

## Chapter 2

# The General Agreement on Trade in Services

### 2.1 Overview

The provision of services is an integral part of global trade. When services are provided across international borders both trade and tax agreements may apply. International trade agreements typically include non-discrimination obligations agreed to by the signatory states that apply generally in the treatment of a non-resident. Tax measures create more complex issues in the application of non-discrimination principles and are therefore often carved out of trade non-discrimination obligations. That means that bilateral tax treaties often govern these issues, not trade agreements. When services are provided by a tax resident of one country to a tax resident of another, the applicable non-discrimination obligations will therefore in large part depend on which trade agreement or tax treaty applies and how they interact. The applicable trade agreement may be multilateral, regional or bilateral. Tax treaties are almost always bilateral.

This chapter begins the discussion of the non-discrimination obligations that apply to the trade in services with an examination of the multilateral World Trade Organization Agreement. As the WTO was the first global agreement to address non-discrimination obligations for trade in services, the issues raised in the negotiations leading up to the final draft of this agreement as they relate to direct tax matters also provides useful background for understanding how tax measures are addressed in the regional and bilateral free trade agreements that follow.

The chapter begins with an overview of the principal non-discrimination obligations found in the General Agreement on Trade in Services (GATS), including the national treatment and most favoured nation obligations that a Member must accord to the services and service providers of other Member States with respect to measures covered by the agreement. It then examines the exceptions to these obligations, in particular those that relate to direct tax measures.

In practice, the GATS non-discrimination obligations are often inapplicable where the two Member States have entered into a tax treaty. While the GATS provides general non-discrimination obligations, Member States may not challenge an alleged violation in respect of “matters that are the result of, or fall within, the scope of an agreement on the avoidance of double taxation (‘tax treaty’).” There are currently over 3000 bilateral tax treaties in force between Member States based on either the Organization for Economic Co-operation and Development (OECD) Model Tax Convention<sup>1</sup> or the United Nations Model Tax Convention. A discussion of the provisions of these Model Tax Treaties that impact non-resident service providers including the tax treaty non-discrimination obligations follows.<sup>2</sup> These tax treaty provisions are important in understanding both the scope of a typical tax treaty and how the national treatment and most favoured nation obligations under the GATS are affected by a tax treaty. They also provide the framework for understanding the specific tax treatment of a non-resident providing services to, or earning income in, another Member State.

Since the GATS effectively excludes a challenge with respect to the national treatment obligation if the measure falls within the scope of a tax treaty, the non-discrimination provisions in the tax treaty may be the only applicable non-discrimination principles upon which the non-resident service provider may rely. The tax treaty non-discrimination principles are therefore examined against the non-discrimination obligations found in the GATS.

Finally, the chapter comments on the potential for differing non-discrimination obligations among WTO Members as a result of the interaction between the GATS and tax treaties based on the OECD and UN Model Tax Treaties entered into between Member States.

## 2.2 Non-discrimination and Trade Agreements: The World Stage

The 1990s witnessed the first significant global cooperation to facilitate the cross-border trade in services. The GATS came into force on January 1, 1995 as part of the Agreement Establishing the World Trade Organization (WTO) with some 127<sup>3</sup>

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<sup>1</sup>The discussion also includes the non-discrimination obligations in the United Nations (2011), which are substantially similar to those found in the OECD (2014).

<sup>2</sup>The OECD and UN Model Treaty non-discrimination obligations are viewed as integral to the study as these are the provisions upon which most bilateral tax treaties are based.

<sup>3</sup>As of July 14, 2016 this number has now expanded to 163 Member governments accounting for over 90% of the world's trade. WTO (2016), online: WTO [https://www.wto.org/english/thewto\\_e/whatis\\_e/tif\\_e/org6\\_e.htm](https://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm).

initial Members<sup>4</sup> and laid the groundwork for most favoured nation and national treatment obligations for services and service providers on a global scale.

The immediate discussion focuses on the GATS, particularly the provisions of the GATS that affect service providers and tax measures. An examination of the OECD and UN Model Tax Treaties, including the specific provisions that impact the cross-border trade in services and the tax treaty non-discrimination provisions follows.

## ***2.2.1 The General Agreement on Trade in Services (GATS)***

### **2.2.1.1 Overview**

The GATS marks the first global attempt to establish a multilateral understanding and agreement covering trade in services. The agreement entrenched major trade obligations for Member States including the obligation to accord most favoured nation and national treatment to the services and service suppliers of other Member States. This was an important and highly significant step forward in the international arena to liberalize the trade in services.

