companies, since in many countries the relevant criterion (or one of the relevant criteria) for tax purposes is identical to the relevant criterion for determining the nationality of the company (e.g. in the USA, place of incorporation). In that situation, a "foreign" company is per definition not a "resident" company and therefore not in the same circumstances as a domestic company, in particular with respect to its residence. The question has been raised in the discussion draft (nos. 21 and 22) whether paragraph (1) should therefore still apply to companies. A decision of the Dutch Supreme Court of 16 March 1994,[12] analysed in the Dutch branch report, shows that article 24(1) MC can also be relevant for foreign companies in a country which applies the same criterion for the attribution of resident and national status to companies (i.e. place of incorporation). The dispute before the court related to the application of the Dutch fiscal unity rules and more particularly to the requirement that a company must be (a) incorporated under the law of the Netherlands and (b) a resident of the Netherlands for purposes of Dutch income tax, in order to participate in a fiscal unity. Based on these conditions, the Dutch tax authorities refused to include a company that was incorporated under the law of the Netherlands Antilles but had its place of effective management in the Netherlands. Since it had its place of management in the Netherlands, it was subject to Dutch income tax on its worldwide income. Consequently the Supreme Court came to the conclusion that it was "in the same circumstances" as a Dutch company in particular with respect to residence and that the refusal to include the Antilles company in a Dutch fiscal unity, just because it was not incorporated under Dutch law, constituted an infringement of the ND provision in the tax arrangement between the Netherlands and the Netherlands Antilles. In 2003 the relevant Dutch legislation was modified to extend the qualifying jurisdictions of incorporation to the Netherlands Antilles, Aruba, the EU Member States and all other states with which the Netherlands has concluded a DTC including a nationality ND clause.

A similar case (referred to as the *Delaware* case) relating to a tax consolidation arrangement in Germany (*Organschaft*) had to be decided upon by the German *Bundesfinanzhof* (BFH). Since German law stated that companies with registered offices outside Germany could not participate in such a tax consolidation, the German tax authorities denied a profit transfer from a German subsidiary to its US parent which had its place of effective management in Germany (and therefore was subject to unlimited tax liability in Germany). Here also the BFH concluded that this denial of participation to the tax consolidation constituted an infringement of the ND provision under the German-US DTC, but more particularly of article 24(5) and not article 24(1).[13]

In the new commentary (paragraph 11(1) and following) proposed in the discussion draft, the issue of the application of article 24(1) MC to legal persons is expressly dealt with. Based on examples that are given in the new commentary

12 *Hoge Raad*, 16 March 1994, *BNB,* 1994/191.
13 BFH, I R 6/99, BStB1 II, 2004, p. 1043.

and that, to a certain extent, are derived from the above case law, it is concluded that the application to legal persons should be maintained. At the same time, it is emphasized that, in order to constitute an infringement of article 24(1), the different tax treatment of legal persons must be solely based on nationality and all other relevant factors must be the same.

The discussion draft also discusses the possible application of the "covert" discrimination analysis, which has often been applied by the ECJ when evaluating whether or not the ND principle in the EC Treaty has been violated, and which could give rise to a substantial increase in the impact of article 24(1). However, the extension of overt nationality-based discrimination to covert nationality-based discrimination is rejected. In the new paragraph (1) of the commentary this would be formulated as follows: "it could not be argued that non-residents of a given State include primarily persons who are not nationals of that State to conclude that a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph". The practical relevance of this different approach is clearly shown in the *Halliburton* case law of the Dutch Supreme Court. In this case the exemption from Dutch transfer tax, which applied to intra-group transfers of immovable property between certain Dutch companies, was refused in a situation where the immovable property was contributed by a German company to a Dutch sister company (with a common US parent company). The Supreme Court dismissed the application of the nationality ND provision in the Dutch-German DTC stating that no distinction on the basis of nationality was made for Dutch transfer tax purposes at the level of the acquiring company (being the taxpayer).[14] However, it also referred the case to the ECJ which decided that this indirect form of discrimination constituted an infringement of the freedom of establishment embedded in the EC Treaty.[15]

2.2.2. Article 24(3): permanent establishment (PE) ND

2.2.2.1. Scope of application

The notion of PE is defined in article 5 MC and constitutes a key element for the allocation of the power to tax cross-border business profits between the contracting states (article 7 MC). Since this notion was not used in article 14 MC relating to independent personal services, it is generally stated that article 24(3) does not apply to the income arising from such independent personal services (see the Austrian report) although in article 24(3) of some DTCs express reference is made to such income (see the Danish report). In more recent DTCs concluded after 2000, when article 14 MC was deleted and fully integrated into article 7, income from independent personal services is generally included in the scope of article 24(3).

14 *Hoge Raad*, 23 December 1992, *BNB,* 1993/71.

15 ECJ, 12 April 1994, case C-1/93.

2.2.2.2. Protection against less favourable tax treatment

Contrary to paragraphs (1) and (5), this paragraph (3) of article 24 MC protects the taxpayer only against more burdensome taxation in the source state and not against "other" taxation. The focus is thus on the quantum of the taxes that are due at the level of the PE. In the OECD commentary (paragraph 24) reference is made to a number of relevant elements relating to the tax assessment that must be taken into account: deductible expenses, depreciation, reserves, tax losses, capital gains. It is also stated that it is permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied. In the US Treasury Technical Explanation of the US MC of 15 November 2006 it is clarified that this provision does not preclude applying different information requirements to a resident of the other contracting state from those that apply to a resident of the USA, since relevant information may not be as readily available to the Internal Revenue Service (IRS) from a foreign as from a domestic enterprise. Also the penalty that would be imposed on persons who failed to comply with such an information requirement was not deemed to constitute a violation of article 24(3). Furthermore the fact that in the USA a foreign partner's distributive share of income effectively connected with a US trade or business is subject to withholding tax, while the distributive share of a US partner is not subject to such withholding tax, is, according to the technical explanation, not discriminatory but constitutes merely "a reasonable method for the collection of tax from persons who are not continually present in the US". However, as pointed out in the Swiss report, the levying of withholding tax could also give rise to a financial disadvantage (pre-financing cost) for the (foreign) taxpayer compared to the ordinary tax assessment method and therefore could be considered less favourable taxation.

Another question relates to the application of a presumptive method to determine the taxable profits of a PE if there are no proper tax and accounting documents available from which the actual net profits of the PE can be derived, when such a presumptive method does not apply to domestic companies. This issue was raised in the Polish, Swedish and Belgian reports. In Poland there is no case law on this issue and the opinions in legal doctrine relating to the conformity of the relevant legal provisions with article 24(3) are divergent. The Swedish Supreme Court ruled in 1995 that the presumptive taxation of foreign insurance companies did not constitute a violation of article 24(3) since it did not necessarily result in a less favourable tax treatment. In Belgium the tax authorities have always argued that there was no violation of article 24(3) since (a) this measure was only applied for practical purposes when the taxpayer himself could not demonstrate the taxable profits of the PE, and (b) there was no proof that the application of this method resulted in a higher taxation of the foreign enterprise. For a long time this position was confirmed by Belgian case law. However, last year the ECJ ruled that this legal provision constituted an unjustifiable violation of the fundamental freedom of establishment embedded in the EC Treaty.[16] It is also remarkable that around the same time, in another, similar case relating to a PE of a Dutch company, the question was submitted to the Benelux Court which ruled that the application of the presumptive determi-

16 ECJ, 22 March 2007, *Talotta*, case C-383-5.

nation of the taxable profits of the PE in accordance with Belgian tax law constituted a violation of article 2(2) of the Benelux Treaty. This article stipulates that nationals of one of the contracting states, being on the territory of another contracting state, should enjoy the same treatment as nationals of that state as regards taxes and charges of any kind.[17] The Belgian legislator had anticipated the outcome of this supranational case law in 2005 by extending the presumptive method for the determination of taxable income to its own residents.

In the discussion draft (no. 20) it is clarified that the comparison for evaluating whether or not a certain tax measure in the source state is discriminatory must be made at the level of the relevant class of taxpayers to which the taxpayer belongs and not at the level of the individual taxpayer. In the 1995 decision of the Swedish Supreme Court, referred to in the preceding paragraph, it was stated that the comparison should be carried out at a general level and should not be limited to a specific year. This gives rise to the following question: what period of time is then relevant for making such a comparison?

In the Serbian report it is stated that the tax assessment basis for PEs of foreign companies is substantially different from that of domestic companies. Apparently the difference is a combination of more and less favourable measures. PEs also cannot benefit from group consolidation, tax loss carryforward and other tax incentives. The question that arises in this respect is whether the prohibition of less favourable treatment must be applied on a “per measure” basis or on a global basis, taking into account all the differences in tax treatment. Under the latter hypothesis it does not seem an easy task to measure and balance the impact of the various measures. Not surprisingly, this issue is included in the list of issues to be further analysed in the annex to the discussion draft.

The current OECD commentary lists a number of tax measures the application of which to PEs is not unanimously accepted by OECD member states, *inter alia* relief from economic double taxation on dividends from subsidiaries, withholding tax on dividends, interest and royalties received, foreign tax credit. Based on the branch reports there are not many states which (still) make a distinction between domestic companies and PEs with respect to the application of these measures. Exceptions are New Zealand, Brazil and India. It can also be derived from the branch reports that many of the EEA Member States have adapted their domestic tax legislation in this respect pursuant to case law of the ECJ or EC directives. In the discussion draft the working group invites WP1 to further discuss these issues with a view to finding a consensus, and, if appropriate, adapting the wording of the commentary accordingly.

The working group also confirms that PEs should be entitled to a credit for foreign withholding tax under article 24(3) in triangular situations, but adds that this does not mean that the PE is entitled to treaty benefits as if it were a resident of the state in which it is established. In this respect it is interesting to note that the Court of First Instance of Brussels granted to the Belgian PE of an Indian company the benefit of a tax sparing credit relating to its Indian source interest income on the basis of article 24(3) of the DTC between Belgium and India.[18]

17 Benelux Court, 19 March 2007, *Metabouw-Bouwbedrijf B.V.* v. *Belgian State*.

18 Court of First Instance of Brussels, 9 November 2006, discussed by L. De Broe and N. Bammens, *Fiscoloog Internationaal*, no. 288 of 30 November 2007.

