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IBFD, Your Portal to Cross-Border Tax Expertise
Taxation and Non-Discrimination: A Reconsideration

Discrimination is in the eye of the beholder. Discrimination and non-discrimination are among the most difficult concepts of law in general, and tax law in particular. In fact all tax systems are built on a welter of distinctions among taxpayers, categories of income and elements of the tax base that are in a constant state of flux.

On one side of the debate, there are those who argue that discrimination can be perceived only in identical, or at least comparable, situations. As residents and non-residents are clearly in a different situation for tax purposes, there is no need to treat them equally; to do so would be to apply equal treatment to unequal situations, which is precisely what constitutes discrimination. This is the view expressed in Art. 24 of the OECD Model Convention. On the other side, there are those who regard discrimination as a much more pervasive concept, and who argue that the tax legislator should not be permitted to do indirectly what is prohibited directly, such as drawing distinctions on the basis of nationality. This view maintains that, as most non-residents are likely also to be non-nationals, discrimination against non-residents is tantamount to discrimination against non-nationals and is therefore also prohibited. This is the position taken by the European Court of Justice. This view is also accepted to a limited extent in Art. 24(3) of the OECD Model Convention, which prohibits certain forms of discrimination against PEs. The conflict between these two interpretations epitomizes the complexity of the concept.

No wonder that the international standard for discrimination in tax matters based on nationality, embodied in Art. 24 of the OECD Model Convention, has come under scrutiny. One example of the attention being paid to this issue is the branch and general reports on the subject written for the Brussels congress of the International Fiscal Association in 2008. In the run-up to that congress, some leading academics in the field of international taxation and some OECD officials, rightly considered to be the guardians of the Model Convention, came together in a seminar at the ITC in Leiden to discuss the situation.

At IBFD we found the papers and presentations for that seminar so provocative and interesting that we thought they should be made available to a wider audience, through publication in a special issue of the WTJ. Hugh Ault and Jacques Sasseville first introduce the other articles, by drawing a roadmap for the discussion and raising the important questions. Ruth Mason deals with the complex problem of discrimination and neutrality in tax matters and the impact of ECJ case law. She suggests that the different objectives of the OECD Model and the EC Treaty
warrant different definitions of tax discrimination, each tailored to its specific context. Yet at the same time she finds the moment ripe for a fundamental reconsideration of the Model Convention and its non-discrimination principle. Brian Arnold and Arthur Cockfield investigate the potential impact on tax matters of non-discrimination provisions in trade treaties. This could be an explosive issue. Prima facie the non-discrimination provisions in these treaties apply to tax matters, and their prohibitions of discrimination tend to be expressed in much more sweeping terms than those of tax treaties. Kees van Raad deals with personal deductions and allowances, and proposes "fractional taxation" of worldwide income as the solution for multinational employees.

The two last contributions overlap to a certain extent. Malcolm Gammie analyses the double taxation of dividends and concludes that, as long as the taxation of corporate profits is divided between the country of residence of the corporation and the country of residence of the shareholders, double taxation is more a matter of competing tax claims and the international distribution of national tax jurisdictions than a question of discrimination. My own contribution pits the international rules on the taxation of various categories of capital income (interest, royalties and dividends) against the ECJ case law on non-discrimination, and finds that the outcome of this case law is quite different from what the outcome would be if Art. 24(3) OECD Model Convention were applied. Yet the conclusions drawn by Gammie and myself are rather similar. Like Ruth Mason, I conclude that, because of the very different contexts, a uniform interpretation and application of the non-discrimination principle in the European Union and in the wider international community is not only not feasible, but also not desirable. The non-discrimination provision of the OECD Model Convention should not be amended, but the commentary on Art. 24(3) could be amended in order to draw some specific forms of discrimination within its prohibition. Malcolm Gammie concludes that it is more appropriate to deal with the principles underlying the cross-border taxation of dividends, including non-discrimination issues, within the context of Art. 10 and its Commentary, rather than seeking to develop these principles as part of an amendment to Art. 24.

Prof. Frans Vanistendael
Editor-in-chief
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**Taxation and Non-Discrimination: A Reconsideration**

1. Introduction

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

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

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

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

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

– such new or amended treaty rules should ensure greater cross-border neutrality, so as to promote the most efficient allocation of resources and thereby maximize global welfare;

– these rules should not substantially alter the existing allocation of taxing rights (the purpose of the seminar is not to review how taxing rights are allocated under the provisions of tax treaties);

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

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

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

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

2. Full capital export neutrality, however, will not be achieved to the extent that the country of residence does not give a credit for (in effect, refund) the part of the tax levied by the country of source that exceeds its own tax. However, it would be unrealistic to expect countries to use domestic tax on domestic income to refund taxes levied by another country. Full capital export neutrality will also not be achieved to the extent that the country of residence does not tax foreign income at the same time as domestic income.
One objective of neutrality that guided the discussion of treaty non-discrimination rules during the seminar was therefore essentially neutrality in the taxation, by the country of source, of income of residents and non-residents.

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

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

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

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

2. Background Notes
2.1. Treatment of dividends

The underlying assumption for this session was that non-discrimination rules of tax treaties should pursue the economic objective of cross-border neutrality so as to promote the most efficient allocation of resources and thereby maximize global welfare. That assumption is
particularly important in the case of cross-border dividends, as their tax treatment will be a main factor in determining the after-tax return on investment.

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

2.1.1. Dividends: allocation of taxing rights under tax treaties

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

Art. 10 (Dividends) applies with respect to the distribution of a domestic company’s profits. It recognizes that the state of source has a prior claim to tax the distributions but that the right is limited to:
- 5% in the case of direct dividends (i.e. those paid to a company holding more than 25% of the capital of the paying company); and
- 15% in the case of portfolio dividends.

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

One could of course question the policy rationale for allowing any additional right to tax dividends. If the state of source has the right to tax the profits of a local company, should that not be enough? That, however, is not really an international tax question; it is the familiar issue of the relationship between the corporate tax and the shareholder tax. The domestic laws of most countries provide for some level of shareholder tax and the amount of shareholder tax levied on dividends was probably higher when the treaty rules applicable to dividends were first designed. Since most countries entering into tax treaties have either a classical or a partial-relief system, it is not surprising that tax treaties allow for the source taxation of dividends. Also, because of the wide variations and frequent changes in domestic laws on this issue (e.g. the United States has gone from a full classical system to 15% shareholder tax in 2003; many European countries have been moving from imputation systems to partial-relief systems as a result of ECJ decisions), the safest approach when negotiating a treaty that is intended to apply for a long period of time is to allow a country the right to tax dividends paid by its resident companies.
Ideally, in the case of portfolio dividends, one would want the tax payable on dividends paid to non-resident shareholders to be the same as that levied on resident shareholders. For practical reasons, however, the correct determination of the deductible expenses related to the investment and the ability to pay of non-residents has historically been considered impossible to determine: the treaty compromise has therefore been to limit the source country right to tax to 15% of the gross amount of the dividend.

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

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

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

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

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

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

If, in a purely domestic context, the shareholder taxation on the dividend does not take account of the tax paid by the company, it is difficult to argue that, in a cross-border context, a resident shareholder should be entitled, in his country of residence, to relief for the corporate tax paid by the foreign company. In the case of domestic intercorporate dividends, however, many tax systems relieve economic double taxation and it is therefore logical to ask...
whether treaties should not provide for the same relief for cross-border dividends. It is, however, technically complex to provide relief for the underlying corporate tax paid by a foreign company and countries that do so only do it in the case of substantial intercorporate shareholdings (e.g. 10% or more).

2.1.3. ECJ decisions on these issues

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

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

– *Athinaiki Zithopia AE* (C-294/99) (see also *Epson Europe BV* (C-375/98)): should a tax imposed on the company on its distributions be treated the same way as a tax on dividends for the purposes of tax treaty limitations (this is especially relevant for systems such as those of Estonia and Chile, which levy higher taxes on distributed profits)?

– *Bosal* (C-168/01) (see also C-439/07 with respect to the 95% deduction rule applicable in Belgium): should expenses that are deductible with respect to investments in domestic shares that give rise to exempt dividends be similarly deductible with respect to investment in foreign shares that give rise to exempt dividends?

– *Manninen* (C-319/02) (see also *Meilicke* (C-292/04), *Lenz* (C-315/02), *Verkooijen* (C-35/98), and *Commission v. Greece* (C-406/07)): should the benefit of an imputation system or partial relief system provided to residents with respect to domestic dividends be extended to foreign dividends received by residents?

– *Test Claimants in the FII GLO* (C-446/04): if a country exempts domestic intercorporate dividends from corporate income tax, should it similarly exempt from corporate income tax dividends received by a domestic parent company from a foreign subsidiary?

– *Denkavit* (C-170/05) and *Amurta* (C-379/05): if a country exempts domestic intercorporate dividends from any withholding tax, should it similarly exempt from withholding tax dividends paid by a domestic company to a foreign company? In particular, should it exempt dividends paid to a foreign company also if the withholding tax otherwise due can be credited in full against the corporate income tax payable by the foreign company in accordance with the provisions of either its domestic law or the applicable tax treaty?

– *Metallgesellschaft Ltd* (C-397/98) (see also *Test Claimants in Class IV of the ACT Group Litigation* (C-374/04)): if a country exempts domestic intercorporate dividends from payment of an equalization tax that is part of its imputation system, should it similarly exempt dividends paid by a domestic company to a foreign company?

– *Bouanich* (C-265/04): should the treatment of share repurchases (or liquidations) be the same for resident and non-resident shareholders? Should it be considered to be discrimination to treat a share repurchase as a capital gain for a resident but as a dividend for a non-resident?
Avoir fiscal (270/83) and Saint-Gobain (C-307/97): should permanent establishments of foreign enterprises be treated like resident shareholders with respect to dividends that they receive? In particular, should permanent establishments of foreign enterprises be entitled to the same tax treaty benefits that are available to resident shareholders?

Orange European Smallcap Fund NV (C-194/06): should the preferential treatment of dividends received by domestic investment funds with domestic investors be extended to domestic investment funds with foreign investors? Should the differential treatment of dividends received by domestic investment funds from different foreign companies be considered to be discrimination?

Kerckhaert and Morres (C-513/04): is it sufficient to provide for the same treatment of domestic dividends and foreign dividends in the hands of resident taxpayers, irrespective of the tax treatment in the other country?

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

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

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

2.2.1. The relevant principles of tax treaties

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

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

The deduction of personal expenses, such as maintenance payments or pension contributions, gives rise to the same issue but, in addition, raises the problem of a possible mismatch between the deduction of the payment and its ultimate taxation. This is especially problem-
atic for pension contributions: whilst allowing the deduction of contributions for a resident may be considered to be merely a deferral of tax, since the pension paid to that resident will be taxed (unless there is a change of residence), a deduction granted to a non-resident is more likely to constitute a tax exemption in the state of source.

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

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

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

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

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

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

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

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

– **Turpeinen** (C-520/04): should it be considered to be discrimination to subject pension payments to non-residents to a flat withholding tax which, in certain cases, is higher than the tax which that taxpayer would have had to pay if he/she had been a resident?

– **Gerritse** (C-234/01): should it be considered to be discrimination to levy a withholding tax on non-resident entertainers at a lower uniform rate deducted at source, whilst the income of residents is taxed according to a progressive table including a tax-free allowance?

– **Schumacker** (C-279/93) (see also **Wallentin** (C-169/03) and **Meindl** (C-329/05)): these cases have held that where a non-resident derives most of his income from a country, that country should grant to that non-resident personal allowances that are available to residents. The fact that the rate applicable to the non-resident on the income that is taxable in the country of source may be lower than the rate applicable to residents of that country is not a justification for that country not granting these allowances.

– **Wielockx** (C-80/94): this case has held that where a non-resident derives most of his income from a country, that country should grant to that non-resident the same right to deduct pension contributions that is available to residents regardless of how taxing rights are allocated on pension payments.

– **Gschwind** (C-391/97): should the benefit of the joint assessment for married couples be given to non-residents?

– **Asscher** (C-107/94): (progressive) income tax rate applied to a non-resident taxpayer should be determined without regard to any income the taxpayer derives from (foreign) sources in respect of which he is not subject to tax in the source country.

– **D** (C-376/03): for the purposes of wealth tax, should it be considered to be discrimination to deny non-residents who hold the major part of their wealth in the state where they are resident entitlement to the allowances which it grants to resident taxpayers?

– **De Groot** (C-385/00): is foreign income being discriminated against if personal allowances of a resident are allocated proportionally to domestic income and foreign income so that part of the personal deductions, such as the deduction of alimony payments made to a former spouse, are allocated to income that is not taxed in the residence country under the exemption method?

– **Ritter-Coulais** (C-152/03) (see also **Lakebrink** (C-182/06) and **Renneberg** (C-527/06): it was held in this case that, for the purposes of determining the taxable income of non-residents in the source state or in the computation of the rate of tax applicable to them, the non-residents should be able to claim rental income losses (negative income) incurred in
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their state of residence through the use of their house located there for their own needs as if that house had been located in the state of source.

– **Blanckaert (C-512/03):** should a non-resident who derives only investment income from a country and who does not pay any social security contributions in that state be entitled to an income tax credit for contributions to a national social security scheme in that country in the calculation of his taxable income there when a resident who also derives only investment income and pays no social security contributions would be entitled to such a credit?

– **Jundt (C-281/06):** it was found incompatible with the freedom to provide services for a country to restrict an income tax exemption granted for part-time teaching activities to teaching activities performed in universities established in that country.

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

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

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

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

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

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

– the provisions of Art. 9, which confirm that countries can adjust the profits of associated enterprises to deal with non-arm’s length transfer pricing and provide for a corresponding adjustment; and

– Art. 10(2)(a), which provides for a lower rate (5%) of tax on direct dividends, i.e. dividends paid to a company that holds at least 25% of the capital of the paying company.

3. Other possible exceptions are Arts. 11(6) and 12(4), which deal with interest and royalties that exceed what would have been paid absent a special relationship between the payer and the beneficial owner of the income, and Art. 13(4), which authorizes the source country to tax capital gains on shares deriving more than 50% of their value directly or indirectly from immovable property located in that country.
The Commentary on the OECD Model also includes a number of references to groups of companies. These are primarily related to anti-abuse measures (see the provisions to prevent the use of conduit or base companies that are included in the Commentary on Art. 1) and the treatment of intercorporate dividends.

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

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

2.3.2. Application of existing non-discrimination rules

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

2.3.2.1. Domestic rules to prevent tax avoidance

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

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

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

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

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

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

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

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

Since domestic rules applicable to groups of companies and related taxpayers vary considerably between countries and change over time, it would seem extremely difficult to design spe-
pecific treaty rules that would achieve that purpose. A generic solution granting some degree of discretion to the tax authorities may be the best that could be achieved. The prototypical example of that approach is Art. XIII(8) of the Canada–United States treaty, which provides that:

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

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

2.3.3. ECJ decisions on these issues

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

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

– **Futura Participations** (C-250/95): should it be considered discriminatory if losses incurred by a non-resident company can be carried forward only insofar as they are economically connected to a permanent establishment and subject to the condition that the company keeps and holds separate accounts relating to that establishment in the year in which the losses arose and which comply with the relevant tax accounting rules?

– **ICI** (C-264/96): should it be considered discriminatory to deny a resident holding company the benefit of consortium relief for losses incurred by resident subsidiaries if the majority of its subsidiaries are resident in other states?

4. Somewhat similar provisions can be found in the United States–Mexico and United States–Spain treaties.
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- **X AB and Y AB (C-200/98):** should it be considered discriminatory to deny tax relief in respect of intra-group transfers between resident companies if the transferee company is owned by two or more non-resident companies which are resident in different states?

- **X and Y (C-436/00):** should it be considered discriminatory to deny resident taxpayers deferral of tax due on capital gains derived from the alienation of shares if either the transferee company itself is resident in another state or its shareholder is a company which is resident in another state?

- **CLT-UFA (C-253/03):** should it be considered discriminatory to deny a non-resident company the benefit of a reduced corporate income tax rate which is applicable to resident companies upon distribution of their profits and imputed to their shareholders to avoid economic double taxation of those profits?

- **N (C-470/04):** should it be considered discriminatory to tax unrealized capital gains inherent in shares or other assets only if they are transferred abroad, e.g. to a different part of the same enterprise carried on by a non-resident company?

- **Marks & Spencer (C-446/03):** should the group relief rules of a country which allow transfers of losses from a resident subsidiary to a resident parent, be extended to allow the transfer of losses from a non-resident subsidiary to a resident parent, and if so, under what conditions?

- **Oy AA (C-231/05):** where domestic rules allow a transfer of profits from a resident subsidiary to a resident parent for tax purposes, should it be considered discriminatory not to allow a similar transfer of profits from a resident subsidiary to a non-resident parent? (In this decision, it was held that such an extension should not be required under the fundamental freedoms as to do otherwise would undermine the allocation of taxing rights between the two countries.)

- **AMID (C-141/99):** should it be considered to be discriminatory to require that a resident corporation first apply domestic losses realized in a given year against profits from its foreign permanent establishments for that year instead of applying these losses against domestic profits for a subsequent year?

- **Leur-Bloem (C-28/95):** should it be allowable, for purposes of determining whether cross-border share-for-share exchanges satisfy the Merger Directive’s criterion of having been made for “valid commercial reasons”, to consider whether they were made for the attainment of a purely fiscal advantage, such as horizontal offsetting of losses?

### 2.4. Withholding taxes

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

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

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

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

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

2.4.2. Justification for withholding taxes

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

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

Rates of final withholding tax on payments to non-residents are almost always lower than those applicable to residents. This reflects a trade-off between a simple and effective collec-
tion of tax and a fairer approximation of the tax that would have been payable if the taxpayer had been a resident. A main issue for discussion is whether that trade-off is still the best approach in policy terms, having regard to the evolution in cross-border assistance between tax administrations, particularly as regards exchange of information and assistance in the collection of taxes.

2.4.3. ECJ decisions on these issues

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

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

– Denkavit (C-170/05) and Amurta (C-379/05): if a country exempts domestic intercorporate dividends from any withholding tax, should it similarly exempt from withholding tax dividends paid by a domestic company to a foreign company?

– Bouanich (C-265/04): should it be considered to be discrimination to treat a share repurchase as a capital gain (subject to normal tax on the gain only) for a resident but as a dividend (subject to withholding tax on the gross payment) for a non-resident?

– Turpeinen (C-520/04): should it be considered to be discrimination to subject pension payments to non-residents to a flat withholding tax which, in certain cases, is higher than the tax which that taxpayer would have had to pay if he/she had been resident?

– Commission v. Belgium (C-433/04): should it be considered to be discrimination to oblige main contractors who use non-resident subcontractors not registered in a state to withhold 15% on the payment for the services rendered and to make the main contractor jointly and severally liable for the tax owed by the subcontractors?

– ELISA (C-451/05): should it be considered to be discrimination to levy a tax at a fixed rate of the commercial value of immovable property which only applies to non-residents who do not reside in countries with which there is a treaty allowing an effective exchange of information?

– Gerritse (C-234/01) (see also Scorpio (C-290/04) and Centro Equestre (C-345/04)): should it be considered to be discrimination to levy a withholding tax on non-resident entertainers at a lower uniform rate deducted at source whilst the income of residents is taxed according to a progressive table, including a tax-free allowance?

2.5. Non-discrimination and anti-abuse rules

Since residents are normally subject to the most comprehensive form of taxation, whereas non-residents are only subject to tax – often at a reduced rate – on certain types of domestic income, there are circumstances in which there are incentives to shift to non-residents income that would normally accrue to residents. This shifting is particularly easy to achieve between related parties.
For that reason, domestic tax laws include a number of anti-abuse rules that apply exclusively to transactions involving non-residents. For instance, controlled foreign company (CFC) rules deal with the use of non-resident base or conduit companies; foreign investment funds (FIF) rules seek to prevent residents from deferring and avoiding tax on investment income through the use of non-resident investment funds; thin capitalization rules may apply to restrict the deduction of base-eroding interest payments to related non-residents; transfer pricing rules may prevent the artificial shifting of business profits from a resident to a non-resident; and exit or departure taxes may prevent the avoidance of capital gains tax or tax on pension payments through a change of residence before the realization of a treaty-exempt capital gain or pension receipt.

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

2.5.1. Anti-abuse rules and tax treaties

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

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

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

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

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

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

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

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

- **Columbus Container Services BVBA & Co.** (C-298/05): should it be considered discriminatory to apply a domestic-law switch-over rule that provides for a switch from the exemption method to the credit method with respect to income of a foreign permanent establishment that would have been subjected to CFC rules if the permanent establishment had been a subsidiary?

- **Test Claimants in the Thin Cap Group Litigation** (C-524/04) and **Lankhorst-Hohorst** (C-324/00): should it be considered to be discriminatory for a country to have thin capitalization rules that do not allow taxpayers to show that there is a commercial justification for the arrangement or, even if they do, that recharacterize interest beyond what would not have been paid at arm’s length? For example, should a thin capitalization rule that is based on a debt-to-equity ratio be considered to be discriminatory?

- **Cadbury Schweppes** (C-196/04): should CFC rules be considered to be discriminatory to the extent that they only apply to profits derived by non-resident controlled companies? Should the answer to that question depend on whether the taxpayer is allowed to escape the application of these rules by showing, “on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives [the] controlled company is actually established in the [foreign country] and carries on genuine economic activities there”? 

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– Commission v. Belgium (C-522/04): should it be considered to be discriminatory for a country to trigger a deemed payment of pensions upon a change of residence by a taxpayer?

– X and Y (C-436/00): should it be considered to be discriminatory to disallow, in order to prevent abuse, the application of rules allowing a tax-free transfer of shares to a company if the transferor is a foreign company or a resident company controlled by a foreign company?

– Hughes de Lasteyrie du Saillant (C-9/02): should departure taxes be considered to be discriminatory if they do not require the tax authorities to demonstrate abusive purpose for the change of residence in each case (compare N (C-470/04))?  

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

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

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

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

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

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

5. The bilateral trade agreements can include certain “friendship, commerce and navigation” agreements dating back a century or more.
tems are not excluded from the various “fundamental freedom” provisions of the Treaty. NAFTA imposes national treatment and most-favoured-nation obligations with respect to investment, goods and services – direct taxes\(^6\) are subject to national treatment obligations with respect to trade in goods to the same extent as under the GATT, subject to qualified national treatment and most-favoured-nation obligations with respect to the purchase or consumption of particular services and totally exempt from those obligations with respect to investors and investment (subject to a limited application of the rules on expropriation).

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

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

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

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

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

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

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

- **Most-favoured-nation treatment.** Art. II of the GATS provides generally that each party shall accord to services and service suppliers of any other party treatment no less favourable than it accords to like services and service suppliers of any other country. Tax officials argued that without proper qualification, most-favoured-nation treatment might require any party to extend to all other parties the most favourable benefits granted under any of its bilateral double taxation treaties and agreements.

- **National treatment.** Art. XVII of the GATS provides generally that, subject to certain conditions and in areas identified by the party, each party shall accord to services and service providers of any other party treatment no less favourable than it accords to its own like services and service providers. Tax officials argued that without proper qualification, national treatment obligations might affect the generally accepted practice of making legitimate distinctions between residents and non-residents under domestic tax systems. They also argued that national treatment is broadly dealt with under the non-discrimination articles of bilateral double tax treaties and that an alleged violation of national treatment obligations might therefore give rise to a jurisdictional conflict. They also took the position that if a tax measure is allowed by a bilateral double taxation treaty, it should not be amenable to challenge as a GATS violation.