The most favoured nation obligation in Article II of the GATS requires that with respect to any measure covered by the GATS that each Member “shall accord immediately and unconditionally to services and service providers of any other Member, treatment no less favourable than that it accords to like services and service providers of any other country.” The national treatment obligation requires that each Member “shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers.”<sup>5</sup> As

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<sup>4</sup>Further negotiations unfortunately ground to a halt in the Doha Round. A number of countries including Canada, the United States, Mexico, Switzerland, Japan, Korea, Hong Kong, Australia, and the European Union are negotiating a new international instrument to further liberalize trade in services. The instrument will be called the Trade in Services Agreement (TISA). Parties to the negotiations are responsible for some 70% of global services trade. The TISA negotiations were borne out of the frustration felt by certain WTO Members when negotiations to liberalize services trade became a casualty of the stalled Doha Round of WTO negotiations. The TISA is to be negotiated outside of the WTO by a subset of WTO Members committed to services trade liberalization. Expectations for the TISA are that it will reflect new types of services that have emerged since the WTO’s GATS (1995) was negotiated some 20 years ago, lock-in liberalization undertaken unilaterally by parties since the GATS came into force, and expand commitments among the parties on market access and non-discrimination.

<sup>5</sup>The GATS, Article XVII.

originally envisioned, these non-discrimination obligations would have applied to all measures under the GATS, including both direct and indirect tax measures to the extent that they affected trade in services. However, as will be seen, the national treatment obligation would remain subject to negotiation and both the national treatment and most favoured nation obligations were made subject to qualifications and exceptions, in particular with respect to direct tax matters.

The GATS applies to all WTO Member countries. The final Agreement consists of “a framework text setting out general multilateral rules governing trade and investment in services”<sup>6</sup> plus a series of annexes and understandings that deal with such matters as the movement of personnel, transport, financial and aviation services and access to telecommunication networks.<sup>7</sup>

The GATS covers four basic modes of service delivery:

1. cross-border services supplied from the territory of one party to the territory of another (e.g., cross-border software support);
2. services supplied in the territory of one party to the consumers of any other (e.g., tourism);
3. services provided through the presence of service-providing entities of one party in the territory of any other (e.g., banking); and
4. services provided by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member (e.g., construction projects or consultancies).<sup>8</sup>

The scope and coverage of the GATS is reliant on basic definitions about who is a service supplier and what is considered a measure “affecting trade in services.”<sup>9</sup> Specifically, the GATS applies to measures by Members “affecting”<sup>10</sup> trade in

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<sup>6</sup>See Broadman (1993).

<sup>7</sup>The GATS.

<sup>8</sup>The GATS Article I at para 2.

<sup>9</sup>WTO (1997b), WTO Doc WT/DS27/R/USA at para 7.285 [EC Bananas Panel Report] defined the scope of application of the in the following terms: “[N]o measures are excluded a priori from the scope of the GATS as defined by its provisions. The scope of the GATS encompasses any measure of a Member to the extent it affects the supply of a service regardless of whether such measure directly governs the supply of a service or whether it regulates other matters but nevertheless affects trade in services.” The Appellate Body upheld this finding and held that no provision of the Agreement “suggest[s] a limited scope of application for the GATS.” WTO (1997a), WTO Doc WT/DS27/AB/R at para 220 [EC Bananas Appellate Body Report].

<sup>10</sup>The Appellate Body, *ibid* also made the following comment: “[t]his Agreement applies to measures by Members affecting trade in services. In our view, the use of the term ‘affecting’ reflects the intent of the drafters to give a broad reach to the GATS. The ordinary meaning of the word ‘affecting’ implies a measure that has ‘an effect on’, which indicates a broad scope of application.”

services. A measure is broadly defined as “any measure by a Member, whether in the form of a law, regulation, procedure, decision, administrative action, or any other form that affects the trade in services”<sup>11</sup> Trade in services is defined simply as the “supply of a service.”<sup>12</sup>

The commitments by WTO Members with respect to measures “affecting trade in services” may be categorized into two broad groups: first, general obligations, which apply directly and automatically to all Members and services sectors, and second, specific commitments concerning market access and national treatment in designated sectors. These specific commitments are set out in individual country schedules, whose scope may vary widely between Members.<sup>13</sup>

### 2.2.1.2 General Obligations (Most Favoured Nation Treatment)

The general obligations assumed under the GATS include a commitment to most favoured nation treatment with respect to all measures affecting services and service providers of other Members (“non-resident service providers”), transparency with respect to measures of general application, the establishment of national inquiry points to respond to other Members information requests, the establishment of administrative review and appeal procedures, and discipline on the operation of monopolies and exclusive suppliers.