This tax benefit is not granted by Belgian domestic law but only by the DTC itself. According to article 23 of the DTC this tax sparing credit can be claimed by residents of Belgium. However, the Court of Brussels ruled that refusing this tax sparing credit to the Belgian PE of the Indian company violated the ND provision of the DTC so that this tax sparing credit also had to be granted to the PE. Consequently, indirectly the PE may claim the treaty benefits. A similar decision has also been rendered in Luxembourg based on ECJ case law.[19]

2.2.2.3. Tax rates and branch taxes

It is clear that the ND provision relating to the taxation of a PE implies that the PE's net profits may not be taxed at a higher rate than the net profits of a resident taxpayer. Generally this does not cause many problems for (foreign) companies (since many states apply a standard corporate tax rate) but it does raise an interesting issue for individuals who exercise their business activity through a PE in the other contracting state, applying a progressive individual income tax rate schedule. It is clear that according to article 7 MC only business profits that are attributable to the PE may be taxed in that other state. But does article 24(3) also require the source state to only take into account this PE income for the determination of the applicable tax rate (and the grant of tax-free threshholds) or may it also consider the overall income of the foreign taxpayer and apply a kind of "exemption with progression approach" relating to the income that is not attributable to the PE, similar to the approach proposed in article 23 MC, to determine the tax rate to be applied to the PE income? The conclusion in the discussion draft is that article 24(3) does not prohibit the latter approach if it is provided for in the domestic tax law of the PE state. This method is applied *inter alia* in the domestic tax law of the Netherlands and Switzerland.[20]

Another issue is the right of the PE state to levy an additional income tax on PE profits to compensate for the fact that no dividend withholding tax can be levied upon the repatriation of these PE profits to the home office of the foreign enterprise. In the new commentary (paragraph 41) proposed in the discussion draft, a branch profit tax which simply constitutes an additional tax on the PE profits is considered to be contrary to article 24(3). The states that apply such a branch profit tax (USA, India, South Africa) include a specific carve-out for this tax in article 24 of their DTCs.[21] In 2001 India even adopted specific legislation to unilaterally override DTCs which did not include such an express carve-out with retroactive effect as of 1962 (year of introduction of the branch profit tax).

Although the US tax authorities agree with this point of view, they are of the opinion that the "branch level excess interest tax" does not violate article 24(3). They justify the conformity of the branch tax with the deemed "excess interest"

19 TA, 29 April 2003, nos. 15343 and 15344, which refers to the ECJ decision of 21 September 1999 in the *Saint-Gobain* case, C-307/97.

20 For a further analysis of this approach, see K. Van Raad, "Non-discrimination of cross border income under the OECD Model and EC Treaty rules – a concise comparison and assessment", in Van Arendonck, Engelen and Jansen (eds.), *A Tax Globalist: The Search for the Borders of International Taxation. Essays in honour of Maarten J. Ellis,* IBFD Amsterdam, pp. 139–143.

21 For example art. 24(5) of the US MC.

by referring to the situation in which a foreign parent company would grant a loan to its US subsidiary and would be confronted with US withholding tax on this interest income. In doing so the IRS seems to have based its conclusion on a comparison between the combined tax liability in the USA of a domestic subsidiary and its foreign parent company and the global tax liability of the foreign enterprise with the US PE. This does not strike us as either the correct comparison under article 24(3) or as a convincing argument to justify the different outcome compared to the branch profit tax analysis.[22] Indeed, both branch taxes constitute, in our view, a supplementary income tax on the net profits of the PE. This view can also be sustained by referring to the decision of the Court of Federal Claims in the *National Westminster Bank Plc* case, in which the court stated that a reduction of the deductible interest expenses of the US branch (PE) of the UK bank, through allocation to the branch of an amount of capital determined on a formulary basis, would violate article 24(3) of the UK–USA DTC.[23] The new commentary (paragraph 42) proposed in the discussion draft makes a distinction between branch profit taxes and taxes imposed on amounts deducted, for instance as interest, in computing the profits of a PE. If such a tax is levied on the beneficiary of the interest income and not on the PE itself, it will not fall within the scope of article 24(3). We assume that the beneficiary is necessarily another person than the foreign enterprise of which the PE is a part (although this is not totally clear on the basis of the wording of the new paragraph).[24]

2.2.2.4. Tax consolidation, group relief, tax-free contributions/ imputation tax regime

It can be derived from several branch reports that after 1993 there has been an interesting development in the application of domestic tax consolidation, group relief or intra-group tax-free contribution systems in an international context. One of these issues relates to the participation of a PE of a foreign company to such a group taxation mechanism which in many states is (was) restricted to domestic companies. Specific reference can be made in this respect to the Swedish and Norwegian reports. In the domestic law of both states the application of the group relief mechanism has been extended to PEs of foreign companies, resident in other EEA Member States, pursuant to EC law developments. The question is raised whether this could also be extended to PEs of foreign companies that are not located in the EEA but in a state with which Sweden/Norway has concluded a DTC including article 24(3). The Norwegian Minister of Finance has already officially declared that this should be the case if the PE is on the contributing side (giving rise to a tax deduction) but not if it is on the receiv-

22 See also M.C. Bennett, " Non-discrimination in International Tax Law: A Concept in Search of a Principle", *The Tillinghast Lectures 1996–2005,* NY School of Law, 2007, pp. 419–420.

23 Fed.Cl. 491 (2003), confirmed on 15 January 2008 by the US Court of Appeals; the main focus of the Court was, however, on art. 7 of the DTC and not on the ND provision.

24 This issue will become even more important under the authorized OECD approach (AOA) relating to the taxation of PEs, proposed by the OECD in its draft report on the attribution of profits to PEs; see also reference to the ND provisions in the general report of P. Baker and R.S. Collier relating to the attribution of profits to PEs for the 2006 IFA Congress in Amsterdam, *Cahiers de droit fiscal international*, vol. 91b, pp. 57–58.

ing side. In the latter hypothesis there is no "less favourable treatment" for the PE if the deduction is refused at the level of the contributing domestic company. Also the Swedish reporter is of the opinion that the extension of the group relief regime to a PE of a resident of a non-EEA treaty partner could be claimed on the basis of article 24(3) of the relevant DTC.

In the discussion draft, however, it is stated that paragraph (3) does not require an extension of domestic regimes for group companies that are restricted to resident companies. The reason for this conclusion is that paragraph (3) only relates to the taxation on profits of the PE itself which excludes the application to rules that relate to the income of groups of related companies. This seems to be a very restrictive interpretation since, in our view, the participation of a PE in a consolidation tax regime relates to the profits (or losses) of the PE itself. Based on article 24(3) a PE should be entitled to the same tax incentives and relief mechanisms as a resident company exercising the same activities, including group relief. The Supreme Court of Spain came to the same conclusion as the discussion draft in its decisions of 15 July 2002 and 12 February 2003, but these decisions are heavily criticized by the Spanish branch reporter since the conclusion of the Supreme Court was based on a comparison of the PE of the foreign company with other Spanish establishments lacking legal personality and not with Spanish domestic companies exercising the same activities, which is the correct comparison under article 24(3) MC.

A similar issue relates to the application of imputation tax mechanisms (according to which the shareholders receive a tax credit for (part of) the corporate tax levied on the profits of the company that are distributed). Reference to such tax credit is made in the branch reports of Argentina, Finland, France (*avoir fiscal*) and the UK (ACT). In most imputation tax regimes such a credit is (was) limited to domestic shareholders. Here also the question was raised whether a PE of a foreign company could claim the benefit of such a credit upon receipt of a dividend distribution from a domestic subsidiary. In the case of *UBS AG* against HMRC, the UK Revenue denied the ACT tax credit which would have been available to a UK company to a UK branch of a Swiss bank receiving UK source dividend income. It argued that the provisions relating to the ACT regime should be considered as a whole and that, since the PE could not pay dividends like a UK company, the grant of the tax credit to the PE would confer a permanent benefit on the PE which would not be the case if the tax credit were granted to a UK company. The UK Special Commissioner disagreed with the reasoning and the conclusion of the Revenue, stating that there was no such suggestion of a global approach in the OECD commentary. The High Court agreed with the Special Commissioner's holding but finally rejected the claim of the taxpayer (treaty relief) since the UK had failed to incorporate the ND article in its domestic law when it ratified the DTC. The decision of the High Court on the substance of the matter was recently overturned by the UK Court of Appeal referring to article 10 of the DTC, which provides for a limited entitlement to the tax credit for non-resident corporate shareholders, and held that it was not conceivable that this express agreement between the contracting states should be overridden by the PE ND provision.[25]

[25] See the UK report for a more extensive analysis of this case law and for a good description of the ACT mechanism and the issues that have arisen in this respect in the appendix.

In the new paragraph 40 of the commentary proposed in the discussion draft it is now expressly confirmed that article 24(3) is restricted to the profits of the PE and does not extend to the taxation of the enterprise as a whole (no global approach). The new commentary derives from this statement (without further explanation) that issues related to various systems for the integration of corporate and shareholders' taxes are outside the scope of this paragraph, which is contrary to the conclusion of the UK Special Commissioner in the *UBS* case.[26]

2.2.2.5. Exclusion of tax allowances and relief for personal and/or family circumstances

The second sentence of article 24(3) states that this ND provision does not cover tax allowances, deductions and other forms of tax relief granted in the source state to resident individual entrepreneurs that relate to their personal and/or family situation. Some states have extended this exclusion to article 24(1) or to all paragraphs of article 24 (see Poland and USA). However, on the other hand, some other states have expressly derogated from this exclusion and have included a provision in some of their DTCs requiring the source state to grant to nationals of the other state the same personal allowances that it grants to its own residents (see for example DTCs concluded by Belgium with Morocco, France, Luxembourg, the Netherlands). It is no coincidence that, with the exception of Morocco, all treaty partners are EU Member States which have also implemented the recommendation of the EC Commission in this respect (the so-called 75 per cent rule) in their domestic legislation after the ECJ ruling on the *Schumacker* case.[27] However, in the current version of the DTCs (as amended) with these EU Member States, a pro rata application of the personal and family allowances is provided for so that these provisions have a broader scope of application than the 75 per cent rule.

