BIAC COMMENT ON ARTICLE 24 – NONDISCRIMINATION

30 August 2005

The above article of the OECD’s Model Income Tax Treaty (the Model) provides, in general, that nationals (citizens) of one of the signatory nations (“home country”) shall not be subjected, in the other signatory nation (“host country”), to “any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements” to which nationals (citizens) of such other signatory nation are subjected. The same principle applies to a person resident in either or both countries, to a host country permanent establishment maintained by an enterprise resident in the home country, and to a host country enterprise owned by residents of the home country. The nondiscrimination concept, broadly similar to the concept of “national treatment,” is subject to certain limitations and modifications spelled out in the Model Treaty’s language, which will be mentioned if (and when) relevant to the context of this discussion.

Article 24 has seldom, in our experience, been raised or availed of in practice to challenge specific tax principles, particularly in the business context (generally involving PEs or business enterprises). Therefore, BIAC commends the Committee on Fiscal Affairs (CFA) for its decision to explore this topic at this time, assigning it a high priority and, importantly, involving BIAC at the initial stage. Once it is brought into the public’s eye, it will become better understood and, hopefully, more useful in practice.

In this regard, CTPA prepared a note for Working Party No.1 (WP1) in advance of the February 23, 2005 consultation with BIAC (regarding PE definition: Article 5, inter alia) for the purpose of engaging the assistance of BIAC on this project. In this note, it was specified that the work is to be completed within 12-18 months from January, 2005 (approximately July 31, 2006 at the outside). The project is to be carried out on an urgent basis, and the responsibility for its conduct has been assigned to an ad hoc Working Group on Non Discrimination (the “WG-ND”). The WG-ND’s mandate is to examine technical issues regarding the application of Treaty Article 24, as well as to consider whether or not new (or alternative) rules should be included in the Article (or perhaps the Commentary). The WG-ND met in February (2/21/05), just prior to the consultation with BIAC. It will meet again in late September, 2005.

The OECD note refers to three specific areas related to the interpretation of Article 24, which will be considered in the course of the study, namely:
- Extension of the various group concepts (e.g. consolidation, intercorporate dividends, tax free transfer of assets) to non-resident members of the group;
- Application of branch taxation; and
- Thin capitalization rules (in the context of the relationship to Article 9, transfer pricing).

BIAC agrees that these areas do need to be addressed in the project so that the meaning of nondiscrimination is clear and unambiguous.
BIAC believes that many of the Commentaries need updating, as the existing wording is very complex and oftentimes ambiguous, leaving opportunity for differing, perhaps inconsistent, interpretations by the member countries. This situation inevitably leads to double taxation. We would suggest that the first priority be given to amending the language of the Article itself, then rewording and revising the Commentaries, as required, to remove ambiguous language.

Finally, the WG-ND must consider Article 24 in the broader context of other recent and ongoing OECD projects, and, accordingly, adjust the language of the Article and the Commentaries to reflect the outcome of these projects. At the moment, some of the conclusions reached in the Article 24 Commentaries are obsolete. We provide some specifics in the discussion to follow.

**Attribution of Profit to a PE**

The rules on attribution of profit to a PE have been recently reformulated in a long-standing OECD project that has already consumed 4-5 years and is still ongoing. BIAC has been heavily involved in this work. The pivotal principle of the new approach is that a PE is to be treated as a separate functional entity apart from the remainder of the corporate entity of which it is of part. Accordingly, unequal treatment to a host country PE can no longer be rationalized by reason of it not being a separate host country enterprise (see Commentary Paragraph 23). Under the new interpretation, except for specifically listed inter-branch transactions affected by specifically listed characteristics deemed to be those of the single enterprise (to be discussed by the OECD and BIAC after the re-issuance of Part I), the PE shall be treated as a separate enterprise with respect to all other inter-branch transactions and to all other host taxation rules.

**Technical Trends**

OECD’s work on nondiscrimination must, of necessity, consider new technical developments in the tax legislation and tax practices throughout the OECD nations. Some of these include (a) the decline in use of split rate and imputation systems to avoid double taxation of corporate earnings in favor of a trend toward the general reduction (perhaps elimination) of taxation of dividends in the hands of the shareholders of a corporation; (b) expansion of the use of a branch profit tax; (c) substantial expansion in the use of group (consolidated) taxation concepts around the world; and (d) proliferation of provisions denying certain (usually extraterritorial) deductions to a host jurisdiction PE.

