



APPLICATION AND INTERPRETATION OF ARTICLE 24 (NON-DISCRIMINATION)

Public discussion draft

3 May 2007



CENTRE FOR TAX POLICY AND ADMINISTRATION

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The prevention of discriminatory taxation is an important role of tax conventions. Tax conventions, however, recognize that residents and non-residents are in a different situation and must often be treated differently for tax purposes. For this reason, the principle of non-discrimination has been carefully incorporated in tax conventions through a set of provisions that are found in Article 24 of the OECD Model Tax Convention (which serves as the basis for the negotiation, application and interpretation of tax conventions).

The differences and complexity of modern legal arrangements and tax systems sometimes mean, however, that it is unclear whether a distinction made by a country for tax purposes constitutes a form of discrimination that violates the provisions of Article 24 or a legitimate distinction that is not contrary to these provisions.

This has led Working Party No. 1 on Tax Conventions and Related Questions¹ to examine the interpretation and application of that Article with a view to providing greater guidance in this area. In order to do so, a Working Group composed of delegates of a few countries were invited to examine practical issues that have arisen in the application of the Article and to draft proposals for clarification of the Commentary on Article 24.

This note includes the proposals that have been drafted by that Working Group. The Working Party has decided to seek the views of interested parties at an early stage of the discussion of these proposals and, for that reason, decided to release these proposals as a public discussion draft.

This draft focuses exclusively on issues related to the interpretation and application of the current provisions of Article 24. The Working Party recognizes, however, that some issues, including primarily those listed in the Annex, require a more fundamental analysis of the issue of non-discrimination and taxation which could lead to changes to Article 24. It was agreed that such work would benefit from the input of experts with a different background and should constitute a subsequent project. The Working Party will start consultations on this second stage of its work in the next few months.

Comments on the Report and proposed changes included therein should be sent **before 31 July 2007** to:

Jeffrey Owens
Director, CTPA
OECD
2, rue André Pascal
75775 Paris
FRANCE
e-mail: jeffrey.owens@oecd.org

¹ The Working Party is the sub-group of the OECD Committee on Fiscal Affairs which is responsible for updating the OECD Model Tax Convention.

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APPLICATION AND INTERPRETATION OF ARTICLE 24 (NON-DISCRIMINATION)

A. GENERAL ISSUES

A-1 General comments on the principles underlying Article 24

Description of the issue

1. It has been suggested that preliminary remarks should be included in the Commentary on Article 24 to reflect some basic principles that should guide the interpretation of the various paragraphs of the Article. Such remarks could cover the following areas:

- *Comparability*: although the wording of the various provisions of Article 24 differs, a common theme is that discrimination can only arise when all factors are equal and the different treatment is solely based on the difference that is prohibited by the relevant provision. A different treatment does not automatically result in a violation of these provisions.
- *No better treatment required*: to what extent can the provisions of Article 24 be used to justify a treatment that is better than that of a national or resident?
- *Relationship with other Articles of the Convention*: clearly, what is expressly mandated or authorized by other provisions of the Convention cannot constitute a violation of the provisions of Article 24.
- *Covert or indirect discrimination*: the question has been asked whether and to what extent the non-discrimination provisions of Article 24 can be interpreted to cover not only “overt” discrimination (i.e. a case where the relevant tax measure clearly distinguishes the two categories of taxpayers compared in the relevant provision, such as a tax measure that would treat nationals and non-nationals differently), but also “covert” discrimination (i.e. a case where the relevant tax measure does not directly distinguish between the two categories of taxpayers compared in the relevant provision but may have that indirect effect, such as a measure that, in practice, applies almost exclusively to non-nationals)? In other words, do the provisions of Article 24 cover “indirect” discrimination, e.g. cases where it may be considered impossible for a foreign taxpayer to meet the conditions for a specific tax treatment although the wording of the provision itself does not exclude foreign taxpayers? The issue would be relevant, for example, where a thin capitalisation rule does not expressly deny the deduction of interest paid to non-residents (so as to potentially contravene paragraph 4 of Article 24) but does so with respect to interest paid to taxpayers who are not subject to the most comprehensive tax liability, which is typically the case of non-residents as opposed to residents.
- *The provisions of Article 24 do not address all forms of possible discrimination*: the provisions of Article 24 cover certain specific situations. Apart from these specific cases, different or less favourable treatment is possible. The broader rules against discrimination that are found in other types of conventions have therefore little relevance for purposes of the application and interpretation of Article 24.
- *Most Favoured Nation Principle and reciprocity*: the provisions of Article 24 do not seek to ensure so-called “most-favoured nation” treatment. It has been suggested that this could be recognized in the Commentary, possibly by referring to a principle of reciprocity that would, for

example, prevent the extension of favourable treatment deriving from a regional agreement to which one of the Contracting States, but not the other, is a member.

Conclusions reached by the Working Group

2. The Working Group agreed that it would be useful to clarify, in an introduction to the Commentary on Article 24, that under the various provisions of the Article, discrimination can only arise when all factors are equal and the different treatment is solely based on the difference that is prohibited by the relevant provision. It also agreed that this introduction should provide that Article 24 does not seek to ensure most-favoured nation treatment and is not intended to provide foreign nationals or non-residents with a tax treatment that is better than that of nationals or resident enterprises. Finally, it could also be usefully clarified that what is expressly mandated or authorised by other provisions of the Convention cannot constitute a violation of the provisions of Article 24.

3. The Working Group also agreed that Article 24 does not cover covert or indirect discrimination. The non-discrimination provisions of Article 24 are precisely drafted and do not introduce an all-encompassing non-discrimination rule (see, for instance, the wording of paragraph 1, which recognizes that residents and non-residents are not in comparable circumstances).

4. It was agreed that this should be explicitly stated in the Commentary without suggesting that States are allowed to deliberately circumvent the provisions of Article 24 by disguising what is really discrimination.

5. Based on these conclusions, the Working Group agreed on the following proposed changes to the Commentary on Article 24.

Proposed changes to the Commentary

6. *Renumber the existing paragraph 1 as paragraph 1.4 and add the following paragraphs 1 to 1.3 immediately before it (additions to the existing text of the Commentary are in **bold italics**):*

General remarks

1. This Article deals with the elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay. The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called “indirect” discrimination. For example, whilst paragraph 1, which deals with discrimination on the basis of nationality, would prevent a different treatment that is really a disguised form of discrimination based on nationality such as a different treatment of individuals based on whether or not they hold, or are entitled to, a passport issued by the State, it could not be argued that non-residents of a given State include primarily persons who are not nationals of that State to conclude that a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph.

1.1 Likewise, the provisions of the Article cannot be interpreted as to require most-favoured-nation treatment. Where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State(s) party to that agreement, nationals or residents of a third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention between the third State and the first-mentioned State. As tax conventions are based on

the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of the specific economic relationship between those Contracting States may not be extended to a resident or national of a third State under the non-discrimination provision of the tax convention between the first State and the third State.

1.2 The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. “in the same circumstances” in paragraphs 1 and 2; “carrying on the same activities” in paragraph 3; “similar enterprises” in paragraph 5). Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents (see, for example, paragraph 20 below).

1.3 Finally, as illustrated by paragraph 58 below, the provisions of the Article must be read in the context of the other Articles of the Convention so that measures that are mandated or expressly authorized by the provisions of these Articles cannot be considered to violate the provisions of the Article even if they only apply, for example, as regards payments to non-residents. Conversely, however, the fact that a particular measure does not constitute a violation of the provisions of the Article does not mean that it is authorized by the Convention since that measure could violate other Articles of the Convention.