2.2.3. Article 24(4): deductibility ND

This is the first of two "indirect" ND provisions in article 24 in the sense that it does not protect the foreign taxpayer from discriminatory tax treatment in the source state directly but indirectly (no discrimination of contractual party or affiliated company in the source state). The discrimination that is prohibited in article 24(4) consists of the non-deductibility of expenses paid to a resident of the other contracting state, which would be deductible if paid to a resident of the source state.

However, this provision is not included in many DTCs concluded by several states (e.g. Brazil, Canada, France, New Zealand, Peru, Poland, Russia) or else DTCs contain carve-outs for specific tax measures (e.g. Brazil).

[26] In future the relevance of this issue will be reduced since in the meantime several countries (e.g. France and the UK) have abolished the imputation tax system in their domestic tax law pursuant to ECJ case law.

[27] ECJ, 14 February 1995, C-279/93 in which the ECJ ruled that, as a general rule, it is up to the residence state of the taxpayer to grant personal and family tax allowances, but that this obligation shifts to the work state (source state) if the taxpayer is taxed in that state on a substantial part of his worldwide employment income (with little income remaining to be taxed in the residence state).

2.2.3.1. Under the same conditions as if it they were paid to residents

A first issue that arises with respect to the interpretation of this sentence is whether or not timing differences with respect to the deduction of the expenses are allowed under article 24(4). There are indeed a number of jurisdictions which provide in their domestic law that expenses incurred *vis-à-vis* foreign (related) taxpayers are deductible only when effectively paid (cash basis) while the same expenses incurred *vis-à-vis* domestic taxpayers are deductible when accrued (accrual basis). The conformity of this deferral of the deductibility of expenses, when paid to foreign taxpayers, with article 24(4) has been justified by the Argentine competent authorities *inter alia* on the basis of a literal interpretation of this provision and more in particular by referring to the use of the word "paid". The US Congress has justified the deferral of the deduction of interest paid to related foreign persons under the so-called "earnings-stripping" provision[28] by referring to the fact that a similar deferral is applied for the deduction of interest payments to related domestic tax-exempt entities. This has been criticized as not being the proper comparison under article 24(4) MC.[29] In the Czech Republic, the Minister of Finance has accepted the argument that this timing difference constitutes a violation of article 24(4) so that the deferral cannot be applied to the deduction of interest paid to non-residents that are entitled to such ND protection under the relevant DTC. This is now also confirmed in the discussion draft (no. 75).

A strict application of the above sentence does not allow for additional restrictive conditions to be imposed with respect to the deductibility of expenses paid to (affiliated) foreign taxpayers. However, a study of the branch reports shows that in several states (mainly in Latin America, e.g. Argentina, Chile, Mexico, Uruguay) such additional conditions are imposed in domestic law. In these branch reports the possible infringement of article 24(4) is invoked unless there are specific carve-outs in the DTCs (e.g. Chile and Mexico).

In other jurisdictions domestic tax law contains specific anti-abuse provisions relating to the deduction of (certain) expenses paid to (affiliated) foreign taxpayers (benefiting from a favourable tax regime) (e.g. Belgium, France, Italy). These anti-abuse rules require additional information to be provided by the taxpayer or even a reversal of the burden of proof relating to the bona fide and/or arm's length character of the expenses. It has already been mentioned in the discussion relating to article 24(3) that the IRS is of the opinion that the requirement to render additional information in a cross-border context does not violate the ND principle of article 24 MC. This will now be expressly confirmed with respect to the application of article 24(4) in a new paragraph 56(1) of the commentary proposed in the discussion draft.

The main issue that has arisen with respect to the application of article 24(4) relates to "thin capitalization" rules. In the domestic law of many states these rules, which aim to reduce the deductibility of interest expenses in the situation of excess debt/leverage, only apply if the interest is paid to (affiliated) foreign

28 IRC s. 163 (j).

29 See Bennett, *op. cit.*, p. 425.

lenders. Although this different treatment by itself seems sufficient to be considered (indirectly) discriminatory *vis-à-vis* the foreign lender, article 24(4) provides for a justification of this discriminatory measure if the denial of the deduction of the excess interest is compatible with the arm's length principle imposed in article 9§1 and article 11§6 MC.

If one accepts that these articles relate not only to the interest rate that is applied but also to the debt–equity ratio of a company[30] they seem to constitute an excellent excuse for the OECD member states to restrict the application of the thin capitalization rules in their domestic law to cross-border situations. This justification has indeed been invoked in several branch reports (e.g. Korea, Spain, New Zealand). In the branch report of Korea reference is made to the legal right of the taxpayer to demonstrate that a higher debt–equity ratio is at arm's length, to justify the compatibility of the Korean thin capitalization rules with article 24(4). In the branch report of Russia, the absence of such a right for the taxpayer is considered an important indication of the non-compatibility of the Russian thin capitalization rules with article 24(4), which has been confirmed in case law relating to the DTC with Germany and the Netherlands. Also the Belgian branch report refers to a clear violation of article 24(4) in its domestic law (article 18,4° ITC) which provides for a one-to-one debt–equity ratio for loans granted by foreign companies that are board members of the Belgian borrowing company. The interest on the excess part of such loans is characterized as a (non-deductible) dividend. This restriction on the deductibility of interest does not apply to loans granted by domestic companies that are board members of the same company.[31] The Supreme Court of Mexico came to the conclusion that the thin capitalization rules in Mexican law, which only apply to financing from foreign related parties, do not violate article 24(4) since their goal is to prevent tax avoidance.[32]

It is clear that within an EEA context, after the ECJ ruling in the *Lankhorst-Hohorst* case,[33] the arm's length justification expressly referred to in article 24(4) is not sufficient to justify the conformity of thin capitalization rules applying exclusively to loans from foreign lenders with EC law.[34] As reflected in their branch reports, most EEA Member States have subsequently adapted their domestic laws relating to thin capitalization rules accordingly.

However, in the discussion draft no mention is made of deleting this justification in article 24(4) and this justification is even indirectly reinforced by the general statement in the proposed new paragraph 1(3) of the commentary, that

30 See para. 2 of the commentary relating to art. 9 §1 MC, but not very clear in para. 35 of the commentary relating to art. 11§6 MC.

31 Very recently the ECJ has ruled that this "discrimination" in Belgian tax legislation constitutes a non-justifiable violation of the fundamental freedom of establishment within the EU; ECJ, 17 January 2008, *Lammens & Van Cleeff NV*, C-105/07.

32 Whether such general justification is sufficient to avoid an infringement of art. 24 is doubtful in our view.

33 ECJ, 12 December 2002, Case C-324/00.

34 See also ECJ, 23 March 2007, *Test Claimants in the Thin Cap Group Litigation*, C-524/04. In this decision the ECJ rejects the reference to art. 9 MC as justification for the different treatment, which was invoked by the German and UK governments. However, at the same time it accepted the application of thin capitalization rules as an anti-abuse rule against "totally artificial constructions".

> "the provision of the Article (article 24) must be read in the context of the other articles of the Convention so that measures that are mandated or expressly authorized by the provisions of these articles cannot be considered to violate the provisions of the Article, even if they only apply, for example, as regards payments to non-residents."

This statement seems to be inspired by the reasoning of the UK Court of Appeal in the *UBS AG* case (see above).

2.2.4. Article 24(5): foreign ownership ND

2.2.4.1. Enterprises the capital of which is wholly or party owned or controlled, directly or indirectly

The precise scope of this second "indirect" ND provision in article 24 MC is not totally clear. First of all, it can be derived from the wording above that it is not necessary that the domestic enterprise in the source state is controlled by one or more residents of the other contracting state. It appears to be sufficient that part of its capital is owned by a resident of the other contracting state so that even minority shareholders could invoke this provision.

The ownership or control need not be direct but can also be indirect, which is confirmed by the Finnish Tax Court in a case where two Finnish subsidiaries were held indirectly by a US company through two intermediate holding companies located in a country which did not have a DTC with Finland. The court ruled that this indirect control was sufficient for the US company to be entitled to the application of article 24(5) of the DTC between Finland and the USA.

Another issue relates to the application of article 24(5) to partnerships. The reference to "capital" seems to exclude partnerships which, according to the domestic law of the state in which they are established, do not have such capital. This is confirmed in the Austrian report and in Luxembourg case law. In the *Mathis Prost* case a Luxembourg limited partnership which was held by Swiss and Belgian residents was converted into a Luxembourg limited liability company (SA). Luxembourg tax law provided that Luxembourg resident partners could benefit from a tax exemption on their share in the hidden reserves of the partnership upon its conversion, while this exemption was not available for non-resident partners. The Belgian partners claimed that this was a violation of article 24(5) of the DTC between Belgium and Luxembourg. However, the Luxembourg administrative court rejected their claim in a decision of 5 April 2000 stating that article 24(5) only protected the enterprise and not the persons controlling it and that it related to the assets and profits directly connected to the enterprise to the exclusion of the capital gains connected to the assets of the partners. In the Luxembourg report reference is made to the analysis of Professor Van Raad, who concluded that if the partnership itself was not subject to income tax in the state of its establishment it could not be considered as an enterprise of that state, so that article 24(5) could not be invoked by the partners of the partnership.[35]

[35] Van Raad, *op. cit.*, p. 187.

In South Africa article 24(5) also applies to partnerships and in Spain there appears to be no agreement on this issue. The argument in favour of the application to partnerships is based on a broad interpretation of the notion "capital" in the sense of "participation to the risks of an enterprise". Unfortunately this issue is not dealt with in the discussion draft and also not included in the list of issues to be further analysed.