We should note, at this point, that BIAC long ago adopted a position that calls for a general abolition of dividend withholding taxes, either unilaterally or bilaterally by treaty. Our view remains unchanged today, and it is notable that the general trend in treaty dividend withholding taxes seems to be heading in that direction (at least among OECD members). In this connection, we would be most pleased to see Article 24 applied to nonresident dividend withholding taxes as well as to branch profits taxes (which, in effect, is the dividend withholding tax in a PE/HO context). With the diminution of split rate and imputation systems, the preferable manner in which to eliminate double tax on corporate profits in the cross border scenario is to eliminate the dividend withholding/branch profit taxes. BIAC would like to see this accomplished by way of legislation in the host country, but, failing that, it could readily be accomplished by way of bilateral treaties.

In light of the current work on attribution of profits to a PE (mentioned above), under the so called “approved OECD approach” treating a PE as a separate enterprise, it would follow that a host country PE should be permitted to join with other, affiliated host country entities in whatever group relief is available in the host country. In this way, losses/profits arising from host country activities and operations could be combined for tax purposes, a logical result.
Article 24 could certainly be interpreted to treat the failure to allow consolidation of the earnings/losses of a host PE with the result of other group enterprises in that country as an instance of discrimination.

Finally, legitimate offshore deductions relative to the host country income earning activities should be unquestionably allowable, where they relate to a local PE (which is also covered by Article 7), unless such country does not allow such deductions to its own enterprises. This issue is presently covered, to our liking, in the existing Commentary (see paragraph 24).

Other Treaties

BIAC believes that the approach that Article 24 takes to encourage national treatment has been applied somewhat narrowly. For one thing, Paragraph 3 of Article 24 excludes from coverage, under the nondiscrimination principle, "personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it gives its own resident." We believe this to be a very short-sighted and inappropriate approach in today's world.

Also, we would like to emphasize Paragraph 4 of Article 24 which appears, on its face, to allow, in calculating host country taxable income, a deduction of interest expense on debt to a person (assuming, presumably, that it passes the arm's length test) who is resident in the other (home) country. Although the language does not specify whether or not the creditor is or is not a related party, it most certainly does not exclude a related party. Nonetheless, the article has never been asserted, to our knowledge, to treat an earnings stripping provision (or other artificially tilted thin capitalization rule) as discriminatory, although, in fact, it is just that.

BIAC would suggest that WP-ND look at other, nontax, 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 non-discrimination article. We think this would be most instructive, leading, perhaps, to a more reasonable interpretation of nondiscrimination in a tax context.

Other taxes

Paragraph 6 of Article 24 carries out an exception from Article 2 (scope article) by applying the nondiscrimination to "taxes of every kind and description." We bring this to the attention of the WG-ND so they may address such other taxes and levies in their study. We believe this would be a very constructive additional aspect of the project, and it would focus attention for all interested parties on the broad scope of coverage of Article 24.

BIAC canvas

BIAC did conduct a circularization of its own members to elicit their comments and reactions to the availability and use of the nondiscrimination articles of their bilateral tax conventions. (Most of the articles are quite similar, if not identical, to Article 24 of the Model.) We received only limited responses, not because those are no issues in the discrimination area, but because, in our view, most of our members have probably never ever considered their rights under the nondiscrimination articles of their treaties; in fact, many of them are probably unaware of the existence of the article.
(a) Oral Responses
We did get some written feedback, which we will summarize at the close of this letter, obviously on a no-name basis. But, in informal oral discussions among our members, certain key issues arose, which we summarize for your edification, as follows:

- **Article 24, Paragraph 1:** This paragraph is intended to protect “nationals” of the home country from more onerous taxation in the host country than host country “nationals.” An informal comment we received on this issue went something like this: “It is difficult to understand why companies in the same circumstances and operating in the same manner can be discriminated against because they have a different nationality. The non-discrimination article should have a broader meaning or be better understood by the fiscal authorities.”