Paragraph 1

1.4 This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

A-2 Provisions applicable to group of companies

Description of the issue

7. It has been argued that the current wording of paragraphs 1, 3 and 5 of Article 24 could have the effect of requiring a State to extend the provisions of its domestic law that apply to a group of companies (e.g. group relief of losses, consolidation, tax-free transfers between companies of the same group) to cover companies of the group which are not residents of that State.

8. In the context of paragraph 1, comments received from the Business and Industry Advisory Committee to the OECD (BIAC) drew attention to a case where head office expenses, e.g. those of a general and administrative nature incurred for the benefit of a multinational group, are charged on a pro-rata basis among the global affiliates in the group. Country X does not accept such charges as deductible by the local X group affiliate, where the expense is incurred abroad and it is charged by a non-local entity to the local group member. BIAC suggests that this is a clear case of discrimination, where the pro-rated expenses would be deductible if the expenses were incurred locally and charged through a local entity. The application of paragraph 1 to companies, especially in the case of double residence, is obviously relevant in this case. This has led to the question whether, based on the earlier conclusions on the scope of paragraph 1, this paragraph has limited application to regimes applicable to groups of related companies.

9. As regards paragraph 3, the question has been raised in publications whether paragraph 3 may generally require extending the benefits of regimes applicable to groups of related companies to the foreign activities of the enterprise that owns the permanent establishment. Tax experts have suggested restricting consolidation to the territory of each State involved. BIAC pointed out that the use of group (consolidated) taxation concepts have substantially expanded around the world and that in the light of the current work within the OECD on attribution of profits to a permanent establishment, under the so-called “authorized OECD approach” treating a permanent establishment as a separate enterprise, it would follow that a host country permanent establishment should be permitted to join with other affiliated host country entities in whatever group relief is available in the host country.

10. In the context of paragraph 5, it has been argued that the current wording requires a State to extend its domestic law provisions for group companies to a group of companies that includes companies not deriving their status as such from the laws in force in that State. This issue covers national provisions for group of companies which allow consolidation or the transfer of losses, the treatment of inter-company dividends, and tax-free transfers. If the general answer should be “yes”, a closer look at the extent of such a requirement would be necessary. For example, group consolidation might not be required at all under Article 24, might be required cross-border, or might be restricted to the territory of each State involved (e.g., if the parent company is in State A and two daughters in State B, consolidation between the two daughters, but not between those and the parent company, could be possible.).

11. These questions are linked to the meaning of the term “similar enterprises” in paragraph 5. Contrary to paragraph 1, paragraph 5 does not explicitly require that the enterprises must be in the same circumstances. However, the term “similar enterprises” might imply that they should be comparable and that this is not always the case. The term “similar enterprises” might suggest that paragraph 5 is dealing with companies as separate entities only and that as far as transactions between the subsidiary and the parent are concerned, the subsidiary of a domestic parent might not be a similar enterprise. Also, the question has been raised whether or not an enterprise is “similar” if the foreign parent company is not necessarily subject to national taxes on a worldwide basis.

Conclusions reached by the Working Group

12. The Working Group agreed to clarify the effect of the limited scope of paragraph 1 to regimes applicable to groups of related companies by including an example into the Commentary. This would sufficiently deal with this issue taking into account the further proposed changes to the Commentary in respect of paragraph 1. Paragraph 1 may still be applicable to resident companies subject to unlimited taxation who are simply not incorporated in that State.

13. The Working Group agreed to explain in the Commentary that paragraph 3 does not require any extension of domestic regimes for group companies which are restricted to resident companies. The reason for that conclusion is that paragraph 3 only relates to the taxation on the permanent establishment itself, which excludes its application to rules that relate to groups of related companies. As a result, paragraph 3 would neither oblige States to extend domestic group taxation regimes to permanent establishments of foreign companies or domestic companies with a foreign head, nor would it oblige States to take into account losses of a foreign permanent establishment of a domestic company. Paragraph 3 should not give an inappropriate advantage to foreign entities (i.e. it would be inappropriate to allow consolidation of the profits of a permanent establishment, which are taxable in the State where the permanent establishment is located, with the profits of its head office or of a sister non-resident company, which are not taxable in that State).

14. As regards paragraph 5, the Working Group agreed that the new proposed Commentary should clarify that the paragraph is similarly limited to the taxation of the enterprise itself and generally excludes

issues related to the taxation of the group to which the enterprise belongs. Therefore, no consolidation of two subsidiaries of a foreign parent would be required under paragraph 5. However, the Working Group agreed that Delegates may consult with consolidation experts and send written comments as there may be situations where an extension of group regimes would be desired. The issue will be included in the list of issues that might require changes to the Article.

15. Based on these conclusions, the Group agreed on the following proposed changes to the Commentary.

Proposed changes to the Commentary

As regards paragraph 1

16. Add the following new paragraphs 11.8 and 11.9 to the Commentary on Article 24 (the preceding proposed paragraphs 11.1 to 11.7 relate to Issue B-1 below):

[11.3 The following additional examples illustrate these principles:]

[...]

11.8 Example 5: Under the domestic income tax law of State A, companies incorporated in that State or which have their place of effective management in that State are residents of the State and companies that do not meet one of these two conditions are non-residents. Under the domestic income tax law of State B, companies incorporated in that State are residents of that State. The State A-State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident only of the State in which it has been incorporated. The domestic tax law of State A further provides that companies that have been incorporated and that have their place of effective management in that State are entitled to consolidate their income for tax purposes if they are part of a group of companies that have common shareholders. Company X, which was incorporated in State B, belongs to the same group as two companies incorporated in State A and all these companies are effectively managed in State A. Since it was not incorporated in State A, company X is not allowed to consolidate its income with that of the two other companies.

11.9 In that case, even if company X is a resident of State A under the domestic law of that State, it is not a resident of State A for purposes of the Convention by virtue of paragraph 3 of Article 4. It will therefore not be in the same circumstances as the other companies of the group as regards residence and paragraph 1 will not allow it to obtain the benefits of consolidation even if the different treatment results from the fact that company X has not been incorporated in State A. The residence of company X is clearly relevant with respect to the benefits of consolidation since certain provisions of the Convention, such as Articles 7 and 10, would prevent State A from taxing certain types of income derived by company X.

As regards paragraph 3

17. Add the following new paragraph 24.1 to the Commentary on Article 24 (changes to the existing text of the Commentary appear in **bold italics**) :

[24. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

[...]

- c) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.
- d) Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.]

24.1 As clearly stated in subparagraph c) above, the equal treatment principle of paragraph 3 only applies to the taxation of the permanent establishment's own activities. That principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment's own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises. Such rules will often operate to ensure or facilitate tax compliance and administration within a domestic group. It therefore follows that the equal treatment principle has no application. For the same reasons, rules related to the distribution of the profits of a resident enterprise cannot be extended to a permanent establishment under paragraph 3 as they do not relate to the business activities of the permanent establishment (see paragraph 40 below).

As regards paragraph 5

18. *Add the following new paragraphs 57.1 to the Commentary on Article 24:*

57.1 Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership). For example, if the domestic tax law of one State allows a resident company to consolidate its income with that of a resident parent company, paragraph 5 cannot have the effect to force the State to allow such consolidation between a resident company and a non-resident parent company. This would require comparing the combined treatment of a resident enterprise and the non-resident that owns its capital with that of a resident enterprise and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone.

57.2 Also, because paragraph 5 is aimed at ensuring that all resident companies are treated equally regardless of who owns or control their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way (see paragraph 57 above), it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents

but, rather, on the fact that dividends paid to non-residents are taxed differently. A similar example would be that of a State that levies a tax on resident companies that make distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. The fact that the latter exemption would not apply to distributions to non-resident companies should not be considered to violate paragraph 5. In that case, it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is restricted to cases where distributions are made in circumstances where the distribution tax could be avoided.