2.2.4.2. Similar enterprise

The comparison should be made with a "similar enterprise" in the source state. In the discussion draft the question of the correct comparison is raised. Two alternatives are presented:

(a) comparison with domestic enterprise owned or controlled by residents of the same state;

(b) comparison with domestic enterprises owned or controlled by residents of third states (i.e. most favoured nation (MFN) clause).

The working group concludes that option (a) is the correct comparison and that there is no need for clarification in the commentary (although there is no explanation of this notion in the current commentary). In some DTCs (*inter alia* DTCs concluded by Canada and Poland) option (b) is applied.

In Spain a very restrictive interpretation is given to the notion of "similar enterprise". It must not only carry on the same activities, but it must also have the same legal form and the same size as the enterprise that is owned or controlled by residents of the other contracting state. In the technical explanation relating to the US MC reference is made to "similar activities or ownership of the enterprise". As pointed out by the US reporters the reference to "ownership of the enterprise" is somewhat mysterious in this context. The technical explanation continues with the enumeration of a number of US tax provisions which provide for a different tax treatment between foreign owned and domestically owned US companies but which are deemed not to violate article 24(5). These provisions include (a) the ineligibility of a US company with non-resident alien shareholders to make an election for S corporation status; (b) application of withholding tax on the distributive share of non-resident partners of a partnership exercising a trade or business in the USA; (c) no possibility of filing consolidated returns with domestic enterprises.

2.2.4.3. Thin capitalization rules/group relief, tax consolidation; tax-free intra-group contributions

The branch reports of several states refer to case law relating to the conformity of their respective thin capitalization rules with article 24(5). In France the domestic thin capitalization rules imposed a certain limit on the deductibility of interest paid by a French company to its shareholders. This limit did not apply if the shareholder was a French parent company or if it was a foreign company resident in France or holding the shares of the French subsidiary through a PE in France. In its 1990 decision in the *SAS France* case, the *Conseil d'Etat* came to the conclusion that this legal provision did not violate article 24(5) of the Franco-Swedish DTC. In its 2003 decision in the *Andritz* case, the *Conseil d'Etat* came to the conclusion that there was a violation of article 24(5) of the DTC between France and Austria. France protected itself against the possible negative outcome of the case law by providing for an express carve-out for this legal provision in article 24 of the DTCs to be concluded and by making a general reservation in this respect in the commentary to the MC. On the same date as the *Andritz* decision, the *Conseil d'Etat* ruled (*Coréal Gestion* decision) that the limit on the deductibility of interest payments to foreign parent companies constituted a barrier to the implementation of the fundamental freedom of establishment under the EC Treaty, so that it could no longer be applied in an EEA context (even if the DTC with the other EEA Member State included a specific carve-out). In New Zealand the courts came to the conclusion that the domestic thin capitalization rules (which apply only to cross-border financing) did not violate article 24(5).

In the discussion draft the working group confirms the preference for applying article 24(4) and not article 24(5) to thin capitalization rules that could be deemed to be discriminatory, a preference which is already reflected in the current commentary. At the same time it proposes to modify the commentary relating to article 24(5) to clarify that, if article 24(5) is nevertheless applied, the exclusion for the application of the arm's length provisions of article 9§1 and article 11§5 (which is explicitly provided for in article 24(4) but not in article 24(5)) should be taken into account. This results in a very restrictive application of article 24(5) to thin capitalization rules, which exceeds the actual wording of this treaty provision. This approach has been extensively criticized in the Indian report, which applies the proposed new commentary also to the transfer pricing rules in India.

A similar approach is applied with respect to the application of article 24(5) to domestic group relief or group profit transfer rules which exclude domestic companies that are foreign owned. There is case law in Finland, Sweden and Germany condemning this restriction in domestic law as a violation of article 24(5) of the applicable DTC. In the German *Delaware* case relating to the participation of a US parent company, with place of management in Germany, to a tax consolidation (*Organschaft*) with its German subsidiary (already referred to above in the analysis of article 24(1)), the BFH finally approved such participation on the basis of article 24(5) of the DTC between Germany and the USA. The Luxembourg Court of Appeals in its decision of 19 April 2007 finally rejected the claim that the refusal of "horizontal" fiscal integration of the six Luxembourg subsidiaries of a Belgian parent company constituted a violation of article 24(5) of the DTC between Luxembourg and Belgium, overturning the earlier decision of the administrative court of first instance. However, this decision and the reasoning of the Court are heavily criticized by the Luxembourg reporters who also regret that the Court did not see the EC law aspects of the case.

Again, notwithstanding the case law referred to above, the working group takes a very conservative position on this issue in the discussion draft (no. 14) and declares that in its view no tax consolidation of two local subsidiaries of a foreign parent company is required under article 24(5). However, it also leaves the door open for a review of its position after consultation with consolidation experts and consequently also includes this issue on the list of issues to be further analysed.

With respect to US law, reference should be made to the *UnionBanCal* case in which a US subsidiary had sold an asset at a loss to its UK parent company and had then left the group. The US company was confronted with section 267 IRC which defers the deduction of the loss suffered upon an intra-group transfer of an asset until the asset leaves the group, but at the same time allows for an upward adjustment of the tax basis of the asset at the level of the purchasing group member when the selling member leaves the group. Finally there was neither deduction of the loss at the level of the US subsidiary nor an upward adjustment of the tax basis at the level of the UK parent. *UnionBalCal* claimed that this was a violation of article 24(5) in the USA–UK DTC. However, the Ninth Circuit Court concluded that the foreign ownership of the US subsidiary did not play a role in the non-deduction of the loss and that this was merely the result of the different tax rules in the UK and USA. In the *Square D* case, in which the US subsidiary of a French parent company could not deduct the interest accrued to its French parent and French sister company until it was effectively paid, the Tax Court decided that the foreign ownership of the US company was merely incidental to its adverse treatment and accepted the IRS's argument that the basis for the deferral of the interest deduction was dependent on the US tax treatment of the payment in the hands of the beneficiary of the income and not on the nationality of the owner of the payer.[36] This decision was confirmed by the Seventh Circuit Court.

In her article on ND in international tax law, Mary Bennett concludes that the IRS and the US courts have so far been unwilling to recognize a violation of the foreign ownership ND provision if the provision is not specifically and exclusively drafted to distinguish between foreign and domestically owned taxpayers.[37]

In contrast to the conservative US approach, reference can be made to the "capital contribution" case law in the Netherlands.[38] In 1994, pursuant to the EC Directive 69/335/EEC concerning indirect taxes on the raising of capital, Dutch domestic law provided for an exemption from Dutch capital tax on certain capital contributions by EU resident companies into a Dutch company. In the cases presented to the Supreme Court non-EU resident companies claimed the same tax exemption based on article 24(5) of their respective DTCs with the Netherlands. In the DTCs with Sweden and Japan this ND provision was identical to article 24(5) MC. In the (then applicable) DTC with the USA, the wording of the ND clause derogated from the MC provision in that it did not refer to the residence of the controlling shareholders but to their nationality. According to the Supreme Court the capacity of the capital contributing company was so closely interwoven with the capacity of the shareholder of the receiving company[39] that the claim for an exemption from capital tax at the level of the Dutch company, which, according to Dutch domestic law, was preserved for capital contributions by EU resident companies, should also be extended to non-EU companies on the basis of the foreign ownership ND provision in the relevant DTC with the Netherlands. In the Dutch branch report it is noted that in the Swedish and US cases the Supreme

36 It was not possible to claim a violation of art. 24(4) since no such provision is included in the DTC between France and the USA.

37 Bennett, *op. cit.,* p. 431.

38 Three decisions of the Dutch Supreme Court rendered on 27 April 1994 relating to capital contributions by respectively a Swedish, a US and a Japanese company into a Dutch company.

39 In all three cases the contributing company was the sole shareholder of the Dutch company.

Court even extended the direct application of the EC directive to non-EU companies since at the time of the taxable event the relevant provisions of the directive were not implemented correctly in Dutch domestic law (application of the MFN clause). Although the MFN approach is expressly rejected in the new commentary (paragraph 1(1)) proposed in the discussion draft,[40] according to the Dutch reporter the decisions of the Supreme Court are in line with the wording of the proposed new commentary since the tax benefit was granted to a Dutch company (being the taxpayer) entering into a transaction with a non-EU resident company, and was not granted as such to the non-EU company.

2.2.4.4. Imputation tax systems

As already mentioned in the analysis of article 24(3), imputation tax systems also give rise to some issues under the ND provisions, including article 24(5). In the *Boake Allen Ltd et al.* case (so called group litigation) the UK courts had to decide on the claim of the taxpayers (UK subsidiaries) that the denial of the right to make a group income election in order to pay dividends to their foreign (respectively US and Japanese) parent companies without paying ACT, on the same terms as a UK subsidiary of a UK parent could have done, constituted a violation of article 24(5) of the DTCs with the UK. The UK government argued that the situation of a foreign parent company was not comparable with that of a UK parent company since the latter, when receiving such dividend income without ACT from its UK subsidiary, would have been liable to pay ACT when it subsequently paid a dividend to its shareholders, which would not have been true for the former. The same reasoning was followed by the High Court and more in particular by Lord Hoffman who finally came to the conclusion that it was not demonstrated that there was discrimination on the specific grounds that the capital of the UK companies was controlled by non-resident shareholders. It should also be noted that the two other Lord Justices were of the opinion that ACT did not fall within the scope of the UK legislation implementing DTCs.[41] Consequently the UK courts seem to share the same conservative approach as the US courts with respect to the interpretation and application of article 24(5) MC. In the UK report reference is made to criticism in legal doctrine relating to this decision especially taking into account the ECJ ruling in 2001 on the joined *Hoechst* and *Metallgesellschaft* cases relating to the (non-) conformity of the UK ACT provisions with the freedom of establishment principle embedded in the EC Treaty.[42]

Similar issues seem to arise (a) in South Africa, relating to the levy of the secondary tax on dividends distributed to non-resident shareholders while domestic law provides for an exemption from this secondary tax if the dividends are paid to a resident shareholder,[43] and (b) in New Zealand, where non-resident shareholders are not entitled to a refund of the imputation tax credit.