- **Article 24, Paragraph 3:** This paragraph provides the same treatment for host country PEs and domestic enterprises. The informal comment regarding the paragraph, which more or less reiterates some of the points made above, can be articulated as: “there is a danger that PEs will be discriminated against since they are not in the same situation as domestic enterprises, particularly with regard to payments made abroad. It should be stressed that the tax treatment of PEs under the Model is not so clear in view of the ongoing OECD project on attribution of profits.”

- **Article 24, Paragraph 4:** This paragraph provides for similar treatment to nonresident owners of a host country enterprise on payments thereto of interest, dividends and royalties by such host country enterprise as that accorded to a host country enterprise owned by host country residents. The informal comment on this issue sounds like this: “although the wording of the provision seems to be straightforward, an unequal treatment may arise from the application of certain thin capitalization rules, including the so-called earnings stripping provisions.”

- **Article 24, Paragraph 5:** This paragraph provides similarity in treatment in the host country of a host country enterprise irrespective of residence of its shareholders. The informal comment forwarded to us raises the question: “of whether or not unequal treatment can be justified (e.g., reversal of the burden of proof) if the relevant treaty has an exchange of information article like Article 26 of the Model.”

(b) Written responses
Our canvas turned up some written responses, which raised the following issues under Article 24, which will again be articulated herein on a no-name basis.

- **Deductibility of certain expenses:** In country X, a resident enterprise, which is a recipient of technical assistance services (as opposed to a transfer of technology), may deduct the related cost whether the services are rendered by the party receiving payment therefore or by an intermediary engaged for the purpose, provided that the payee is a host country entity. If the payee is a foreign entity (home country or otherwise), the deduction is denied. This rule seems clearly to run counter to the spirit and intent of Article 24, and it would seem that a strong case can be made under Article 24 for deductibility in the situation in which the deduction is denied.

- **Similar circumstances:** Similar to item (i) above is the case where head office expenses, i.e., those of 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 to the local X group affiliate, where the expense is incurred abroad and it is charged by a nonlocal entity to the local group member. This, again, seems to be a clear case of discrimination,
contrary to Article 24, where the pro rated expenses would be deductible if the expenses were incurred locally and charged through a local entity.

- **Interest deduction:** Under host country legislation, 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. Clearly, this host country provision is a violation of Article 24, paragraph 4.

- **Mergers, spin-offs, etc.:** Provisions permitting tax-free mergers, acquisition, and divestitures exist, we believe, in almost every OECD member state. Our respondent from Country Y pointed out that these provisions are limited to cases in which all enterprises participating in the transaction must be local enterprises. It is our impression that the Country Y rule, which requires local nationality to be a participant in one of these tax-deferred transactions, is the general rule, rather than the exception, among the OECD member states. This situation, although not specifically covered in Article 24, seems to run contrary to the spirit and intent of a concept of nondiscrimination, and it would seem to be a justification for a broader principle of national treatment in the taxation area.

- **Reaction of EU resident:** One of our respondents, located in an EU member state, provided some insight into the EU approach which would be important input for the WG-ND. We were advised that the European Court of Justice (ECJ) has, in tax matters, rendered many decisions where differences in treatment between resident and nonresident were identified. These decisions are based on the European Treaty where discrimination is addressed in a range of articles dealing with freedom of persons, services and capital. Consequently, the ECJ has decided that, basically, any tax rules that draw a distinction between domestic and non-domestic taxpayers is forbidden.

Examples of this in the ECJ include the following:
- Payments made to a pension fund in a foreign country are not deductible whereas they are if made to resident fund;
- Costs incurred by shareholder with respect to nonresident subsidiaries are not deductible whereas they are if incurred by resident subsidiaries; and
- Credits on dividends received from foreign company are not allowed against domestic source income whereas they are if received from resident companies.

By reason of the trend of globalization, the WP-ND should seriously consider the developments within the EU with a view to a revision of Article 24, which would reflect the EU approach. Nondiscrimination should mean just that, none whatsoever!

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BIAC appreciates this opportunity to express our preliminary views on this topic. We also appreciate our involvement at this early stage of the project. We look forward to a continuing exchange of views, perhaps in greater detail, as the project moves forward over the next year or so.

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