These general obligations, and in particular obligations with respect to most favoured nation treatment, are subject to limitations.<sup>14</sup> Member countries could deviate from the most favoured nation obligation in the “Annex on Article II Exemptions” if the conditions for such exemptions were met.<sup>15</sup> This flexibility was considered necessary in order to maintain existing regulations or agreements inconsistent with the most favoured nation obligation and to preserve the prospective right to use reciprocal or unilateral liberalization measures. Almost all countries have claimed some most favoured nation exemptions in areas such as civil

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<sup>11</sup>The GATS, Article XXVIII(a): In WTO (2000), WTO Doc WT/DSI39/AB/R at paras 151–152 and 155 [Auto Industry Appellate Body Report] the Appellate Body held that whether a measure “affects” trade in services must be assessed before any further consistency of a measure with other GATS provisions is considered.

<sup>12</sup>The GATS, Article XXVIII(b): the “supply of service” includes, but is not limited to the “production, distribution, marketing, sale and delivery of a service.”

<sup>13</sup>The GATS, Article XX.

<sup>14</sup>The wording “treatment no less favourable” in the GATS Article II(1) has been interpreted broadly by the WTO Appellate Body to include both de facto as well as “de jure discrimination.” See the Auto Industry Appellate Body Report at para 234.

<sup>15</sup>Members were allowed to seek such exemptions before the Agreement was entered into force. New exemptions can only be granted to new Members at the time of accession or, in the case of current Members, by way of a waiver under Article IX(3) of the WTO Agreement. All exemptions are subject to review, and should in principle not last longer than 10 years. Further, the GATS allows groups of Members to enter into economic integration agreements or to mutually recognize regulatory standards, certificates and the like if certain conditions are met.

and maritime aviation, telecommunications and financial services.<sup>16</sup> Similar exemptions have also been claimed with respect to national treatment. However, if an exemption was not claimed, the most favoured nation obligation applies unconditionally to any measure affecting trade in services unless, as discussed below, the difference in tax treatment is the result of a tax treaty.

### **2.2.1.3 National Treatment and Market Access: Specific Commitments**

In addition to the general obligations described above the GATS sets out a framework within which the terms of each Member's specific commitments to liberalize the trade in services on a sector-by-sector basis are recorded. This portion of the GATS is often referred to as a 'bottom-up' agreement. This reference recognizes that each Member could choose the service sectors it wished to open up to foreign service providers or to exclude by omission (e.g., include tourism, exclude health care). The GATS 'bottom-up' approach can be contrasted with regional agreements like the NAFTA, which adopt a 'top-down' approach that proceeds on the assumption that all services are included in the agreement unless specifically excluded.

As a result of the GATS approach to the liberalization of trade in services, market access was and continues to be a negotiated commitment in specified sectors,<sup>17</sup> as is the commitment to provide national treatment to the services and service providers of other Members.<sup>18</sup> The extension of national treatment in any particular sector could be made subject to conditions and qualifications. Each country's commitments thus tend to reflect national policy objectives and constraints.<sup>19</sup> Once committed, a Member may not impose discriminatory measures benefiting domestic services or service suppliers.

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<sup>16</sup>See Schedules to the GATS to view a specific country's schedules. For Canada see WTO (1994a) WTO Doc GATS/EU16, online WTO <http://docsonline.wto.org>. Canada has claimed exemptions for film, video and television co-production, with respect to fishing, banking, trust and insurance services, air and marine transport, and for certain services related to agriculture.

<sup>17</sup>Further, market access commitments may be made subject to various types of limitations that are enumerated in Article XVI(2). For example, limitations may be imposed on the number of services suppliers, service operations or employees in the sector, the value of transactions, the legal form of the service supplier, or the participation of foreign capital.

<sup>18</sup>The GATS, Article XVII provides that "each Member shall accord to services and service suppliers of any other Member, in respect of all measures affecting the supply of services, treatment no less favourable than that it accords to its own like services and service suppliers." The GATS limits the application of this standard to those sectors specified in each Member's Schedule of Concessions, and allows Members to set forth any applicable conditions.

<sup>19</sup>The existence of specific commitments triggers further obligations concerning, inter alia, the notification of new measures that have a significant impact on trade (GATS Article III) and the avoidance of restrictions on international payments and transfers (GATS Article XI).