40 For a critical analysis of this new commentary, see A. Zalasinski, "Article 24(1) of the OECD Model Convention and the exclusion of MFN Treatment: A Comment on the OECD Public Discussion Draft", *Intertax*, vol. 35, 2007, pp. 460–472.

41 See also decision of the UK Court of Appeal in the *UBS AG* case.

42 Joined cases C-397/98 and C-410/98.

43 Although, according to the branch reporter, this constitutes a violation of art. 24(5) there is so far no case law on this issue.

In the new commentary (paragraph 57(2)) to article 24(5) proposed in the discussion draft, the same reasoning as that developed by the UK government in the *Boake Allen* case is used to exclude the different treatment of resident and non-resident shareholders for imputation tax purposes from the scope of this ND provision.

2.2.5. Article 24(6): other taxes

Article 24(6) MC extends the material scope of the ND provisions beyond the scope of the taxes defined in article 2 MC (mainly income taxes) to all other taxes that apply in the source state.

This provision is systematically included in the DTCs of several states (e.g. Belgium, Brazil, Denmark, Norway, Mexico, Russia, South Africa, Spain, Switzerland, USA) but is also systematically excluded from the DTCs of several other states (e.g. Canada, Chile, Czech Republic, France (requirement of reciprocity for gift and estate taxes), New Zealand, Serbia, UK).

Not surprisingly some of the branch reports of the latter category of states refer to discriminatory provisions in their domestic tax law relating to other taxes (e.g. nationality-based discrimination relating to real estate transfer tax in the Serbian tax legislation).

2.3. The shortcomings of article 24 MC

The above overview of the application of article 24 MC in various countries shows that the tax authorities and courts of some jurisdictions interpret the provisions of article 24 MC in a very restrictive manner so that the scope and impact of these provisions are even further reduced. This conclusion applies in particular to the UK and the USA. And even if the courts come to the conclusion that there could be a possible violation of the ND provisions, this does not provide the taxpayer with an effective remedy against the violation because the treaty provisions concerned have not always been properly enacted in domestic legislation (the “treaty underride” phenomenon in the UK) or because treaty provisions can be explicitly overridden by a subsequent domestic law provision (see the Indian report for an example of a treaty override with retroactive effect).

This is in contrast with the broad interpretation given to article 24 by the tax authorities and courts of some EEA Member States in order to broaden its scope (clearly under the influence of ECJ applicable case law). Special attention can be drawn in this respect to the broadening of the scope of article 24 in the DTCs concluded by Belgium and the Netherlands by inserting an additional provision relating to cross-border pension contributions made by, or on behalf of, individuals who are temporarily seconded to the other contracting state. This provision aims at guaranteeing the deductibility of these contributions in the work state (subject to the same limitations as for contributions made to a domestic pension scheme), even if they are paid to a pension scheme in the other contracting state, subject to certain conditions. This provision is included in the draft Belgian MC of June 2007 and has also been part of the tax treaty policy of the Netherlands for almost 20 years. As pointed out in the Dutch report, this provision is clearly inspired by EC law and more in particular by the principle of free movement of workers within the EU, as well as by the extensive case law of the ECJ relating to taxation of cross-border pensions.[44]

Notwithstanding this broad and more flexible interpretation of article 24 MC in EEA Member States, there has also in these states been little case law relating to the application of article 24 and its impact on the domestic tax laws has been minimal and totally overshadowed by the development of the ND principle in EC law. The reports refer to many examples of situations in which article 24 MC could not resolve the discrimination issue for the taxpayer, which was finally resolved pursuant to ECJ case law (see, for example, the *ACT* case in the UK and the case of presumptive taxation of PEs in Belgium). This has also resulted in domestic legislation making a distinction between foreign taxpayers who are resident within the EEA and foreign taxpayers who are not resident within the EEA. In the German report the question is raised whether the preferential treatment of EU nationals over third country nationals does not create a new form of discrimination which could be deemed to be contrary to the constitutional principle of equal treatment. The German BFH seems to accept this difference on the basis of the theory of "two parallel worlds".[45] However, in our view, it is not optimal to have such parallel worlds within the OECD context so that a substantial revision of article 24 MC seems absolutely necessary. The German reporter distinguishes between two different tendencies in this respect in the public debate in Germany: (a) a more extensive interpretation of the existing ND provisions, or (b) a new and broader ND provision.

The ongoing discussion within WP1 relating to article 24 MC is thus very welcome. However, the preliminary results, reflected in the discussion draft, are not very promising. Many of the approaches reflected in the discussion draft have been discussed in some branch reports and have also been dealt with in case law referred to in the branch reports. It is not very encouraging to note that in many instances the working group has opted for the conservative approach taken by the tax authorities and courts in some of the states (e.g. UK and USA) where a more flexible application was considered possible within interpretation limits. Examples of conservative interpretations applied in the discussion draft relate to thin capitalization rules, group relief/tax consolidation regimes, imputation tax regimes. Restrictions or exceptions currently included in the ND provisions of article 24 MC are maintained and even reinforced in the discussion draft. This trend can be illustrated by the following examples:

- "in the same circumstances, in particular with respect to residence" (article 24(1): rejection of more extensive and flexible interpretation based on "covert" discrimination;
- "except where the provisions of article 9§1, article 11§6 and article 12§4 apply" (article 24(4)): conservation of this justification for discriminatory measures in paragraph (4) and implicit extension of this justification to paragraph (5), based on the new argument that "measures that are mandated or expressly authorized by the provisions of the (other) Articles cannot be

44 See *inter alia*, ECJ, 5 July 2007, *European Commission* v. *Belgium*, C-522/04.

45 BFH I R 21/4, BStB1 II 2005, p. 716 ("application of rules by different setters of rules. Unequal treatment created through the implementation of Community law cannot be imputed to the national legislator").

considered to violate the provisions of the (ND) Article even if they only apply, for example, to payments to non-residents";
- new argumentation for the exclusion of public entities and charitable organizations from the personal scope of application of article 24 MC which is in sharp contrast with the attention that has been given to the application of the ND principle in the EC Treaty to such entities, both by the European Commission and by the ECJ.[46]

3. ND at the crossroads of international taxation

Taking into account (a) the fact that the 1993 general report included an overview of the ND principle in the national law of the various states as well as a general analysis thereof, and (b) the absence of new major developments in this respect since 1993 in most states, we will limit our analysis in this section of the general report to some general conclusions that can be derived from the 2008 branch reports.

3.1. National (constitutional) law

Since 1993 some additional states have adopted a constitution containing the general principle of equality before the law. Many of these constitutions contain an explicit general prohibition against discrimination or else such a general ND principle is derived from their equality principle. Of the 31 states for which a branch report was prepared only Canada, Israel and the UK do not have a constitution. In some of the constitutions the equal treatment and ND principles do not cover taxes (i.e. Denmark, Norway and New Zealand). In Switzerland and the USA the competent courts can review and sanction discrimination in cantonal/municipal or state legislation, but not in federal legislation. In the Netherlands there is a ban on judicial review of the conformity of domestic law with the Constitution and there is also no judicial review in Sweden for lack of a specific constitutional court. However, in the Netherlands and Sweden the courts may review the (lack of) respect in domestic law of the fundamental principles embedded in international agreements to which these countries are a party when they have a higher hierarchical ranking than domestic law. In the branch reports of those two states express reference is made to the ND principles in the International Convention on Civil and Political Rights (ICCPR) and in the European Convention on Human Rights (ECHR). In the Swedish report a particular reference is made to the *Darby* case of the European Court on Human Rights related to discrimination under Swedish income tax law.[47]

The constitutions of Belgium, Brazil, Chile, France, Italy, Luxembourg, Mexico, Peru, Poland, and Spain contain a specific provision relating to the application of these or related principles in tax matters. These provisions often

[46] For example ECJ, 14 September 2006, *Stauffer* case, C-386/04.
[47] ECHR 17/1989/ 177/233; see discussion of this case in section 3.3 below.

refer *inter alia* to the "ability to pay" principle, the rule of consistency and of universality.[48]

In many states the constitutional principles of equality and ND apply expressly also to foreigners (e.g. Argentina, Brazil, Finland, India, Poland, Mexico, Peru, Serbia, Switzerland, Uruguay). In other states the ND principle applies implicitly (often on the basis of case law of the constitutional court) to such foreigners (e.g. Austria, Belgium, Italy, Luxembourg, South Africa, Spain). Although in many states with constitutional ND protection its application in tax related case law has increased substantially since 1993 (e.g. Austria, Belgium, France, Uruguay), there does not seem to be much case law relating to cross-border tax situations (see also the explicit remarks in this respect in the Dutch and Swedish reports).

Consequently with respect to international taxation, DTCs remain an important source of protection against certain forms of discrimination. This is illustrated in the branch report of Chile which refers to case law in which the Supreme Court came to the conclusion that a tax provision giving rise to less favourable tax treatment of a PE of a foreign enterprise than that of a resident company did not violate the constitutional ND principle since the PE was not deemed to be in the same circumstances as a resident company. In the branch report of Brazil, however, the practical relevance of the ND principle in the DTCs is considered to be minimal because of the more extensive scope of the constitutional ND principle. This is illustrated by a case before the Superior Tribunal of Justice, in which the application of withholding tax on dividends distributed by a Brazilian company to a Swedish shareholder was considered to violate the principle of equal treatment of foreign capital under the Constitution, as well as under article III of the GATT. No reference was made to article 24 of the DTC between Brazil and Sweden, which, in any event, would not have precluded the dividend WHT. Also in the Swiss report reference is made to case law of the Administrative Court of Zurich which stated that the scope of the nationality ND provision in Swiss DTCs did not exceed that of the principle of equality guaranteed under the Swiss Constitution. Although the Swiss reporter admits (referring to case law of the Supreme Court) that in some aspects the constitutional principle of equality is broader than the conventional nationality ND principle in the Swiss DTCs, he also refers to a basic difference (and added value of the latter principle): under the former principle the unequal treatment can be justified, while this is not possible under the latter principle (so-called "absolute" nature of the ND principle in article 24 MC).