- **Dispute resolution.** Art. XXII of the GATS provides for consultation among the parties when a dispute under the agreement arises. Art. XXIII of the GATS contains procedures to be followed when a party feels that the actions of another party are not in accord with the agreement. The power to ultimately settle a dispute is given to the Council for Trade in Services (CTS): Art. XXIII provides that disputes arising under the GATS between signatory countries may be referred to the CTS for binding resolution. Tax officials argued that since bilateral double tax treaties contain their own long-established procedure (the MAP) for addressing tax disputes, using the GATS dispute resolution procedures in the area of taxation would allow forum shopping.

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

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

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

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

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

- Tax treaties are bilateral instruments and the coverage of tax treaties in incomplete (not all countries enter into these treaties). WTO instruments ensure broader coverage and their multilateral nature is more likely to reduce economic distortions.

- The non-discrimination provisions of tax treaties have very limited application and do not guarantee national treatment and most-favoured-nation treatment, which are the cornerstones of the WTO rules.

- Tax treaties lack an effective dispute resolution mechanism. The mutual agreement procedure (at least before the introduction of mandatory arbitration) is merely equivalent to the consultation phase of the WTO-type dispute resolution mechanism (this issue is further discussed below).
2.6.3. The case for not applying trade and investment agreements to tax measures

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

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

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

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

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

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

2.6.4. The resolution of disputes concerning non-discrimination rules

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

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

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

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

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

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

Another available mechanism is that of the mutual agreement procedure of Art. 25(1) and (2). While the mutual agreement procedure provisions of most existing tax treaties only require states to “endeavour to resolve” cases presented by taxpayers, the OECD Model has been amended to include a new Art. 25(5) to provide for the mandatory arbitration of issues arising from cases that the states are unable to resolve within 24 months. This new provision,
which will gradually be added to tax treaties, will ensure that if the tax administrations of the contracting states cannot solve through consultation a non-discrimination issue brought by a taxpayer, the issue will be decided by an independent party.

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

2.6.4.2. Dispute resolution mechanisms in international trade and investment agreements

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

2.6.4.3. Dispute resolution mechanism applicable to the EC Treaty

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

States use their tax systems to influence inbound and outbound investment, but the non-discrimination article of the OECD Model limits states’ ability to apply tax preferences for resident investors over non-resident investors. This paper attempts to lay out the tax policy issues underlying the non-discrimination article, and to do this, it will give background on the traditional capital neutrality benchmarks – namely, capital export neutrality (CEN) and capital import neutrality (CIN). The specific questions framed by the seminar organizers make reference to the non-discrimination principle under EC law, so the paper will also compare the OECD Model non-discrimination principle with that of the EC Treaty.

1. OECD Non-Discrimination Article

Art. 24 of the OECD Model prohibits states from discriminating in four areas. A state must (1) not subject foreigners to “more burdensome” taxes than those imposed on nationals who are “in the same circumstances”; (2) not subject permanent establishments of companies residing in its treaty partner to “less favourable” taxes than those applicable to domestic companies engaged in the “same activities”; (3) allow its own residents to deduct interest, royalties, and other expenses paid to residents of the treaty partner “under the same conditions” as for such payments to domestic residents; and (4) not subject foreign-owned enterprises to “more burdensome” taxation than “similar” domestic enterprises.

2. Tax Neutrality and Legal Prohibitions on Distortions

In a tax-neutral system, taxes would not influence business decisions. A world in which no state assessed taxes of any kind would be tax neutral, and in such a world – setting aside other regulatory restrictions on trade and investment – capital would be invested wherever the return would be highest.1 Because it would lead to an efficient allocation of global capital, tax neutrality would result in global welfare gains in which every state would share. Not every state’s share of the global welfare gain from neutrality would be equal, however, and some states – such as tax havens – could suffer losses from a tax-neutral system as compared to the current system. For this and other reasons, states deviate from tax neutrality.

In a 2001 article, Prof. Alvin Warren suggested that, when considering discrimination against international commerce, we should bear in mind at least four kinds of business activities: (1) domestic production by domestic producers; (2) foreign production by domestic producers; (3) domestic production by foreign producers; and (4) foreign production by foreign producers. Comparing the taxation of pairs of these cases gives insight into whether states dis-
criminate against international commerce. Prof. Warren placed the cases into the following matrix:

<table>
<thead>
<tr>
<th></th>
<th>domestic production</th>
<th>foreign production</th>
</tr>
</thead>
<tbody>
<tr>
<td>domestic producer</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>foreign producer</td>
<td>3</td>
<td>4</td>
</tr>
</tbody>
</table>

Four types of direct tax discrimination are relevant for our inquiry: A state could: (a) provide an **inbound preference** by favouring foreign producers engaged in domestic production over domestic producers engaged in domestic production (i.e. favour Case 3 over Case 1 in Prof. Warren’s matrix); (b) engage in **protectionism** by favouring domestic production over foreign production (i.e. favour Cases 1 and 2 over Cases 3 and 4); (c) provide an **outbound preference** by favouring domestic producers engaged in foreign production over domestic producers engaged in domestic production (i.e. favour Case 2 over Case 1); or (d) enact **outbound restrictions** that favour domestic producers engaged in domestic production over domestic producers engaged in foreign production (i.e. favour Case 1 over Case 2). I will discuss each of these types of discrimination in turn, beginning with inbound investment and activity.

- **Inbound preferences.** The first type of discrimination involves an inbound preference, under which a state prefers economic activity by non-residents to economic activity by residents. States enact inbound preferences when they assess lower tax rates on non-residents’ domestic activities than on residents’ domestic activities through a variety of mechanisms, including by offering special subsidies or tax holidays only to non-residents, a practice called “ring-fencing”. While states regard some inbound preferences as permissible, others have been condemned as “harmful” – but it is difficult to draw a satisfying conceptual distinction between productive and harmful tax competition. Legal and political initiatives to identify and eliminate harmful tax preferences for inbound investment include the OECD Harmful Tax Competition Project, the EU Code of Conduct for Business Taxation, and the EC Treaty’s prohibition of state aid. Legal prohibitions on tax discrimination, however, have not been interpreted to prohibit states from offering inbound preferences.

- **Inbound restrictions (protectionism).** The exact opposite of an inbound preference would be an “inbound restriction”. Rather than seeking to encourage inbound investment, states
may deviate from tax neutrality because they want to protect domestic investment and business activity from foreign competition. To accomplish this goal, the state might apply higher effective tax rates to income owned by non-resident taxpayers than to income owned by residents, thereby making it more expensive for non-residents than for residents to conduct economic activities in the host state. Such restrictions might include harsher taxation of income and gains from non-residents’ domestic investment than of income and gains from residents’ domestic investment. favouring domestic producers over foreign producers would involve residence or nationality-based discrimination, in which the state would treat Cases 1 and 2 in the matrix above better than Cases 3 and 4. Unlike inbound preferences, which are generally not prohibited under OECD or EC non-discrimination principles, preventing protectionist taxation lies at the heart of most non-discrimination principles, including those found in the EC Treaty, the US Constitution, trade treaties and tax treaties. For example, the OECD Model non-discrimination article forbids states to tax the permanent establishments of companies resident in their treaty partners worse than their own resident companies.

As with non-residents’ inbound investment, states may also seek to influence their own residents’ outbound investment. The next two paragraphs consider outbound preferences and restrictions. It is important to note, however, that the OECD Model’s non-discrimination article does not apply to outbound situations.

- **Outbound preference.** To encourage its residents to invest abroad, a state may subsidize their foreign investment. Subsidies could take the form of lighter taxation of foreign investment compared to domestic investment. As with inbound preferences, outbound preferences generally do not violate OECD or EC non-discrimination principles. However, the prohibition of state aid in the EC Treaty constrains EU Member States’ ability to enact outbound subsidies that affect the functioning of the common market. Additionally, trade treaties prohibit export and other outbound subsidies, including those enacted through the income tax code. For example, the US DISC/FSC/ETI regimes were determined to constitute illegal export subsidies under the GATT/WTO.

6. States employ a variety of mechanisms to increase foreigners’ effective tax rates. These include taxing them on a larger base by denying them deductions available to residents (e.g. gross basis taxation), denying them subsidies available to residents, and taxing them at higher nominal rates.

7. See e.g. ECJ, 29 April 1999, Case C-311/97, Royal Bank of Scotland (invalidating a Greek law that taxed branches of Greek banks at 35%, but branches of banks established in other EU Member States at 40%).


10. OECD Model Art. 24(1) (forbidding states to subject non-nationals to worse tax treatment than nationals); OECD Model Art. 24(3) (preventing states from taxing the branches of companies resident in their treaty partners worse than their own resident companies). See also Bennett, note 5, at 454 (“The OECD has stated that the principle enshrined in [Art. 24(5)] is broadly aimed at preventing ‘tax protectionism’ (‘i.e., the deterrence by tax measures of investment from outside the country’),’ citing OECD, “Issues in International Taxation No. 2: Thin Capitalisation”, at 26-27, Para. 66).

Outbound (exit) restriction. Finally, a state seeking to keep capital and business activities at home may want to discourage its residents from investing abroad by taxing their foreign investment more harshly than their domestic investment.\(^{12}\) Enacting such "outbound restrictions" would be a sensible strategy if: (1) capital investment were a zero-sum game, such that a dollar invested abroad removed a dollar from the domestic economy, and (2) the state's goal was to maximize national, not global, welfare.\(^{13}\) Outbound restrictions might include exit taxes\(^{14}\) or harsher taxation of a resident's income from foreign activities than her income from domestic activities. For example, until recently, many EU Member States assessed higher taxes on foreign dividends than domestic dividends.\(^{15}\) By singling out cross-border commerce for harsher tax treatment, both protectionist taxes and outbound restrictions undermine global economic efficiency and economic integration. The OECD and EC Treaty conceptions of non-discrimination diverge when it comes to restrictions on outbound investment. Although the non-discrimination principle in the EC Treaty prevents EU Member States from enacting restrictions on their own nationals' and residents' outbound investment, the non-discrimination article of the OECD Model does not apply to outbound situations. Therefore, under the OECD Model, a state may tax its own residents more harshly on their foreign activities than on their domestic activities. Although unconstrained by the non-discrimination article, states' treatment of their own residents' outbound investment is limited elsewhere in the OECD Model by the requirement that the residence state relieve double taxation.

The following table summarizes the kinds of distortions states might seek to introduce and the legal constraints on their ability to do so. Checkmarks indicate the existence of legal constraints on a state's ability to enact particular restrictions.

<table>
<thead>
<tr>
<th>Type of distortion</th>
<th>OECD non-discrimination</th>
<th>EC non-discrimination</th>
<th>Other legal constraints</th>
</tr>
</thead>
<tbody>
<tr>
<td>inbound preference</td>
<td></td>
<td></td>
<td>✓ OECD Harmful Tax Practices ✓ EC state aid</td>
</tr>
<tr>
<td>inbound restriction</td>
<td>✓</td>
<td>✓</td>
<td>✓ trade treaties</td>
</tr>
<tr>
<td>outbound preference</td>
<td></td>
<td></td>
<td>✓ trade treaties ✓ EC state aid</td>
</tr>
<tr>
<td>outbound restrictions</td>
<td></td>
<td>✓</td>
<td></td>
</tr>
</tbody>
</table>

\(^{12}\) Peggy Musgrave advocated such measures under the rubric "national neutrality". See Brewer Richman (Musgrave), P., Taxation of Foreign Investment Income – An Economic Analysis (Baltimore: Johns Hopkins Press, 1963).


\(^{14}\) Under an 'exit tax', a state taxes a resident on the deferred appreciation in her assets when she moves abroad. See e.g. ECJ, 11 March 2004, Case C-9/02, De Lasteyrie (finding an exit tax to abridge the EC Treaty's freedom of movement of workers).

\(^{15}\) ECJ, 15 July 2004, Case C-315/02, Lenz (striking down such differential taxation).
I have given a brief description of the contours of the tax treaty non-discrimination principle and compared it to other legal prohibitions on tax discrimination. The differences among these standards suggest that the scope of legal prohibitions on tax discrimination is context-dependent. I will now turn to the question of whether the tax treaty conception of non-discrimination coincides with either of the standard efficiency benchmarks: capital export neutrality and capital import neutrality.

3. Capital Export Neutrality and Capital Import Neutrality

When trying to answer the question, “How do states define discrimination for purposes of the OECD Model?” one place to begin is with the traditional efficiency criteria introduced by Peggy Musgrave in the 1960s: capital export neutrality and capital import neutrality. I will only briefly review these familiar concepts.

Capital export neutrality (CEN) promotes locational neutrality. A tax system achieves CEN when taxes do not affect taxpayers’ decisions about whether to invest at home or abroad. States achieve CEN by ensuring that their residents’ investments are subject to the same taxation, no matter where those investments are made. Stated generally:

CEN obtains if the tax on domestic activity by the residence state is the same as the tax on outbound activity by the combination of the source and residence states.

States could achieve CEN globally if all states currently taxed only their residents on their income, wherever earned. CEN could accommodate source-based taxation, as long as all states fully credited (and refunded) it. A state may implement a capital export neutral system just for its own residents (i.e. unilaterally) by taxing residents on their worldwide income as it accrues, while allowing unlimited credits for foreign tax. This can be seen as equivalent to fully refunding the foreign tax as the first step, and then subjecting foreign income to domestic tax rules as if it were domestic-source income. In this way, residents would effectively always pay tax according to their home state’s tax rules and tax rates, even on their foreign investments.

In contrast, capital import neutrality (CIN) promotes competitive neutrality. It promotes effective competition between resident and foreign investors in a particular jurisdiction by taxing them in the same way, no matter where the foreign investors reside and regardless of the tax rates assessed by the foreign investors’ home states. This has two elements. When taxing in a source capacity, a state wishing to achieve CIN should assess the same taxes on foreign and domestic investors. That is, it must not distinguish between foreign and domestic investors. Likewise, when taxing in a residence capacity, the source state should exempt foreign-source income in order to ensure that foreign income is subject only to the source state’s tax. Stated generally:

CIN obtains if the tax on outbound activity by the combination of the source and residence states is the same as the tax on domestic activity by the source state.

Notice, however, that even if a state pursuing CIN taxes resident and non-resident taxpayers in the same way on their investments within its territory, competition between residents and non-residents may nevertheless be distorted by taxes imposed by the non-residents’ home state(s). For example, a non-resident may be subject at home to a worldwide tax regime with rates exceeding those of the source jurisdiction. Likewise, exempting its residents’ foreign
income from tax does not guarantee that competition abroad (in source states) will be free from tax distortions, since the source state(s) may tax resident and non-resident taxpayers differently. Thus, states cannot unilaterally achieve CEN, whereas they can unilaterally achieve CIN by taxing foreign income on an accrual basis while offering unlimited foreign tax credits. CIN can only be achieved globally if all states both exempt foreign-source income and tax the domestic investment of resident and non-residents in the same way.\footnote{16}

To make tax-neutral both the decision of where to locate investment and where to reside, states would have to simultaneously achieve CEN and CIN. This would require global harmonization of tax rates, bases, and method of double tax relief. To see why, recall that:

**CEN** obtains when the tax on domestic activity by the residence state is the same as the tax on outbound activity by the combination of the source and residence states, and

**CIN** obtains when the tax on outbound activity by the combination of the source and residence states is the same as the tax on domestic activity by the source state.

Thus, CEN and CIN can only be achieved simultaneously when:

the tax on domestic activity by the residence state is the same as the tax on domestic activity by the source state.\footnote{17}

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16. Other capital efficiency benchmarks exist, including Peggy Musgrave’s “national neutrality” (NN) – under which states prefer domestic investment by their residents to foreign investment by their residents by taxing residents’ foreign-source income, but allowing only a deduction, rather than a credit, for foreign taxes. A new benchmark has been introduced by Mihir Desai and James Hines. See Desai, M.A., and Hines, J.R., “Evaluating International Tax Reform”, 56 National Tax Journal (2003), p. 487 et seq. Under “capital ownership neutrality” (CON), the ownership of capital assets should not be distorted by taxes – a condition satisfied if all states exempt foreign-source income or all states tax foreign-source income while allowing an unlimited foreign tax credit. However, as directed by our seminar organizers, I will not focus on NN or CON today.

17. Formalization of the argument makes it clear. Income can be owned by either domestic residents or foreign residents, and income can be sourced either domestically or abroad. Let \( i_j \) be \( o \)-owned, \( s \)-sourced income. Thus, \( i_{jo} \) is a domestic resident’s domestic income; \( i_{jo} \) is a foreign resident’s domestic income, and \( i_{jo} \) is a domestic resident’s foreign income. States generally do not assess income taxes on \( i_{jo} \) foreign residents’ foreign income, so that case is not considered here. The tax on a particular item of income depends on: (1) the taxing jurisdiction, \( j \) (the tax jurisdiction is either the residence state, \( R \), or the source state, \( S \)); (2) the residence of the owner of the income, \( o \), viewed from the perspective of the taxing state (the owner’s residence may be domestic, \( D \), or foreign, \( F \)); and (3) the source of the income, \( s \), again from the perspective of the taxing jurisdiction (the source of the income may be either domestic, \( D \), or foreign, \( F \)). Let \( t_{ij} \) denote the tax by state \( i \) assessed against a resident of \( o \) on income sourced in \( s \). Thus, \( t_{ijo} \) is the tax by the residence state on a domestic resident’s domestic income, \( t_{ijo} \) is the tax by the residence state on a domestic resident’s foreign income, \( t_{ijo} \) is the tax by the source state on a foreign resident’s domestic income, and \( t_{ijo} \) is the tax by the source state on a domestic resident’s domestic income.

Recall that locational neutrality obtains if the tax by the residence state on domestic activity is the same as the tax by the combination of the source and residence states on outbound activity, so locational neutrality obtains if:

\[
  i_{jo} (1 - t_{ijo}) = i_{jo} (1 - t_{sjo}) + i_{jo} (1 - t_{rjo})
\]

and savings neutrality obtains if the tax by the combination of the source and residence states on outbound activity is the same as the tax by the source state on domestic activity, so savings neutrality obtains if:

\[
  i_{jo} (1 - t_{ijo}) + i_{jo} (1 - t_{rjo}) = i_{jo} (1 - t_{rjo}) + i_{jo} (1 - t_{rjo})
\]

Thus locational and savings neutrality obtain simultaneously if:

\[
  i_{jo} (1 - t_{rjo}) = i_{jo} (1 - t_{rjo})
\]

That is, if:

\[
  t_{rjo} = t_{rjo}
\]

Since \( t_{rjo} \) is the tax by the residence state on domestic residents’ domestic income, and \( t_{rjo} \) is the tax by the source state on domestic residents’ domestic income, for locational and savings neutrality to hold simultaneously requires the source and residence states to tax domestic income the same way.
Since CEN and CIN cannot be achieved simultaneously without global tax harmonization, the question of how to tax cross-border income is usually framed as a choice between CEN or CIN. In that sense, it is important to understand the incentives created by each system. Our discussion of the incentives, however, must account for the fact that no state implements pure CEN or pure CIN. Instead, all states' tax systems are mixed – they contain both CEN and CIN elements – although in some states, CEN principles predominate, while in other states CIN principles predominate.

For example, although "pure" CEN would direct states to currently tax their residents' worldwide income and grant unlimited foreign tax credits, most states taxing worldwide income permit some deferral and limit foreign tax credits to the tax that would have been assessed on similar income earned domestically. These deviations introduce locational distortions. For example, CEN with a credit limitation makes the choice about whether to invest at home or abroad neutral, but only with respect to investment in states with lower tax rates. For states with higher taxes, CEN does nothing to remove the disincentives for foreign investment created by those higher foreign taxes. In other words, "neutrality" under CEN with a foreign tax credit limitation means elimination of the pre-existing incentive to invest in lower-tax states; it does nothing to change the tax disincentive for investing in higher-tax states.\(^{18}\)

Under exemption, taxpayers' locational decisions are neutral with respect to states with the same tax rates, but CIN does nothing to remove the disincentive for investing in higher-tax states. Likewise, under CIN, investors receive the benefit of any lower tax rates that may be available abroad, and as a result CIN does not eliminate tax incentives to invest abroad in lower-tax states. In other words, CIN does not change the pre-existing locational distortions created by the existence of different tax rates in different states. While CIN does not achieve locational neutrality, it aims to achieve competitive neutrality by insuring that taxpayers with income from the same jurisdiction face the same taxation on those investments, no matter where the investors reside.

As with CEN, deviations from "pure" CIN abound. For example, states usually exempt only the active foreign-source income of their residents, although "pure" CIN prescribes that states should exempt all their residents' foreign-source income, including their passive income.

4. The Relationship between CEN, CIN and Tax Discrimination

The broad tax prescriptions of CEN and CIN are familiar, yet the implications of these benchmarks for tax discrimination are less obvious. Perhaps states could use CEN and CIN to define discrimination. For example, if states thought that the primary purpose of the non-discrimination article should be to ensure locational neutrality – that taxpayers' decisions regarding where to invest should not be distorted by taxation – states might define as discrimination any violation of CEN. This would mean:

- **On a residence basis:** a state should tax residents' foreign and domestic income the same way, which implies an unlimited credit for taxes paid at source.

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\(^{18}\) Aspects of the tax systems in many credit countries move them closer to exemption. By lowering taxes on domestic-source income, these deviations – including deferral of tax on unrepatriated profits, foreign tax credit averaging, and favourable interest allocation and sourcing rules – may put taxpayers in a better after-tax position than an exemption system would.
On a source basis: CEN creates no clear obligation for states when they tax in a source capacity. As long as the home state fully credits the taxes imposed at source, it should not matter whether the source state taxes non-residents more harshly than it taxes domestic investors.  

The OECD non-discrimination principle, however, does not seem to be coextensive with CEN. First, the OECD Model does not implement CEN on a residence basis because it does not prescribe whether states should use credit or exemption to relieve double tax, and it does not prevent states employing the credit method from limiting foreign tax credits. Second, even though CEN contains no prescription regarding source-base taxation, the non-discrimination article of the OECD Model limits states’ ability to tax foreigners more than domestic investors.

Nor does the non-discrimination article implement CIN. If states thought that the primary purpose of the non-discrimination article of the OECD Model should be to ensure competitive neutrality in the host state, states might define as discrimination any violation of CIN. This would mean:

- On a residence basis: a state should exempt foreign-source income.
- On a source basis: a state should treat foreign and domestic investors’ domestic-source income the same for tax purposes.

The OECD Model does not implement CIN, since it does not require states to exempt foreign-source income. However, the Model non-discrimination article is consistent with CIN insofar as it constrains the source state’s ability to treat foreign and domestic investors differently. However, the Model non-discrimination article does not go far enough to achieve CIN, since it allows certain deviations from the principle that residents and non-residents should be subject to the same taxation on their income from the source state.

The following table summarizes the implications of CEN and CIN for non-discrimination:

<table>
<thead>
<tr>
<th>Taxing posture</th>
<th>CEN</th>
<th>CIN</th>
</tr>
</thead>
<tbody>
<tr>
<td>source</td>
<td>no effect</td>
<td>state must treat domestic income earned by residents the same way as domestic income earned by non-residents</td>
</tr>
<tr>
<td>residence</td>
<td>worldwide taxation with an unlimited credit (i.e. state must treat residents’ foreign income the same way as residents’ domestic income)</td>
<td>exemption (i.e. state may treat residents’ foreign income differently from their domestic income)</td>
</tr>
</tbody>
</table>

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19. There are many other reasons to require similar treatment of foreign and domestic taxpayers, but the desire to achieve CEN does not appear to be one of them. Another way of making this point would be to say that CEN has nothing to do with how the source state taxes. CEN focuses on making the decision about where to invest neutral, but the burden of achieving that neutrality is placed entirely on the residence state. While CEN focuses on destination of investment, CIN focuses on the origin of investment. CIN places obligations on the state when it taxes in a source capacity because the state wants its market to be equally attractive to all foreign and domestic investors.