A-3 Discrimination against one taxpayer or a class of taxpayers?

Description of the issue

19. The test for discrimination can theoretically be applied at the level of the individual taxpayer who is adversely affected, or at the level of his class of taxpayers as a whole. In other words, is it possible to consider that a tax measure does not violate a non-discrimination provision if one particular taxpayer is treated less favourably but other taxpayers in the same group enjoy advantages from that measure?

Conclusions reached by the Working Group

20. The Working Group agreed that the correct interpretation of the provisions of Article 24 is that the comparison should be at the level of the individual taxpayer and not at the level of the class of taxpayers to whom the taxpayer belongs. It did not consider, however, that changes to the Commentary were needed to clarify that this was the correct interpretation of the provisions of the Article.

B. ISSUES RELATED TO PARAGRAPH 1

B-1 Application of paragraph 1 to companies

Description of the issue

21. Paragraph 1 of Article 24 prevents discrimination based on nationality but only with respect to companies “in the same circumstances, in particular with respect to residence”. Under the domestic law of many countries, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for purposes of Article 4. Under the definition of the term “national” in subparagraph *f*) of paragraph 1 of Article 3, however, registration or incorporation will also be the criterion to determine the “nationality” of a company (since a company will usually “derive[e] its status as such from the laws in force” in the State in which it has been incorporated or registered). It is therefore unclear how the residence of a company can be distinguished from its nationality for purposes of paragraph 1 of Article 24.

22. This concern has led some States to question whether paragraph 1 should apply to companies. Paragraph 11 of the Commentary on Article 24 explains that “it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1” (this result is achieved through the definition of “national”). Other States, however, consider

that the other provisions of Article 24 may be sufficient to deal with the discriminatory treatment of companies and that it may be better not to apply paragraph 1 to companies given the risk that paragraph 1 be interpreted so as to prevent different treatment of resident and non-resident companies, a result which would be clearly unintended given that such a distinction is a crucial feature of most tax systems (see, for example, the reservation by France in paragraph 66 of the Commentary on Article 24).

Conclusions of the Working Group

23. The Working Group agreed that the Commentary should be amended to clarify that resident and non-resident companies are not in the same circumstances for purposes of paragraph 1, except where residence is totally irrelevant for purposes of the provision or administrative measure under consideration. The Group agreed that the different treatment of resident and non-resident companies is allowed by paragraph 1 even where residence and nationality are linked through the criterion of incorporation or registration. Paragraph 1 only prohibits a different tax treatment that is based exclusively on the fact that the entity derives its status from the domestic law of another State and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of tax systems (e.g. source based and worldwide taxation are not comparable and withholding taxes that often apply only to payments to non-residents are implicitly allowed under provisions such as Articles 10 and 11); paragraph 1 was never intended to prevent such different treatment. The Group agreed that a few examples should be included in the Commentary to illustrate these conclusions.

Proposed changes to the Commentary

24. *Replace the existing paragraph 11 of the Commentary on Article 24 by the following (changes to the existing text appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

11. In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term "national" in subparagraph ~~f~~ **g**) of paragraph 1 of Article 3.

11.1 By virtue of that definition, in the case of a legal person such as a company, "national of a Contracting State" means a legal person "deriving its status as such from the laws in force in that Contracting State". A company will usually derive its status as such from the laws in force in the State in which it has been incorporated or registered. Under the domestic law of many countries, however, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for the purposes of Article 4. Since paragraph 1 of Article 24 prevents different treatment based on nationality but only with respect to persons or entities "in the same circumstances, in particular with respect to residence", it is therefore important to distinguish, for purposes of that paragraph, a different treatment that is solely based on nationality from a different treatment that relates to other circumstances and, in particular, residence. As explained in paragraphs 3 and 4 above, paragraph 1 only prohibits discrimination based on a different nationality and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of domestic tax systems and of tax treaties; when Article 24 is read in the context of the other Articles of the Convention, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same State

for purposes of the Convention (under the rules of Article 4) are usually not in the same circumstances for purposes of paragraph 1.

11.2 Whilst residents and non-residents are usually not in the same circumstances for the purposes of paragraph 1, it is clear, however, that this is not the case where residence has no relevance whatsoever with respect to the different treatment under consideration.

11.3 The following examples illustrate these principles.

11.4 Example 1: Under the domestic income tax law of State A, companies incorporated in that State or having their place of effective management in that State are residents thereof. The State A-State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Since a company incorporated in State B that would have its place of effective management in State A would be a resident of State A for purposes of the State A - State B Convention, the fact that dividends paid to such a company by a company incorporated in State A would not be eligible for this exemption, even though the recipient company is in the same circumstances as a company incorporated in State A with respect to its residence, would constitute a breach of paragraph 1 absent other relevant different circumstances.

11.5 Example 2: Under the domestic income tax law of State A, companies incorporated in that State are residents thereof and companies incorporated abroad are non-residents. The State A-State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Paragraph 1 does not extend that treatment to dividends paid to a company incorporated in State B. Even if a company incorporated in State A and a company incorporated in State B that receive such dividends are treated differently, these companies are not in the same circumstances with regards to their residence and residence is a relevant factor in this case (as can be concluded, for example, from paragraph 5 of Article 10, which would prevent the subsequent taxation of dividends paid by a non-resident company but not those paid by a resident company).

11.6 Example 3: Under the domestic income tax law of State A, companies that are incorporated in that State are residents thereof. Under the domestic tax law of State B, companies that have their place of effective management in that State are residents thereof. The State A-State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that a non-resident company that is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information is subject to an annual tax equal to 3% of the value of that property instead of a tax on the net income derived from that property. A company incorporated in State B but which is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information cannot claim that paragraph 1 prevents the application of the 3% tax levied by State A because it is treated differently from a company incorporated in State A. In that case, such a company would not be in the same circumstances, with respect to its residence, as a company incorporated in State A and the residence of the company would be relevant (e.g. for purposes of accessing the information necessary to verify the net income from immovable property derived by a non-resident taxpayer).

11.7 Example 4: Under the domestic income tax law of State A, companies incorporated in that State are residents of State A and companies incorporated abroad are non-residents. The State A-State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. Under State A's payroll tax law, all companies that employ resident employees are subject to a payroll tax that does not make any distinction based on the residence of the employer but that provides that only companies incorporated in State A shall benefit from a lower rate of payroll tax. In that case, the fact that a company incorporated in State B will not have the same residence as a company incorporated in State A for the purposes of the A-B convention has no relevance at all with respect to the different tax different under the payroll tax and that different treatment would therefore be in violation of paragraph 1 absent other relevant different circumstances.

B-2 Interpretation of the term “in the same circumstances”

Description of the issue

25. There is some uncertainty as to what are the relevant factors in determining whether taxpayers are in the same circumstances for purposes of paragraph 1. Paragraphs 3 to 8 of the Commentary on Article 24 provide that the phrase refers to taxpayers who are placed, from the point of view of the application of the ordinary taxation laws and regulations, in “substantially similar circumstances” both in law and in fact. The term “substantially” is somewhat unclear, although paragraph 1 provides expressly that a resident and a non-resident are not in the same circumstances.

Conclusions reached by the Working Group

26. The Working Group noted that changes made under other issues would provide some clarification on the meaning of the phrase “in the same circumstances”. It agreed, however, to clarify that taxpayers with limited tax liability are usually not in the same circumstances as taxpayers with unlimited tax liability.