The national treatment obligation is met if a Member accords the services and service suppliers of any other Member treatment no less favourable than that it accords to its own like services and service suppliers. This can be achieved through formally identical or different treatment but the treatment would be considered less favourable if it modified, in law or in fact, the conditions of competition in favour of the Member's own service industry. The concept of what are "like services and service suppliers" under the GATS is still to a large extent uncharted territory."<sup>20</sup>

#### 2.2.1.4 Taxation Measures

Taxation measures, to the extent that they affect services or service providers are also subject to the national treatment<sup>21</sup> and most favoured nation obligations. Some countries therefore claimed national treatment<sup>22</sup> qualifications or most favoured nation exemptions.<sup>23</sup> Canada, for example, listed a qualification to the national treatment obligation for tax measures that result in differences of treatment with respect to expenditures made on scientific research and experimental development services.<sup>24</sup> Further qualifications have been claimed at both the federal and provincial levels related to small businesses that are Canadian controlled private corporations.<sup>25</sup> Surprisingly few countries claimed most favoured nation exemptions and with exception of the United States drafted these exemptions very narrowly.<sup>26</sup> The specifics of each countries exemptions and qualifications can be found in each country's schedule to the GATS.<sup>27</sup>

It is important to note that the most significant exclusions for tax measures from the non-discrimination obligations in the GATS are the result of specific provisions

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<sup>20</sup>See Cossy (2006).

<sup>21</sup>See the GATS Article XVII.

<sup>22</sup>See the WTO (1994b), WTO Doc GATS/SC/90, online WTO <http://docsonline.wto.org> at 9–10, setting forth limitations on national treatment for foreign employee benefit trusts and excise taxes on transfers to foreign entities. See Lang and Stack (2000) at 566–581.

<sup>23</sup>A quick review of the schedules reveals that many countries, including Canada, the US and Mexico, have claimed most favoured nation exemptions with respect to tax provisions. See for example WTO (1994a) at para 3 detailing the exemption from taxes on income of non-residents from international transport on the basis of reciprocity with the resident country. The US has also listed tax measures relating to favourable treatment for Mexican and Canadian residents, the Caribbean Basin Initiative, international transport income (including aircraft and rolling stock) derived by residents of countries with reciprocal measures, earnings from communication satellites and denials of deductions for residents of countries participating in international boycotts or maintaining discriminatory tax regimes. WTO (1994a).

<sup>24</sup>See WTO (1994b).

<sup>25</sup>*Ibid* under Part I Horizontal Commitments.

<sup>26</sup>Farrell (2013) at Chapter 8.3.1.

<sup>27</sup>See WTO, *Schedules of Commitments and Lists of Article II Exemptions*, online: WTO [http://www.wto.org/english/tratop\\_e/serv\\_e/serv\\_commitments\\_e.htm](http://www.wto.org/english/tratop_e/serv_e/serv_commitments_e.htm).

in the GATS rather than claims by individual Member countries. The three most significant of these exclusions are outlined below.

First, the preferential tax treatment of parties from one country over another is expressly authorized under the GATS provided it is the result of a tax treaty.<sup>28</sup> The most favoured nation obligation is limited by Article XIV(e) of the GATS. It permits Members to adopt tax measures inconsistent with the most favoured nation requirement if “the difference in treatment is the result of an agreement on the avoidance of double taxation or provisions on the avoidance of double taxation in any other international agreement or arrangement (“tax treaty”) by which a Member is bound.”

Second, there is an exception from the national treatment obligation as it relates to the tax treatment of services and service providers<sup>29</sup> listed under the General Exceptions to Article XIV of the GATS. Specifically Article XIV(d) provides that any Member may adopt or enforce direct<sup>30</sup> tax measures that are inconsistent with national treatment, “provided that the difference in treatment is aimed at ensuring the equitable or effective imposition or collection of direct taxes in respect of services or service suppliers of other Member countries.” The meaning of the expression “equitable or effective” is defined in a footnote<sup>31</sup> that provides

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<sup>28</sup>Subject to the requirement that such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services.

<sup>29</sup>As discussed, the potential for discrimination in direct tax matters became a major issue in the final days of negotiating the WTO Agreement in the Uruguay Round. The US strongly opposed the inclusion of direct taxes in the national treatment requirements under the GATS. See Stahl (1994).

<sup>30</sup>Direct taxes are defined in the GATS Article XXVIII(o) as “all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of property, taxes on estates, inheritances and gifts, and taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.”