20. This example does not assume harmonized base or rates.
Adding the implications of CEN and CIN to the table presented earlier, we would have:

<table>
<thead>
<tr>
<th>Type of distortion</th>
<th>OECD non-discrimination</th>
<th>EC non-discrimination</th>
<th>CEN</th>
<th>CIN</th>
</tr>
</thead>
<tbody>
<tr>
<td>inbound preference</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>inbound restriction</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>outbound preference</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>outbound restrictions</td>
<td>✓</td>
<td></td>
<td>✓</td>
<td>✓</td>
</tr>
</tbody>
</table>

The OECD non-discrimination principle seems to adopt a hodgepodge of the restrictions that would be adopted under pure CEN or pure CIN. For example, the tax treaty conception of non-discrimination is consistent with CIN insofar as it prohibits some inbound restrictions. Likewise, it is consistent with CEN in that it does not preclude inbound preferences. However, the tax treaty non-discrimination principle differs from all of CEN, CIN and the EC Treaty conception of non-discrimination, because it does not prohibit outbound restrictions. Thus, it would not be accurate to describe the non-discrimination principle in the OECD Model as implementing either CIN or CEN.

5. Determining the Purpose and Scope of the OECD Non-Discrimination Article

If the non-discrimination article in the OECD Model does not implement CEN or CIN, what normative values does it pursue? And what can we learn from analysing how the OECD non-discrimination principle deviates from the prescriptions of CEN and CIN?

The principal questions for this seminar and for Member State representatives negotiating tax treaties are: “What are states trying to accomplish with the non-discrimination principle?” and “Should the non-discrimination article be modified to pursue those goals more effectively?” If the goal of the OECD non-discrimination article were to implement CEN or CIN, then the article should be altered to bring it more in line with the implications of those theories as discussed above. However, there may be other values at work besides locational and competitive neutrality.

Usually, states cite the goal of encouraging bilateral investment as a principal reason for entering into tax treaties. This suggests an interest in encouraging both inbound and outbound investment, although another question we might ask is whether states hope to encourage inbound and outbound to the same extent. States might also be using the non-discrimination article to achieve a certain division of tax revenue. If so, that goal might help explain why states in which the CEN theory predominates support a conception of discrimination that places burdens on the source state, even though CEN contains no non-discrimination prescriptions for source states. Specifically, credit states may be reluctant – for revenue reasons – to credit discriminatory taxes levied by the source state.

Once states determine what they are trying to accomplish with the non-discrimination principle, they will have a better idea of how to define its scope. Thus, an important idea that I am trying to communicate today is that the definition of tax discrimination is highly context-specific. Tax discrimination may mean one thing in a common market context, and something different in a tax treaty context. For example, the OECD non-discrimination article, as currently formulated, targets restrictions on inbound investment, but not outbound invest-
ment. This contrasts with the EC non-discrimination principle, which also covers outbound investment. An obvious question raised by this difference is whether inbound and outbound investment should be treated differently.

There may be good reasons to be more concerned about discrimination against outsiders’ domestic activities than discrimination against insiders’ foreign activities. For example, outsiders have no political representation (or only proxy representation through their business associates) in the host state’s political processes. Or perhaps sovereignty considerations drive the decision to exclude outbound investment from coverage under the non-discrimination article. States might be reluctant to agree in tax treaties to provisions that significantly constrain their ability to tax their own residents.

Again, we arrive at the conclusion that in order to properly interpret the non-discrimination article of the OECD Model, and in order to determine whether and how to modify the article, states need to decide what should constitute discrimination. I would like to suggest that this fundamental question deserves the attention of the OECD and Member State representatives.

Another scope question involves whether the non-discrimination principle will be interpreted to require national treatment only or most-favoured-nation treatment. Under current interpretations, the OECD non-discrimination article requires national treatment. In contrast, trade treaties generally provide for most-favoured-nation treatment. The EC Treaty’s prohibition of discrimination does not seem to require most-favoured-nation treatment for tax treaties. Although early European Court of Justice (ECJ) cases, including *Saint-Gobain* and the *Open Skies* cases, seemed to suggest that the EC non-discrimination rule required most-favoured-nation treatment, in recent cases, including the *D* case, the ECJ concluded that the EC Treaty does not imply most-favoured-nation treatment, at least for bilateral tax treaties.

Two major and related issues concern how to evaluate taxpayer comparability and justifications for discrimination. The nationality paragraph of the non-discrimination article of the OECD Model allows source states to treat nationals and non-nationals differently if they are not “in a similar situation”. Resident and non-resident taxpayers are considered to be dissimilar under this provision, and therefore they can be treated differently. The decision to consider non-resident taxpayers to be dissimilar to resident taxpayers significantly narrows the potential scope of the nationality paragraph. In contrast, a more expansive view of similarity, such as that seen in the European Union – where the ECJ frequently judges residents and non-residents to be similarly situated – results in a broad application of the non-discrimina-

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21. ECJ, 21 September 1999, Case C-307/97, *Saint-Gobain* (holding that a Member State must grant to permanent establishments of EU companies benefits equivalent to those available under tax treaties to resident companies).


23. ECJ, 5 July 2005, Case C-376/03, *D* (holding that the EC Treaty did not imply a most-favoured-nation requirement for tax treaties).
tion principle. In the same vein, a narrow or broad interpretation of the phrase “same activities” in the PE non-discrimination article will narrow or broaden the scope of the discrimination protection provided by the Model. Thus, judgements about comparability determine the strength of the prohibition of non-discrimination.

Justifications for discrimination can be seen as an extension of the issue of taxpayer comparability. Aside from residence and non-residence, there are some specific situations where states might decide that differences in treatment of otherwise similar situations are nevertheless justified. For example, deviations from the non-discrimination principle might be justified where necessary to prevent abuse or tax evasion. Likewise, tax sparing involves worse treatment for residents’ domestic investment than residents’ foreign investment, since tax sparing involves granting credits for foreign taxes not actually paid. Although this practice violates the principle of equal treatment (as well as CEN), perhaps it could be justified by the public policy goal of encouraging investment in lesser-developed states.

6. Should the OECD Non-Discrimination Article Be Coextensive with the EC Treaty Non-Discrimination Principle?

Now I would like to turn to the specific questions posed in the materials for this seminar. One question is whether the tax treaty non-discrimination principle should be brought more in line with trade treaties and the EC conception of non-discrimination. Brian Arnold will address the trade question shortly, so I will focus on the similarities and differences between tax treaties and the EC Treaty as background for our discussion.

First, the similarities. Neither EU Member States nor the parties to bilateral tax treaties have any mandate (or present intention) to harmonize their substantive tax laws. As a result, neither EU Member States nor parties to bilateral tax treaties can simultaneously achieve both CEN and CIN. This means that, in both cases, states must make choices about what kind of “neutrality” to pursue. Somewhat different decisions have been made in this regard in the European Union and in tax treaties, and with good reasons.

An important difference between tax treaties and the EC Treaty is that under tax treaties, residents and non-residents are presumed to be dissimilar. While the ECJ also has declared that resident and non-resident taxpayers are not necessarily similar for tax purposes, in a large majority of tax cases that presumption has been overcome, and in my view, it is much easier to overcome that presumption in the EC Treaty context than in the tax treaty context. As noted earlier, the broader the conception of “similar” taxpayers, the broader the applicability of the non-discrimination principle. Thus, as a practical matter, the non-discrimination principle in the EC Treaty has a much broader scope than the tax treaty non-discrimination principle.

The other important difference in scope is that the EC Treaty prohibition of discrimination applies both inbound and outbound, whereas the OECD conception only applies inbound.

If states are to seriously consider approximating two legal standards in two very different kinds of legal contexts, there should be good reasons for doing so – reasons that go beyond the fact that both the EC Treaty and the OECD Model employ the same terminology, namely, “discrimination”. There are endless legal contexts that employ non-discrimination principles. For example, why not approximate the OECD Model to the standard for tax discrimination under the US dormant Commerce Clause or the US Privileges and Immunities
Clause? The US Supreme Court has interpreted the Commerce Clause and the Privileges and Immunities Clause of the US Constitution to prevent one US state from subjecting the residents of other US states to more onerous taxation than that to which their own residents are subject. Likewise, the Supreme Court has held that the US states may not use their tax systems to discriminate against out-of-state products and activities.

With many non-discrimination standards to choose from globally, why approximate the OECD Model standard to the EC Treaty standard? It is true that the purposes of the EC Treaty and bilateral tax treaties are largely congruent – both aim to encouraging mutual investment. But similar goals motivated the founding of the United States and guide the US Supreme Court in its interpretations of the Commerce Clause and Privileges and Immunities Clause of the US Constitution. It is also true that there is a substantial overlap in the membership of the OECD and the European Union – 19 of the 30 OECD Member countries are also members of the European Union. But substantial overlap of membership is not identity of membership, and as the membership of the OECD grows, the proportion of EU Member States will fall. Even if membership in the two organizations were identical, the relevant question would still be whether non-discrimination principles developed by the ECJ to serve the interests of the European common market also serve the interests of states negotiating tax treaties. That is a question that we will try to answer in the balance of the seminar as we go through particular issues on our agenda.

I would suggest that the differences in the purposes of the OECD Model and the EC Treaty warrant different definitions of tax discrimination in each context. The project under way in the European Union aims at a true economic union – one without internal economic borders, or at least without meaningful ones. The EC non-discrimination principle has been expounded primarily by the ECJ, an institution with a clear political agenda to promote the integration of Europe. Ultimately, Europe may experience meaningful political integration in addition to economic integration. In contrast, the aims of bilateral tax treaties are considerably more modest, and the modest scope of the OECD non-discrimination article properly reflects that. Thus, it is not clear to me why the interpretation of a different non-discrimination principle in a decidedly different treaty would be imported to the OECD Model.

Finally, the discrimination prohibition in the EC Treaty and its interpretation by the ECJ have been subject to serious criticism because they lack coherent guiding principles. Therefore, setting aside whether the EC Treaty and the OECD Model have sufficiently similar goals so as to make approximation a sensible goal, if the EC non-discrimination principle is no clearer than the OECD non-discrimination principle, assimilating the two principles will not increase clarity or legal certainty.

The materials supplied by our hosts express concern that courts in Europe already familiar with the EC non-discrimination concept may incorporate it into their interpretations of non-discrimination articles of tax treaties. But it seems to me that courts, which are professional legal interpreters, can easily distinguish between the purposes, scope and intent of a bilateral tax treaty and those of the EC Treaty. And, of course, it is nearly inconceivable that a court sitting in a non-EU Member State would import EC concepts of non-discrimination to interpret the non-discrimination article of a bilateral tax treaty. The last place a US court interpreting the non-discrimination article in the United States–Canada tax treaty would look for guidance is the EC Treaty, and rightly so! Nor need we be especially worried that a US court would apply dormant Commerce Clause precedents when interpreting the tax treaty non-discrimination article.
7. The Need for Fundamental Re-Examination

I would suggest that the idea of changing the non-discrimination standard, while inspired by recent jurisprudence in the ECJ, has at its root an abiding criticism. That criticism involves the failure of the OECD Model to modernize along with developments in international taxation. For example, tomorrow we will discuss whether best practices for dividend taxation enunciated by the ECJ under the EC Treaty's non-discrimination principle should be assimilated into the OECD Model. We could ask whether the problems with dividend taxation under the current Model stem from failure to harmonize the OECD non-discrimination provision with EC law, or whether those problems really stem from tax practices, such as source state withholding, that are approved by the OECD Model but that appear obsolete in light of widespread adoption of corporate tax integration regimes.

More importantly, the OECD non-discrimination article lacks a coherent guiding principle. Rather than adding a European gloss to the OECD non-discrimination article, perhaps it is time for a fundamental reconsideration of the goals of the tax treaty and the non-discrimination principle.

8. Further References


Arthur J. Cockfield* and Brian J. Arnold**

What Can Trade Teach Tax?
Examining Reform Options for Art. 24 (Non-Discrimination) of the OECD Model

Although international trade agreements contain broad non-discrimination provisions that are potentially applicable to tax measures, in general tax measures are carved out of trade agreements and are dealt with exclusively under bilateral income tax treaties. This paper examines the relationship between tax and trade agreements with respect to the protection against discrimination and suggests that trade and tax should remain separate because there is relatively little that trade can offer tax in terms of policy guidance or even inspiration with respect to income tax discrimination issues. As an alternative to subjecting income tax systems to the non-discrimination provisions of trade agreements, the paper discusses the possibility of certain limited changes to the Commentary on Art. 24 of the OECD Model, to expand the protection against discrimination.

1. Introduction

International trade policy and international tax policy have traditionally been examined as distinct topics with separate histories, objectives and outcomes. Although international trade agreements contain broad non-discrimination provisions that are potentially applicable to tax measures, in general, tax measures are carved out of trade agreements and are dealt with under bilateral tax treaties.

In 2007, the OECD issued a public discussion draft regarding possible changes to the Commentary to Art. 24 (Non-discrimination) of the OECD Model.1 These changes were incorporated into the Commentary on Art. 24 in the July 2008 Update.2 The discussion draft highlighted certain issues – including the relationship between trade and tax policy – requiring more fundamental analysis to guide further reforms with respect to Art. 24.

Our analysis suggests that trade and tax should remain separate because there is relatively little that trade can offer tax in terms of policy guidance with respect to income tax discrimination issues. First, tax systems must continue to discriminate on the basis of residence, because domestic tax laws – as well as tax treaties themselves – impose different tax consequences, depending on the status of a person as a resident or a non-resident. For this reason,

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The authors are grateful for comments on an earlier draft provided by Cameron MacKay.

Art. 24 of the OECD Model generally only extends protection against discrimination to the nationals of each treaty party, and permits discrimination on the basis of residence in many circumstances.3

Second, while governments have ceded authority over trade practices (such as tariff and non-tariff barriers), the governments of OECD Member countries continue to desire to maintain sovereign control over tax policy, including the need to treat resident and non-resident taxpayers differently. For example, governments have accepted the necessity to be bound at the supranational level by global trade organizations, such as the World Trade Organization (WTO), yet they have refused to give up control over their tax regimes to any world tax authority that could impose binding rules on participating states. Most governments appear to be unwilling to provide broader protection against income tax discrimination beyond the protection already afforded by their tax treaties, as this might unduly constrain their ability to pursue domestic tax policy goals.

Finally, it is not apparent that income tax rules that discriminate against non-residents or in favour of resident taxpayers currently present a major impediment to cross-border trade and investment. There appears to be very little evidence, at least outside the European Union, that income tax discrimination is unduly harming national or international economic interests. In fact, a more significant policy concern is that OECD Member countries and other states have often adopted international income tax rules to attract inward foreign direct investment, thus discriminating in favour of foreign investors.4

For these reasons, in the authors’ view, trade agreements should generally continue not to apply to income tax measures, leaving non-discrimination issues to be dealt with exclusively in tax treaties.5 Even if the broader protection against discrimination in trade agreements is considered to be desirable, it is unclear whether such protection should be implemented by extending the protection in trade agreements to cover income tax measures or whether the protection against discrimination in the provisions of Art. 24 should be expanded.

This paper is organized as follows. Section 2. discusses the relationship between trade agreements and tax treaties, including the reasons why trade and tax policy have traditionally been considered to be distinct areas of scholarly enquiry. Section 3. examines the arguments in favour of and against expanding the protection against income tax discrimination in trade agreements or tax treaties. Section 4. discusses some possible reforms with respect to non-discrimination, including certain limited changes to the Commentary on Art. 24 of the OECD Model. This is followed by a brief conclusion.


4. The OECD has made ongoing efforts to address this policy concern within its harmful tax competition project, which prohibits certain preferential income tax regimes that favour non-residents with respect to transactions involving cross-border financial and other services. See OECD, Harmful Tax Competition: An Emerging Global Issue (Paris: OECD, 1998).

2. The Relationship between Income Tax Treaties and Trade Agreements

2.1. National treatment and most-favoured-nation treatment within trade agreements

The most important guiding principles concerning protection against discrimination in trade agreements are national treatment (NT) and most-favoured-nation (MFN) treatment. Under NT, countries agree to provide foreign businesses and investors with no less favourable treatment than that accorded to domestic businesses and investors. Under MFN treatment, countries agree to provide to businesses and investors from the other country treatment that is no less favourable than that provided to the businesses and investors of any other country. Therefore, for example, if countries agree to extend a benefit to another country, such as low tariffs, that benefit must be extended to all of the other participating countries. However, countries agreeing to provide MFN treatment are not obliged to provide treatment as favourable as that provided to their own nationals.

The use of both NT and MFN principles is supported by a significant body of theoretical and empirical literature in trade policy that suggests that governments unilaterally or collectively adopting these principles will, in the long term, benefit their domestic economies. Under conventional trade theory, the reduction of tariff and non-tariff barriers to trade results in greater efficiencies for the domestic economy as a result of comparative advantage and specialization. In addition, MFN and NT principles restrain the ability of special interest groups to obtain protectionist policies from their governments. As a result, NT and MFN principles have remained the cornerstone of global trade agreements such as the WTO agreements, regional free trade area agreements (such as the North American Free Trade Agreement – NAFTA), and regional customs union agreements (such as the EC Treaty).

With the exception of the EC Treaty, trade agreements that incorporate NT and MFN principles have traditionally governed the treatment of indirect (i.e. consumption) taxes on goods and services, but have generally not applied to direct (i.e. income) taxes on individuals or businesses. For instance, Art. III(1) of the General Agreement on Tariffs and Trade (GATT) adopts the NT principle for the taxation of goods by providing that “internal taxes and other internal charges... should not be applied to imported or domestic products so as to afford protection to domestic production”. In addition, Art. III(2) indicates that the “products... imported... shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products”. As a result of these provisions, for example, countries are prohibited from imposing a value added tax (VAT) or goods and services tax (GST) on imports unless domestic goods and services are subjected to such a tax.

Trade agreements, however, differ in the way they treat cross-border income taxes – a topic to which we now turn.

7. The theory of comparative advantage and the view that free trade benefits all participating countries are often traced to early work by David Ricardo. See Ricardo, D., On the Principles of Political Economy and Taxation (London: John Murray, 1817).
2.2. Income tax carve-outs under trade agreements

Most trade agreements contain provisions that seek to exempt or “carve out” income tax measures. There are several approaches.

First, certain trade agreements contain a general carve-out that provides that, to the extent there is any conflict or inconsistency between a tax treaty and the trade agreement, the tax treaty prevails. Some trade agreements, such as the NAFTA, additionally provide that they do not affect the rights or obligations of any country under any tax treaties. Under this approach, countries can agree through their tax treaties not to prohibit discriminatory taxes, despite the fact that such behaviour is prohibited by their trade agreements. In addition, trade agreements sometimes provide that NT and MFN obligations do not extend to any non-conforming tax measures that are in force at the time the agreement is concluded, or to measures that continue or amend such pre-existing measures in a way that does not increase the non-conformity. Under the NAFTA, this broad exemption is narrowed to a certain extent by prohibiting future tax laws that arbitrarily discriminate between persons, goods or services of the NAFTA countries or which “arbitrarily nullify or impair benefits”. In addition, NT and MFN obligations do not apply to income tax measures unless they relate to the purchase or consumption of particular services. The NAFTA applies, however, to any income tax measures that expropriate assets of foreign investors if the tax authorities agree that a particular measure amounts to an expropriation (see 3.1. and 4.3.).

The GATT, on the other hand, does not contain a general carve-out for income tax measures, although its provisions protecting against tax discrimination have generally been interpreted to apply only to consumption (or indirect) taxes on products, and not to income (or direct) taxes. In addition, the GATT prohibits export subsidies, which include income tax subsidies that are contingent on export performance. Due to the absence of a general carve-out provision, the GATT is potentially applicable to certain income tax measures, such as income taxes, that favour domestic products over foreign products. Under one view, a general carve-out provision is not needed in the GATT because its provisions have been interpreted to apply to income taxes only in very narrow cases. Under another view, the GATT should have a general carve-out in order to avoid the inappropriate application of trade non-discrimination rules to income tax provisions.

11. See Art. 2103(2) NAFTA. For a discussion of the interaction between the NAFTA and tax matters, see Cockfield, A.J., NAFTA Tax Law and Policy: Resolving the Conflict between Sovereignty and Economic Interests (University of Toronto Press, 2005), pp. 46-49.
12. See e.g. Art. 2103(4)(d) and (e) NAFTA.
13. See Art. 2103(4)(a) NAFTA. The only tax currently covered is the Mexican assets tax. See Annex 2103.4(1) NAFTA.
14. See Art. 2103(6) NAFTA.
15. In certain narrow situations, GATT NT obligations extend to income tax measures. See WTO Panel Report WT/DS 155/R, “Argentina – Measures Affecting the Export of Bovine Hides and the Import of Finished Leather” (19 December 2000) (holding that a practice whereby Argentina charged and collected an income tax in advance on imported goods at a higher rate than the one applied on domestic products was a violation of NT principles under GATT).
18. Ibid., p. 50.
Other trade agreements have developed more complex ways to deal with the interaction between trade and tax policy. For example, the General Agreement on Trade in Services (GATS) prohibits tax measures that constitute arbitrary or unjustifiable discrimination, as well as disguised restrictions on trade in services.\(^{19}\) Tax measures that violate NT obligations are acceptable if they are aimed at "ensuring the equitable or effective imposition or collection of direct taxes".\(^ {20}\) In addition, each participating country has submitted a list of tax measures that are not prohibited. WTO members have claimed NT qualifications for many taxation measures listed in a Schedule attached to the GATS.\(^ {21}\)

Under Art. XXII(3) of the GATS, “[a] Member may not invoke Article XVII [requiring national treatment for services and service suppliers]... with respect to a measure of another Member that falls within the scope of an international agreement between them relating to the avoidance of double taxation”. As a result, the non-discrimination article in bilateral tax treaties generally has primacy over the GATS NT provisions with respect to disputes involving the taxation of services and service suppliers. Disputes relating to non-discrimination obligations must normally be resolved in accordance with the non-discrimination provision in the tax treaty, using the mutual agreement procedure. Access to the dispute resolution procedures under the GATS is thus denied if the disputed matter falls within the scope of a tax treaty between the countries. Finally, tax measures that violate MFN obligations are acceptable if the difference in treatment is permitted under the provisions of an applicable tax treaty.\(^ {22}\) In other words, a country does not have to provide a benefit that it grants to another country under the tax treaty with that country to all WTO members.

