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NON-DISCRIMINATION IN BILATERAL TAX CONVENTIONS

(Note by the Chairman)

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I. INTRODUCTION

1. The purpose of this paper is to explain the non-discrimination obligation contained in bilateral tax conventions. Most such conventions are patterned on the OECD *Model Tax Convention on Income and on Capital* (the "Model") prepared by the Committee on Fiscal Affairs and recommended to OECD Member countries by the Council. The Model contains provisions designed to prevent double taxation and tax avoidance and evasion as to taxes covered by the Model and to prevent discrimination as to all types of taxes (direct and indirect) imposed at all levels of government. In this way the Model promotes the expansion of international trade and investment.

II. THE SCOPE OF NON-DISCRIMINATION OBLIGATIONS IN THE MODEL

2. Non-discrimination obligations under the Model obligate the Contracting States to provide no less favourable taxation (1) of a national of the other State in similar circumstances, recognising that residents and non-residents are not in the same circumstances; (2) of stateless persons who are residents of either State; (3) of a permanent establishment located in a state carrying on the same activities as domestic enterprises of that State; (4) as to the tax deductibility of otherwise deductible business expenses when paid to a non-resident; and (5) of foreign owned or controlled domestic enterprises. These obligations apply to taxes of every kind and description (that is, to all direct and indirect taxes) levied by, or behalf of, the State, its political subdivisions or local authorities.

3. Thus, the non-discrimination provision under the Model would provide national treatment covering all types of taxes to enterprises with a significant presence, i.e., through a local subsidiary of "permanent establishment" (essentially a branch that conducts substantial activity locally) in a Contracting State. The provision would also provide national treatment regarding the deductibility of payments made to foreign persons, thereby indirectly protecting non-resident investors.

4. The Model does not include obligations of most-favoured-nation (MFN) treatment for several reasons. First, no two tax systems are the same, and each tax convention is specifically tailored to the differences between the two tax systems covered by the convention. Applying a particular tax convention to residents of third countries could lead to unbalanced results and to situations where the same income is taxed twice or not at all. Second, undertaking MFN obligations regarding taxes could favour investors from tax haven countries.

III. NONDISCRIMINATION OBLIGATIONS IN TAX CONVENTIONS DIFFER FROM THOSE CONTAINED IN INVESTMENT AGREEMENTS

Resident/non-resident distinctions

5. The non-discrimination obligations in tax conventions differ from those in typical investment agreements because they allow distinctions that would be prohibited in investment agreements. For example, investment agreements often include broad national treatment obligations that cover portfolio, ad well as direct, investment. By contrast with investment agreements, the non-discrimination provisions of tax conventions do not protect non-resident portfolio investors. Issues regarding portfolio investors are handled comprehensively and carefully in various other provisions of tax conventions, such as those dealing with interest and dividends.

6. The more limited non-discrimination obligations in tax conventions reflect the practical problems of cross-border taxation. For example, countries frequently collect taxes from non-residents through a system of withholding at source. Withholding is most frequently imposed on passive income, such as dividends, interest, rents, and royalties. Because the recipient may have no connection with the country of source other than the investment generating the income, withholding at the time of payment is likely to be the only realistic opportunity for the source country to collect its tax. Withholding is often not required on payments to residents. However, the application of withholding tax systems is appropriate. Residents have substantial economic connections with their country of residence; so that country is likely to have ample opportunity to collect its tax later, when a tax return is filed. Non-residents may be beyond the collection jurisdiction of the taxing country.

7. Further, withholding tax rates do not necessarily approximate the progressive income tax rates imposed on the net income of residents receiving the same types of income. While residents are taxed on world-wide income, most taxing jurisdictions tax non-residents only on income source within the taxing jurisdiction; it is appropriate that rate structures reflect this distinction. Even if an attempt were made to equate effective tax rates under withholding regimes with effective tax rates on residents an accurate comparison of the two would be extremely difficult.

8. The more limited non-discrimination obligations of tax conventions are a practical and appropriate response to the factual differences in the circumstances of residents and non-residents.

Other distinctions

9. The resident/non-resident distinction applied in the Model is clear-cut; other distinctions permitted under the Model are more subtle. In conjunction with other Model provisions, the non-discrimination obligations under the Model accommodate measures taken by countries to ensure that foreign-owned or controlled companies do not unjustifiably narrow their tax base through related-party transactions. One such unacceptable practice involves the removal of profits from the taxing jurisdiction of the country where the subsidiary is located by funding the subsidiary mainly with debt and deducting large interest, payments paid to tax haven companies. For example, a company in State X provides $100 billion to a tax haven company in State Y that provides a loan of $100 billion to the first company. The State X company deducts the “interest” paid on the loan from its taxable profits, thereby reducing the State X tax base; the tax haven company is likely to pay little or no tax on the interest it receives.