<sup>31</sup>Specifically, the footnote to the GATS Article (XIV) refers to the following activities: “Measures that are aimed at ensuring the equitable or effective imposition or collection of direct taxes include measures taken by a Member under its taxation system which:

- apply to non-resident service suppliers in recognition of the fact that the tax obligation of non-residents is determined with respect to taxable items sourced or located in the Member’s territory; or
- apply to non-residents in order to ensure the imposition or collection of taxes in the Member’s territory; or
- apply to non-residents or residents in order to prevent the avoidance or evasion of taxes, including compliance measures; or
- apply to consumers of services supplied in or from the territory of another Member in order to ensure the imposition or collection of taxes on such consumers derived from sources in the Member’s territory; or
- distinguish service suppliers subject to tax on worldwide taxable items from other service suppliers, in recognition of the difference in the nature of the tax base between them; or
- determine, allocate or apportion income, profit, gain, loss, deduction or credit of resident persons or branches, or between related persons or branches of the same person, in order to safeguard the Member’s tax base.



illustrations of taxes and tax policies that may be excluded from the national treatment obligation. These include, for example, the right to impose withholding tax, as well as to apply special provisions such as transfer pricing rules to prevent tax avoidance. The footnote further specifies that tax terms or concepts listed in the footnote describing the tax carve out from the national treatment obligation are to be determined according to tax definitions and concepts or their equivalent under the domestic law of the Member taking the measure.<sup>32</sup>

Note that the exception from the national treatment obligation for direct tax measures described above is not absolute. Each Member State remains subject to the overriding non-discrimination obligation in Article XIV of the GATS which imposes the requirement that “such measures are not applied in a manner which would constitute a means of arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services.” This non-discrimination obligation, which is basic to international trade law, imposes an important albeit limited restriction on the discretion of a Member State when imposing direct tax measures on the services or service providers of other Member States in contravention of the GATS national treatment obligation.<sup>33</sup>

Third, the role of the GATS, including the non-discrimination obligations, is severely limited with respect to tax measures if a bilateral tax treaty is in effect between the Member countries.<sup>34</sup> A Member may not invoke the national treatment obligation under either the consultation or dispute resolution provisions in the GATS with respect to a measure of another Member that falls within the scope of an international agreement related to the avoidance of double taxation.<sup>35</sup> The result of this exclusion is unclear. The OECD has opined that the phrase ‘falls within the scope’ of a tax treaty is inherently ambiguous, leaving some doubt as to whether a tax treaty will apply to all measures relating to taxation,<sup>36</sup> or whether some tax measures may remain subject to the non-discrimination obligations in the GATS.

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(Footnote 31 continued)

Tax terms or concepts in the GATS Article XIV(d) and in the footnote are determined according to tax definitions and concepts, or equivalent or similar definitions and concepts, under the domestic law of the Member taking the measure.”

<sup>32</sup>The GATS Article XIV(d).

<sup>33</sup>Note however, that no justification is required under Article XIV unless the national treatment obligation is otherwise violated. To establish such a violation three conditions must be met; first the non-resident service provider must be ‘like’ a national service provider, second, the difference in treatment must be based on the national origin of the service or service provider and third the treatment accorded to the non-resident must be less favourable than that accorded to a resident national. See WTO (1 December, 1993).

<sup>34</sup>The GATS, Article XXII(3). This will serve to prevent debate about a Member government’s right to exercise wide powers under its domestic law to both safeguard the tax base and to define its scope.

<sup>35</sup>The GATS, Article XXII(3).

<sup>36</sup>See OECD (2014), Commentary to Article 25, para 44.1.

The OECD provides the following additional guidance. “While it seems clear that a country could not argue in good faith that a measure relating to a tax to which no provision of a tax convention applied fell within the scope of that convention, it is unclear whether the phrase covers all measures that relate to taxes that are covered by all or only some provisions of the tax convention.”

If one accepts the widely held view that all matters of non-discrimination with respect to direct tax measures fall within the scope of a tax treaty,<sup>37</sup> it follows that any disputes relating to an alleged violation of the national treatment obligation with respect to a tax measure must be resolved using the mechanism provided in the applicable tax treaty. This would clearly include any challenge with respect to direct taxes but could also include any challenge with respect to an indirect tax measure if indirect tax measures are addressed in the non-discrimination provisions in the tax treaty.<sup>38</sup>

If one is of the view that a direct tax measure may violate a GATS non-discrimination obligation but falls outside the scope of a tax treaty, the issue of the ‘scope’ of the tax treaty must first be resolved before the GATS non-discrimination obligation will apply. In case of disagreement between Members as to whether a measure falls within the scope of such an agreement between them, the GATS provides that “it shall be open to either Member to bring this matter before the Council for Trade in Services. The Council shall refer the matter to arbitration. The decision of the arbitrator shall be final and binding on the Member.”<sup>39</sup>