As discussed in the Commentary on Art. 25 (Mutual agreement procedure) of the OECD Model, the GATS carve-out provisions raise at least two concerns.\(^ {23}\) First, if there is a disagreement about whether a measure falls within the scope of a tax treaty that existed at the time of entry into force of the GATS, the parties can bring the matter before a GATS tribunal only if both states agree.\(^ {24}\) For tax treaties that are entered into, or amended, after the GATS came into force in 1995, taxpayers can seek a remedy under the GATS (if the matter is established not to be within the scope of the tax treaty) and/or tax treaties. Second, as mentioned, the dispute resolution process under the GATS is unavailable to the extent the “disputed measure falls within the scope of a tax treaty”. According to the OECD, the phrase “falls within the scope” is “inherently ambiguous [because] it is unclear whether the phrase covers all measures that relate to taxes that are covered by all or only some provisions of the tax convention”.\(^ {25}\)

To provide greater certainty, the OECD suggests that governments might include in their bilateral tax treaties a provision to ensure that any disputes concerning the application of a
tax treaty must be resolved by the competent authorities under the mutual agreement procedure and that such disputes can never be brought before the GATS dispute resolution procedures unless both parties to the tax treaty consent.26

The third approach involves the broad application of trade and investment agreements to prohibit discriminatory income tax measures in a number of different contexts. This approach is illustrated by the EC Treaty, which prohibits income tax discrimination that violates the freedom of movement for goods, services, persons and capital among the EU nations. The European Court of Justice has been very active in recent years in striking down various aspects of national income tax systems as discriminatory, thereby forcing certain European countries to design new income tax rules to comply with the EC Treaty.27 Broad protection against income tax discrimination may be more feasible for the highly integrated economies of Europe under a customs union agreement that contemplates significant political linkages and the use of supranational legal institutions such as the European Commission, the European Court of Justice and the European Parliament.

2.3. Why have trade policy and tax policy followed different paths?

Trade and tax policy share a common goal, which is to facilitate cross-border trade and investment. A number of factors, however, explain why academics and policymakers have historically treated trade and tax as two separate topics.

First, unlike trade theory, there is little theoretical or empirical support for the view that a country should unilaterally reduce its discriminatory income tax treatment of foreign businesses and foreign investors to promote domestic economic growth.28 As mentioned, trade theory supports the general view that, even if no other country agrees, a government should unilaterally abolish its tariffs so that imports will be cheaper, and domestic industry can focus on areas in which it has a comparative advantage. Empirical studies have generally confirmed that free trade promotes domestic productivity gains and, in the long term, causes domestic economic growth and higher standards of living for citizens.

In addition, economists have developed a stronger consensus view with respect to the requirements for optimal international trade policy when compared to international tax policy, with respect to which there are ongoing theoretical, empirical and behavioural uncertainties.29 For instance, it is unclear whether income taxes significantly influence cross-border investment behaviour, how taxpayers react to international tax changes, and what is meant by a “fair” allocation of the international tax base among governments.

It may not be possible to reconcile competing theoretical frameworks for trade and tax policy. The search for optimal trade policy can be compared with efforts to prepare a farmer’s field for planting, and fostering the best possible environment for the crops to grow. Optimal
tax policy, on the other hand, is more akin to an attempt to effectively reap and share the harvest of crops after the growing season is over.\textsuperscript{30} Taxes are designed to fund public goods and services: in imposing taxes fundamental tax policy considerations call for the pursuit of other goals – equity and efficiency – that may, at times, conflict. Because trade and tax policy pursue common goals (e.g. to reduce barriers to international trade and investment) as well as differing goals (revenue collection in the case of tax), the two areas have remained distinct areas of study in most cases.\textsuperscript{31}

Second, income tax policy remains a critical government tool to promote domestic policy goals, such as wealth redistribution or economic development of particular industries or geographical areas. For this reason, most governments are extremely reluctant to enter into any binding multilateral agreements that would restrict their use of tax policy as an economic tool. In fact, as tariff and non-tariff barriers have fallen over the past half century under binding agreements like the GATT, governments may be even more reluctant to give up political control over their tax systems. On the other hand, in an increasingly globalized world, it is recognized that a government's control over international income tax policy is limited in many situations; most governments need to ensure that their tax policies do not inhibit inbound and outbound foreign investment. These constraints may lead to convergence in country practices in certain cases.\textsuperscript{32}

Third, unlike the situation under trade policy, there is less evidence that discriminatory income tax treatment poses a significant policy problem. Most studies of non-discrimination under tax treaties simply assume that discrimination is undesirable and that protection against discrimination should be expanded. Outside the European Union, there have been few court cases involving discriminatory income tax treatment. A 1991 review of discriminatory income tax provisions in five countries revealed few cases of alleged discrimination, as well as a lack of reliable information that discriminatory income tax treatment is harmful.\textsuperscript{33} Although the general reports for the 1993 and 2008 Congresses of the International Fiscal Association dealing with non-discrimination suggested that the protection in Art. 24 should be expanded, modernized, and made more coherent, neither report presented any evidence that discriminatory income tax practices were increasing or having a serious negative

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30. Building on the analogy used by Malcolm Gammie in “The Taxation of Inward Direct Investment in North America Following the Free Trade Agreement”, 49 Tax Law Review 4 (1994), pp. 615-674, at 617: “As trade and investment flows have increased throughout the world, trade negotiators and tax policymakers have become conscious of each other’s presence. They nevertheless have continued to plow their separate furrows. They are, however, plowing the same field, which is getting smaller.”


32. This theme is apparent in recent government reports that seek to promote the “competitiveness” of their income tax regimes with those in places elsewhere. In particular, certain government reports advocate reforming worldwide/credit systems in exemption (or territorial) tax systems – in part because the latter approach appears to be increasingly deployed by other governments. See e.g. United States, Department of Treasury, Treasury Conference on Business Taxation and Global Competitiveness: Background Paper (Washington, D.C.: Dept. of Treasury, 2007); United Kingdom, HM Treasury and HM Revenue & Customs, Taxation of the Foreign Profits of Companies: A Discussion Document (London: HM Treasury, 2007); New Zealand, Inland Revenue Department, New Zealand’s International Tax Review: A Direction for Change (December 2006); and Canada, Advisory Panel on Canada’s System of International Taxation, Enhancing Canada’s International Tax Advantage (April 2008).


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impact on cross-border activities.\textsuperscript{34} Also, since the NAFTA was formed in 1994, there have only been a handful of cases about direct or indirect tax measures violating NT obligations or the protection against expropriation.\textsuperscript{35}

In fact, and as mentioned at the outset of this paper, an area of greater policy concern is that governments offer preferential income tax treatment to foreign investors, and not discriminatory treatment. For example, governments can offer tax incentives such as tax holidays to foreign investors to encourage them to locate or expand businesses within their borders; these tax incentives are typically not extended to domestic businesses. Studies have shown that countries – especially developing countries – have accelerated their use of tax incentives in the last two decades.\textsuperscript{36} In addition, governments often extend more favourable tax treatment to the foreign-source income of residents than to their domestic-source income (by, for example, permitting interest deductions for foreign-source income that is exempt from tax). For these reasons, it is not clear that the interests of source countries are being harmed by discriminatory income tax measures.

3. What Should Be the Relationship between Trade Agreements and Tax Treaties?

3.1. Extending the protection against discrimination in trade agreements to income taxes

Some commentators have suggested that the protection against discrimination in existing trade agreements should be extended to include income tax measures.\textsuperscript{37} Because the purpose of trade agreements is to reduce and/or eliminate barriers to trade, it seems natural to extend protection against discrimination, which is currently restricted to consumption taxes, to include income taxes as well. The rationale for such an extension is that income tax measures can sometimes distort or discourage the provision of cross-border goods and services\textsuperscript{38} – for instance, by affecting the location of cross-border investments.

Similarly, there may be an income tax incentive or disincentive for members of an international corporate group to trade goods and services in order to shift taxable income or deductible expenses to a country with higher or lower taxes. Moreover, as mentioned above, the elimination or reduction of traditional tariff and non-tariff barriers to trade may mean that income tax measures are now playing a greater role in distorting trade patterns.

Nevertheless, the extension of broad NT and/or MFN obligations in trade agreements to income tax measures raises a number of policy concerns.

35. See e.g. International Trade Canada, Dispute Settlement NAFTA Chap. 11 – Investment, “NAFTA Chapter Eleven Arbitration between Pope & Talbot, Inc. and Canada” (26 June 2000); Feldman v. Mexico (2002), ARB(AF)/99/1 (holding that Mexico’s VAT policy discriminated against a US citizen’s company vis-à-vis its domestic competitors in contravention with national treatment obligations under NAFTA).
37. See Hinnekens and Hinnekens, note 34, p. 53.
First, tax treaties are typically negotiated on a bilateral basis, with each side bargaining for reciprocal benefits that are often tied to the unique economic relationship between the two countries. For instance, certain countries include provisions in their tax treaties to deal with pensions to ensure that retired workers will not be discriminated against in the event they move to the other country. In situations where such cross-border migration is infrequent, the governments may be unwilling to extend protections against discrimination, in part because it can take up significant government administrative resources to ensure equal treatment for non-residents.

Another example involves withholding taxes on certain payments to non-residents. Typically, similar payments to resident taxpayers are not subjected to withholding obligations. Because withholding taxes are imposed on the gross amount of payments to non-residents, they may result in higher tax burdens on non-residents in some circumstances. However, for most governments witholding taxes are the only effective method for collecting tax from non-residents; as a result, they would likely be unwilling to give up withholding taxes on non-residents because of revenue shortfalls and the effect on the allocation of tax revenues between capital-importing and capital-exporting nations.39

Outside the European Union, it seems clear that, in most situations, governments would be unwilling to give up extending benefits to tax treaty partners on a reciprocal bilateral basis in favour of extending benefits to all parties to a trade and investment agreement. Moreover, it also seems clear that many governments, or at least their tax officials, do not wish to extend broader protection for non-residents against discrimination than is already afforded through their tax treaty network. Broadening non-discrimination in income tax matters would likely be seen as an unacceptable intrusion into a nation’s tax sovereignty, as most governments continue to desire, for various policy reasons, to tax residents and non-residents differently.

Second, unnecessary duplication may arise if income tax non-discrimination provisions are included in both trade agreements and tax treaties. Many OECD Member countries have an extensive network of tax treaties that typically incorporate some form of protection against income tax discrimination based on Art. 24 of the OECD Model.40 A similar non-discrimination provision is included in the UN Model, which is used as the basis for treaty negotiation by developing countries.41 In some situations, trade agreement non-discrimination provisions would simply duplicate the provisions in tax treaties. In other situations, the provisions might conflict. Under the general approach mandated by the GATT and the GATS, the provisions of the tax treaty would prevail in the event of any inconsistency, which calls into question the need for similar provisions in trade agreements. Finally, trade agreements and tax treaties have separate dispute resolution processes for alleged tax discrimination, so that two separate claims covering the same situation could go forward, along with the potential for conflicting outcomes. This duplication is undesirable because it would be inefficient and would encourage forum shopping.

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39. As a result, the GATS, for example, permits countries to maintain withholding taxes that are exempt from NT obligations because they represent a measure “aimed at ensuring the equitable or effective imposition or collection of direct taxes”. See Art. XIV(d), footnote 6, GATS.
40. Only Canada and New Zealand have made blanket reservations on Art. 24, but both countries include non-discrimination articles in their treaties, although the protection afforded by these articles is somewhat narrower than that afforded by Art. 24.
Third, it may be too difficult for non-tax experts to determine if a tax measure is an inappropriate barrier to cross-border trade. Because international tax laws are highly technical, tax treaties are normally negotiated by government officials specializing in tax treaty and international tax issues, not trade specialists, as is generally the case with respect to the negotiation of trade agreements. As indicated in the OECD’s discussion draft, under one view “if [trade] agreements are too broadly drafted and if tax laws and treaties are not carefully taken into account, the obligations imposed by these agreements may inadvertently have an impact on legitimate tax measures and upset the reasonable expectations and needs of taxpayers and tax authorities.” For this reason, if trade agreements potentially apply to income tax measures in situations such as expropriation, certain agreements – such as the NAFTA – permit the tax authorities to determine whether the income tax measures are covered before the claim can go forward (see 4.3.).

Finally, in situations where international agreements, such as the EC Treaty, offer broad protection against income tax discrimination, it is not clear that the results are sensible for the member countries. If the European Court of Justice invalidates an income tax measure of a Member State, it may lead to undesirable outcomes as EU Member States react in a piecemeal fashion to reform their laws to comply with the EC Treaty. Under EU law, no centralized body such as the European Commission can mandate new income tax rules without the unanimous consent of the EU Member States. For example, the ECJ has invalidated controlled foreign corporation rules as discriminatory except in limited circumstances. In response, some countries have made their controlled foreign corporation rules applicable to both resident and foreign controlled corporations, for no good policy reason other than to avoid a charge of discrimination.

Another example involves thin capitalization rules, which deny interest deductions for excessive debt financing of a resident corporation by related non-residents. The ECJ has ruled that, as a result of the EC Treaty, thin capitalization rules cannot impose unequal treatment between resident and non-resident EU companies. Certain EU governments, such as Italy and Germany, have reacted to this development by enacting earnings-stripping rules that specify acceptable debt levels for domestic corporations owned by residents and non-residents. Other countries may choose a different reform path to try to comply with the ECJ ruling. The end result could be a patchwork of different laws, potentially making the situation worse. In addition, for those countries that have adopted earnings-stripping rules, the ECJ decision has resulted in tax changes that affect domestic firms with no international activities. Non-EU countries are unlikely to find this outcome acceptable.

The solution for resolving alleged cases of discrimination under trade agreements may need to involve the development of something akin to an international tax court with the power to bind governments with respect to income tax measures. Due to tax sovereignty concerns, this solution is not realistic for the foreseeable future.

45. See ECJ, 12 December 2002, Case C-324/00, Lankhorst-Hohorst GmbH.
On the other hand, there may be limited areas where trade agreements can help to prevent abuses. In certain cases, income tax measures can act as disguised restrictions on trade or result in arbitrary, unreasonable or unjustifiable discrimination. In particular, income tax measures can be used to expropriate a non-resident’s assets. For this reason, certain trade agreements include prohibitions against the use of tax measures to expropriate a non-resident’s property. By way of example, the NAFTA prohibits income tax measures that have the effect of arbitrarily expropriating the assets of non-residents without due process of law and payment of compensation.

3.2. Extending protection against discrimination in tax treaties

Instead of broadening the protection against discrimination in trade agreements to cover income tax matters, the non-discrimination article in tax treaties could be revised to provide more comprehensive protection. Under one view, the protection against discrimination in Art. 24 of the OECD Model is too narrow and ineffective to prevent cases where income taxes unduly discriminate against non-resident taxpayers. The narrowness of typical treaty non-discrimination provisions allows income tax measures that discriminate against foreign businesses and foreign investors. This lack of protection has the potential to distort cross-border trade and investment. To rectify this problem, the argument goes, tax treaties should expand the protection against discrimination on the same or roughly the same basis as the protection offered by trade agreements.

This approach raises some of the same concerns that would arise if trade agreements provided comprehensive protection against income tax discrimination. For instance, expanding protection in tax treaties could prevent countries from offering tailor-made reciprocal tax benefits to each other, and might unduly infringe on a government’s sovereign ability to develop tax policy as it wishes.

In addition and as previously mentioned, it is not clear that income tax discrimination is seriously harming the economic interests of governments. Before significant changes are made to Art. 24 of the OECD Model, more research is needed to determine the extent to which income tax discrimination is harming national and/or international welfare.

4. Possible Reforms

The preceding analysis shows that international trade policy offers few lessons for international tax policy and confirms that cross-border income tax matters should remain the near-exclusive prerogative of tax treaties. Nevertheless, there may be room for modest incremental changes for the protection against discriminatory income tax measures in tax treaties.

46. See Art. 2103(6) NAFTA.
4.1. General carve-out from trade agreement preferable

As discussed above, trade agreements display several different approaches to the scope of protection against discrimination concerning the income tax measures. The EC Treaty prohibits many types of cross-border income tax discrimination in order to prevent income tax measures from being used to undermine the fundamental freedoms guaranteed in the Treaty. The GATT and many bilateral trade agreements are traditionally limited to taxes on products, which generally excludes income taxes. The GATS contains provisions applicable to income taxes in respect of services and service providers, but allows countries to maintain income tax provisions that are inconsistent with the NT and MFN obligations in certain circumstances. Other trade agreements, such as the NAFTA, provide that generally income tax measures are to be dealt with under the bilateral tax treaties between the countries.

The first approach under the EC Treaty is unusual and, as mentioned, is appropriate only for countries participating in regionally integrated economic areas with significant political linkages. The GATT approach appears to be working reasonably well, although there may be some uncertainty with respect to the application of the GATT to income tax measures that affect products.

The GATS approach is more nuanced concerning the application of the protection against discrimination to income tax measures, as discussed in 2.2. First, the approach under the GATS requires each participating government to draft a list of income tax provisions that are excluded from the agreement. Most governments have included a broad list of income tax measures to ensure they can adopt tax policies without concern about those policies being invalidated. As a result, the list of excluded items is equivalent, in effect, to a general carve-out. Second, the GATS permits countries to maintain non-conforming measures as well as changes to these measures that do not increase the non-conformity. Disputes may arise as to whether or not changes to non-conforming measures are subject to the GATS. Third, there is considerable uncertainty with respect to the exclusion from the NT obligations of the GATS for income tax measures intended to ensure the equitable or effective imposition or collection of income taxes.49

Because of the problems with the first three approaches, a general carve-out for income tax provisions (such as that used in the NAFTA) is preferable, subject to specific exceptions for special situations, such as expropriation. Moreover, the trade agreement should expressly state that the provisions of an applicable tax treaty should prevail to the extent there is inconsistency between the trade agreement and the treaty.

4.2. Limited MFN treatment may be appropriate

Because virtually all of the world’s tax treaties are bilateral in nature, the use of MFN principles in these treaties is appropriate only in limited cases. For the most part, governments want to extend tax benefits on a reciprocal basis. Broad MFN provisions could result in the extension of the benefits provided to one country to all of the country’s other treaty partners even where these other countries have not reciprocated by extending their own tax benefits.

49. In contrast, under the NAFTA these obligations do not apply to income tax measures unless they relate to the purchase or consumption of particular services. In addition, the relevant taxes on services are explicitly set out in an Annex to the NAFTA.
Nevertheless, in certain narrow cases, the use of MFN principles may be an appropriate way to modify the bilateral nature of tax treaties without the need to renegotiate all or many of a country’s tax treaties. For example, some governments have found it useful to extend MFN treatment in respect of cross-border withholding taxes. For instance, when Canada and Mexico first negotiated a tax treaty in 1991, they inserted MFN provisions to the effect that if Mexico agreed to a lower withholding tax rate on interest or royalties with another OECD country, then the lower rate (to a minimum of 10%) would apply for purposes of the Canada–Mexico tax treaty. Thus, when Mexico and the United States agreed to lower withholding tax rates in their tax treaty, the withholding tax rates on the same amounts in the Canada–Mexico tax treaty were automatically reduced.

MFN clauses may also be useful to trigger the renegotiation of treaties in certain circumstances. For example, if country A agrees to more favourable terms in a treaty with another country than it has in its treaty with country B, those more favourable terms would not be extended to country B automatically; however, country A would be under an obligation to renegotiate the treaty with country B.

While the EC Treaty prohibits income tax discrimination in certain cases, the EU Member States continue to negotiate bilateral tax treaties with reciprocal benefits, which can result in the fragmentation of European capital markets. The use of MFN obligations in this context may serve to reduce trade and investment distortions that would otherwise persist in light of the differing tax treatment offered by each tax treaty. MFN obligations could result in greater harmonization of the tax treaty provisions negotiated between the EU nations.

The Commentary on Art. 24 of the OECD Model indicates that the existing provisions of the article “cannot be interpreted as to require most-favoured-nation treatment.” The Commentary could be revised to discuss the circumstances in which it might be appropriate for countries to include MFN provisions in their treaties and to provide some wording that countries might use in this regard.

4.3. Dispute resolution

The mechanisms for resolving disputes concerning discrimination are very different under trade agreements and tax treaties. Under tax treaties, disputes are generally between a taxpayer and a state rather than between two states. Taxpayers can take their claims to domestic courts or request the competent authorities of the two states to “endeavour to resolve” the issue using the mutual agreement procedure under Art. 25 of the OECD Model. The mutual agreement procedure has been subject to criticism because it is often lengthy and the competent authorities are not required to come to a decision. Moreover, the taxpayer is not directly involved in the process. The European Union once again represents an exception to

50. A 2005 study found that MFN clauses were used in almost 600 tax treaties. See Hofbauer, I., “Most-Favoured-Nation Clauses in Double Taxation Conventions – A Worldwide Overview”, 33 InterTax 10 (2005), pp. 445-453.
51. A new tax treaty was negotiated in 2006 between Canada and Mexico whereby the two countries agreed to withholding tax rates of 10% for interest and royalties; hence, the MFN provision was deleted. See the Convention between the Government of Canada and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income (signed on 12 September 2006).
52. For recommendations to harmonize EU tax treaty policy, see Commission of the European Communities, “Report of the Committee of Independent Experts on Company Taxation” (Brussels: European Commission), p. 206.
the general rule as the Member States have agreed to binding dispute resolution for transfer pricing disputes.54

In July 2008, Art. 25 was revised to add Art. 25(5), which provides for mandatory arbitration for cases that have not been resolved within two years from the presentation of the case.55 The addition of mandatory arbitration will serve to give confidence to taxpayers about the use of the mutual agreement procedure56 and will encourage the competent authorities to resolve disputes efficiently and in a timely manner. This reform is consistent with the view in trade policy that mandatory dispute resolution processes involving an independent party are required to force agreement, in order to promote more certain treatment of cross-border trade and investment. This enhanced certainty, it is thought, in turn encourages heightened levels of cross-border activity, which should benefit all of the participating economies. As a result, the expanded use of mandatory arbitration processes within tax treaties should help to smooth over problems caused by the interaction of two different national tax systems.

Although the mutual agreement procedure could possibly be used for disputes between the states themselves, to our knowledge, this is not frequently the case. In contrast, disputes between states are specifically provided for under the dispute resolution procedures of trade agreements and such disputes are not uncommon.

In fact, disputes between states under trade agreements have been settled by means of mandatory dispute resolution processes for at least a half century. Under the GATT and the GATS, an individual, business or state can apply for relief before a dispute resolution panel of experts. The decisions of the panel are binding but are subject to appellate review. The ruling by the panel, including any modifications by the appellate review, is endorsed (unless there is a consensus that it be rejected) by the WTO’s General Council, which functions as the Dispute Settlement Body. The dispute settlement procedures also allow for the participation of third states and mandate consultation between the states prior to the establishment of a dispute resolution panel.

The problem with allowing taxpayer–state disputes about discrimination to be resolved by domestic courts is not generally that domestic courts might have a tendency to be nationalistic; rather, it is that the courts do not have the jurisdiction or the capacity to consider and balance competing tax policy considerations. The job of a court is to resolve the dispute before it, and not to protect the integrity of the tax system as a whole. As a result, a process for settling state–state disputes about tax discrimination would be preferable. That said, it would not be feasible to deny taxpayers the right to contest income tax measures as discriminatory in domestic courts. That right has existed for many years and taxpayers can generally be relied on to pursue their interests (whether on the basis of non-discrimination or some other ground) more than their governments.

To avoid jurisdictional conflicts between trade and tax agreements, trade agreements should specify that, if a tax treaty has been negotiated between two governments involved in a potential dispute, then disputes surrounding whether the alleged non-conforming measure falls

55. Details concerning the arbitration process are set out in the Commentary on Art. 25.
56. The arbitration process contemplates that taxpayers will be able to make written presentations and oral presentations as well if the arbitrators agree. See Para. 20 of the Annex to the Commentary on Art. 25.
within the scope of the trade agreement should be exclusively resolved under dispute resolution processes of the tax treaty. Thus, disputes involving income tax measures will be dealt with through the mutual agreement procedure of the tax treaty unless the tax treaty partners both agree that the dispute should be heard under the trade processes. If the relevant trade agreement does not mandate this outcome, governments can negotiate provisions in their tax treaties to ensure the matters are settled by the mutual agreement procedure (this is the approach already encouraged by the OECD with respect to the GATS – see 2.2.).