The ND provisions in DTCs should in principle have more added value in countries with no constitutional ND principle or no ND protection at all in their national law. This principle has been expressly recognized in the Danish and Norwegian reports, but at the same time it is acknowledged in these reports that the practical impact of article 24 of the DTCs has been limited, mainly because of the strong development of the ND principle under EC law (extended to the EEA). Furthermore, it is noteworthy that some other states lacking such constitutional protection (as well as EU law protection) against discrimination in tax matters (particularly Canada and New Zealand) have been reluctant to include

48 See the German report for a good overview and description of the various principles that relate to the application of the principle of equality in tax matters.

the ND provision in their DTCs (see their general reservation in the commentary relating to article 24 MC). Other states like the UK and the USA have included the model ND provisions in their DTCs, but, as analysed above, their authorities and courts have given a rather restrictive interpretation to these provisions when applied in practice. But in the UK domestic tax legislation has felt the impact of the ND principle of the EC Treaty.

3.2. Commercial treaties

The term "commercial treaties" covers a variety of often old bilateral treaties in the field of international economic law and investment, such as treaties of friendship, commerce and navigation (FCN) and bilateral investment treaties (BITs).

As taxation is closely linked to cross-border economic flows, the problems to be dealt with are often common. Commercial treaties thus accessorily provide (more often implicitly than expressly, indirect and later also direct) tax protection in the area of cross-border economic activity. As the problem and the approach to this protection are essentially international, commercial treaties are often analysed as parallel developments or even as precursors of the ND clause in DTCs.

Paragraph 2 of the OECD commentary on article 24 describes the process as follows:

> "It is noteworthy that the principle on non-discrimination, under various descriptions and a more or less wide scope, was applied in international fiscal relations well before the appearance at the end of the 19th Century, of the classic type of double taxation convention. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc…) concluded by states, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other state equality of treatment with its own nationals. The fact that most clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope."

Where countries have concluded a commercial treaty as well as a DTC, the question arises as to their respective application to taxes. If no express provision is made to this effect (typically stipulating the priority application of the DTC), it is suggested that the taxpayer should be entitled to choose the more advantageous application for him. Another question arises, with respect to tax ND clauses, as to the application of older commercial treaties to modern income taxes. Van Raad concludes that here the widely accepted method of ambulatory application prevails.[49]

The protection provided by FCN treaties and BITs is that of ND, the standards being national treatment and/or MFN of nationals, residents or companies of any third countries. Treaty practice varies according to the period and to the negotiating states and shows no common patterns. In 1922 the International Chamber of

[49] Van Raad, *op. cit.*, pp. 252 and 215.

Commerce had placed on the agenda of its session in Rome the issue of a nationality versus residence-based ND tax principle. It opted for the former version, but it was heavily criticized by doctrine (Schanz, Dorn) and little or not at all implemented in treaty practice.

The impact of commercial treaties today is perhaps typically reflected in US treaty practice. US treaties entered into force over a period stretching from the 19th to the mid-20th centuries. The USA has negotiated no new FCNs since 1968. It has nearly 40 BITs for the purpose of helping protect private investment, developing market-oriented programmes in partner countries and promoting US exports. Almost all of them are with developing countries.[50]

3.3. Human rights and freedoms treaties

The main international instruments dealing *inter alia* with international (tax) discrimination are:
- the ECHR (1950);
- the ICCPR (1966);
- the International Covenant for Economic, Social and Cultural Rights (1976);
- the American Convention on Human Rights (1978);
- the Universal Declaration of Human Rights (1948).

Their impact in the international tax area to date is described in most branch reports as "none", "very little", "negligible" or "not discernible" as confirmed by the practical absence or scarcity of cases brought under those treaties in this area.

This finding may be surprising as some of the treaties contain express ND principles. This is the case with article 26 ICCPR and article 14 ECHR (usually in conjunction with article 1 of protocol 1). A number of reasons may explain their limited effect. In the first place, the treaty may not be self-executing because, upon ratification, an express declaration was added to the effect that it conferred no direct right of action in the absence of national legislation providing it (as was the case of the US Senate ratifying the ICCPR). In the second place, the provision may offer protection for ND only in relation to the enjoyment of the other rights in the treaty, as is the case with article 14 ECHR. Protocol 12 broadens its scope of application into a free-standing application, but the UK and Switzerland have not ratified it.

Article 26 ICCPR is not subject to the same limitation. It would thus be a free-standing equality right, save that countries such as Switzerland have formulated a reservation in connection with the scope of the rights guaranteed by the ICCPR. Moreover, some countries simply have not signed the human rights treaties. New Zealand and South Africa, for instance, did not sign the ICCPR, although its provisions may still function as a guide point of reference and authoritative interpretation of the New Zealand Bill of Rights Act for the national courts. In other countries (Norway, Austria) which have signed the ECHR and/or ICCPR, the impact of articles 14 and 26 is negligible, especially in tax practice, save for penalty (criminal) taxes and procedural (fair trial) tax issues. Also in Canada, the

[50] US Report referring to Office of the US Trade Representative's Summary of US Bilateral Investment Treaty Program, 2006.

Convention is not applied to ordinary tax matters (e.g. tax discrimination). Upon ratification of the ICCPR, the USA attached understandings to the effect that the provision on discrimination would not be interpreted more broadly than domestic anti-discrimination and equal protection law. In Argentina the national courts preserved the rights that could be derived from the American Human Rights Convention essentially to those flowing from other treaties (e.g. DTCs). In France, th ICCPR is not intended to set rules unrelated to tax matters. In Mexico, only constitutional rights apply. International human rights treaties may be applied only as an enhancement to constitutional rights, their role being thereby reduced to a bare minimum. In Uruguay, the constitutional system prevails and the reason for including the ND clause in treaties executed by Uruguay is to ensure that the other party follows the same principles as those laid down in the Uruguayan constitutional system even if its own system does not impose them.

The result, in so far as international tax discrimination is concerned, is that the case law in many countries that are a party to the human rights treaties applies the same method of judicial interpretation to the scope and standard of the principles of equality and ND under those treaties, including the wide margin of appreciation left to the legislator to make distinctions in tax law, thereby showing deference to the elimination of unjustified distinctions too. A distinction between resident and non-resident taxpayers is not *per se* considered to be in breach of article 26 ICCPR (and probably also not of article 14 ECHR) according to the Lower Court of ’s Hertogenbosch in the *Wielockx* case.

This linking of human rights treaty provisions and constitutional provisions of equality and ND in tax cases may actually have a complementary effect expanding the scope of the protection in the tax field. In the words of the Belgian reporters:

> “In Belgium the principles of equality and non-discrimination, as resulting from constitutional law and international law, are certainly not opposed to one another. On the contrary, they are in fact now complementary in Belgium. This complementarity now only reinforces the scope of these fundamental principles.”

They explain this new interaction of the two legal sources in Belgian case law as the work of the recent institution of the Belgian Constitutional Court. Thus, on a regular basis, Belgian taxpayers contesting tax norms invoke a combination of articles 10 (equality) or 11 (ND) of the Constitution and of article 1 of protocol no. 1 leading to the application of article 14 ECHR. Knowing that a foreseeable later action before the European Court of Human Rights requires that all domestic remedies have been exhausted, an action brought before the Constitutional Court offers the procedural combination meeting this requirement. Another prospective effect derived from the interaction of the human rights treaty principle and the (often more extensive) application of the principle in constitutional systems is the general prevalence of the latter over the national tax practice and, in some countries, also over (article 24) bilateral tax treaties.

While successful case law relating to international tax discrimination under the human rights treaties has generally been exceptional, there are signals that a greater impact in terms of protection may be on the way. An early signal (although described as “rather unusual” by the UK reporter) was the *Darby* case

(1990), involving a Finland resident working and taxable in Sweden and as a Swedish non-resident not allowed to contract out of the application of the Swedish Church tax. The complainant invoked article 14 ECHR in conjunction with article 1 of the first protocol. The European Court of Human Rights held that article 1 applied, and that there was no justification for this distinction between residents and non-residents. But *Darby* is still, by a long shot, not a European or universal charter of taxpayers' rights.

3.4. WTO agreements

If the general reporter to the 1993 IFA Congress made no reference to the WTO in discussing the tax activity of "multilateral treaties that created bodies having sovereignty characteristics intended to regulate free trade zones (see EC Treaty)", there was probably a good reason for it. In that same year GATT was replaced by the WTO agreements at the conclusion of the Uruguay round. In his report on "Non-discrimination principles in WTO agreements and their application to direct taxation", Michael Daly (WTO) explains how the set of international rules affecting trade and those affecting direct taxation traditionally evolved quite separately, notwithstanding the fact that both have the similar goals of removing (tax) obstacles to the cross-border movement of goods, services, capital, and notwithstanding the analytical equivalence between cross-border flows of products and factors. As tariffs declined, attention focused on taxation including direct taxes and their equivalent effects. This recognition led to the Uruguay round and the WTO agreements, especially GATT (1994) on goods, GATS on services, and subsidies and countervailing measures (SCM) such as export subsidies. This new development related both to principles becoming also applicable to direct taxes and also to own dispute settlement procedures likewise applying to members' tax laws.

The cornerstone principle of the WTO agreements is ND, namely MFN and national treatment. Imported goods must be treated the same or no less favourably than domestically produced goods (article III: GATT); remission, calculated in relation to exports, of direct taxes is considered an export subsidy prohibited under article XVI: 4 GATT and annex 1(e) SCM.

GATS applies MFN (article II) and national treatment principles (article XVII) to services and service suppliers alike. However, it is significant that national treatment commitments of countries are not covered if aimed at "the equitable or effective imposition of direct taxes in respect of services or service suppliers of other members". Also tax measures departing from MFN treatment are not covered if they result from DTCs (carve-out).