27. Based on this conclusion, the Group agreed on the following proposed change to the Commentary.

Proposed changes to the Commentary

28. *Add the following new paragraph 4.1 to the Commentary on Article 24:*

4.1 The expression “in the same circumstances” can in some cases refer to a person's tax situation. This would be the case, for example, where a country would subject its nationals, or some of them, to a more comprehensive tax liability than non-nationals (this, for example, is a feature of the United States tax system). As long as such treatment is not itself a violation of paragraph 1, it could not be argued that persons who are not nationals of that State are in the same circumstances as its nationals for the purposes of the application of the other provisions of the domestic tax law of that State with respect to which the comprehensive or limited liability to tax of a taxpayer would be relevant (e.g. the granting of personal allowances).

B-3 National treatment versus most-favoured-nation

Description of the issue

29. The question has arisen whether paragraph 1 could allow a national of one Contracting State to obtain benefits granted by the other Contracting State to nationals of third States, for example in the context of regional agreements.

Conclusions reached by the Working Group

30. The Working Group agreed that the wording of paragraph 1 was clearly restricted to national treatment so that it was impossible to argue that the tax treatment, in one Contracting State, of a national of the other Contracting State should not be other or more burdensome than the taxation of nationals of third States in the same circumstances to which benefits may have been granted by reason of their nationality, e.g. through regional agreements. Thus, a resident and national of State A could not argue that paragraph 1 of Article 24 of the State A-State B treaty requires State B to treat him, for tax purposes, in the same way as another resident of State A who is a national of State C.

C. ISSUES RELATED TO PARAGRAPH 3

C-1 Structure and rate of tax for purposes of paragraph 3

Description of the issue

31. Paragraph 36 of the Commentary on Article 24 states that in countries "where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 3 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems". Also, in paragraphs 40 to 43, the Commentary describes the impact of paragraph 3 on a split-rate system and on an imputation system ("avoir fiscal" or "tax credit") and leaves the solution to these problems to bilateral negotiations.

32. The Commentary's description and discussion of the different problems related to the structure and rate of tax should, as a minimum, be updated (e.g. BIAC pointed out that the use of split-rate and imputation systems is in decline). More importantly, however, the issue arises as to whether the reference in paragraph 3 to "taxation on the permanent establishment" extends to the treatment of the enterprise to which the permanent establishment belongs as regards the repatriation or deemed distribution of the profits of the permanent establishment.

Conclusions reached by the Working Group

33. The Working Group agreed to clarify the scope of paragraph 3 of Article 24. The thrust of that clarification is that issues related to various systems for the integration of the corporate and shareholder's taxes are outside the scope of paragraph 3 because paragraph 3 is restricted to the taxation of the profits from the activities of the permanent establishment itself and not to the taxation of the enterprise as a whole. This reflects the Working Group's conclusion that even though paragraph 3 does not use the words "in the same circumstances", the phrase "taxation on a permanent establishment" and the reference to "enterprises, carrying on the same activities" effectively restricts the scope of the paragraph. Since a permanent establishment, by its very nature, does not distribute dividends, the tax treatment of distributions is therefore outside the scope of paragraph 3, i.e. paragraph 3 deals with the realisation of profits and not with the decisions of the company and its shareholders after the realisation of profits concerning, for example, the distribution of these profits. That approach finds support in the second sentence of paragraph 3 which

confirms that tax aspects related to the taxpayer that owns the permanent establishment, such as personal allowances and deductions, are outside the scope of the paragraph.

34. This led the Group to discuss the issue of branch taxation. Branch taxation raises a paragraph 3 issue to the extent that it results in a higher rate of tax being applied to the profits of the permanent establishment than to those of a local enterprise. The Group concluded that a branch tax that is simply imposed as a supplementary rate applicable to the profits of a permanent establishment would indeed constitute a violation of paragraph 3. The Group, however, distinguished such a tax from a tax that would be imposed on amounts deducted as interest in computing the profits of a permanent establishment (e.g. “branch level interest tax”). In that case, the tax would not be levied on the permanent establishment itself but, instead, on the enterprise to which the interest is considered to be paid and would therefore be outside the scope of paragraph 3.

35. The Working Group also agreed to clarify that, for purposes of paragraph 3, the permanent establishment of a foreign enterprise should be compared with a local enterprise that has a similar legal structure as that of the foreign enterprise (e.g. a permanent establishment of a sole proprietorship should not be compared to a domestic company).

36. Based on these conclusions, the Group agreed on the following proposed changes to the Commentary.

Proposed changes to the Commentary

37. *Add the following new paragraph 22.1 to the Commentary on Article 24:*

22.1 It is also clear that, for purposes of paragraph 3, the tax treatment in one Contracting State of the permanent establishment of an enterprise of the other Contracting State should be compared to that of an enterprise of the first-mentioned State that has a legal structure that is similar to that of the enterprise to which the permanent establishment belongs. Thus, for example, paragraph 3 does not require a State to apply to the profits of the permanent establishment of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.

38. *Replace the existing paragraph 36 of the Commentary on Article 24 by the following (changes to the existing text appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

36. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 3 raise, with regard to the rate applicable in the case of permanent establishments, ~~especially difficult and delicate problems, which here too arise from the fact that~~ ***some specific issues related to the fact that*** the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

39. *Replace the existing paragraphs 40-43 of the Commentary on Article 24 by the following (changes to the existing text appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

40.—~~As regards the split rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 3 to extend it to permanent establishments of non resident companies. This attitude is based, in particular, on the view that the split rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is~~

therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate as, generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

41. — This view is, however, disputed. The States in favour of extending the split rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognised that, by the effects of their provisions, such conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split rate system. As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where distributions of profits made can be deducted from the taxable income of a company.

42. — As regards the imputation system ("*avoir fiscal*" or "tax credit"), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 3, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishments. In fact, it has identical effects to those of the split rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the *avoir fiscal* or tax credit. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the *avoir fiscal* or tax credit to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.

43. — Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

40. *Since a permanent establishment, by its very nature, does not distribute dividends, the tax treatment of distributions made by the enterprise to which the permanent establishment belongs is therefore outside the scope of paragraph 3. Paragraph 3 is restricted to the taxation of the profits from the activities of the permanent establishment itself and does not extend to the taxation of the enterprise as a whole. This is confirmed by the second sentence of the paragraph, which confirms that tax aspects related to the taxpayer that owns the permanent establishment, such as personal allowances and deductions, are outside the scope of the paragraph. Thus, issues related to various systems for the integration of the corporate and shareholder's taxes (e.g.*

advance corporate tax, précompte mobilier, computation of franked income and related dividend tax credits) are outside the scope of the paragraph.

41. *In some States, the profits of a permanent establishment of an enterprise of another Contracting State are taxed at a higher rate than the profits of enterprises of that State. This additional tax, sometimes referred to as a “branch tax”, may be explained by the fact that if a subsidiary of the foreign enterprise earned the same profits as the permanent establishment and subsequently distributed these profits as a dividend, an additional tax would be levied on these dividends in accordance with paragraph 2 of Article 10. Where such tax is simply expressed as an additional tax payable on the profits of the permanent establishment, it must be considered as a tax levied on the profits of the activities of the permanent establishment itself and not as a tax on the enterprise in its capacity as owner of the permanent establishment. Such a tax would therefore be contrary to paragraph 3.*

42. *That situation must, however, be distinguished from that of a tax that would be imposed on amounts deducted, for instance as interest, in computing the profits of a permanent establishments (e.g. “branch level interest tax”); in that case, the tax would not be levied on the permanent establishment itself but, rather, on the enterprise to which the interest is considered to be paid and would therefore be outside the scope of paragraph 3 (depending on the circumstances, however, other provisions, such as those of Articles 7 and 11, may be relevant in determining whether such a tax is allowed by the Convention; see the last sentence of paragraph 1.3).”*

C-2 Comparable circumstances for purposes of paragraph 3

Description of the issue

40. Contrary to paragraph 1, paragraph 3 does not provide that the enterprise that is the object of the comparison has to be in the same circumstances as the permanent establishment. All that is required is that the enterprise be "carrying on the same activities". This might imply that a permanent establishment and an enterprise are always in the same circumstances for purposes of paragraph 3.