As mentioned, it seems appropriate for trade agreements to prohibit the use of income taxes that act as disguised restrictions on trade or that result in arbitrary, unreasonable or unjustifiable discrimination or expropriation. Trade agreements should contain provisions requiring the competent authorities (i.e. the tax authorities) to give their consent before any taxpayer claim can proceed on these grounds.57

5. Conclusion

Trade and tax policies have traditionally been separate and different. A number of factors suggest this approach remains sensible, including the fact that governments continue to treat residents and non-residents differently for income tax purposes and the lack of evidence that income tax discrimination is unduly harming national or international welfare. For this reason, trade agreements should continue to carve out income tax matters, which should remain the near-exclusive prerogative of tax treaties, subject perhaps to a few very narrow exceptions. If the protection against discrimination afforded by the provisions of tax treaties is considered not to be sufficiently broad to allow cross-border activities to flourish, the appropriate action is not to extend the provisions of trade agreements to income tax measures or to import broad NT or MFN treatment provisions into tax treaties, but rather to identify the offensive tax provisions precisely and then amend Art. 24 or perhaps some other article of the treaty to deal with that problem.

57. See Art. 2103(6) NAFTA.
Non-Residents – Personal Allowances, Deduction of Personal Expenses and Tax Rates

This contribution deals with the question whether – from the perspective of cross-border neutrality – tax reductions for personal circumstances should be applied only by the country of residence, or whether they should also be granted by the source country, and, if so, how such tax reductions should be allocated between the two countries. It starts from the rule for the deduction of business expenses, which is often also denied by source countries in the absence of a permanent establishment. Tax neutrality would require taxation of only net business income in the source country. The paper refers to Art. 24(3) of the OECD Model, which specifically excludes non-resident taxpayers from personal deductions in the country of source. It also refers to ECJ case law prescribing the mandatory deduction for personal circumstances in the source country, when substantially all of the income is earned in that country. However, deductions for business expenses mostly relate to income that is specifically taxable in the source country. Deductions for personal circumstances are mostly related to overall income, part of which may be taxable in the country of residence. The result would be an unjustified benefit to the taxpayer because of a double deduction for personal circumstances. In order to avoid such double deduction, the paper submits a proposal for “fractional taxation”, doing away with the traditional distinction between residence and source countries. Each country calculates the tax liability on worldwide taxable income, taking into account all personal related deductions, but it applies its tax rules only to the pro-rata fraction of the income that is subject to tax in its own jurisdiction. The principle is illustrated in the conclusion by a concrete example of tax calculation.

1. Introduction

Non-discrimination in cross-border taxation has many dimensions. It may pertain to interest deductions for payments to foreign creditors, deductibility of contributions to foreign pension plans, etc. The areas, however, where non-discrimination, both under tax treaties and in EC tax law, has received most attention, concern less favourable taxation of non-resident taxpayers compared to residents and, to a lesser extent, of foreign versus domestic-source income.

This contribution deals with a typical aspect that arises in cross-border taxation of individuals. For tax policy reasons, most countries reduce the tax burden of individual taxpayers by taking into account their personal circumstances. In cross-border situations the question arises whether from the perspective of cross-border neutrality this reduction could be applied only by the taxpayer’s residence country or whether it should also be granted by the source country. In the latter case, does that necessarily result in an excessive reduction of the combined source and residence country taxes, as compared to the tax burden borne by a taxpayer who earns the same amount of income from a single country? If so, is it possible to design a mechanism through which the two countries involved contribute to the tax reduc-
tion, in such a way that the combined amount is the same as a taxpayer with the same overall income derived from his residence country would receive?

2. Business Expenses

Since income as a basis for taxation is generally viewed as a net notion, individual income tax systems subject resident and non-resident taxpayers to tax typically on the basis of the net amount of their income, i.e. the gross income they receive reduced by the expenses incurred for earning it (such expenses will be referred to here as “business expenses”). For reasons of efficiency, for particular categories of income resident taxpayers and, more frequently, non-resident taxpayers, however, may instead be subject to tax on the gross amount thereof, at a (relatively low) flat tax rate. The amount of tax so due supposedly approximates the amount that results from the application of regular tax rates to the net amount of the income. In instances where non-resident taxpayers are taxed on a gross income basis, while in respect of resident taxpayers a net basis is applied, a denial of the deduction of business expenses to non-resident taxpayers may in individual cases result in a higher amount of tax due by them.

It is obvious that in a cross-border neutral tax system non-resident taxpayers should be allowed to be taxed on a net basis1 and take into account the same types of business expenses as resident taxpayers to determine the amount of income on the basis of which they are taxed. At a different dimension, it should be equally obvious that in respect of foreign-source income resident taxpayers should be entitled to the same business deductions as in respect of domestic-source income.

3. Personal Expense Deductions and Person-Related Tax Reductions (“Personal Tax Reliefs”)

Most countries allow, as a rule, resident taxpayers to deduct from their net income particular types of personal expenses, such as medical expenses, charitable contributions, and sometimes even interest on consumer loans; these deductions are hereafter referred to as “personal expense deductions”. In addition, in taxing individuals many tax systems take into account the civil status of the taxpayer, whether they have minor children in their care, and other personal aspects, by granting them fixed-amount personal allowances and tax credits, tax rate differentiations, the privilege to file a joint return (couples), etc.; these benefits will be referred to here as “person-related tax reductions”. Both types of relief hereafter jointly also referred to as “personal tax reliefs” are based on tax policy considerations to take into account the personal ability-to-pay of individual taxpayers.

Non-resident taxpayers are typically not entitled in the source country to either personal expense deductions or person-related tax reductions. Traditionally, the reason for the source country not to grant these reliefs to non-resident taxpayers is that these taxpayers are supposed to enjoy such benefits in their residence country. An extension of these benefits to them by the source country is assumed to give them double benefits and thereby an advantage over the source country’s resident taxpayers. This brings up the fundamental issue of how source countries should make the comparison between their non-resident and resident

1. Cf. OECD Commentary on Art. 17, Para. 10, where in the 2008 update the fifth and following sentences were added. The added text includes the suggestion for a paragraph to be added to Art. 17 for states that want to give to non-resident artistes and sportmen the option to be taxed on a net basis.
taxpayers to determine whether the former category is treated less favourably. In order to compare its tax treatment of non-resident taxpayers with the treatment of its residents, should the source country restrict the comparison to how it treats its own resident taxpayers who are in exactly the same position as the given non-resident taxpayer with regard to domestic income etc., or should the source country consider the non-resident taxpayer's cross-border aspects and take into account:

- how the non-resident is taxed in his own residence country in respect of the income derived from the source country, and/or
- the additional income the non-resident derives from sources in his residence country and third countries for purposes of determining the tax rate to be applied by the source country to the income from the source country?

The first item, which has not received much attention under the single rule in Art. 24 of the OECD Model, that deals with taxation of non-resident taxpayers (the permanent establishment non-discrimination provision of Art. 24(3)), has become a well-known issue in EC tax law. The following questions arise when establishing under the EC Treaty's freedom of movement rules whether in a cross-border situation an obstacle is created or discrimination occurs (particularly with regard to dividend and interest income):

- May the source country, in determining whether a non-resident taxpayer is treated less favourably than a resident taxpayer, take into account benefits (e.g. a credit for the source country's tax) that the non-resident is entitled to in his residence country in respect of the given item of income?
- Is the source country required to treat the non-resident at par with resident taxpayers, irrespective of the way the non-resident's residence country treats the income its resident has derived from the source country?

4. Business Deductions vs. Personal Expense Deductions and Person-Related Tax Reductions

The essential difference between expenses a taxpayer incurs in connection with his gross income ("business expenses") and "personal expense deductions", is that the first group is by definition related to particular items of income, whereas the second group of expenses (deductible personal expenditures) typically lack a connection with items of (domestic and foreign) income.

Most countries restrict in their domestic tax law the right to personal deductions to their resident taxpayers, and, as a rule, deny it to non-resident taxpayers. The permanent establishment non-discrimination provision of Art. 24(3) of the OECD Model, which in its first sentence grants to non-resident taxpayers the right to be taxed on their business income earned through a permanent establishment in the source country not less favourably than resident taxpayers, confirms this practice by denying in its second sentence expressly these non-resident taxpayers the right to the personal expense deductions that resident taxpayers have:

2. The bottom line for the Court appears to be that it cannot be accepted that, in a cross-border situation, in the end a loss or deduction that would be taken into account in a fully domestic situation, will not be taken into account anywhere (see ECJ, 13 December 2005, Case C-446/03, Marks & Spencer).
... This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

As noted above, if non-resident taxpayers would be given the right to the personal tax reliefs that the source country grants to its own residents, non-resident taxpayers would be entitled to such reliefs twice. Depending on the marginal tax rates at which the taxpayer is taxed in the source and residence countries, the value of the combined effective tax reductions in the two countries resulting from the personal expense deductions and personal allowances, may or may not give cross-border taxpayers an advantage over taxpayers that derive all of their income from a single country and who are therefore entitled to personal deductions only in that country. It is therefore difficult to understand why countries occasionally have extended in their tax treaties an unrestricted and unconditional right to personal tax reliefs to non-resident taxpayers, as was done in Art. 25(3) of the 1970 Netherlands–Belgium tax treaty:

Individuals who are residents of one of the States shall benefit in the other State from the same personal allowances, reliefs and deductions on account of civil status or family responsibilities which the last-mentioned State grants to its own residents.

5. Non-Resident Taxpayer Deriving (Almost) All of his Income from Source Country

If a resident taxpayer derives (almost) his entire income from one foreign country, generally he cannot effectively (fully) take into account in his residence state the personal expense deductions and person-related tax reductions to which he is entitled under his residence country's domestic tax law. To deal with this obstacle to cross-border movement of persons, in 1993 the European Commission issued a Recommendation under which each Member State should tax residents of other Member States that derive at least 75% of their taxable income from the first Member State, on the same footing with resident taxpayers of that state with respect to business, professional and employment income. The Recommendation indicates that in such a case the residence state of such individuals may opt not to grant “deductions or other tax reliefs” to its residents if they benefit from such deductions or reliefs in the other state. No further details are provided (e.g. what if the source state partially grants deductions and reliefs?), but that is perhaps in the nature of a recommendation (as distinguished from a regulation and a directive). The 1995 Schumacker decision by the ECJ followed this path shown by the European Commission, but increased the 75% threshold to “all or virtually all”, which is generally understood as amounting to at least 90%.

Many countries have introduced or upgraded in their domestic tax law rules that allow non-resident taxpayers that derive most of their income from that country as source country, to opt for taxation in the same manner as is applicable to resident taxpayers (but, of course, only on the income for which they are liable to tax in the source country and not on the worldwide income). It is obvious that this approach provides a solution only if the taxpayer derives (almost) all of his income from a single foreign country and not from more than one foreign country.

3. ECJ, 14 February 1995, Case C-279/93, Schumacker.
4. Interestingly, in the Netherlands, the non-resident may opt to be taxed as a resident taxpayer on his worldwide income (including domestic income offsetting foreign losses) with double taxation relief (as applies to resident taxpayers) for those items of his worldwide income for which he would not be taxable as a non-resident taxpayer.
6. Proportional Granting of Personal Tax Reliefs by Residence and Source Countries

What if the amount of the personal expenses is attributed proportionally to the overall income and both the residence state and the source state take into account as a deduction only the corresponding fraction of the total personal expenses? As a matter of fact, various residence countries do this implicitly by computing the amount of double taxation relief their resident taxpayers are entitled to (or, in case of the foreign tax credit, the limit on the amount of the foreign tax credit) in a way that reduces the amount thereof by that fraction of the personal expenses that equals the ratio of their foreign income to their worldwide income. Clearly, such an approach is acceptable only if the given country, when it acts as source country, allows a deduction for the personal expenses that are proportionally attributable to the income non-residents derive from that country. Further, cross-border neutral treatment is reached only when, in cases where the residence country applies this restriction to its resident taxpayers, the source country concerned grants the non-resident taxpayer a supplementary proportional relief.

7. The Effect of Person-Related Deductions (Personal Expense Deductions and Personal Allowances) on Residence and Source Country Taxation

If both the taxpayer’s residence country and source country permit him to effectively apply personal expense deductions and personal allowances, he will have the benefit of dual deductions. In practice, both countries apply smaller or greater restrictions in applying these deductions, as is demonstrated in the following example.

Example

We assume that resident A (married, two children) of State R has a worldwide income of 500, of which he derives 300 from State S, and that both states apply the same tax rate (a flat 20%) and the same personal allowance (100 for a married person with two children). State R will compute as tax on A’s worldwide income after personal allowance: 20% of (500 – 100 =) 400 = 80. If State S as source state does not grant A as a non-resident the deduction of the personal allowance, A’s State S tax amounts to 20% of 300 = 60. If State S does grant A the full personal allowance (100), A’s tax is 20% of (300 – 100 =) 200 = 40. If it grants only the fraction of the personal allowance (100) that corresponds with the ratio of his State S income (300) over his worldwide income (500), the fraction that State S takes into account is (300/500 of 100 =) 60, resulting in taxable income of A in State S of (300 – 60 =) 240 and a tax amount of (@ 20%) 48.

If State R grants A a double taxation relief for his State S income in the form of an (income) exemption, it computes the tax due by A by applying its tax rate of 20% to A’s domestic income of (200 100 =) 100, which is 20. If State R applies exemption through a proportional reduction of the tax computed on the basis of the worldwide income (WWI) after deduction of the personal allowance (20% of 400 = 80), it can take into account as foreign income the amount computed in either of the three following ways: (a) without any personal allowance (foreign income of 300 – 0 = 300: reduction of State R’s 80 tax on WWI by 300/400 thereof is 60; remaining State R tax: 80 – 60 = 20), or (b) with deduction of the full personal allowance (foreign income of 300 – 100 = 200: reduction of 80 tax on WWI by 200/400 thereof is 40, with remaining tax of 80 – 40 = 40), or (c) with deduction of the income-proportional fraction of the personal allowance (foreign income of 300 – 60 = 240: reduction of 80 tax on WWI by 240/400 thereof is 48, with remaining State R tax of 80 – 48 = 32).

In case State R is a credit country, it has similar choices: it may compute the ordinary credit limitation based on foreign income of 300, 200 or 240, with resulting limitations of respectively 60, 40 and 48.

If A would, as a resident of State R, derive his entire WWI of 500 from State R, his tax would be 20% of (500 – 100 =) 400 = 80. Now A derives of his 500 worldwide income 300 from State S, State R may compute the double taxation relief to be granted to A based on varying assumptions as to State S having taken the personal allowance into account (full, partial or no personal allowance). Many countries that provide double taxation relief in the form of an ordinary foreign tax credit or in the form of an exemption through a proportional reduction of the tax due on the worldwide income, compute the relevant amount of foreign income by assuming that the foreign country has allowed as a deduction in computing the taxable amount of foreign income a proportional fraction of the personal allowance: 300 – 60 = 240 (in that case State R’s 80 tax on WWI will be reduced by 240/400 = 48 to 32). At the same
time, in the absence of a situation where the taxpayer derives at least 90% of his worldwide income from the foreign country (in which case a number of source countries will grant non-resident taxpayer A a full personal allowance), the source country will typically not permit A to deduct the whole or even a proportion of the personal allowance. As a result, the combined tax amounts due by A to States R and S (both states applying the same 20% tax rate) will amount to 60 (State S tax) plus 32 (State R tax) is 92, compared to 80 if A would have derived his 500 WWI income from State R only.

If resident A of State R derives his income partially from State S, in current country practice the disallowance by State S of personal allowances to non-resident taxpayers combined with restricted double taxation relief granted by State R results in a higher tax burden for A compared with the situation where A derives the same amount of overall income from a single country. At the same time – and this involves a different perspective –, when a residence country grants double taxation relief in the form of an exemption through a proportional reduction of the tax on WWI or in the form of an ordinary foreign tax credit, assuming that State S applies (different from the example above) a graduated (i.e. progressive) income tax rate, the taxpayer may benefit from the fact that the exempt income, or the ordinary credit limitation, as the case may be, is computed by State R as if State S had determined (but generally would not have done so) its tax rate to be applied to the income A derived from State S on the basis of the average rate that State S would have applied to A’s WWI.

All in all, many states in the position of State R may at the same time overtax resident taxpayer A who derives part of his income from State S, by effectively reducing the personal allowance he is entitled to take into account in determining his tax liability in State R, and undertax him by basing the double taxation relief granted to him on an unrealistically high amount of tax relating to the foreign income. Depending on the circumstances, the resulting tax burden imposed by State R will amount to either overtaxation or undertaxation, and only accidentally a tax burden may result that equals the burden in a full domestic situation.

8. Conclusion and Proposal

As is clear from the preceding paragraphs, even under "laboratory" conditions of residence and source countries having identical tax rules, it is difficult if not impossible with individual income tax systems that apply person-related tax reliefs and graduated tax rates, to design rules that do not result for a taxpayer with cross-border income in an overall tax situation which differs from the situation in which he had derived all of his income from a single country, unless both residence and source states accept a proportional approach to applying personal deductions and tax rates.

In 1999, I contributed to the Festschrift of my Leiden colleague Ferdinand Grapperhaus a brief essay (in Dutch) on what I dubbed "fractional taxation" (FT) of taxpayers with cross-border income. In that contribution I developed an approach to cross-border taxation where countries in taxing cross-border income give up their traditional roles as residence countries and source countries. Instead, each country individually computes the cross-border taxpayer’s worldwide income and the amount of tax that would be due on that income, but subjects the taxpayer only to that fraction of such tax that reflects the ratio of the taxpayer's domestic income to his worldwide income.
income over worldwide income (both computed under the pertinent country’s own tax rules). In this way, every element of the given country’s tax rules (including personal expense deductions and person-related tax reductions) is applied to the taxpayer concerned pro rata parte (proportionally). Given the larger and smaller differences among countries’ individual income tax systems, this approach may be the closest one can get to cross-border neutrality of income taxation.

The FT approach described in the preceding paragraph can be summarized in the following three steps to be taken by each of the countries from which the taxpayer derives income:

– compute the taxpayer’s worldwide income on basis of its own tax rules;
– apply its own tax rate to that worldwide income; and
– apply to the resulting tax the fraction: domestic income over worldwide income (both computed under the given country’s domestic tax rules).

The following numerical example illustrates the operation of the FT system:

Example

Resident X of France derives income not only from his residence country F (France), but also from NL (Netherlands) and G (Germany). The amounts of income derived from these countries are, under the rules of each of these countries, determined as follows:

<table>
<thead>
<tr>
<th>Country</th>
<th>Under French Tax Law</th>
<th>Income from France Itself</th>
<th>Netherlands</th>
<th>Germany</th>
</tr>
</thead>
<tbody>
<tr>
<td>F</td>
<td></td>
<td></td>
<td>45</td>
<td>30</td>
</tr>
<tr>
<td></td>
<td>worldwide income</td>
<td></td>
<td>90</td>
<td></td>
</tr>
<tr>
<td></td>
<td>personal deductions</td>
<td>&lt;assume&gt;</td>
<td>30</td>
<td></td>
</tr>
<tr>
<td></td>
<td>taxable income</td>
<td></td>
<td>60</td>
<td></td>
</tr>
<tr>
<td></td>
<td>French tax</td>
<td>&lt;assume&gt;</td>
<td>16</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Country</th>
<th>(1) Net income derived from</th>
<th>(2) Total income [= (1)]</th>
<th>(3) Personal deductions permitted &lt;assume&gt;</th>
<th>(4) Taxable income [= (2) - (3)]</th>
<th>(5) Tax &lt;assume&gt;</th>
<th>(6) Fraction [= (1) / (2)*]</th>
<th>(7) Tax [= (6) x (5)]</th>
</tr>
</thead>
<tbody>
<tr>
<td>F</td>
<td>45</td>
<td>30</td>
<td>15</td>
<td>90</td>
<td>30</td>
<td>60</td>
<td>16</td>
</tr>
<tr>
<td>NL</td>
<td>55</td>
<td>20</td>
<td>5</td>
<td>80</td>
<td>12</td>
<td>68</td>
<td>24</td>
</tr>
<tr>
<td>G</td>
<td>48</td>
<td>12</td>
<td>15</td>
<td>75</td>
<td>15</td>
<td>60</td>
<td>20</td>
</tr>
</tbody>
</table>

* Computation of the per-country amounts under the law of F, NL and G.

Of course, as it would be prohibitively impractical to require taxpayers with foreign income to file a complete tax return in each country from which they derive income, taxpayers should be given the option to be taxed on their gross income at a flat rate of, e.g., 35%. But if they prefer to be taxed right, they should be allowed to do their homework.
The FT approach reminds one of Home State Taxation (HST), which was developed as a step to harmonized company taxation within the European Union. An important difference (and drawback of the fractional taxation system) is that in the HST system one state computes the WWI, which – after distribution of the amount thereof among the states involved – is used in all countries involved by subjecting the income slice received to the (corporate) income tax rate of the given country.

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Non-Discrimination and the Taxation of Cross-Border Dividends

At a domestic level, dividend tax systems are usually designed to relieve the economic double taxation of corporate profits and are related to the personal taxation of savings income. Increasingly over the last 40 years, however, international considerations have intruded upon domestic tax policy. Source country taxation of corporate profits and residence country personal taxation of dividends have limited domestic tax policy options and decoupled corporate and personal tax systems. This article examines the issues for dividend tax policy in an international setting and the role of bilateral tax treaties in addressing those issues. The article explains how, within the European Union, the freedoms guaranteed by the EU Treaties have dictated Member States’ tax policy options. It concludes that general non-discrimination principles, in contrast to specific treaty provisions, have a limited role to play in resolving the competing claims of source and residence countries to tax the return on corporate activity.

1. Introduction

This paper considers the taxation of cross-border dividends and the role (if any) that non-discrimination principles should have in setting tax treaty policy in this field. The paper is divided into six parts, as follows:

– the general determinants of domestic policy for the taxation of corporate profits;
– dividend taxation systems in a domestic setting;
– corporate and dividend taxation systems in an international setting;
– dividend taxation systems in a bilateral treaty setting;
– dividend taxation systems in an EU setting; and
– conclusion.

2. The Domestic Taxation of Corporate Profits

Most legal systems provide for the incorporation of corporate entities with separate legal personality as a convenient mechanism for groups of individuals to own and finance assets jointly, usually with limited liability. Within that opening statement lies a major conundrum that tax systems have to resolve.

On the one hand, tax systems are concerned to tax individuals, because it is only individuals and not legal entities (such as companies) that have the capacity to bear tax. This points the way to taxing individuals directly rather than indirectly through the legal entities in which they have an interest.
On the other hand, what most tax systems seek to tax is the return on productive assets, either as it accrues or as it is consumed. In practical terms it is often easier to tax the return on productive assets in the hands of the person to whom the return immediately accrues (i.e. the person or entity which owns the assets), rather than indirectly by taxing the individuals who ultimately benefit from those returns.

Account must also be taken of the financial intermediation that may separate the entities that own and/or use productive assets from the individuals that ultimately benefit from the returns on those assets. This separation may be significant, not just in terms of the number and variety of entities that stand between the productive assets and the individuals in question, but also in terms of the time that may elapse from when a particular return accrues and the time when it becomes available for personal consumption.