In some tax treaties, the treaty partners have attempted to add some clarity about the scope of their tax treaty. For example, in the case of the Canada-US Tax Treaty, a Third protocol provides that “for the purposes of GATS, Canada and the US agree that a tax measure will fall under the tax treaty if it relates to Article XXV (Non-Discrimination) or, if it does not relate to non-discrimination, it falls within another tax treaty provision, but only to the extent that the measure relates to a matter dealt with in that tax treaty provision.”<sup>40</sup> If there is a tax treaty between the Member States but it does not include a non-discrimination clause the issue is less clear. One argument is that that GATS limited non-discrimination obligations apply. The other argument is that the issue of non-discrimination falls within the scope of a tax treaty and that no non-discrimination obligation applies if none is included in the tax treaty.<sup>41</sup>

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<sup>37</sup>The OECD and UN Model Tax Treaties both include a non-discrimination article. See 24(3). In order to avoid doubt some tax treaties have clarified the role of the GATS.

<sup>38</sup>See for example Article XXV of the Canada-US Tax Treaty.

<sup>39</sup>A footnote to Article XXII(3) provides that if there is a disagreement about whether the matter falls within the scope of a tax treaty and the tax treaty was in existence at the time the WTO Agreement entered into force, one country cannot unilaterally challenge the issue of the tax treaty’s scope under WTO procedures. Both parties to the existing tax treaty must consent if the WTO dispute resolution procedure (rather than a tax treaty procedure) is to be engaged. However, if future tax treaties are silent on the issue, either treaty partner may unilaterally apply to determine whether a matter falls within the scope of a tax treaty before the WTO’s Council for Trade in Services, which may then refer the matter to binding arbitration.

<sup>40</sup>Canada-US Tax Treaty, Article XXIX.

<sup>41</sup>See the discussion in Chap. 3 at Sect. 3.2.3.4.

Whether or not a measure falls within the scope of a tax treaty can have important consequences for a non-resident. If the matter falls within the scope of a tax treaty the limited non-discrimination obligation under Article XIV of the GATS for direct tax measures in respect of a non-resident service provider is effectively eliminated. If the matter falls within the scope of a tax treaty, there is no non-discrimination obligation that would prevent a Member State from applying a tax measure that is arbitrary or a disguised restriction on the trade in services. The non-resident must rely solely on the non-discrimination obligations in the applicable tax treaty.

Tax treaties will play a central role in determining which non-discrimination obligations apply to the tax treatment of a non-resident service provider. Tax treaties will also play a central role in the determination of how taxing rights are allocated between the source and resident state.<sup>42</sup>

### ***2.2.2 The OECD and UN Model Tax Treaties: The Taxation of Non-resident Service Providers and Tax Treaty Non-discrimination Obligations***

The OECD and UN Model Tax Treaties, and the more than 3000 bilateral tax treaties based on these Models prevent double taxation, provide for the exchange of information, and help to reduce fiscal evasion. The treaties operate by allocating the right to tax income to the resident or source State, or in some cases, to both. Both Model Tax Treaties provide for the taxation of several broad categories of income, including income from business, real property, transportation, dividends, interest, royalties, gains from alienation, income from employment, directors fees, payments to artists and sportspersons, income from pensions and annuities, income from government services, payments to students, other income and in the case of the UN Model Tax Treaty, income from independent personal services.

Which tax treaty article applies is important in determining both host country tax liability and the applicable non-discrimination obligation, if any.<sup>43</sup> As there can be considerable overlap among the tax treaty articles in the case of payments for services, a question frequently posed is whether the payment for services represents

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<sup>42</sup>As will be discussed below, the most favourable non-discrimination obligation under a tax treaty for a non-resident arises in circumstances where the non-resident provides services to a tax treaty partner through a permanent establishment, although even that obligation is very limited. See discussion in Chap. 3 at Sect. 3.2.3.3.1.

<sup>43</sup>Some assistance in resolving the distinction between these Tax Treaty articles can be found in the Commentary to the OECD Model Tax Treaty.

business profits,<sup>44</sup> royalties<sup>45</sup> or other income.<sup>46</sup> If the applicable tax treaty includes an independent personal services article, that article would also be included in this inquiry. The details of these tax treaty articles are discussed further in Part III. Importantly, any applicable non-discrimination obligation found in a tax treaty is determined by whether the non-resident meets the specific conditions outlined in the non-discrimination article. This in turn will depend on which of the income allocation rules in the tax treaty is applied by the source country to the non-resident service provider.<sup>47</sup>

### 2.2.2.1 Taxation of Service Providers

Income earned from the provision of services by a non-resident under the OECD and UN Model Tax Treaties is generally subject to the business profits article or in some cases the independent and dependent personal services articles in the applicable tax treaty. Payments for specific services, such as those provided by directors or senior managers, government,<sup>48</sup> artists and sportspersons<sup>49</sup> or that affect students or apprentices,<sup>50</sup> may be subject to separate tax treaty provisions. The details of these tax treaty articles are not important to this part of the study and are not included in the discussion that follows.