As the WTO widened the scope of application of its rules, the risk of more disputes concerning consistency between WTO rules and domestic and international measures, notably in the direct tax area, also increased. If there could still be doubt about the application of the free movement of goods (article III) to direct tax measures, these doubts were set aside by the DISC/FSC/ETI panel reports and appellate body (DSB) rulings. The European Community had in 1972 started a procedure against the USA on grounds that its domestic international sales corporation (DISC) legislation resulted effectively in a tax subsidy for US export activities. In its successive tax legislation concerning foreign sales corporation

(FSC) and extraterritorial income exclusion (ETI) activities, the USA had counterattacked on account of export subsidy tax legislation on the part of some European states (application of GATT article XVI:4 and SCM).

As the USA did not in due time implement the DSB rulings, the DSB imposed onerous retaliation awards. This led to the expectation that members would henceforth heed WTO standards and sanctions, which would become an important factor in members' shaping of domestic tax policy and the application of the ND clause in DTCs/MC.

Even so, questions can be raised with respect to WTO principles, and in particular the conceptualization of standards, as well as DSB procedures. According to self-declared general principles, WTO principles should be predictable and transparent. The reports of the panel and the appellate body show how they struggle with tax principles and issues of fiscal territoriality, fiscal nexus, benchmarking of (un)reasonable export benefits, transnational profit allocation, use of capital import neutrality and/or capital export neutrality principles and transfer pricing while the WTO legal framework does not provide for tax harmonization or multilateral tax agreements and for much tax expertise in what is essentially a trade agreement not designed to fit settled international taxation principles. No less critical questions relate to DSB procedures, as they risk being extremely slow (the settlement of the DISC/FSC/ETI saga lasted 30 years), are highly risky (in the case of DISC/FSC/ETI an award over US$5 billion and hardly less in the pending case concerning government assistance (tax incentives) to Airbus and Boeing – over US$ 4 billion). They are very contentious and negotiated in a mood of "economic warfare" and are not very transparent, principled and convergent on the basis of settled tax rules. The problem of bridging this wide gap between world trade principles and classical (OECD) international tax principles is not resolved by imposing heavy sanctions.

3.5. Regional economic grouping treaties: MERCOSUR and NAFTA

Latin American countries have been active in promoting regional integration. After creating the Latin American Free Trade Association in 1960, they replaced it in 1980 with the Latin American Integration Association (ALADI). Today it groups together 12 member states and frames a variety of bilateral and multilateral subregional treaties. MERCOSUR is one of those multilateral subregional integration-type treaties. It was created in 1991 (Asunción Treaty) and currently includes Argentina, Brazil, Paraguay and Uruguay as member countries. ALADI and MERCOSUR tax principles, legal framework and enforcement are described in more detail in the Argentina branch report.

The regional treaties aim at preventing discrimination. The ALADI treaty provides for an *in rem* ND rule: goods manufactured or originated in one member country may not be subject to more burdensome taxation than locally manufactured goods. Capital (investments) coming from one member country may not be treated less favourably than when they come from non-member countries (MFN). The MERCOSUR treaty mainly provides for the "four freedoms" (goods, services, capital and persons) within the region. Member countries are required to repeal all tax and economic barriers that could constitute an obstacle to free trade.

Disputes concerning MERCOSUR rule infringements are settled by *ad hoc* arbitration tribunals and may be appealed before the Permanent Tribunal of Revision. In 2007 MERCOSUR implemented rules providing for binding consultation by member countries. Notwithstanding these principles of ND, restriction-based provisions on free movement, and dispute settlement procedures, the Argentine branch reporter points to the bright line that is drawn between direct and indirect taxation. While in the latter field MERCOSUR rules are well developed and applied in most member countries, very little progress in case law has been made in the former field. No precedents dealing with the (in-)compatibility of direct taxes under the MERCOSUR treaty are reported, although some cases are pending before local courts. In practice this leaves the determination exclusively to national law and bilateral treaties. As the ND international tax arena becomes more sophisticated and complex, the OECD MC article in Argentina's DTCs does not seem able to cope with the development, resulting in divergent national ND applications.

Even if MECOSUR principles and judicial framework were comparable with those of the EU, the crucial activity and specific ND contribution of the ECJ would be (as yet) totally missing, as well as the prospect of Community harmonization legislation in the field.

It is noteworthy how, during the last 15 years, ALADI/MERCOSUR member countries have expanded their network of bilateral DTCs and investment treaties. However, the personal asset tax case is interesting in seeing how the Argentina government construes the regional treaty *vis-à-vis* DTCs.

This federal levy, applied to shares held by non-residents in Argentine companies, and its exemption for Spanish shareholders, were not found in DTCs with ALADI member countries. As there was no specific exemption, the tax was levied on a Brazilian company which filed a DTC competent authority consultation request leading to an ND-based ruling against this tax levy. However, this ruling was reversed by the Argentina executive branch:[51] the Treaty of Montevideo cannot be analysed in the light of DTCs, as its standards predicate the protection of investment, namely MFN treatment of capital, thereby excluding tax matters from its investment protection.

Among other regional trade treaties, reference is made to the North American Free Trade Agreement (NAFTA 1992). This provides for the gradual elimination of national restrictions on trade and investment between the United States, Mexico and Canada. At the time of the 1993 general report it had just come into force. However, as to income taxes, the US report points out that its application is not significant and certainly not a fruitful source for protection from tax discrimination. It requires national treatment to the same extent as article III GATS, does not override any relevant DTC and applies a policy of deferring on this point to the DTC that exists between the parties and which trumps NAFTA. It did, however, provide impetus for the US tax treaty with Mexico and the Canadian protocol providing for favourable withholding tax rates.

51 Ruling of 30 June 2006.

3.6. European Community Treaty (EEA)

EC law is special, in matters of taxation as in other areas, even though the final economic goals are fairly similar to those of WTO agreements and trade integration treaties such as MERCOSUR. EC intermediary goals may be different. They include an internal market based on fundamental freedoms, the abolition of competitive distortions and harmonization legislation. The principles implementing these means are special: ND, non-restriction of market participants' freedoms, prohibition of certain state aid and loyal cooperation. Also the institutional framework conditions are different, notably in the context of the role of the ECJ and its broad interpretative powers. The tax principles are described in the expert report of Lyal (Commission) together with recent trends in ECJ case law in direct taxation matters. The EU reporter concludes that the core principle is that of ND, extended by ECJ interpretation to many forms thereof (overt and covert, direct and indirect).

Questions can be raised as to the extension of ND principles to all (tax) restrictions of the freedoms, notably those not involving (direct or indirect) forms of nationality discrimination. Examples of tax rulings based on restrictions without distinction as to the (domestic versus cross-border) tax situation might be *Futura Participations* and *De Coster*.[52] They remain exceptional in view of the broad interpretation of the ND principle, but market participants might be tempted to apply the pure and simple tax restriction approach as it would alleviate the burden of proof relating to similarity.

A restriction-based approach to tax prohibition may also raise problems of implementation. ND is national context (i.e. inward) focused while that approach, in accordance with traditional principles of international taxation (allocation of tax jurisdiction), creates potential problems of "locational" tax neutrality and ignores the free cross-border movement approach of the internal market. An extension beyond ND in the tax area would be controversial in view of the balance in the (vertical) allocation of tax competences between Community and sovereign Member States. The application of ND in its many forms is also subject to exception for imperative reasons of public interest. The ECJ has in its income tax case law given a rather strict application to this self-imposed restraint thereby adding to the safeguarding and protection of the freedoms of the market participants.

In 1993 the general reporter, dealing with the ND tax principles in the different legal orders, had concluded that the tax case law of the ECJ was still too incomplete to make a useful evaluation of the impact of EC ND tax principles. Today, this tax case law is still evolving, but is sufficiently well developed to determine its robust impact on the direct tax systems of EU Member States.

Another perspective and approach will be our speculation whether that same EU ND tax principle may, in one form or another, also serve as the better example for the revision of bilateral tax treaties of non-EU member states.

[52] ECJ, C-250/95 (*Futura Participations*); C-17/00 (*De Coster*).

3.7. International customary law

In almost all branch reports (with the exception of Israel and of the unusual reference in the DTC between Germany and Hungary to "generally accepted principles of equality") it is stated that there exists no fundamental principle of fiscal ND that is internationally recognized as customary law. At best fiscal ND, and/or equal treatment, as embraced by the OECD, are internationally called for as a matter of comity or as a moral principle (e.g. in general conventions and universal declarations on human rights).[53]

4. Reconsidering article 24 MC in the light of ECJ case law

The first question in the directives to the branch reporters enquired about discussion, if any, in national doctrine, parliamentary proceedings and case law, dealing with the role and dogmatics of ND, specifically of the principle of article 24 MC in DTCs at work in their jurisdiction. The response was often that this was a theoretical and arcane search. ND is in the bilateral tax treaties "because the OECD put it in". Dogmatic or philosophic discussions were never the order of the day.

ND is a negative expression or statement of the equality principle which goes back to Aristotle (*Nicomachean Ethics*). For its formulation (equal treatment of equals) to be meaningful, it begs further definition of its essential elements, mainly determining the criterion of reference, the scope of application, the comparable circumstances and the justification, if any, of infringement. Applied to cross-border situations, ND may be differently worded and construed depending on the (national, bilateral, regional, worldwide) instrument. It may also provide for implementation according to a variety of principles: national treatment, MFN, capital import neutrality or capital export neutrality in a perspective of inbound or outbound movement, different concepts of non-restriction of cross-border investment or activity, level playing field, reciprocity and alignment of tax burdens according to capacity to pay. Still other ND principles are not primarily targeted on economic measures but are more ethical or generally focused (human rights and personal freedoms, national constitutions).

This composite picture of ND principles explains why the application of the afore-mentioned multitude of instruments, key principles and implementing standards at the crossroads of cross-border taxation systems gives rise to interface situations of tax overlapping and conflict but also to opportunities for cross-fertilization and complementarity of concepts and interpretations. We deal with them as they affect article 24 MC/DTC, which was also the point of reference in the 1993 report. For dealing with international tax challenges, the better instrument, which has served well the international tax order of interdependent economics, is the existing network of some 1500 bilateral tax treaties, most of them

53 Van Raad, *op. cit.*, p. 26; General Report 1993, *op. cit.,* p. 3; K. Vogel, *Double Taxation* (1991), p. 1091.

patterned after OECD MCs, thereby enjoying the factual authority and tax expertise of that organization.