This description of the issues of corporate taxation, couched in terms of the corporate owner of productive assets and the individuals who ultimately benefit from the returns on those assets, illustrates that it is not meaningful to think about the effect of taxes on companies in isolation, divorced from the effects of those taxes on individuals. What we want to know is whether corporate taxes operate to reduce the incomes of their ultimate owners, through lower post-tax profits and dividends.

In a domestic context, a corporate tax operates as a source or withholding tax on the company’s ultimate owners. At least, the taxation of companies’ ultimate owners is what a corporate profits tax is, in theory, designed to achieve. In reality, however, the effective incidence of a corporate tax may be very different. Rather than reducing the incomes of the ultimate individual owners of the company, the corporate tax may function to reduce the incomes of suppliers of goods and services to the company through the lower price it is prepared to pay, including its workers through lower wages, or of consumers, as a result of the higher prices it charges.

Who bears the effective incidence of corporate taxation in any particular case will depend upon the form of the tax, the nature of the economy in which the tax is imposed and the choices that are open to the corporate entity that faces the formal incidence of the tax. Each state may reach a different decision as to the suitability and form of company taxation, depending upon its view of whether and to what extent the tax is likely to be borne by the ultimate owners, suppliers, workers or consumers.

3. Dividend Tax Systems in a Domestic Setting

Every OECD country chooses to tax corporate profits. In a domestic setting, the basic justification for doing so – despite the uncertain incidence of the tax – is the administrative justification to which I have alluded. It is easier to tax a relatively small number of companies directly on the returns that they earn from productive assets than it is to tax the much larger number of individuals on the indirect benefits that they may ultimately derive from the productive use of corporate assets.

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2. It is not part of this paper to consider whether income or consumption is the more appropriate tax base for personal taxation. I need only note two points: first, that the choice of income or consumption as the personal tax base does not answer finally the issue of a separate corporate tax and, second, that most corporate profits taxes are designed in theory to support the taxation of personal income rather than consumption.
Malcolm Gammie

As a general matter, there is a substantial degree of uniformity in the way in which states choose to do so. The tax base in almost every OECD country can be broadly described as some measure of financial accounting profit net of depreciation and interest and other non-equity financial costs. The detailed measurement of taxable profits, period by period, in each jurisdiction may differ materially, particularly in terms of (a) when income and expenses are recognized, (b) the granting of particular incentives (e.g., for research and development or investment in particular assets or activities), (c) whether profits are regarded as domestic (taxable) or foreign (exempt or taxable with credit), (d) relief for losses and (e) how transactions with associated entities (groups) are dealt with.

It is unnecessary in the context of this paper to explore this detail. The important aspect is the relationship between the source taxation of some measure of corporate profits and the taxation of the persons whom ultimately benefit from those profits. The benefits to those most immediately interested in the profits are generally derived from the sale, redemption or repurchase of shares or from the receipt of dividends.

Virtually no tax system has consistently achieved a uniform treatment of these different forms of return derived from equity investment in corporate entities. Ordinary share sales may be taxed, if at all, as capital gain (or loss) without any explicit recognition of any corporate tax paid. Because capital gains are usually taxed at lower rates than ordinary income, the effect may be similar to an exemption or partial exemption method of taxing dividends (see below). Any profit on redemption or repurchase of shares may be taxed as capital gain or as income or as some combination of the two. Dividends, on the other hand, are usually subject to special measures that are designed to reduce or eliminate the economic double taxation of corporate profits that would otherwise arise from taxing the company in respect of its corporate profits and then shareholders in respect of any distribution of those profits.

A tax system that does not seek to eliminate the economic double taxation of dividends is usually referred to as a classical system. Under such a system, dividends are taxed at ordinary income tax rates without relief for any corporate tax paid on the profits from which the dividends are declared. Most countries, however, have usually recognized the corporate tax paid by adopting one of three basic systems of dividend taxation to relieve economic double taxation of corporate profits:

- dividend deduction or split rate systems;
- exemption or partial exemption of dividends; and
- imputation systems, which may give a full or partial credit for the corporate tax.

This paper does not explore the relative merits of classical and integration systems of dividend taxation. Dividend deduction and split rate systems function to reduce the corporate

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3. It is worth noting, however, that the current trend is to restrict relief for interest and other non-equity financial costs. This reflects a variety of factors: the need to maintain corporate tax yields while reducing the nominal corporate tax rate on profits, the desire to narrow the gap between debt and equity at a time when states are abandoning imputation systems (see below) and the difficulty of taxing foreign profits (and therefore to avoid giving a deduction for the costs of financing untaxed profits). It is not part of this paper to explore these issues further.

4. Generally, I will refer in what follows only to dividends, but the system may also apply to any form of distribution, including redemptions and repurchases treated as such.

5. Often referred to in economic debate as the "traditional" or "old" view of dividend taxation, in contrast to the "new" view of dividend taxation. One main reason for favouring an integrated rather than a classical system has been to reduce the incentive for companies to borrow, on the basis that the financial costs of borrowing are deductible whereas the costs of equity finance are not. The current trend to restrict deductions for debt finance has the effect
Non-Discrimination and the Taxation of Cross-Border Dividends

tax on distributed profits, either to zero (dividend deduction) or to a lower rate than is applicable to retained profits (split rate). Under these systems, dividends paid remain taxable in shareholders' hands at their usual personal tax rate. Exemption or partial exemption systems leave the corporate tax rate unaltered on retained and distributed profits but lower the personal tax rate on dividends to zero (exemption) or to a lower rate (partial exemption) than is generally applicable to other income.

Imputation systems seek to achieve a more accurate result by giving shareholders credit (a "dividend tax credit") against their personal tax liabilities on dividends for the actual corporate tax suffered on the profits out of which the dividend is paid (full imputation) or for part of that corporate tax (partial imputation). If and to the extent that the company has paid insufficient tax on its profits to support the dividend tax credit, either dividends will carry a reduced or no tax credit or the company is required to account for the equivalent of the dividend tax credit on making any distribution.

The above assumes that the recipient of the dividend is an individual shareholder who is subject to tax on the dividend. This may only be true, however, in a minority of cases. Dividends are more likely to flow between two corporate entities or from a company to a financial intermediary or other intermediate savings vehicle, such as an insurance company or mutual or pension fund. Special arrangements may be necessary in relation to any of these to ensure that corporate profits represented by dividends paid are not subject to successive tax charges. This may most easily be achieved by exempting dividends from tax in the hands of such intermediaries or by allowing such intermediaries to pass on dividend tax credits as and when they pass dividends up the chain to those ultimately entitled to them. At the same time, any exemption must not become a mechanism for postponing personal tax liabilities indefinitely or for "selling" dividend tax credits to those who can reclaim them or otherwise use them to best advantage.

4. Corporate and Dividend Tax Systems in an International Setting

Historically, the resolution of the issues of corporate and dividend taxation has been largely a matter for domestic tax policy. Increasingly over the last 40 years, however, international considerations have intruded upon domestic tax policy. In particular, in an open economy setting the choice of dividend taxation system is driven significantly by international rather than domestic policy considerations.

In an international context the source taxation of corporate profits offers the main opportunity for taxing the foreign owners of companies operating in the domestic economy. Companies may be locally incorporated and resident or may be foreign companies that have chosen to operate through a local permanent establishment (PE). The majority of foreign investment tends to be through locally incorporated and resident companies rather than PEs.
Malcolm Gammie

In either case, however, the source or host country will seek to tax the resident company’s profits or, in the case of a permanent establishment, the profits attributable to the PE.

In other words, because corporate taxes are generally levied on the profits of all firms operating in the domestic economy, regardless of their ownership, the tax operates to collect tax from foreign investors whom the host country would otherwise have difficulty taxing, given their location abroad. At the same time, the perception that tax is being suffered by anonymous foreign corporations or their foreign owners may appear politically attractive in a domestic context.

The imposition of corporate tax on foreign investors may in fact function to deter some inward investment and in reality the effective incidence of the corporate tax may well be shifted to a significant extent onto domestic workers in the form of lower wages and onto local property owners in the form of lower rents. Whatever the effective incidence of the tax, however, politically it is likely to be difficult to sell the idea that foreign investors should be relieved entirely of the domestic corporate tax, while resident investors remain fully liable.

The development of dividend taxation systems internationally reflects this. Dividend deduction and split rate systems have tended to fall out of use because they extend the benefit of the lower (or zero) corporate tax rate automatically to foreign investors. Countries prefer only to extend the benefit of a lower corporate tax rate to foreign equity investors on their share of source country profits if they have extracted some “quid pro quo” for that benefit from the shareholder’s state of residence under a bilateral double taxation treaty. A country with a dividend deduction or split rate system may seek to maintain its taxing rights over corporate profits though a dividend withholding tax, but its ability to do so will be constrained if it wishes to conclude bilateral treaties based on the OECD Model.9

A partial or full dividend exemption system does not carry this disadvantage, because it operates to reduce the personal tax rate on dividends rather than the corporate tax rate on profits. As such, foreign investors continue to suffer full corporate tax on the local company’s profits.

On the basis that a dividend deduction or split rate system taxes dividends in full, it may deter foreign investment by resident investors if the dividends they derive from abroad do not benefit from the equivalent relief in the source state. At the same time, if an exemption or partial exemption system extends to foreign dividends, it may encourage foreign rather than domestic investment if the source state relieves distributed profits or taxes profits at a lower rate than the investor’s state of residence. In either case the origin state has the opportunity to adjust for such differences by taxing or relieving foreign dividends in a different way to domestic dividends.10

From a state’s perspective as the host state of inward investment, an imputation system offers more flexibility than either of the other systems. In contrast to a dividend deduction or split

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9. Para. 9 of the Commentary on Art. 10, and see below.
10. As appears from the subsequent discussion of the ECJ case law, it is important to keep in mind that, internationally, the dividend taxation system of every state has to be considered from two perspectives: that of a source or host state (in relation to inward investment by foreign investors) and that of residence or origin state (in relation to outward investment by the state’s own residents). The two perspectives may have to be combined if the state acts as an intermediate state, acting in both capacities for investment derived from abroad and ultimately invested abroad through a resident intermediary.
rate system, it does not offer any automatic reduction in the corporate tax rate to foreign investors. In contrast to an exemption or partial exemption system, it need not operate to deter inward investment because it allows the host state to offer inward investors the benefit of its dividend tax credit unilaterally or by agreement under a treaty. At the same time, investors resident in an imputation country\(^\text{11}\) cannot get credit for foreign tax against their domestic corporate or personal tax liabilities, so encouraging domestic rather than foreign investment. Again, however, it is within the residence or origin state’s control as to whether and to what extent it discriminates against foreign investment by its residents.

As this discussion suggests, at its heart corporate and dividend taxation systems operate internationally on a classical rather than an integrated model. This is because personal income taxes generally operate on a residence basis, with resident individuals being liable to tax on or by reference to their worldwide income. Accordingly, dividend taxation is principally of concern to the origin or residence state. Corporate taxes, as has been noted, operate on a host or source state basis. While a single state in respect of domestic corporate investment may choose to integrate its corporate and dividend taxation systems, neither source nor residence state is likely to forgo its taxing right to secure the cross-border integration of corporate and dividend taxation in two states.

Accordingly, the economic double taxation of corporate profits – first at the corporate level in the source state and a second time in the residence state at the level of the equity investor – is therefore an integral part of cross-border corporate investment. It merits observation, however, that this outcome is not necessarily inconsistent with domestic investment. The reality is that domestic tax systems do not eliminate economic double taxation entirely, in the sense that tax at the corporate level is usually only a first stage of taxation leading to an adjustment (and the potential of further tax) as and when the profits are eventually distributed to the person ultimately entitled to them. Intermediate stages of distribution may not attract further tax liabilities, but the final distribution to individuals may well do so, reflecting that the return to corporate investment will usually only be charged to tax at a single rate, while personal incomes are usually subject to progressive rates of tax.

5. Dividend Tax Systems in a Bilateral Tax Treaty Setting

Bilateral treaties are not concerned to eliminate the economic double taxation of corporate profits for the simple reason that, as just explained, the international tax system is founded on the basis that both the residence and the source state has a legitimate claim to tax corporate profits, once in the hands of the company and again on distribution to shareholders. Accordingly, to the extent that the real issue of cross-border corporate investment is that of unrelieved economic double taxation, the existence of a bilateral double taxation treaty should not be expected to make any relevant contribution to resolve the issue.

Bilateral treaties, reflecting Art. 10 of the OECD Model Tax Convention on Income and on Capital (“OECD Model”), are concerned to eliminate the juridical double taxation of dividends, i.e. the taxation by two states of the same income in the hands of the same person.

11. Looking at the matter from the state’s perspective as the state of residence rather than the host state.
The first two paragraphs of Art. 10 provide as follows:

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividend is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax charged shall not exceed:
   a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;
   b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

Art. 10(1) is declaratory of the residence state’s taxing right over dividends derived by its resident taxpayers. Art. 10(2), however, preserves the source state’s taxing rights over both the company’s profits and any dividends declared out of those profits, subject to limitation by reference to whether the foreign investor is a direct investor (Art. 10(2)(a)) or a portfolio investor (Art. 10(2)(b)).

The Commentary Art. 10(1) notes that, as a general rule, all the OECD countries tax residents in respect of the dividends that they receive from non-resident companies. The Commentary continues:

On the other hand, taxation of dividends exclusively in the State of the beneficiary’s residence is not feasible as a general rule. It would be more in keeping with the nature of dividends, which are investment income, but it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished.

As this indicates, a source state’s claim to tax dividends paid to non-resident investors is really rather poor. Nevertheless, it may be appropriate that the OECD Model should recognize that a source state may have a proper claim to tax dividends paid by its companies. It may be said that the OECD Model should not seek to place a source state under unwarranted pressure to forego its taxing right where the exercise of its right would otherwise be consistent with its dividend taxation model, for example where the source state has adopted a classical system for domestic dividends.

On the other hand, as Art. 10(2) recognizes, a source state has no more than limited taxation rights over cross-border dividends, irrespective of its domestic dividend taxation model. Even a domestic classical system is likely to remit tax to some extent on dividends paid between corporate entities, in particular by a subsidiary to its parent company. Similarly, the limitation of the source state to a 15% withholding tax in the case of portfolio dividends is regarded as “a reasonable maximum figure” on the basis that “a higher rate could hardly be justified since the State of source can already tax the company’s profits”.

12. Para. 5 of the Commentary on Art. 10.
13. Ibid., Para. 6.
The source state’s taxing right may be viewed in effect as a parasitic right, allowing the source state, where it can, to appropriate part of the revenues that the residence state would otherwise derive from taxing foreign dividends. To the extent that the residence state does not tax foreign dividends, the imposition by the source state of a dividend withholding tax seems more likely to discourage inward equity investment or to lead to a shifting of the effective burden of the withholding tax (ignoring for the moment the corporate tax) onto local factors.

The origin state may be more likely to exempt foreign dividends from tax in the case of direct investment. However, an origin state may also not tax foreign portfolio dividends where they are derived by domestic tax-favoured savings vehicles or represent intermediated international investment in a case in which the ultimate investors are not resident in the origin state but where the intermediate investment vehicle is still regarded as the beneficial owner of the dividends.

In other circumstances, most source states are content to charge corporate tax only on the profits of inward direct investment, namely where the investment is made through a permanent establishment of foreign company rather by establishing a local subsidiary company. In that case, the remittance of local PE profits to the head office is not a dividend for the purposes of Art. 10 of the OECD Model.

6. Dividend Tax Systems in an EU Setting

The Community’s competence in the field of dividend taxation is founded upon one legislative measure, namely the Council Directive of 23 July 1990 on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, and the general principles of Community law enshrined in the EC Treaty (and now the EU Treaties) – namely the non-discrimination principle and the guarantee of free movement for persons and capital enshrined in the Treaty.

As matters presently stand, the Community has no direct legislative competence in the direct taxation field. The legislative authority for the Parent-Subsidiary Directive is Art. 94 of the EC Treaty, relating to the approximation of laws of the Member States as directly affect the establishment or functioning of the single market. Within its field of application, the Parent-Subsidiary Directive ensures that dividends paid cross-border within the European Union by subsidiary companies to their parent companies can be paid without withholding tax in the source state and with the benefit of exemption or taxation with credit in the residence state.

Non-Discrimination and the Taxation of Cross-Border Dividends

The exemption may be explicit or implicit in the non-taxation of foreign dividends where credit is given for the underlying foreign tax on the profits from which the dividends are paid.

The OECD Model does not deal specifically with branch profits taxes that are designed to collect the additional tax that a source state would otherwise expect to recover if the investment were made through a local subsidiary rather than a PE. Where a source state does seek to impose such a tax, it may be made subject to specific treaty provisions.


Art. 43 guarantees freedom of establishment throughout the single market and Art. 56 guarantees the freedom of movement of capital and payments within the single market and between Member States and third countries. As this indicates, Art. 56 (alone amongst the Treaty freedoms) is relevant to non-EU countries, although to date the Court has tended to construe Art. 56 in a more restrictive manner in its third-country application. The EC Treaty also guarantees the free movement of goods and workers and the provision of services within the single market. The freedoms are now found in the Treaty on the Functioning of the European Union.

With effect from 1 January 2009, a “parent–subsidiary” relationship is established when one company owns 10% or more of the capital or voting rights of another company.
of the parent company. Outside its field of application, the situation is governed by the general principles of Community law derived from the EC Treaty. In this respect, Member States have been unable to ignore the significant influence that Community law has on their choice of domestic tax legislation, especially in the field of dividend taxation, through the general freedoms guaranteed by the EC Treaty, which require that Member States exercise their direct taxation powers consistently with Community law.20

The EC Treaty enshrines two basic principles that may impact upon the direct taxation measures that Member States choose to implement:

1. Nationality non-discrimination, under which a national measure, i.e. the rules governing a Member State's domestic market (in this context the rules governing the taxation of dividends), may not treat one person less favourably than another on grounds of nationality (or, in this context, tax residence); and

2. The market access principle, under which a measure (in this context a measure designed to tax cross-border dividends) may not impede or restrict the cross-border movement of persons or capital.

The two principles are closely related and the market access principle can be viewed as a judicial development of a single non-discrimination principle recognized by the EC Treaty.21 It is appropriate, however, to recognize market access as a distinct principle for a better understanding of the scope and application of non-discrimination in an EU context.

Nationality non-discrimination has particular relevance in the case of a rule that aims to regulate a Member State's domestic or national market. It requires discrimination in its stricter meaning; i.e. that two persons in comparable positions are treated differently on grounds of nationality. At an early stage, the Court of Justice expanded the application of this principle to prohibit discrimination by reference to any criterion other than nationality (such as tax residence) where the criterion was likely to have the same effect as nationality discrimination.22 Identifying the correct comparator is fundamental to this principle. In a tax context, this usually comes down to whether the Member State subjects both persons to the same tax rights over both in respect of the same item of income, such as dividends.

The market access principle has particular relevance for rules (in this case the tax rules) that affect nationals of a Member State seeking to access the markets of other Member States. Discrimination, in the sense of a direct comparison in the treatment of two persons, is not a necessary feature of a market access breach of the EC Treaty. What matters is whether the effect of the particular rule is to impede or restrict market access. In the tax field this is usually because the rule treats a cross-border situation less favourably than the corresponding domestic situation, so that the rule produces a higher effective tax burden or involves more onerous compliance and greater cost in a cross-border situation.

20. ECJ, 14 February 1995, Case C-279/93, Schumacker, Para. 21.

21. The relationship between the two, and the origins of market access in non-discrimination, is apparent when one considers that an obvious effect of discrimination on grounds of nationality is to impede or restrict entry by non-nationals to a particular market.

22. ECJ, 12 February 1974, Case 152/73, Sotgiu v. Deutsche Bundespost.
In applying Community law principles to particular tax rules, it is important to identify whether the rule in question should be viewed from a host state perspective or an origin state perspective. In other words, does the rule affect inward investment by non-nationals, requiring a host state perspective, or does the rule affect outward investment by a state’s own nationals, requiring an origin state perspective?

Nationality discrimination usually involves a Member State in its capacity as host state; i.e. as the state into whose domestic market a non-national has entered and about which the non-national complains of discrimination vis-à-vis host state nationals in a comparable position. As just noted, in the tax field, the factor that usually underlies the comparison (so that the two can be viewed as being in the same position) is whether the Member State is exercising a comparable taxing jurisdiction for the purposes of the particular tax rule.

The market access principle may affect a Member State both as host state and as origin state. In the direct tax field, however, the market access principle is particularly important because, at an international level, all tax systems necessarily distinguish domestic and international situations. Inevitably, therefore, origin state nationals may be subject to different tax rules according to whether they operate or invest in the domestic or foreign markets.

“Equal treatment” is an expression that perhaps captures better than most the application of these principles. Basically, resident shareholders are entitled to equal taxation treatment in their origin state whether they choose to invest at home or abroad, and inward investors are entitled to equal taxation treatment as domestic investors in any host state. In the case of outward investment, equal treatment does not imply the application of the same tax rules for both domestic and foreign investment. The situations (domestic versus foreign investment) are in fact different, so that a different mode of taxation may be needed. What is important is that the mode of taxing each is such as to eliminate any market access effect of the different treatment, so that the different treatment accorded to each does not produce a less favourable result for foreign investment; in other words to secure equal treatment of the two situations after allowing for the fact that domestic and cross-border situations are different.

In the case of inward investment, equal treatment is more likely to mean the same treatment, i.e. the application of the same rule for domestic and foreign investors, because that is the basis of the comparison being made on the assumption that both are subject to the same host state tax rules. The first direct tax case, on the availability of the French dividend tax credit to foreign insurance companies operating through French PEs, makes this point. At point 14 of its decision, the European Court of Justice (ECJ) said:

Article 43 is thus intended to ensure that all nationals of Member States who establish themselves in another Member State, even if that establishment is only secondary, for the purpose of pursuing activities there as a self-employed person receive the same treatment as nationals of that State...

Accordingly, France’s attempt to exclude PEs and limit the dividend tax credit to French subsidiaries was ruled incompatible with freedom of establishment.

The subsequent ECJ case law illustrates the application of the principles just outlined in both inbound and outbound cases. Thus, it is now well established that Member States may not tax non-resident shareholders who receive dividends from domestic companies more heavily
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than resident shareholders. This does not imply, however, that a Member State that adopts an imputation system must extend the benefit of its dividend tax credit to foreign investors. If the Member State asserts taxing rights over the foreign shareholder by seeking to tax dividends derived from local companies, it must give the foreign shareholder the benefit of the dividend tax credit to put it on a par with domestic shareholders. If the Member State does not assert any taxing right over the foreign shareholder in respect of its dividends, it is not bound to give the benefit of the dividend tax credit, even though the dividend may be subject to tax in the foreign shareholder’s state of residence.

Conversely, Member States may not tax dividends received by their residents from companies based in other Member States more heavily than dividends received from domestic companies. Thus, if a Member State adopts an imputation system under which it gives a dividend tax credit for the corporate tax paid by local companies, it must also give a dividend tax credit by reference to the corporate tax paid by foreign companies. It is immaterial that the corporate tax in the latter case is paid to a foreign Treasury. In Manninen, the European Court had little difficulty in concluding that the Finnish dividend imputation system, in failing to give credit for Swedish corporate tax paid on a foreign dividend derived by a Finnish resident individual, breached Community law, given the function of the imputation system to eliminate economic double taxation in a domestic context.