In general, payments made for services performed by a resident of one Contracting State on behalf of a resident of the other Contracting State are not taxable in the other State unless the service provider has or had a fixed base (or permanent establishment) in the other State. If so, payments are taxable only to the

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<sup>44</sup>“Business profits,” a term undefined in the OECD Model Tax Treaty and most tax treaties, are not taxable in the host country unless the enterprise carries on business in that country through a permanent establishment. The OECD Model Tax Treaty provides that business profits do not include income dealt with separately in other treaty articles. Thus business profits would generally include amounts not specifically covered in the personal service income articles.

<sup>45</sup>In the past, a blurring has occurred between business profits, royalty income and income from personal services. The problem has been distinguishing a payment in respect of management or technical service fees, which may be exempt as business profit under the OECD Model Tax Treaty Article 7, or the OECD Model Tax Treaty Article 14 (Independent Personal Services), from a royalty for the transfer of know how, which is potentially subject to a withholding tax under the royalty provisions.

<sup>46</sup>OECD Model Tax Treaty, Article 21.

<sup>47</sup>See discussion in Chap. 6 at Sect. 6.2.

<sup>48</sup>See e.g. Article 19 of the *Convention between the Government of Canada and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income*, 12 September 2001 (entered into force 12 April 2007) [*Mexico–Canada Tax Treaty*].

<sup>49</sup>*Ibid*, Article 17.

<sup>50</sup>*Ibid*, Article 20.

extent that the services are performed in the other State and profits are attributable to that fixed base (or permanent establishment).<sup>51</sup> Even if payments are exempt from host country taxation under a tax treaty they may remain subject to interim or other taxes under the domestic law of that country, particularly if payment for the services is sourced there.

Both the OECD and UN Model Tax Treaties include a business profits article. Only the UN Model Tax Treaty continues to include an independent personal services article. This minor difference between the OECD and UN Model Tax Treaties is important for service providers. Business profits that are attributable to a permanent establishment benefit from a non-discrimination obligation under both Model Tax Treaties. There is no tax treaty non-discrimination obligation if the independent personal services article in a tax treaty applies.

### Business Profits

Whether payments for the provision of services will be considered income from business will depend on the specific tax treaty. The answer may vary widely, and for good reason. The OECD Model Tax Treaty has undergone significant changes over the past two decades that have affected how income from services may be taxed. For example, Article 14, which formerly governed the taxation of independent personal services under the OECD Model Tax Treaty, was removed from the Model Tax Treaty in 2000. Provision for these services was subsumed under the business profits article, Article 7.<sup>52</sup> Some countries followed the OECD lead and eliminated the independent services article from their tax treaties. However, many older tax treaties retain the independent personal services article, as do tax treaties based on the UN Model Tax Treaty. The independent personal services article is still commonly found in the OECD and UN based tax treaties and is the basis for taxing payments for services that in other tax treaties would otherwise fall under the business profits article.

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<sup>51</sup>*Ibid.*

<sup>52</sup>Article 14 (Independent Personal Services) was deleted from the OECD Model Tax Treaty on April 29, 2000, on the basis of the report OECD, *Issues Related to Article 14 of the OECD Model Tax Convention*, Issues in International Taxation, No 7 (2000) which was adopted by the Committee on Fiscal Affairs on January 27, 2000. According to the OECD Commentary at that time there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. It was also thought it was unclear which activities fell within Article 14 as opposed to Article 7. The result of the deletion of Article 14 is that income derived from professional services on other activities of an independent character is now governed by Article 7 as business profits under the OECD Model Tax Treaty.

## Permanent Establishments

The importance of determining whether a permanent establishment exists in the host country is first that it establishes the host country's right to tax the income sourced in the host country based on the treaty provisions and second it engages the tax treaty non-discrimination obligation for any income attributable to the permanent establishment. Assuming the domestic tax law of the host country imposes tax on income from business activities in the host country, the right of the host country to tax business profits sourced within its borders depends on whether the individual or entity has a permanent establishment in the host country. The existence of a permanent establishment in the host country also engages one of the non-discrimination obligations in Article 24 of both Model Tax Treaties.