Even so, the provision shows serious shortcomings with respect to (the lack of) legal certainty, coherence and effectiveness. We have discussed them in this report and they were also referred to in the general report submitted 15 years ago. If, therefore, the problems and uncertainties of article 24 MC/DTC are old, the awareness of the need for improvement and the search for ways to deal with it, are new. Two different situations and approaches can be envisaged.

One approach involves the straightforward application and interpretation of the overlapping principle of another tax system. In the EU context, this approach is very effective in view of the direct and priority effect of Community law, the inspired interpretation methods of the ECJ and of the increasing awareness, on the part of individual Member States (*nolens volens*) and of national judges and internal market participants, of the weight and implications of ECJ case law regarding the EU ND tax principle. The EU report offers guidance as to this increasingly rich body of ECJ case law resulting in an ND principle that goes well beyond a simple prohibition of nationality tax discrimination.

In order to identify and prevent incompatibilities of article 24 MC/ DTCs with EC Treaty law, the Commission followed up, in June 2005, its October 2001 Communication "Towards an Internal Market without tax obstacles" with a working document entitled "EC Law and Tax Treaties" which provided an overview of MC articles that need to be adjusted.[54] Specifically with respect to article 24 MC, the document states that it "should reflect the fundamental non-discrimination principles of the Treaty". This implies that nationality and residence confer the same rights; that in special cases persons not residing in the Community may enjoy the same benefits as residents; that permanent establishments must be treated in the same way as resident subsidiaries; that public institutions and non-profit foundations or bodies set up in one state qualify in contracting Member States for the provisions of national legislation, i.e. exemptions or other benefits relating to inheritance or gift tax granted to similar national entities; that provisions available to groups of companies within a Member State must also be applicable where one of the members of the group is resident in another Member State. In the context of free movement of capital, this also implies that dividends distributed by companies residing in the Community must enjoy the same benefits as dividends distributed by national companies.[55]

At the OECD end, the discussion draft (annex) lists four ways in which courts (primarily in EU Member States) may bring about a possible impact of Community law rubbing off on article 24 MC of DTCs between EU Member States (and even with non-EU states):

- because courts may be tempted in deciding freedom cases to extend ECJ principles to the interpretation of that article; or

54 Lyal also points in his report to provisions other than the ND provision in EU Member States' DTCs that are affected by ECJ case law concerning tax discrimination (*Gilly*, *Saint-Gobain*, *Amurta*, *D*).

55 While this working document envisages alternative forms of "communitarization" to the effect of introducing an "EU version of the OECD MC" (in particular directive, multilateral European treaty or model convention), the absence of follow-up on this document may suggest that the official action will be limited to a soft form of Commission coordination of Members States' treaty practices and policies.

- because they may feel obliged to apply EC Treaty principles to residents of non-EC states with which they have a corresponding tax treaty provision; or
- because they may want to use, in their discussion of alternative ND rules for tax treaties, the concepts and reasoning developed under EC Treaty and ECJ case law;
- because they may restrict the ability of EC Member States applying technical solutions reflected in the commentary on article 24.

5. A principle in search of coherence and convergence

Our critical review of the provisions of article 24 MC/DTC and of its recent case law described in the branch reports found fault with its incoherent, incomplete, uncertain, ineffective and outdated conceptual framework. The need for its amendment is fulfilled to a degree that is no longer insignificant in DTCs between EU Member States as a result of the direct and priority application of the rich ECJ case law concerning ND to their tax laws and treaties. This reduces increasingly the room left for negotiation and debate about interpretation framework and policy.

The situation and approach are different for the DTCs of non-EU member states. A recommended application based on another concept (for instance with the ECJ case law as role model) raises new legalistic and conceptual issues relating to scope and standards with a view to amending the current version of article 24 MC. Changes and innovative language are necessary if the job is that of providing an overarching prohibition: covert forms of nationality discrimination and certain cases of indirect tax discrimination, new parameters for identifying similar situations, the possibility of justification of ND infringement, the proportionality requirement and, more generally, that of ensuring coherence in a system that is at present "an odd collection of paragraphs, which has been accumulated from different sources at different times and reveals no overarching theory".[56]

Can it be argued that the needed improvement, reshaping, modernization and upgrading of article 24 MC can be achieved by ambulatory interpretation in recognition of new complexities, experiences and emerging concepts in the international tax scene and specifically in the blend of constitutional, international and supranational ND principles? The strict wording and historic footprint of the provisions of article 24 MC are such that flexible interpretation is not the right method to achieve extension and improvement where that involves changes in the concepts. Such changes can only result from innovative language and new standards.

Can it be argued that they can be achieved if the revision is documented by OECD commentaries? This official stamp would give it the weight and status of "supplementary means of interpretation" in the sense of article 32 of the Vienna Convention on Treaties as it arguably would reflect a consensus of OECD member countries' administrations and emanate from the official representative organization in charge of recommending and coordinating the proper application

[56] Bennett, *op. cit.*, p. 411.

and interpretation of MC treaty provisions. However, the blessing of OECD commentary and endorsement by consensus of representatives of national administrations does not set aside the limits of interpretation of the bilateral principle. The need to amend and extend the standards and scope of article 24 MC raises substantive and conceptual new issues. Whose standards? Which standards, exceptions, scope? With an eye for the better legal source of inspiration at a time when governments around the world face increased strains on revenue and may be tempted to dip more heavily into the pockets of foreign taxpayers, Bennett is not the only one wanting to deal with these new needs by drawing on EC Treaty counterparts and rich ECJ tax case law:

> "It has been impossible to ignore the impact of that jurisprudence on the analysis of bilateral tax treaty non-discrimination issues, even though many in the tax treaty world like to politely pretend that the ECJ has no direct relevance to tax treaty provisions and therefore cannot cause any discomfort."[57]

It must be said that BIAC and the OECD discussion draft look for inspiration to alternative legal sources that may serve as examples:

> "A number of non-tax agreements such as the WTO Agreements include general rules intending to prevent some forms of trade or investment discrimination … BIAC had suggested that the general non-discrimination provisions of these other agreements should be a source of inspiration for extending the Treaty language on the Commentary."

Also Avery Jones was critical of the new inspiration that may be derived from ECJ case law, but that was in the early stages of ECJ tax jurisprudence. His criticism might, in the meantime, more appropriately be addressed to the other trade agreements (as echoed in our evaluation by the experiences with the first important WTO tax case law of the FSC/ETI saga):

> "The problem is that international trade negotiators do not understand direct tax. Either they put their heads in the sand, as in the EC Treaty, or more normally these days they opt out of tax, as in NAFTA and GATS … The thinking is presumably that trade treaty negotiators regard tax as an arcane mystery. They know that there are lots of tax treaties around that apparently work, so why not leave tax alone and get on with things they understand?"[58]

If there is a reservation with recommending EC ND principles as currently interpreted by the ECJ, it is a quite different one. Is the ECJ an appropriate source, considering that this role model is derived from an integrating treaty and case law based on teleological interpretation with an internal market as ultimate goal? There are more modest role models that the countries might apply and that are less aggressive and more proportionate than ND principles and the concepts of ECJ case law. Such ND interpretation might not even be able to satisfy the objec-

57 *Ibid.*, p. 455.
58 J.F. Avery Jones, "Are tax treaties necessary?", *op. cit.*

tives, for instance where it purports to prohibit tax discrimination based on destination as well as tax discrimination based on origin.[59]

There is merit in a reservation on grounds of lack of proportionality and recognition of different frameworks and objectives of both ND principles. The EC role model should be sized down and adapted to the specific amendment needs and bilateral framework of MC/DTC. Our recommended approach would be that of a two-stage propelled rocket. The first paragraph would provide the core principle of an overarching prohibition of tax discrimination based on the nationality, residence or other equivalent *in personam* characteristic of the taxpayer, thereby extending the scope of current paragraph (1) to also cover current paragraph (3) (PE ND). The core principle would thus provide for a more extensive and tax effective specific dimension of (overt and covert) distinction and parameters for comparing similar circumstances, and would allow the justification of tax discrimination for imperative reasons of public interest measured by proportionality.

The second paragraph of a new article 24 MC would contain current paragraphs (4) and (5). The commentary would widen their scope to include further cases of ND application (based more on principles of (non-) tax restriction than of (non-) direct discrimination) as the contracting states may from time to time want to add cases on a mutually negotiated base. The new commentary would make clear that the justified changes do not extend to fundamental freedoms, tax disparities and complete non-restriction, (full) level playing field and outbound tax neutrality, reverse discrimination, MFN treatment, ECJ interpretation methods inspired by internal market objectives.

This controlled (adapted) application of the EU ND tax concept would thus present a combination of (a) an overarching ND principle, extending and upgrading the scope and standard of the current one to the level of a prohibition of direct tax discrimination on grounds of nationality or residence, thereby contributing to its coherence, effectiveness, transparency, proportionality and reasonableness, and (b) the prospect of negotiated cherry-picking in the wider area of indirect discrimination, contributing to the flexibility and adaptability to national policies and mutual economic interests and improving chances of acceptance of the package by contracting states.

It is understood that in this proposal its elaboration and coordination by the CFA OECD is of crucial importance. It is also understood that this CFA contribution and the renegotiation and ratification of the DTC provision by the contracting states is a long-term project. An interim update of the commentary on article 24 MC may provide new interpretations with immediate effect, even though it would offer only limited potential for improvement in terms of the increased effectiveness and coherence of the current provisions, as shown by the outcome of the 2007 discussion draft.

This report shows that the search for a more effective, coherent, modern and convergent version of article 24 MC/DTCs, with an eye on ND principles in other tax systems, is definitely under way.

59 German report, referring to M.J. Graetz and A.C. Warren, "Income tax discrimination and the political and economic integration of Europe", 115 *Yale L.J.*, pp. 1186 and 1219.