It is beyond the scope of this paper to consider the Court’s case law on dividend taxation in detail. The important point, in the present context, is that the Court’s case law is directed mainly at the issue of the economic double taxation of corporate profits rather than the issue of the juridical double taxation of corporate or dividend income by two Member States. This is because the Court is concerned with the internal consistency of a single Member State’s dividend taxation system. From a domestic perspective, the principal policy issue of dividend taxation systems, as this paper has explained, is usually to recognize and alleviate to some extent the economic double taxation of corporate profits.

The ECJ recognizes, however, that an impediment to intra-Community trade or investment that arises from the different choices that Member States make as to what to tax or not, and how to tax, is not a market access breach. This is just the natural outcome of leaving each Member State with competence in the direct taxation field rather than it being a matter of Community competence. In other words, the issue of market access breach is one that has to be examined in the context of the direct taxation system of a particular Member State and not by comparison with the direct taxation systems of other Member States.

Thus, the interaction of the dividend taxation systems of two or more Member States may impede or restrict cross-border investment within the European Union. This, however, is not an issue for the Court, on the basis that the Court has no competence to eliminate juridical
double taxation of corporate or dividend taxation. That is a matter that is left to Member States to eliminate by agreement.\textsuperscript{29}

As the earlier analysis indicates, the international tax system functions on the basis that source countries are entitled to tax corporate profits and that residence countries are entitled to tax dividends derived by its residents from those profits. Art. 10(2) of the OECD Model preserves source countries’ taxing rights over the dividend, but in a European context any attempt by the source country to exercise that right must be internally consistent with its domestic tax system. If a source country does not tax domestic dividends, it will not be able to justify the taxation of cross-border dividends by reference to the fact that the residence country may tax the dividend in any event, even if the residence country has recognized the source country’s taxing right under a bilateral treaty.\textsuperscript{30}

The fact that internationally tax systems sanction the economic double taxation of corporate profits and do not grant cross-border dividend tax credits means that a domestic dividend tax system that is either classical in nature or offers partial or full dividend exemption is more compatible with international arrangements. Imputation systems generally discriminate between domestic and foreign investment by failing to grant a dividend tax credit to foreign investors (other than through a bilateral treaty) and offering no dividend tax credit to domestic investors for foreign corporate taxes. The essential problem, as explained above, is that in a single market such as the European Union (or, indeed, the United States), such discrimination is not permitted under the rules of the single market. It is unsurprising, therefore, that imputation systems of dividend taxation do not exist in the United States and that EU Member States have preferred to abandon imputation and to adopt instead classical, exemption or partial exemption systems of dividend taxation, where the tax (if any) levied on dividends is unrelated to the tax (if any) paid on corporate profits (whether domestically or abroad).

7. Conclusion

Based on this analysis, I would suggest the following conclusions on the question of non-discrimination and the taxation of cross-border dividends:

(1) International taxation is firmly based on the taxation of corporate profits by the source state and taxation of dividends by the state of residence of the shareholder. There remain fundamental questions as to whether and to what extent it is possible for countries to maintain in the long term source taxation of corporate profits, and it may already be the case that the effective burden of such source taxes are largely shifted to local factors. Nevertheless, so long as this remains the model for international taxation, economic double taxation of corporate profits will remain at the heart of international taxation. This is not a matter for any treaty non-discrimination principle, but more fundamentally represents the competing taxation claims of source and residence states.

(2) The ECJ case law provides a model for eliminating discrimination that arises from the internal inconsistencies of a country’s dividend tax system in taxing differently both domestic and foreign investors and domestic and foreign investment by the state’s resi-

\textsuperscript{29} See Art. 293 of the EC Treaty.
\textsuperscript{30} See ECJ, 14 December 2006, Case C-170/05, Denkavit Internationaal BV. Source country taxation of dividends on direct investment is in any event prohibited in cases covered by the Parent-Subsidiary Directive.
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dents. The former situation – differential taxation of domestic and foreign investors by the host state – has an obvious application in a treaty non-discrimination context, in requiring the source state to treat investors based in another contracting state in the same manner as domestic investors. The latter situation – different treatment of domestic and foreign investment by a state’s residents – is not so obviously the subject of a non-discrimination rule. There is no reason, however, why as a matter of principle one contracting state should not seek to agree that the other contracting state should not discriminate against investment by its residents in the first state by according equal treatment to the returns to that investment.

(3) In terms of eliminating juridical double taxation of dividend income, the ECJ case law has less to offer. Art. 10(2) of the OECD Model implicitly recognizes the poor claim that any source state has to tax outbound dividends. A non-discrimination principle might at least recognize that any source state taxation of dividend income should be consistent with the state’s domestic taxation system for dividends.

(4) In any discussion of these issues, the question naturally arises as to whether reliance on a separate non-discrimination provision of a treaty is apt, given the explicit provisions of Art. 10 of the OECD Model. Every treaty is and will remain a matter for bilateral negotiation between states by reference to their current and possible future tax systems. In so far as the OECD Model is concerned it would seem more appropriate to deal with the principles underlying the cross-border taxation of dividends, including any non-discrimination principles, within the context of Art. 10 and its Commentary, rather than seeking to develop those principles as part of Art. 24.
Taxation and Non-Discrimination,  
A Reconsideration of Withholding Taxes in the OECD

This article deals with the different concepts of non-discrimination on the basis of nationality in the OECD Model and indirect or covert discrimination in the European Treaties, as interpreted by the European Court of Justice. It discusses the different tax results of both concepts for the distribution of dividends and interest and includes a discussion of a case of distributions by a collective investment fund. It concludes that the divergent application of the concept of non-discrimination is rather justified.

Problems of discriminatory taxation on capital income received or distributed by non-resident taxpayers could be resolved by adding a few recommendations to the Commentary on Art. 24 of the OECD Model and by including some measures against double taxation in the treaty articles related to these specific categories of income.

1. Introduction

1.1. Limitations on the objectives of the OECD Model

The discussion of this subject starts from the assumption that the ultimate goal of the non-discrimination provisions in the OECD Model consists in cross-border fiscal neutrality. From the introduction to this seminar and the contribution by Ruth Mason, it appears, however, that the rules of the present OECD Model are not consistent in achieving this cross-border neutrality. For the incoming and outgoing flows of investment, capital import neutrality (CIN) and capital export neutrality (CEN) are only partially realized and never can be achieved simultaneously.

The non-discrimination principle in the OECD Model is not purely based on CIN, because (1) it allows to a certain degree dissimilar tax treatment of resident and non-resident taxpayers with similar investments in the source country and (2) it does not impose total exemption of the foreign-source income from investment, but leaves the choice of taxing to the country of residence of the taxpayer. On the other hand, the OECD Model is also not purely based on CEN, because (1) it puts limits on taxing rights of source countries and (2) it does not provide for unlimited and fully refundable credits in the country of residence for taxes levied in the country of source.

It is also clear that, for reasons of national tax policy, countries may want to deviate from neutrality in the domestic tax system, to protect domestic investors from foreign competitors or just to keep capital inside the country. The OECD Model is not a pure model: it does not
impose on Member countries full tax neutrality under all circumstances, nor does it impose equal treatment under all circumstances. The objectives of the OECD Model as it stands today are limited on both counts.

1.2. The role of withholding taxes in the OECD Model

The OECD Model does not explicitly refer to withholding taxes. It restricts itself to allocating taxing rights between contracting states without specifying how these taxing rights should be exercised. Allocating taxing rights to the country of source does not necessarily mean that the tax should be levied by way of withholding. As a result, there may be some overlap in the discussion dealing with withholding taxes and the discussion on dividend taxation and the taxation of non-resident taxpayers on a net basis.

1.3. The guiding principles of non-discrimination

The non-discrimination principle under the OECD Model is based on the concept of nationality in the strict sense of the word (i.e. the national legal status of an individual and the national law applicable to companies and other legal entities). Only with regard to the tax treatment of a permanent establishment can Art. 24(3) be interpreted as prohibiting discrimination against non-resident taxpayers owning such permanent establishment. The purpose of this paper is to investigate whether any lessons may be learned for the application of the principle of non-discrimination of the OECD Model, from the case law which the European Court of Justice (ECJ) has developed on the basis of the fundamental economic freedoms in the EC Treaty. On the basis of the EC Treaty and its concept of equal treatment under the law, the ECJ has developed a broader concept of non-discrimination that includes “covert” or “indirect” discrimination, and which is generally considered to prohibit different tax treatment that is based on residence, when a resident and a non-resident taxpayer are deemed to be under the same circumstances. Although amending Art. 24 in the sense of the ECJ case law is not on the agenda, an analysis of that case law may be helpful in re-examining the role of the non-discrimination principle in some specific bilateral or even multilateral cases.

2. Does Residence Equal Nationality?

2.1. Residence and nationality for physical persons

One of the core questions in international taxation is what the distinctive criterion is to determine whether a taxpayer falls within the worldwide tax liability of a particular national tax jurisdiction? The general answer to this question is: the residence of a taxpayer in the territory of a national tax jurisdiction. For a physical person, Art. 3 of the OECD Model makes an attempt to catch the concept of residence in a succession of criteria that reflects the old English saying: “my home is my castle”. That means that the criteria for determining unlimited or worldwide tax liability for physical persons are totally different from the criteria used for determining their nationality. Nationality is determined by birth, by marriage or by choice after a kind of apprenticeship process whereby the candidate of a nationality is tested after a minimal period of residence in the new country of choice. Birth, marriage and choice are not suitable criteria for taxation of worldwide income. With the major exception of the United

2. OECD Commentary on Art. 24(3), Para. 19.
States, nationality is not a criterion that is relevant for the distribution of tax jurisdiction between contracting states. Only in a very subsidiary order may nationality play a role.

This also explains the logic of a prohibition of discrimination on the basis of nationality of physical persons. It is precisely because nationality is to a large extent not relevant in determining the tax jurisdiction, that it cannot reasonably be used as a criterion to make a distinction in tax treatment. Making a distinction on the basis of nationality would be almost as arbitrary as making a distinction based on gender, race or religion. The latter distinctions are prohibited in many cases by national constitutions. Nationality, however, is a relevant criterion to make general legal distinctions, because the world is divided in states to which citizens belong mainly on the basis of nationality. Therefore, a distinct treatment against nationals from other countries may be admitted in many national constitutional orders, because nationality is relevant. In tax, however, it is mostly not relevant and therefore it is justifiable to eliminate nationality as a criterion to make a distinction in taxation, at least between taxpayers who are subject to unlimited or worldwide taxation in the tax jurisdictions of both contracting states.

On the other hand, residence is a relevant criterion for tax purposes because it permits a more efficient control of the taxpayer by the tax administration. Source also provides the administration a handle on taxable transactions that originate in a particular tax jurisdiction. Therefore, the distinctions between limited and unlimited tax liability and between the country of source and the country of residence are quite logical. From the point of view of the taxing authority, residence and source are two very different positions from which to approach a taxpayer, in particular with respect to tax compliance. Since residence is a relevant criterion to make a distinction for tax purposes, it is also a justifiable criterion to make such distinctions. This explains perfectly well why physical persons who are residents of both contracting states can claim the benefits of a tax treaty.

2.2. Residence and nationality for legal entities

For legal entities and in particular for companies, the same question arises and prima facie the answer should be the same. The problem here, however, is that the criteria to determine the nationality and the residence of a legal entity and in particular for companies are quite similar in some jurisdictions but totally dissimilar in other jurisdictions.

For company law purposes, many (mainly common law) countries follow the incorporation doctrine. This doctrine states that the "nationality" or national law that applies to a company is determined by the law applicable in the place of incorporation, which in most cases is identical to the registered seat of the company. This means that the national law of original incorporation remains effective regardless of where in the world the company may establish its headquarters, effective seat of management or any other premises. Like for individuals, this criterion of incorporation cannot be used to determine the jurisdiction for worldwide taxation for a company, because as companies are free to choose their law of incorporation, they would be free to choose their tax jurisdiction.

Civil law countries, however, often apply a different criterion to determine the "nationality" of legal entities in general and companies in particular. They follow the theory of the siège réel, meaning that the nationality of a company is determined by the location where it is effectively established. This concept comes very close to the tax concept of "effective place of management". A prohibition of discrimination based on nationality in such a legal system...
means for legal entities and companies that a different tax treatment based on something like the "effective place of management", e.g. on the place of residence, is prohibited. This is a concept of discrimination that leads to a totally different consequences compared to the concept developed in countries which apply the doctrine of incorporation, as will be illustrated below by the case law of the ECJ.

The "effective place of management" or the "place of effective management" is the ultimate criterion used to determine the residence of a company for tax purposes. This concept indicates that tax law tends to be based on "real" facts, whereas the place of incorporation is just the location of a legal fiction. The effective place of management doctrine provides a series of factual facilities and advantages to national tax administrations for purposes of tax compliance. Although for the great majority of companies the place of incorporation in fact coincides with the effective place of management, the two criteria are totally distinct and do not have any conceptual connection. Therefore, the place of incorporation is not a criterion for the division of tax jurisdiction for legal entities or companies. From this observation it follows quite naturally that nationality in the sense of the law of incorporation is not a justifiable criterion for making distinctions for tax purposes between companies. Hence the prohibition of discrimination on the basis of nationality in Art. 24 of the OECD Model, which also applies to legal entities. Since residence is a relevant criterion for recognizing tax jurisdiction, it also applies to legal entities. Hence the conclusion that residence is a justifiable criterion for making distinctions for tax purposes. This is also the intellectual basis for the way the non-discrimination provision is formulated in Art. 24 of the OECD Model and the way it is explained in the Commentary. However, neither the text of the OECD Model, nor the Commentary, reveals that in many jurisdictions the criteria for determining nationality and residence of legal entities and companies are almost the same. It is no coincidence that this ambiguity came into the open in the ECJ decisions which had to deal with siège réel jurisdictions.

2.3. The concept of nationality in the EC Treaty

2.3.1. Discrimination on the basis of nationality in the EC Treaty

Like the OECD Model, the EC Treaty prohibits discrimination on the basis of nationality. This prohibition of different treatment on the basis of nationality can be found in Arts. 11, 39, 43 and 49 of the EC Treaty. Only Art. 56 of the EC Treaty on the free movement of capital does not mention nationality, because nationality is apparently a notion that is not relevant for cross-border capital movements. There is not one single provision in the EC Treaty that refers to discrimination on the basis of residence. Therefore, a major question, certainly for lawyers from a common law background, is how it is possible that this prohibition of discrimination on the basis of nationality did develop into a prohibition on the basis of residence? The answer in the field of taxation lies in the first case and third case decided by the ECJ on matters of direct taxation: Avoir Fiscal and Biehl.1

4.  ECJ, 8 May 1990, Case 175/88, Biehl.
2.3.2. Identity of nationality and residence for legal entities

In the *Avoir Fiscal* case, the first line of defence of the French government was that the different tax treatment was “based on the distinction between ‘residents’ and ‘non-residents’, which is to be found in all legal systems and is internationally accepted. It is an essential distinction in tax law.” The French government defended the different treatment on the basis of the terms “resident” and “non-resident” as used in tax law.

The ECJ replied to this argument by referring to the concept of nationality as it was used, not in tax law, but in company law:

> It must first be emphasised in that regard that freedom of establishment, which Article 52 grants to nationals of another Member State and which entails their right to take up and pursue activities as self-employed persons under the conditions laid down for its own nationals by the law of the country where such establishment is effected, includes pursuant to Article 58 of the EEC Treaty, the right of companies or firms formed in accordance with the law of a Member State and having their registered office, central administration, or principal place of business within the community to pursue their activities in the Member State concerned through a branch or agency. With regard to companies, it should be noted in this context that it is their registered office in the above mentioned sense that serves as the connecting factor with the legal system of a particular state, like nationality in the case of national persons. Acceptance of the proposition that the Member State in which a company seeks to establish itself may freely apply to it a different treatment solely by reason of the fact that its registered office is situated in another Member State would thus deprive that provision of all meaning.

In referring to the registered office as the connecting factor for the national law applicable to companies in general, like the criterion of nationality for individuals, the ECJ used the same criterion for nationality as the one used in the incorporation doctrine. I.e., the ECJ dealt with the question as discrimination on the basis of nationality for company law purposes and not as a different treatment on the basis of residence for tax purposes. The reason for this view is that Art. 48 of the EC Treaty specifically lists three connecting factors for determining the nationality of companies and not for determining their status as resident or non-resident in a tax jurisdiction. The ECJ cited in the first sentence all various connecting factors determining nationality without distinction. But in the second sentence, it only listed the registered office while referring to nationality. Apparently the ECJ either was unwilling to notice, or oblivious to the fact, that criteria like place of central administration or principal place of business were at the same time connecting factors for nationality in company law but also connecting factors used for determining residence for tax purposes. An important element in that respect was the earlier and well-settled case law on the right of establishment in other areas of law; the ECJ was clearly not willing to make an exception for tax law. After all, in countries which apply the doctrine of the *siège réel* for company law purposes, the criteria of central administration, principal place of business and effective place management are very close to the same criteria determining residence for tax purposes. Therefore it was quite natural that in those tax jurisdictions the decision in *Avoir Fiscal* was afterwards interpreted as a prohibition of different treatment on the basis of residence for corporate income tax purposes. In those jurisdictions, corporate nationality and corporate residence are synonyms. Although this has not been argued very often, discrimination based on the effective seat of...
management (residence) should be considered tantamount to discrimination based on
nationality in siège réel countries.

In a recent important decision on the criteria to be used for the determination of nationality
for company law purposes, the ECJ has confirmed this traditional doctrine: Member States
have the exclusive power to determine in their national law the criteria and conditions for the
nationality of companies and are allowed thereby to choose freely one of the three criteria
listed in Art. 48 of the EC Treaty. This means that a company established under the regime of
the siège réel is not entitled under the EC Treaty to move its central place of management to
another Member State, while maintaining the nationality of its state of origin. It is too early
to judge the impact of this decision on the rights (a) of entities established under the regime
of the siège réel to move their central place of management and thereby change their nationality
to that of the new place of establishment, or (b) of entities established under the law of
incorporation to move their central place of management, while maintaining their nationality
under their state of origin. The only thing that seems certain in this recent decision is that
Member States using the criterion of the siège réel for company law purposes are entitled to
prevent a company from moving their central place of management to another Member State,
while maintaining the nationality of their state of origin for company law purposes. That out-
come does not seem to be unreasonable, because otherwise Member States adhering to the
doctrine of the siège réel would be obliged to accept the incorporation doctrine, whenever a
legal entity would move its central place of management to another Member State and still
wish to continue to operate under the law of its original incorporation. Although the decision
does not have an immediate tax impact, it maintains the traditional cleavage between “incor-
poration” countries and siège réel countries for the determination of nationality for tax pur-
poses.

2.3.3. The concept of indirect discrimination

A second answer lies in the indirect concept of discrimination as it was elaborated for tax
purposes in the Biehl case. This case concerned the application to a tax situation of a much
older decision on discrimination on the basis of nationality in Sotgiu v. Deutsche Bundespost.8
In that case the ECJ decided clearly that, under certain circumstances, a different treatment
based on residence should be equated to discrimination on the basis of nationality:

The rules regarding equality of treatment... forbid not only overt discrimination by reason of
nationality, but also all covert forms of discrimination which, by the application of other criteria of
differentiation, lead in fact to the same result. It may therefore be that criteria such as place of ori-
gin or residence of a worker may, according to the circumstances, be tantamount, as regards their
practical effect, to discrimination on the grounds of nationality...9

This interpretation of the concept of covert or indirect discrimination was confirmed in
Biehl:

Even though the criterion of permanent residence in the national territory referred to in connec-
tion with obtaining any repayment of an over-deduction of tax applies irrespective of the national-
ity of the taxpayer concerned, there is a risk that it will work in particular against taxpayers who

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7. ECJ, 16 December 2008, Case C-210/06, Cartesio.
8. ECJ, 12 February 1974, Case 152/73, Sotgiu v. Deutsche Bundespost.
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are nationals of other Member States. It is often such persons who will in the course of the year leave the country or take up residence there.10

2.3.4. The condition of equal circumstances for resident and non-resident taxpayers

Taken together, both strands of case law firmly established the rule that, depending on the circumstances, a differentiation in the tax treatment solely based on the residence of the taxpayer is tantamount to prohibited discrimination based on nationality.

It is also clear, however, that different treatment of resident and non-resident taxpayers does not always amount to prohibited discrimination on the basis of nationality. Such would only be the case if the resident and the non-resident taxpayer were in the same circumstances. Already in Sotgiu the ECJ made that distinction when it held that, with respect to a separation allowance awarded to postal employees, the postal service was entitled to make a distinction according to whether employees had their residence within the territory of the state or abroad. For workers whose home was within the territory of the state, the allowance was indeed only temporary and bound to an obligation to transfer their residence to the place of employment; while for non-resident employees the allowance was available for an indefinite period, because there was no such obligation to transfer the residence.11 The condition that residents and non-residents should be situated in the same circumstances was confirmed in the field of taxation in Schumacker:

... the fact that a Member State does not grant to a non-resident certain tax benefits which it grants to a resident is not, as a rule, discriminatory since those two categories of taxpayers are not in comparable situations.... The position is different, however, in a case such as the one where the non-resident receives no significant income in the State of his residence and obtains the major part of his taxable income from an activity performed in the State of employment, with the result that the State of his residence is not in a position to grant him the benefits resulting from the taking into account of his personal circumstances. There is no objective difference between the situation of such a non-resident and a resident engaged in comparable employment....12

However, the fact that one taxpayer is a resident and the other taxpayer is a non-resident is in itself also not decisive to conclude that both categories of taxpayers are in different circumstances and can therefore be treated differently. That argument, which was used by the German government in the Saint-Gobain case,13 has been rejected by the ECJ. The Court made a comparison of the circumstances under which dividends received by a domestic company and dividends received by the German branch of a French company had been subject to tax, and came to the conclusion that the branch of the non-resident company and the subsidiary were in a comparable situation and therefore should be treated the same way.14

The two lines of ECJ case law explain why identical wording on discrimination on the basis of nationality under the EC Treaty has resulted in an approach that is radically different from the non-discrimination concept used in the OECD Model. Of course, that different interpretation has had a considerable impact on specific cases of taxation of income from capital and the application of withholding taxes.

12. ECJ, 14 February 1995, Case C-279/93, Schumacker, Paras. 34, 36 and 37.
13. ECJ, 21 September 1999, Case C-307/97, Saint-Gobain, Para. 45.
3. Taxation of Dividends

3.1. Country of source

3.1.1. Distribution to non-resident individual shareholders (without PE)

Generally speaking, it is difficult to draw the line for the taxation of dividends paid to individuals, because there is a wide variety of tax systems (classical system, with progressive or proportional rates; full or partial exemptions from personal income tax; full or partial credits; split rate systems in the corporate income tax, etc.). Although the ECJ has yet to decide a specific case of withholding tax on dividends distributed to a non-resident individual shareholder, it has established in some non-dividend cases that non-resident individual taxpayers should not be taxed on income from capital at a higher rate than resident taxpayers. In these cases the sole rate differential was sufficient to establish the discrimination. There were no considerations as to the relative advantages of taxing net income compared to taxing gross income at a lower rate.