41. A practical example of the difficulty would be that of a foreign charitable organization carrying on business activities in a State through a permanent establishment situated therein. If that organization did not get the benefits of the tax exemption given to charitable organizations of the State of the permanent establishment, could it obtain that treatment under paragraph 3?

Conclusions reached by the Working Group

42. The Working Group agreed to clarify that regulated and unregulated activities are not the same so that the taxation of a permanent establishment whose activities include the borrowing and lending of money but which is not registered as a bank is not entitled to the same tax treatment as domestic banks since it does not carry on the same activities.

43. As regards the issue of the application of paragraph 3 to charitable organisations, the Working Group concluded that, as regards charitable organisations that would qualify as enterprises of a Contracting State having a permanent establishment in the other State, the effect of paragraph 3 would depend on the particular treatment and regulation of charitable activities for tax and non-tax purposes. For instance, the Group noted that its above conclusion on regulated and unregulated activities would be relevant to the extent that charitable activities are regulated in a country. Similarly, if a country restricted the preferential treatment of charitable activities to activities taking place in the country, the fact that such treatment would not apply to organisations that carry on charitable activities outside the country would not violate paragraph 3. The Group also noted that paragraphs 5 to 8 of the Commentary on Article 24 already deal

with this issue in the context of paragraph 1 and agreed that similar paragraphs might be included in the Commentary on paragraph 3.

44. Based on these conclusions, the Group agreed on the following proposed changes to the Commentary.

Proposed changes to the Commentary

45. *Add the following new paragraph 22.2 to the Commentary on Article 24:*

22.2 Similarly, regulated and unregulated activities would generally not constitute the “same activities” for the purposes of paragraph 3. Thus, for instance, paragraph 3 would not require that the taxation on a permanent establishment whose activities include the borrowing and lending of money but which is not registered as a bank be not less favourably levied than that of domestic banks since the permanent establishment does not carry on the same activities. Another example would be that of activities carried on by a State or its public bodies, which, since they are controlled by the State, could not be considered, for the purposes of paragraph 3, to be similar to activities that an enterprise of the other State performs through a permanent establishment.

46. *Replace paragraph 28 of the Commentary on Article 24 by the following (changes to the existing text of the Commentary appear in **bold italics** for additions and ~~striketrough~~ for deletions):*

28. Also, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

28.1 Finally, the provisions of paragraph 3 should not be construed as obliging a State which accords special taxation privileges to non-profit institutions whose activities are performed for purposes of public benefit that are specific to that State, to extend the same privileges to permanent establishments of similar institutions of the other State whose activities are not exclusively for the first-mentioned State’s public benefit.

C-3 Application of paragraph 3 to specific domestic provisions

Description of the issue

47. Paragraphs 24 to 28 of the Commentary on Article 24 discuss to what extent certain domestic provisions have to be extended to permanent establishments under paragraph 3. These paragraphs provide, for example, that deductions, depreciation and reserves allowable to local enterprises should be extended to permanent establishments insofar as the profits from the activities to which such deductions, depreciation and reserves relate are taxable in that State, options of carrying forward or backward a loss should be made available as regards the loss on the own business activities of the permanent establishment, the same rules should apply with respect to the taxation of capital gains realised on the alienation of assets and tax incentive measures should be extended insofar as the permanent establishment fulfils the same conditions and requirements and is allowed to exercise the activities to which these incentives are applicable.

48. A first question is whether the application of paragraph 3 to other provisions of domestic law should also be discussed. BIAC referred to new technical developments in the tax legislation and tax practices throughout the OECD countries that have the effect of denying certain (usually extraterritorial) deductions to a host jurisdiction permanent establishment. It suggested that legitimate offshore deductions

relative to the host country income earning activities should be unquestionably allowable where they relate to a local permanent establishment.

49. Another question is whether paragraphs 29 to 35 of the Commentary on Article 24, which discuss the application of paragraph 3 to special rules for the taxation of dividends distributed between companies but which indicate that no consensus could be reached on this issue, could be revisited in order to now present an agreed view.

50. Similarly, paragraphs 49 to 54 of the Commentary on Article 24 discuss the extension to permanent establishments of domestic rules granting relief of double taxation in the case of dividends, interest and royalties received from another State. These paragraphs should be reviewed to ensure consistency with the conclusions on the treatment of dividends distributed between companies and to take account of recent changes in the domestic law of some OECD countries.

Conclusions reached by the Working Group

51. The Working Group first concluded that there was no need to expand the list of domestic provisions that are currently analysed in paragraphs 24 to 28 of the Commentary but that it should be clarified, as proposed below, that these paragraphs do not provide an exhaustive discussion of the consequences of paragraph 3. It also concluded that the issue raised by BIAC was more related to paragraph 3 of Article 7 than to paragraph 3 of Article 24.

52. As regards the revision of paragraphs 29 to 35 and 49 to 54, the Working Group decided to invite the Working Party to further discuss these issues in light of the paragraphs below with a view to find a consensus and, if appropriate, change the Commentary accordingly.

53. Paragraphs 29 to 35 of the existing Commentary conclude that there are different opinions on the issue of whether paragraph 3 requires that a “participation exemption” or “indirect tax credit” regime available to dividends received by a domestic company should be available with respect to the dividends received by the permanent establishment of a foreign company. Paragraph 33 concludes that:

In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 3. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

54. Paragraphs 34 and 35 go on to put forward solutions that would address the main problem that would arise from extending the benefits of the “participation exemption” or “indirect tax credit” to permanent establishments, i.e. the loss of the withholding tax on dividends (see below), but these solutions would require changes to the wording of other Articles, in particular Article 10.

55. The Group noted that the main argument put forward in paragraph 31 against extending the benefits of the “participation exemption” or “indirect tax credit” to permanent establishments is the fact that in the case of dividends received by a resident company, a withholding tax may be levied upon a subsequent re-distribution of the dividends by that company, whereas, in the case of dividends received by a permanent establishment, paragraph 5 of Article 10 would prevent the State where the permanent establishment is located from levying such a withholding tax upon a subsequent re-distribution.

56. This appears to be a legitimate practical concern but it is not clear to what extent that is different from the problem arising from branch taxation and the Working Party may therefore want to discuss the issue in light of the proposed conclusions on branch taxation (see section C-1).

57. The Group also noted that paragraphs 29 to 35 do not expressly distinguish between dividends received by a permanent establishment from companies that are resident of the same State or third States. The Working Party may want to discuss whether and to what extent the conclusions should be the same for these two categories of dividends.

58. As regards paragraphs 49 to 54, which deal with extension to permanent establishments of domestic rules granting relief of juridical double taxation in the case of dividends, interest and royalties received from another State, the Working Group concluded that it should be confirmed that paragraph 3 of Article 24 requires States to extend relief of double taxation to permanent establishments but also to clarify that this does not mean that the permanent establishment is entitled to treaty benefits as if it were a resident.

59. Also, the Working Group agreed that since the OECD Model Tax Convention does not allow source taxation of royalties, it would be more appropriate for paragraphs 50 to 52 not to refer to source taxation of royalties but simply to note that the same conclusions apply to other income that may be taxed at source under some treaties.