10. The tax regimes described here, the first (withholding taxes) involving a non-resident portfolio investor and the second (thin capitalisation) involving a resident subsidiary of a foreign investor, do not create investment distortions. Rather, prohibiting the use of these measures would be quite likely to create

investment distortions through tax-motivated investment. Prohibiting their use could also mean that investors that do not utilise tax haven companies are worse off than those that do, because, as opposed to the latter, the former do have to pay their taxes.

IV. RELATIONSHIP OF NON-DISCRIMINATION OBLIGATIONS TO OTHER TAX TREATY PROVISIONS

11. The non-discrimination obligations in the Model are incorporated into comprehensive income tax conventions, rather than in other types of agreements, for several reasons. As part of a tax convention, non-discrimination protection for some types of investors is joined with tax rate reductions for others, thereby protecting investors comprehensively. This approach also reduces the risk that the non-discrimination obligations could be utilised by a tax haven country with which a treaty relationship would not be appropriate. Further, the interaction of the non-discrimination and other provisions of tax conventions, including provisions on payments between related parties, helps to ensure the appropriate taxation of payments made by foreign-owned or controlled corporations.

V. EFFECT OF THE MODEL

12. The Model is the subject of a Recommendation of the OECD Council, the governing body of the OECD. While Member countries are not legally bound to adopt and apply the provisions of the model, they have a political commitment to adhere generally to its text and not deviate from it without good cause. Member countries have entered formal Reservations to provisions of the Model that they do not intend to follow. The authority of the Model extends far beyond the OECD area. It is widely used in negotiations that OECD Member countries hold with non-Member countries, and even, in negotiations between non-Member countries. The UN Model non-discrimination provision is essentially the same as the OECD Model.

VI. NON-DISCRIMINATION IN NETWORK OF BILATERAL INCOME TAX TREATIES

13. The network of tax conventions between OECD members is almost complete. Most of these conventions contain non-discrimination provisions along the lines of the Model. Some OECD Member States deviate from Article 24 of the Model in some of their bilateral tax conventions. For example, deviations my occur in non-discrimination obligations regarding permanent establishments. Often these deviations accommodate different regimes in the Contracting States as to the tax treatment of a permanent establishment.

VII. DISPUTE SETTLEMENT UNDER TREATY NON-DISCRIMINATION PROVISIONS

14. Under Article 25 of the Model, a procedure that is included in almost all bilateral tax conventions confers legal rights directly on taxpayers. A taxpayer may make formal complaints about perceived violations of the Convention, including non-discrimination provisions, to the “competent authority” (usually senior officials of the Ministry of Finance) of his country of residence. As an alternative, the taxpayer may utilise the domestic court system in the country imposing the tax at issue. Also, while not yet used, some recent bilateral tax conventions contain arbitration provisions. Taxpayers are utilising the competent authority process or the domestic court system; and the overwhelming number of cases are being resolved this way.

ANNEX I. SCOPE OF THE NON-DISCRIMINATION ARTICLE

Paragraph 1 of Article 24 of the OECD Model provides:

> Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article I, also apply to persons who are not residents of one or both of the Contracting States.

Paragraph 2 of Article 24 of the OECD Model extends these benefits to stateless persons who are residents of one of the Contracting States.

Paragraph 3 of Article 24 provides that a permanent establishment in a Contracting State must be treated no less favourably than a domestic enterprise carrying on the same activities. This protection does not extend to personal allowances and benefits based on civil status or family responsibilities.

Paragraph 4 of Article 24 requires that payments (of interest, royalties and other disbursements) made by an enterprise of a Contracting State to a resident of the other Contracting State be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State, conditioned on treaty norms for the tax deductibility of payments between associated enterprises.

Paragraph 5 of Article 24 obligates a Contracting State not to subject an enterprise that is owned or controlled, directly or indirectly, by one or more residents of the other contracting State to more burdensome taxation and connected requirements than that imposed by other similar enterprises of the first-mentioned State.

Paragraph 6 of Article 24 applies the non-discrimination obligations to taxes of every kind and description, whether or not otherwise covered under the treaty.