3.1.2. Distribution to non-resident corporate shareholders (without PE)

With respect to the distribution to corporate shareholders, the ECJ has made it clear that it will not tolerate, with respect to the distribution of dividends, a different treatment by the country of source between resident and non-resident shareholders. When there is no withholding tax for dividends distributed to resident corporate shareholders, no withholding tax will be allowed on dividends distributed to non-resident corporate shareholders of other EU Member States. This position remains unchanged even when the bilateral tax treaty provides for such withholding taxes and even when the bilateral treaty provides for a tax credit for such withholding tax in the country of residence, or even when in the country of residence there is a unilateral provision for such credit in the national tax law. When between domestic companies double taxation is eliminated by way of tax credit for the amount of tax withheld on the dividend at the time of distribution, the EFTA Court has held that non-resident parent companies are entitled to the same tax credit as the one applied on distributions to domestic parent companies.

Notwithstanding the fact that ACT was specifically excluded from the notion of withholding tax in the Parent-Subsidiary Directive, the ECJ has held that, when no ACT was applicable on dividend payments between domestic subsidiaries and parent companies, a similar exemption from ACT should apply to dividends paid by a resident subsidiary company to its non-resident parent.

3.2. Distribution of dividends to PEs

When a subsidiary in the source state distributes a dividend to a PE belonging to a company in the state of residence holding the shares in the subsidiary, there is no ironclad obligation under Art. 24(3) of the OECD Model that the source state must apply a tax treatment similar to the tax treatment applied to resident shareholders.

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15. ECJ, 4 March 2004, Case C-334/02, Commission v. French Republic, Fixed levy on income from capital; 9 November 2006, Case C-520/04, Turpeinen, withholding tax on pensions.
16. ECJ, 14 December 2006, Case C-170/05, Denkavit Internationaal; 8 November 2007, Case C-379/05, Amurta.
17. EFTA Court, 23 November 2004, Case E-1/04, Fokus bank ASA.
19. ECJ, 8 March 2001, Joined Cases C-397/98 and C-410/98, Hoechst AG, Metallgesellschaft and others.
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to the one applied between domestic companies (e.g. when there is no withholding tax on dividends distributed between domestic companies, there is no withholding tax on dividends distributed on shares held by a PE). The OECD Commentary states that: “It is for the contracting states which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.” Although the ECJ has not expressed itself on questions of a discriminatory withholding tax applied to the dividends distributed to the PE of a non-resident company, there is little doubt what the outcome would be, since there is a long line of cases that permanent establishments are to be treated in the same way as domestic companies.

When a PE receives, from a third country, dividends on shares connected to the PE in the state of source, in the OECD Commentary, there is again no firm obligation for the state of source to eliminate double taxation by way of credit:

States that cannot give credit... may wish to supplement the provision in their convention... by wording that allows the State in which the permanent establishment is situated to credit the tax liability in the State in which the income originates to an amount that does not exceed the amount that the resident enterprise in the Contracting State in which the permanent establishment is situated can claim on the basis of the Contracting State's convention with the third State.

The “may wish” formulation is far from a firm obligation. Again, there is no case law of the ECJ on this specific question. However, the decision in Saint-Gobain obliging Member States to grant an indirect tax credit for foreign corporate income tax on dividends received by a PE, makes it clear that Member States do have an obligation to also grant a direct tax credit for any withholding tax levied in another Member State, when domestic companies would have the benefit of the same tax credit.

There seems to be no room for convergence between (i) the position of the ECJ, which gives priority to the relationship between the country of source and the country of the establishment of the PE, and (ii) the OECD Commentary, which traditionally gives priority to the relationship between the country of source and the country of residence, ignoring the country in which the PE has been established. In triangular cases the Commentary to the OECD Model sticks to the relationship between the state of source of the dividends and the state of residence of the company. Technically, however, the tax credit of the state of residence is limited to the tax liability of companies resident in the state in which the permanent establishment is located. In many cases the granting of this tax credit is based on provisions for unilateral relief under domestic law of the country of the PE. However, when there is no unilateral domestic tax credit, the OECD Commentary suggests that the credit would legally be incorporated in the tax treaty between the country of residence and the country where the PE is located. This amounts to providing a legal basis for the tax credit on a conventional basis, like the ECJ is suggesting in its case law. For the OECD, however, the treaty between the state of residence and the PE’s state is controlling. In Saint-Gobain, the ECJ seems to refer to the treaty between the country of source of the dividends and the country in which the PE is located. In the perspective of the OECD, the PE derives its rights from the treaty concluded by the country of residence of the company with the country of the PE, while for the ECJ the

22. Case 270/83 Avoir Fiscal; Case C-307/97 Saint-Gobain.
23. 2005 Commentary on Art. 24(3), Para. 52; 2008 Commentary on Art. 24(3), Para. 70.
Frans Vanistendael

PE is entitled to treaty privileges in its own right on the basis of the treaty between the PE country and the source country.

3.3. Country of residence

3.3.1. Distributions to individuals

Dividends received by individuals from distributions by non-resident companies are entitled to the same tax treatment as dividends received from distributions by resident companies. I.e., when there is a tax credit against personal income tax for the withholding tax paid on dividends by domestic companies, such tax credit should also apply for tax withheld on dividends received from abroad. Although the ECJ only dealt with cases of indirect credit for underlying corporate income tax, there is no shadow of a doubt that the ECJ would also strike down any discriminatory treatment resulting from the refusal of a tax credit for foreign withholding tax on dividends received by resident individuals, if such credit were available to domestic-source dividends.

There are limits to what the ECJ can do with respect to juridical double taxation by giving relief for taxes withheld on dividends. In Kerckhaert-Morres the Court held that there was no obligation under the EC Treaty for the country of residence of the shareholder, to give relief for double juridical taxation by way of a tax credit for foreign tax withheld, if such relief was also not granted for domestic-source dividends. The reason for this refusal to act on double juridical taxation, which clearly poses an obstacle to investments in another Member State, was that there was no discrimination – neither in the country of source, nor in the country of residence – and therefore it was impossible for the Court to decide which country should give up its taxing rights. If the country of source applies a withholding tax in a non-discriminatory manner and the country of residence taxes foreign and domestic dividends in the same way, there is no discrimination to point at. In the reasoning of the ECJ, double juridical taxation resulting from the cumulative application of two non-discriminatory tax rules (one in the country of source and another in the country of residence) cannot be eliminated on the basis on the non-discrimination principle of the EC Treaty.

3.3.2. Distributions to companies

Foreign-source dividends received by companies must be treated the same way as domestic dividends, i.e. if there is relief available against double juridical taxation for domestic dividends, such relief must also unconditionally be made available for foreign-source dividends. This has not yet been decided by the ECJ with respect to foreign withholding taxes, but rather with respect to underlying corporate income tax. The reason for this is probably that most Member States either unilaterally or by treaty provide for effective tax credits for foreign withholding tax on dividends paid to resident companies. However, the Court has taken a major decision in FII Group Litigation, indicating that inbound foreign-source dividends should be treated in a similar (but not necessarily identical) way as domestic dividends with respect to double tax burdens. The case dealt with underlying corporate income tax, but it is clear that the ECJ would maintain the same decision in the case of foreign withholding tax.

25. ECJ, 7 September 2004, Case C-319/02, Manninen.
26. ECJ, 12 December 2006, Case C-513/04, Kerckhaert-Morres.
27. ECJ, 12 December 2006, Case C-446/04, FII Group Litigation.
The importance of this case lies in the fact that exemption and credit were held to be two equivalent systems for the elimination of double corporate income tax. When exemption is applied domestically and tax credits are applied to foreign-source income, there is no problem, because withholding tax on dividends will almost always be covered by the amount of tax liability in the corporate income tax. The problem is the reverse situation – when credits would be applied domestically and exemption to foreign-source dividends. There is no ECJ precedent available. For the elimination of underlying corporate income tax, the result could be considered as being equivalent. For foreign withholding tax, however, that would very likely not be the case if the foreign-source dividend were exempt, because there would be no tax liability for the parent company in the country of residence to offset the foreign withholding tax. It is unlikely that the ECJ would intervene, because the statutory text of the Parent-Subsidiary Directive allows both systems to eliminate double taxation and combines an exemption in the country of residence with an abolition of withholding tax in the country of source. However, in cases outside the scope of the Parent-Subsidiary Directive and if the country of source does not discriminate between resident and non-resident shareholders in applying the withholding tax, it is unlikely that the ECJ would intervene, because of its recent doctrine of respecting the separate exercise of tax jurisdictions by Member States in a non-discriminatory way.

3.4. Dividends received and distributed by collective investment funds
3.4.1. Special position of collective investment funds: the Orange European Smallcap Fund decision

Collective investment funds always occupy a special position within the general area of taxation of capital income, because in many tax regimes they benefit from various systems of transparency aimed at neutralizing any intermediary tax between the original source of capital income and the final beneficiary, be it an individual or a legal entity. There are many different ways of exemption and tax credits in which this intermediate tax neutrality can be organized, and therefore it is almost impossible to put forward general conclusions with respect to the prohibition of non-discrimination. However, immediately after the OECD seminar of April 2008 took place, of which this publication is a report, the ECJ has decided the Orange European Smallcap Fund (OESF) case, which gives an interesting indication on how the ECJ intends to resolve at least some of the problems. This case in fact contains two different decisions – one on dividends received by an investment fund and another on dividends distributed by an investment fund.

OESF was a fund established in the Netherlands, where it was subject to a corporation tax at 0%, on the condition that, with a few regulated exceptions, all profits were distributed to its shareholders within a set period of time. When the profits of the fund originated in dividends of Dutch companies, Dutch dividend tax was withheld at source, but the fund was entitled to receive a refund of that dividend tax levied at source. When the profits originated in foreign-source dividends, the foreign tax withheld at source was in principle creditable against the

28. In Case C-307/97 Saint-Gobain, there was a direct credit for foreign withholding tax, but this tax could be offset against the German corporate income tax due on the dividends, because there was no exemption of the dividends or any indirect credit for underlying corporate income tax.
30. ECJ, 20 May 2008, Case C-194/06, Orange European Smallcap Fund.
corporate income tax, but because of the application of the 0% rate, no corporate income tax was due and therefore the credit was not effective. There was no refund of withholding tax.

However, a special tax regime was provided for in Art. 28(1)(b) of the Corporation Tax Law, providing for a concession on account of the amount of tax deducted outside the Netherlands on the yield of the securities, not in excess of the amount of tax which in the case of direct investment by the shareholder would have been deductible on the basis of domestic (Netherlands) tax rules or similar provisions in a tax treaty. This deduction did only apply, however, on the condition that all the income received by the collective investment fund had been distributed exclusively to persons resident in the Netherlands. The idea of this special regime was to put investors in a collective fund in the same position as if they had made a direct investment in the securities in which the fund had made the investment, e.g. to neutralize any tax consequences of the fund as intermediary.

Where the investors having an interest in the fund capital were not exclusively persons resident in the Netherlands, the amount of the tax deduction was reduced by a rate determined by the proportion of shares held by the non-resident shareholders in the total number of shares. The litigation concerned fund income from Germany and Portugal.

Portugal at the time did not have a tax treaty with the Netherlands. Therefore, no credit was available to Dutch resident beneficiaries for the tax withheld on fund income from Portuguese investments. Under the old (1959) tax treaty with Germany, no credit was provided for tax withheld in the source country and therefore the same handicap applied to fund income from German-source investments.

In addition, OESF had investors from Member States other than the Netherlands, and from third countries. As a result, the tax deduction for tax withheld on securities which did qualify for a deduction under the special regime of Art. 28(1)(b), on the basis either of a domestic tax provision or of a treaty provision, was reduced for all shareholders in the fund (residents, non-residents, EU and non-EU, with or without tax treaty), by the proportional share held by non-resident shareholders in the total shareholding of the fund.

OESF challenged both limitations for tax deduction on the basis of the free movement of capital in Arts. 56 and 58 of the EC Treaty.

3.4.2. Discrimination with respect to capital income received by the fund

The first question submitted to the ECJ was whether Arts. 56 and 58 of the EC Treaty prohibit a restriction of the scope of a tax concession granted to a collective investment fund on account of tax withheld at source on dividends distributed in another Member State, to the amount of tax which a natural person, resident in the same state as the investment fund, could have credited on the basis of a tax treaty with the first Member State.

The position of OESF, with the support of the European Commission, was that since under the Netherlands tax legislation tax deducted on dividends distributed by Netherlands companies was reimbursed, such tax also had to be offset for dividends received from German and Portuguese companies. Failure to do so would mean that dividends distributed in Germany and Portugal would be treated less favourable than dividends originating in the Netherlands. Such less favourable treatment makes investment by collective investment funds
in states other than the Netherlands less attractive and therefore constitutes a restriction on the free movement of capital.\(^{31}\)

The ECJ categorically rejected that position on the basis of its holding in *Kerckhaert-Morres*.\(^{32}\) It considered that the Netherlands treated domestic-source dividends and German and Portuguese-source dividends exactly the same way by taxing collective investment funds on those dividends at the same zero rate:

... by not charging fiscal investment enterprises tax on dividends from Germany or Portugal, the Kingdom of the Netherlands treats those dividends in the same way as dividends from Netherlands companies, in respect of which those enterprises are not taxed either. In addition by refraining from taxing dividends from other Member States, the Kingdom of the Netherlands avoids the imposition of a series of charges to tax arising from the exercise of its own fiscal power, just as it does in respect of dividends paid by Netherlands companies.\(^{33}\)

The overarching argument of the ECJ was founded in the parallel and non-discriminatory exercise of national fiscal sovereignty in the source and the residence state:

... Community law does no require a Member State to grant a concession in response to offset the disadvantage resulting from a series of charges to tax that is exclusively due to the parallel exercise of the various Member States' fiscal sovereignty.\(^{34}\)

### 3.4.3. Discrimination with respect to capital income distributed by the fund

The second question submitted to the ECJ was whether Arts. 56 and 58 of the EC Treaty prohibit the reduction of the tax concession granted to a collective investment fund on account of tax withheld at source on dividends distributed in another Member State, in the proportion of the amount of shares held by non-resident individuals or entities in comparison to the total amount of shares held by all shareholders in the investment fund.

The argument of the Dutch tax administration was that the distinction was based on the fact that the two categories of shareholders were not in the same circumstances and therefore could be treated differently. Only resident companies that were shareholders in the fund were entitled to claim credit for foreign withholding tax, while non-resident companies were not entitled to do so. It referred to Art. 58(1)(a) of the EC Treaty permitting Member States, for the application of the free movement of capital, to make a distinction between taxpayers who are not in the same position with regard to their place of residence.

Relying on its holding in *Denkavit Internationaal BV*,\(^{35}\) the Court rejected this position, because it considered that both categories of shareholders (resident and non-resident companies) were in the same situation:

... the Kingdom of the Netherlands taxes dividends which are distributed by a fiscal investment enterprise to its shareholders who are resident or established in the Netherlands as well as to those who are resident or established in another Member State. Therefore, such an enterprise, whose shares are partly held by shareholders resident or established in other Member States, cannot be disregarded as being in a different position from that of another enterprise whose shareholders are resident or established in the Netherlands.\(^{36}\)

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31. Case C-194/06 Orange European Smallcap Fund Paras. 24-26.
32. Case C-513/04 Kerckhaert-Morres Para. 20.
33. Case C-194/06 Orange European Smallcap Fund Para. 35.
34. Case C-194/06 Orange European Smallcap Fund Para. 47.
35. Case C-170/05 Denkavit Internationaal Para. 37.
36. Case C-194/06 Orange European Smallcap Fund Para. 78.
Because collective investment funds with resident and with non-resident shareholders were held to be in the same situation when distributing dividends, the ECJ decided that Dutch tax law could not provide for a reduction of tax credits on shares held by non-resident shareholders:

... as soon as the Kingdom of the Netherlands decided to grant fiscal investment enterprises established within its territory a concession for tax deducted abroad and to exercise its fiscal sovereignty over all dividends distributed by such enterprises to their shareholders, whether resident or established in that Member State or in others, it had to extend the benefit of that concession to fiscal investment enterprises which included shareholders not resident or established in that Member State....

The argument advanced by the Dutch tax administration that the proportional reduction applied to shares held by non-resident shareholders was intended to reflect the difference in tax rate between dividends received by resident shareholders (subject to a higher tax rate) and dividends received by non-resident shareholders, generally subject to the lower tax rate of 15% resulting from tax treaty provisions, was not accepted by the Court. The reduction was not targeted at shareholders resident in tax treaty countries, but hit the collective investment funds across the board, thereby affecting all shareholders, regardless of the applicable tax rate.

Finally it should be mentioned that the ECJ also decided that the same prohibition against restriction of the tax reduction in proportion to the shares held in the fund by non-resident shareholders, also applied to shareholders resident in third countries outside the European Union, because Art. 56 of the EC Treaty specifically provides that the free movement of capital also applies to capital movements with third countries.

4. Taxation of Interest and Royalties

4.1. Absence of significant case law

There is very little ECJ case law with respect to taxation of interest and withholding taxes on interest, and none at all with respect to royalties. However, the fundamental freedoms of course also apply to payments of interest and royalties and therefore the conclusions with respect to dividends can by and large also be applied to payments of interest or royalties, in particular with respect to income received by permanent establishments of companies resident in other Member States. However, issues have been raised in the area of taxation of business income and income from services with respect to the deduction of expenses, which have not yet been raised in the area of passive investment income from interest and royalties. The major issue that has remained moot until now is whether applying a low proportional withholding rate on gross income for non-residents is discriminatory, when residents are taxed progressively, but starting at a zero rate, on net income from investment (e.g. after deduction of expenses). As to the obligation to provide a tax credit to resident taxpayers for foreign tax withheld in the state of source, the ECJ has held in Kerckhaert-Morres that there is no obligation for the state of residence to provide for a credit, if such credit is not available for withholding tax on domestic-source interest.

37. Emphasis provided by author.
38. Case C-194/06 Orange European Smallcap Fund Para. 79.
39. Case C-194/06 Orange European Smallcap Fund Paras. 86-97.
40. ECJ, 12 June 2003, Case C-234/01, Gerritse.
41. Case C-513/04 Kerckhaert-Morres.
4.2. Application of fundamental freedoms

Some rules would without any doubt be considered discriminatory, such as: (1) applying the same tax rate for interest and royalty payments for resident and non-resident taxpayers, but allowing deduction of expenses only for resident taxpayers, (2) applying a low-rate withholding tax to all non-resident taxpayers but excluding from withholding tax interest or royalty payments to domestic business taxpayers or companies, because their interest will be taxed as business income anyway, (3) more generally exempting from withholding taxes payments of interest or royalties to certain categories of domestic taxpayers (e.g. banks, insurance companies, certain investment vehicles), while maintaining such withholding on payments to non-resident banks, insurance companies and investment vehicles, and (4) allowing a tax credit for foreign withholding taxes paid to domestic taxpayers, but not allowing such credit for PEs of non-resident taxpayers receiving the same income.

4.3. Disadvantageous taxation of foreign-source interest

One question which remains unresolved is that of double taxation of foreign-source capital income. The Kerckhaert-Morres case has made it clear that double juridical taxation resulting from the combination of foreign withholding taxes in the state of source and non-discriminatory taxation in the state of residence, does not constitute a violation of the fundamental freedoms.

In Commission v. France, better known as the “Fixed Levy” case, the ECJ dealt with differential tax treatment of interest from domestic sources and foreign-source interest to resident taxpayers. Interest received from various sources by resident taxpayers was subject to rates varying from 15% to 60%, depending on the nature of the income. However, for certain categories of income of which the debtor was a resident of France, taxpayers had the option of electing a fixed levy of 15%. That option was not available for interest due by non-resident debtors. The ECJ held that the exclusion from the levy for interest paid by foreign debtors constituted a violation of the freedom to provide services and the free movement of capital (Arts. 49 and 56 EC Treaty). The Court could not find justifications based on fighting tax avoidance or the necessity of fiscal supervision, and found that there were less cumbersome alternatives to achieve these justified goals of public policy.

4.4. Recharacterization of interest into dividends

Another unresolved problem which may have an impact on withholding taxes is the recharacterization of interest into dividends following the application of transfer pricing rules on excessive interest payments, or thin cap rules on interest paid in case of undercapitalization. The recharacterization of interest into dividends may result in the application of withholding tax at a higher rate in the country of source, when the source country uses the full recharacterization into dividends as a sanction. The ECJ has struck down in a number of cases the application of thin capitalization rules in the country of source and thereby reduced the

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42. Case C-513/04 Kerckhaert-Morres.
43. Case C-334/02 Commission v. France (Fixed levy).
44. ECJ, 12 December 2002, Case C-324/00, Lankhorst-Hohorst; 13 March 2007, Case C-524/04, Thin Cap Group Litigation.
problem considerably. However, in the Interest and Royalties Directive, the Member States have unanimously decided not to apply the Parent-Subsidiary Directive on dividends in cases in which interest paid in a parent-subsidiary relationship is recharacterized as a dividend. This means that in such cases, when recharacterization is permitted under the ECJ case law, the higher withholding tax on dividends can be applied to such interest payments in the state of source. In such cases the standard relief of the Parent-Subsidiary Directive that withholding tax on dividends in the state of source should not apply, is not available. The question remains whether in such a case of recharacterization of interest Member States are justified in applying a tax regime that is clearly more onerous than the general tax regime for dividends prescribed by the Parent-Subsidiary Directive. The answer is not yet known, but is probably “no”.

5. Conclusion

The conclusion of this contribution may be twofold: one on the general principle of discrimination and one on the more specific questions regarding withholding taxes. From the general analysis of the prohibition of discrimination on the basis of nationality, it follows that there are widely divergent interpretations of the same words: “discrimination on the basis of nationality”. That is not very surprising, because the context in which these words are applied is quite different between the European Union and the international community at large. The European Union is an internal market, which imposes certain forms of equal treatment and makes their reciprocal application mandatory, which is certainly not the case in the international community. In view of the many different ways the principle of non-discrimination is applied in the area of taxation within the national constitutional order, this is again not surprising. It points to the conclusion that uniform interpretation and application of the principle of non-discrimination in the European Union and the international community is not only not feasible, but also not desirable, because of the radically different context.

This does not mean that there is no room for improvement and in particular for a more neutral, if not equal, treatment of non-resident taxpayers with respect to the application of withholding taxes and the credit for such tax. One step forward would be to change the recommendation in Paras. 47 and 48 of the Commentary on Art. 24(3) of the OECD Model with respect to the withholding tax on dividends distributed to PEs by a subsidiary in the same state into a binding text in the Model or at least into a binding commitment in the Commentary. The strengthening of this text is nothing else than the consistent application of the literal text of Art. 24(3), which requires that taxes are levied on PEs in a way that is “not less favourable” than the taxes on domestic enterprises.

A similar approach could be applied to Para. 52 of the Commentary on the same Art. 24(3) with regard to tax credits for taxes withheld in a third country on dividends distributed to a PE in the source state. The Model should incorporate such tax credits in the text of the con-

vention, or at least in a firm commitment in the Commentary, if domestic companies benefit from such credits for dividends coming from the same “third” country. Such binding commitments would improve the negotiating position in bilateral tax treaties of those countries striving for a more neutral treatment of withholding taxes on dividends paid to PEs.

It also would help if PEs would be entitled to the lower rates of withholding taxes. That would require, however, that the PE be entitled to claim treaty protection for lower withholding taxes vis-à-vis the third country. It would raise the spectre of treaty shopping through PEs, but spectres are there to be chased and put into their right place.

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48. The revised 2008 Commentary on Art. 24(3) has not been changed on these points in comparison with the 2005 text. The step forward has not been taken – neither with respect to domestic withholding tax on dividends, interest and royalties paid to a PE, nor with respect to a tax credit for dividends and interest sourced in a third state.
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