Proposed changes to the Commentary

60. *Replace paragraph 25 of the Commentary on Article 24 by the following (changes to the existing Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

25. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, ***they do not constitute an exhaustive list of the possible consequences of that principle with respect to the determination of the tax base. The application of that principle may be less clear in the case of*** ~~the same does not always hold good for~~ the tax incentive measures which most countries, faced with such problems as decentralisation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

61. *Replace paragraphs 49 to 52 of the Commentary on Article 24 by the following (changes to the existing Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

E. Credit for foreign tax

49. In a related context, when ***foreign income is included in the profits attributable to*** a permanent establishment ~~receives foreign income which is included in its taxable profits~~, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

50. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B), credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises as to the extension to permanent establishments of the benefit of ***credit provisions included in*** tax conventions concluded with third States. ***Whilst the permanent establishment is not itself a person and is therefore not entitled to the benefits of these tax conventions, this issue is relevant to the taxation on the permanent establishment.*** This question is examined below ***in*** ; the particular case of dividends ~~or~~; interest and royalties being dealt with in ~~paragraph 51.~~

F. Extension to permanent establishments of the benefit of the credit provisions of double taxation conventions concluded with third States

51. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends ~~or~~; interest ~~or royalties~~ from a third State, then the question arises as to whether and to what extent the Contracting State in which the permanent establishment is situated should credit the tax that cannot be recovered from the third State.

52. There is agreement that double taxation arises in these situations and that some method of relief should be found. The majority of Member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3. States that cannot give credit in such a way or that wish to clarify the situation may wish to supplement the provision in their convention with the Contracting State in which the enterprise is resident 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 resident enterprises 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. If the tax that cannot be recovered under the convention between the third State and the State of residence of the enterprise which has a permanent establishment in the other Contracting State is lower than that under the convention between the third State and the Contracting State in which the permanent establishment is situated, then only the lower tax collected in the third State shall be credited. This result would be achieved by adding the following words after the first sentence of paragraph 3:

"When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends ~~or~~; interest ~~or royalties~~ from a third State and the **holding or debt-claim** ~~right or the asset~~ in respect of which the dividends ~~or~~; interest ~~or royalties~~ are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends ~~or~~; interest ~~or royalties~~, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State can claim under that State's convention on income and capital with the third State."

If the convention also provides for other categories of income that may be taxed in the State in which they arise and for which credit should be given (e.g. royalties, in some conventions), the above provision should be amended to also cover these.

C-4 Paragraph 3 and transfer pricing rules

Description of the issue

62. Transfer pricing rules may affect the relationship between a permanent establishment and the rest of the enterprise of which it is part. It could be argued that this results in taxation that is less favourable than that on a domestic enterprise. This raises the question of the relationship between Articles 24, 7 and 9 of the OECD Model.

Conclusions reached by the Working Group

63. The Working Group agreed that since the application of the arm's length standard to the determination of the profits attributable to a permanent establishment is mandated by paragraph 2 of

Article 7, this cannot be considered a violation of paragraph 3 of Article 24, especially since the same arm's length standard would also apply to transactions between a domestic enterprise and a foreign related enterprise. It agreed that this could be usefully clarified in the Commentary, as suggested below.

Proposed changes to the Commentary

64. *Add the following new paragraph 24.2 to the Commentary on Article 24:*

24.2 Also, it is clear that the application of transfer pricing rules based on the arm's length standard in the case of transfers from a permanent establishment to its head office (or vice versa) cannot be considered to be a violation of paragraph 3 even if such rules do not apply to transfers within an enterprise of the Contracting State where the permanent establishment is located. Indeed, the application of the arm's length standard to the determination of the profits attributable to a permanent establishment is mandated by paragraph 2 of Article 7 and that paragraph forms part of the context in which paragraph 3 of Article 24 must be read; also, since Article 9 would authorize the application of the arm's length standard to a transfer between a domestic enterprise and a foreign related enterprise, one cannot consider that its application in the case of a permanent establishment results in less favourable taxation than that levied on an enterprise of the Contracting State where the permanent establishment is located.

C-5 Tax rates applicable to the profits attributable to a permanent establishment

Description of issue

65. To what extent can the State where a permanent establishment is located take into account the profits of the whole enterprise to which the permanent establishment belongs in applying a progressive scale of tax rates? Also, should the tax-free threshold be granted in the State where the permanent establishment is located and in the State of the foreign enterprise? Similarly, in order to be able to compare the tax rate on the permanent establishment's profits with the tax rate of a domestic enterprise, to what extent can the worldwide income of the enterprise (possibly minus the amount of the tax free threshold) be the basis for the application of the progressive tax rate?

66. Another question is which elements are covered by the second sentence of paragraph 3; specifically, whether this sentence allows for the application of tax-free thresholds to residents only.

Conclusions reached by the Working Group

67. The Working Group noted that these issues were already addressed in paragraphs 37 to 39 of the Commentary on Article 24, which recognise that paragraph 3 allows the State where the permanent establishment is located to take account of the overall profits of the enterprise in determining the rate at which the profits of the permanent establishment should be taxed. Whilst a majority considered that the conclusions put forward in these paragraphs were correct and that no changes were needed, others suggested that they appeared to conflict with the Working Group's conclusion that paragraph 3 refers to taxation on the activities of the permanent establishment, not to taxation of the foreign enterprise as a whole (see Issue C-1 "Structure and rate of tax for purposes of paragraph 3").

68. The Group discussed extensively whether such conflict existed. Many delegates considered that paragraphs 37-39 were a logical extension of the principle of exemption with progression recognized in Article 23 on elimination of double taxation: in determining the tax rate applicable to the profits of a permanent establishment, it was logical to take account of the overall ability to pay of a taxpayer, which

could only be determined by taking account of the overall income of that taxpayer. That did not mean, however, that taxation was then applied to profits not attributable to the permanent establishment.

69. Delegates discussed the existing practices of countries in that area. Two specific examples were discussed. First, it was noted that if a taxpayer had two or more permanent establishments in a country, most countries would aggregate the profits of these permanent establishments for purposes of taxation, thereby taking account of at least some other profits of the foreign enterprise in determining the rate applicable for the taxation on a single permanent establishment. Second, it was also noted that many countries would similarly aggregate the permanent establishment profits with those that are taxable without limitation under other Articles (e.g. Article 17) for purpose of determining the applicable rate. Reference was also made to a United Kingdom decision that confirms the principles put forward in paragraphs 37-39 and to the fact that some countries expressly confirm that result in their treaties.

70. It was noted, however, that whilst paragraph 3 did not prohibit States from taking account of the foreign profits of an enterprise in determining the applicable tax rate which is then applied only on the profits of the permanent establishment, it was clear that this could only be done if the domestic tax law provided for that result.

71. As regards tax-free thresholds, the Working Group agreed that whether or not a domestic tax-free threshold is covered by the first or the second sentence of paragraph 3 depends on how that threshold is designed under domestic law. Assume, for example, that a personal tax credit of 2 000 is granted to individuals who have dependent children. In that case, the second sentence of paragraph 3 would prevent a non-resident individual with dependent children who has a permanent establishment to which profits of 2 000 are attributable from claiming that he should not pay any tax in that State. A second example would be where the domestic law provides that the tax rate on the first 10 000 of income of a resident individual taxpayer is 0%, that the tax rate on the subsequent 15 000 of income is 20% and that the rate applicable to the remaining income is 35% but that the rate applicable to non-resident individuals is 25%. In that case, whilst a non-resident individual who has a permanent establishment to which profits of 5 000 are attributable but who has 30 000 of other foreign income could not claim that he should not pay any tax in that State, paragraph 3 would require the application of the domestic tax rates to that individual. The applicable rate would then be determined by taking into account the worldwide income. In the above example, that would mean that since the taxpayer would pay tax of 6 500 if he were a resident, the maximum rate applicable under paragraph 3 is 18.57% (i.e. 6 500/35 000). This conclusion is based on the fact that in the second example, the tax-free threshold is related to the amount of income and not to the civil status or family responsibilities of the taxpayer (second sentence of paragraph 3).²

D. ISSUES RELATED TO PARAGRAPH 4

(see also issue E-1 “Thin Capitalisation rules”)

D-1 Deductions covered by paragraph 4

Description of the issue

72. With certain exceptions, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State and debts to a resident of the other

2. As indicated in paragraph 8 of the Annex, the question of whether EU law might require a different result should be further examined.

Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State.

73. BIAC suggested that a domestic provision under which interest expenses are disallowed as deductions when the underlying borrowing is from a foreign (unrelated) party, as contrasted to the situation in which the borrowing is from a local (unrelated) party is in violation of Article 24. Another case was raised in the context of deferral of taxes. Domestic rules may generally allow deductions when expenses are accrued but allow non-residents such deductions only when the respective payment was paid.

74. Also, the question arises whether paragraph 4 allows a State to take account of the different compliance and administration issues arising in the case of payments to non-residents. This is relevant for countries that have domestic law provisions imposing more or different requirements as regards the deduction of payments made to non-residents. These provisions may have been introduced to avoid tax evasion, especially where there is only limited exchange of information possible and no agreement for assistance in collection.

Conclusions reached by the Working Group

75. As regards the deferral of deductions, the Working Group agreed that different rules as to when expenses may be deducted may be in violation of paragraph 4 (subject to the other requirements of that paragraph).

76. As regards the question of whether paragraph 4 allows a State to take account of the different compliance and administration issues arising in the case of payments to non-residents, the Group noted that paragraph 59 of the Commentary on paragraph 5 already includes a statement that additional information requirements would not constitute a violation of that paragraph and agreed that a similar clarification should be made with respect to paragraph 4. Based on this conclusion, the Group agreed on the following proposed change to the Commentary.

Proposed changes to the Commentary

77. *Add the following new paragraphs 56.1 to the Commentary on Article 24:*

56.1 Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.

E. ISSUES RELATED TO PARAGRAPH 5

E-1 Thin capitalisation rules

Description of the issue

78. The Working Group examined whether and to what extent the current wording of paragraphs 4 and 5 can be interpreted to allow the application of thin capitalisation rules and whether any clarification is necessary in this regard.

79. BIAC has suggested that paragraph 4 allows, in calculating the taxable income of a company resident of a Contracting State, a deduction for interest paid on money owed to another person (assuming, presumably, that it passes the arm's length test) who is resident of the other State. According to BIAC,

although the wording does not specify whether or not the creditor is or is not a related party, it most certainly does not exclude a related party. BIAC thinks that an unequal treatment may arise from the application of certain (artificially tilted) thin capitalisation rules, including the so-called earnings stripping provisions.

Conclusions of the Working Group

80. The Working Group noted that paragraph 56 of the current Commentary already deals with the application of paragraph 4 with respect to thin capitalisation rules:

56. Paragraph 4 does not prohibit the country of the borrower from treating interest as a dividend under its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

81. The Working Group agreed that paragraph 56 was correct but noted that it only deals with thin capitalisation rules that have the effect of recharacterising interest as a dividend. Since some thin capitalisation rules have the effect of disallowing or deferring the deduction of interest rather than recharacterising it as a dividend, it was agreed to modify the paragraph to clarify that it applies more generally.

82. As regards paragraph 5 of Article 24, however, the Group concluded that paragraph 58 of the Commentary should be amended since paragraph 5 would generally not be relevant for most thin capitalisation rules because the direct focus of thin capitalisation rules is not the relationship between an enterprise and the persons who owns its capital (i.e. company-shareholder relationship) but, instead, the payment of interest from a resident enterprise to a non-resident related creditor (debtor-creditor relationship), which would seem to be outside the scope of paragraph 5 since that paragraph addresses discrimination based on foreign ownership of the capital of the enterprise. This was illustrated by the fact that the thin capitalisation rules of most countries would apply to a local company with a local parent that makes interest payments to foreign related companies. Under that view, thin capitalisation rules would generally be outside the scope of paragraph 5 as they would not constitute discrimination based on foreign ownership of the capital of a domestic enterprise but, instead, on the fact that the domestic enterprise has foreign related creditors.

83. The Group also agreed that the Commentary should clarify that even if in cases where thin capitalisation rules apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents, these rules do not violate paragraph 5 to the extent that they result in adjustments to profits that are made in accordance with paragraph 1 of Article 9 or paragraph 6 of Article 11.

84. Based on this conclusion, the Group agreed on the following proposed changes to the Commentary.

Proposed changes to the Commentary

85. *Replace paragraph 56 of the Commentary on Article 24 by the following (changes to the existing text of the Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

56. Paragraph 4 does not prohibit the country of the borrower ~~from treating interest as a dividend under~~ ***from applying*** its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment

results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

86. *Replace paragraph 58 of the Commentary on Article 24 by the following (changes to the existing text of the Commentary appear in **bold italics** for additions and ~~strikethrough~~ for deletions):*

58. Since the paragraph prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise, it would not prima facie be relevant with respect to rules that provide for a different treatment of an enterprise based on whether it pays interest to resident or non-resident creditors. The paragraph is not concerned with rules based on a debtor-creditor relationship as long as the different treatment resulting from the rules is not based on whether or not non-residents own or control, wholly or partly, directly or indirectly, the capital of the enterprise. For example, if under a State's domestic thin capitalisation rules, a resident enterprise is not allowed to deduct interest paid to a non-resident associated enterprise, that rule would not be in violation of paragraph 5 even where it would be applied to payments of interest made to a creditor that would own or control the capital of the enterprise, provided that the treatment would be the same if the interest had been paid to a non-resident associated enterprise that did not itself own or control any of the capital of the payer. Clearly, however, such a domestic law rule could be in violation of paragraph 4 to the extent that different conditions would apply for the deduction of interest paid to residents and non-residents and it will therefore be important to determine, for purposes of that paragraph, whether the application of the rule is compatible with the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 (see paragraph 56 above). Paragraph 5, though relevant in principle to thin capitalisation, is worded in such general terms that it must take second place to more specific provisions in the Convention. Thus paragraph 4 (referring to paragraph 1 of Article 9 and paragraph 6 of Article 11) takes precedence over this paragraph in relation to the deduction of interest. This would also be important for purposes of paragraph 5 in the case of thin capitalisation rules that would apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents. Indeed, since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the Vienna Convention on the Law of Treaties), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.

E-2 Interpretation of the term “other similar enterprises”

Description of the issue

87. Paragraph 5 forbids a Contracting State to give less favourable treatment to an enterprise the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. Neither the Article nor the Commentary, however, states with which resident enterprise it should be compared. Two different interpretations appear possible: to compare it with a domestic enterprise owned by residents or to compare it with a domestic enterprise owned by third-country residents, which would be tantamount to making paragraph 5 a most favoured nation clause. A third view may be that both options are within the scope of paragraph 5.

Conclusions reached by the Working Group

88. The Working Group reached the conclusion that the right comparator for the purposes of paragraph 5 was a domestic enterprise owned by residents but agreed that there was no need to clarify this issue in the Commentary as long as there was no practical reason to do so.

F. ISSUES RELATED TO PARAGRAPH 6

F-1 Application of Article 24 to all taxes notwithstanding Article 2

Description of the issue

89. The question has been raised whether changes to the Commentary should be made to emphasise the fact that Article 24 apply to all taxes and not only income taxes. BIAC suggested discussing the application of Article 24 to such other taxes and levies on the grounds that it would focus attention for all interested parties on the broad scope of coverage of Article 24.

Conclusions reached by the Working Group

90. The Working Group agreed that, in light of paragraph 6 of Article 24, there was no doubt as to the broad scope of the Article and noted that that broad scope will be emphasised by the addition of the examples in proposed paragraphs 11.6 and 11.7 of the Commentary.

ANNEX

ISSUES THAT REQUIRE A MORE FUNDAMENTAL ANALYSIS OF THE ISSUE OF NON-DISCRIMINATION AND TAXATION

1. Should there be changes to the Article to deal with other forms of tax discrimination?

Description of the issue

1. Should amendments be made to Article 24 to deal with other forms of tax discrimination? Some of the suggestions that have been made are:

- A provision along the lines of paragraph 8 of Article 26 of the Belgium-Netherlands treaty, which deals with the right to claim the benefit of the personal allowances which is granted in one contracting State);

8. The right to family allowances deriving from the social security legislation of a Contracting State shall be considered equal, for taxation purposes in the other Contracting State, to the right to family allowances deriving from the social security legislation of this State.

- Addition of a paragraph dealing with cross-border reorganizations (along the line of the following paragraph XIII(8) of the Canada-U.S. treaty:

8. 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.

2. Application of provisions of non-tax agreements to taxation and relationship between Article 24 and such other agreements

Description of the issue

2. A number of non-tax agreements, such as the WTO Agreements (and in particular the GATS) and bilateral investment agreements, include general rules intended to prevent some forms of trade or investment discrimination. Since tax measures may be used as a form of disguised discrimination against foreign production or investment, these provisions sometimes apply to some or all forms of taxation. This creates a potential overlap with tax treaty provisions and, since these provisions are often very broadly

worded, uncertainty as regards their application to some tax measures. Paragraphs 44.1 to 44.7 of the Commentary on Article 25 already deal with some problems created by the provisions of the GATS.

3. BIAC has suggested that the general non-discrimination provisions of these other agreements should be a source of inspiration for extending the scope of Article 24. According to BIAC, the Working Group should

[...] look at other, non-tax, treaties which contain nondiscrimination articles or clauses, e.g., bilateral investment treaties, trade agreements, other bilateral or multilateral agreements, where the concept is applied much more broadly. Article 24 should be contrasted with the “national treatment” and “most favored nation” clauses of these other treaties. The intention should be to provide additional guidelines for determining when a case is to be regarded as discriminatory (either by amending the Treaty language or the Commentary), so that taxpayers can rely on the protection of the nondiscrimination article. We think this would be most instructive, leading, perhaps, to a more reasonable interpretation of nondiscrimination in a tax context.

3. Possible impact of European Community Law on Article 24

Description of the issue

4. European Community law may interact with tax treaties in different ways, which can have an impact on treaties between EC member States and also with non-EC member States.

5. First, courts, primarily in EU States, might be tempted to extend to the interpretation of Article 24 some of the principles elaborated by the ECJ in deciding tax cases related to the four freedoms.

6. Second, it has been argued that Article 24 can result in an indirect application of provisions of the EC-Treaty to residents of non-EC Member State, insofar as the case is covered by the provisions of that Article. The following is an example of this type of argument. Some European States have rules which allow non-resident taxpayers who are nationals of a European State to opt for the tax treatment of residents if their income derived from their territory represents 90% or more of their worldwide income. For instance, a national of Austria who is a resident of the U.S. can opt for such a treatment if he earns at least 90% of his income in Austria. A national of the U.S. being resident in the U.S. and earning at least 90% of his income in Austria does not benefit from such an option. Thus, it could be argued that EU-States that have introduced specific rules for nationals of EEC/EC Member States might be forced to extend these rules to nationals of States with which they have a tax treaty provision corresponding to paragraph 1 of Article 24.

7. Third, it might be useful to consider some of the concepts and arguments developed under European Law, e.g. the concept of justification, when discussing the desirability of alternative or additional non-discrimination rules for tax treaties.

8. Fourth, there might be more technical issues where the impact of European Law on the interpretation of Article 24 is unclear and should be examined. For example, it was suggested that the conclusions reached under section C-5 “Tax rates applicable to the profits attributable to a permanent establishment” and already reflected in paragraphs 37-39 of the Commentary on Article 24 might create a problem for EU member States as European law might restrict their ability to apply these conclusions.

4. Application of paragraph 1 to persons who are not residents of either States

Description of the issue

9. The second sentence of paragraph 1 states that the provision shall also apply to persons who are not residents of one or both of the Contracting States. The principle is also illustrated in paragraph 2 of the Commentary on Article 24. This approach might lead to unwelcome results, e.g., when States make a concession to a third treaty partner based on nationality.

5. Inclusion of paragraph 2 of Article 24 in treaties

Description of the issue

10. Because some countries do not include paragraph 2 in their tax treaties, the question arises whether paragraph 2 should be kept in the Model Tax Convention.

6. Application of paragraph 1 to transparent entities

Description of the issue

11. The application of paragraph 1 in the case of transparent partnerships is problematic. A transparent partnership itself is not taxed and cannot, therefore, claim to be subjected to “any taxation or any requirement connected therewith, which is other or more burdensome” than taxation or requirements to which nationals are subjected. The partner cannot claim that different treatment is based on the fact that the partnership derives its status from the domestic law of another State because due to the definition in subparagraph g) (ii) of paragraph 1 of Article 3 the partnership is regarded as being a national itself (a national cannot base its complaint on the nationality of another non-national).

7. Meaning of “other or more burdensome taxation or any requirement connected therewith”

Description of the issue

12. To what extent do the words “other or more burdensome taxation or any requirement connected therewith” allow some differences of treatment? It may be useful to examine that wording if it is agreed that some differences of treatment can be justified by taking into account the overall treatment of the national of the other State. Some of the questions that relate to that issue are: the impact of paragraph 1 of Article 24 on procedural requirements; the relationship between paragraph 1 and the other provisions of the treaty allowing a State to tax; whether cash-flow disadvantages and the decrease of liquidity constitutes other or less favourable treatment; the impact of paragraph 1 on denials of subventions.

8. Group regime issues related to paragraph 5 of Article 24

Description of the issue

13. Some commentators have argued that it might be appropriate to allow consolidation of profits of a foreign owned or controlled subsidiary, which is taxable in the State where it is located, with the profits of other resident companies of a group. Considering that the State would be able to take into account both the losses and the profits of such subsidiary (since it would tax two resident subsidiaries of the same foreign parent), it may be argued that such subsidiaries should benefit from domestic group regimes.

9. Treaty exemption that depends on VAT liability

Description of the issue

14. The issue was raised whether or not discrimination might arise from a system under which technical fees derived by a non-resident that does not have a permanent establishment in a country may only be found to be exempt under a treaty concluded by that country if the taxpayer agrees that the fees are subject to VAT. Such a rule would deny treaty benefits in case the taxpayer does not pay VAT.

10. Dispute resolution of issues related to Article 24

Description of the issue

15. Since taxpayers can generally claim the benefits of tax treaties in domestic courts, they may convince a court that a tax measure is in violation of the non-discrimination Article even if both States, which are the parties that concluded the tax treaty, disagree. Since most of the provisions of Article 24 are relatively general in their application and since there is some uncertainty as to their exact scope (in particular as regards paragraph 3 and 5), there is a real risk that Courts may strike down a legitimate tax measure as a violation of the non-discrimination Article. This may make some States reluctant to include some or all of the provisions of Article 24 in their bilateral treaties and may make it very difficult to extend the scope of the Article.