Both the OECD and UN Model Tax Treaties include specific provisions that are intended to clarify what is considered to be a permanent establishment for purposes of the Treaty. In summary, and beginning with Article 5(1) of the OECD Model Tax Treaty, a permanent establishment “means a fixed place of business through which the business of the enterprise is carried on”<sup>53</sup> (‘the general rule’). The OECD Model Tax Treaty then provides an illustrative list in Article 5(2) of specific kinds of operations that *prima facie* come within this general rule, followed by specific deeming rules in Articles 3 through 7 to include or exclude certain activities within the meaning of permanent establishment. It ends with a general statement clarifying that the existence of a subsidiary corporation does not of itself create a permanent establishment for the parent corporation.

The term ‘permanent establishment’ includes especially a place of management, a branch, an office, a factory, a workshop, and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. The illustrative list provides an indication that a permanent establishment may exist; it does not provide that one necessarily does exist. The OECD Commentary is clear that the condition in the general rule in Article 5(1) that there must be a fixed base through which the business is carried on must also be met before a permanent establishment exists.<sup>54</sup> This proviso does not extend to “a building site or construction or installation project which also constitutes a permanent establishment under Article 5(3) if it lasts for more than twelve months.”

The OECD Model also includes deeming rules that either exclude certain activities that would otherwise fall within the general meaning of permanent establishment or include activities that would otherwise fall outside it. For example,

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<sup>53</sup>According to the OECD Commentaries, a general principle to be observed in determining whether a permanent establishment exists is that the place of business must be “fixed” in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it must be foreseeable that the enterprise’s use of this building or other physical location will be more than temporary; OECD (2014), Commentary on Article 5 at paras 4–8.

<sup>54</sup>*Ibid* at Article 5(2), para 12.

activities that are considered to be largely of a preliminary nature such as collecting information, storage, advertising or displaying goods are excluded from the permanent establishment rule. In contrast the activities of dependent agents who habitually conclude contracts on behalf of that enterprise may result in a deemed permanent establishment under the Treaty.<sup>55</sup>

The UN Model Tax Treaty further expands the permanent establishment concept to include broader host country taxation rights. Specifically, the UN Model Tax Treaty provides for a six-month test to determine whether a building or construction site constitutes a permanent establishment as compared with the OECD Model Tax Treaty's twelve-month test and the UN Model Tax Treaty expressly includes supervisory activities. Other provisions<sup>56</sup> provide for a permanent establishment based on the activities of an independent agent<sup>57</sup> or the furnishing of services, including consultancy services, through employees or other personnel engaged by the enterprise, if the activities continue (for the same or a connected project) within a Contracting for more than six months in any twelve-month period.<sup>58</sup>

In many cases the answer to the question "is there a permanent establishment" is obvious. For example, based on the general rule and the illustrative list in Article 5, it is clear under both Model Tax Treaties that if an enterprise is operating a mine, an oil or gas well, a quarry or any other place of extraction of natural resources it will have a permanent establishment in the host country. The non-resident enterprise has a fixed place of business through which the business is carried on and will be taxable with respect to any profits attributable to that permanent establishment.

It is more difficult to determine if a permanent establishment exists where the provision of services is concerned.

A non-resident service provider will have a permanent establishment in the host country if the non-resident meets the general rule in Article 5(1). The general rule is met if the non-resident service provider carries on business in the host country through a fixed place of business. There are no time tests associated with this

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<sup>55</sup>A third deeming rule in Article 5 provides that "an enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business."

<sup>56</sup>United Nations (2013), Article 5(7).

<sup>57</sup>Other differences under the UN Model Tax Treaty that may affect whether a permanent establishment is found include the omission of the word delivery from Article 5 paragraph 4 with the result that delivery activities are not treated as ancillary and the expansion of the deeming rule with respect to when dependent agents will create a permanent establishment—to include cases where a dependent agent regularly maintains a stock and makes deliveries from it.

<sup>58</sup>United Nations (2013), Article 5(3)(b). A deemed service permanent establishment will exist in these circumstances even if an enterprise has no fixed place of business in the taxing state as required under Article 5(1). See the Revision of the *Manual for the Negotiation of Bilateral Tax Treaties*, UN Committee of Experts on International Cooperation in Tax Matters, 7th Sess, UN Doc E/C.18/2011/CRP.2/Add.1 (Geneva: 24–28 October, 2011) at 12.

provision.<sup>59</sup> It is simply a question of fact that will be determined under the domestic law of the host country. The issue of when a fixed place of business exists for a non-resident service provider is no doubt one that will remain subject to considerable uncertainty.

Both the OECD and UN Model Tax Treaties (or Commentaries) also offer optional provisions for the taxation of services that may be included under the permanent establishment article in the respective Model Tax Treaties.

The optional provision under the OECD Model Tax Treaty was added in 2008 and can be found in the OECD Commentaries. It includes two deeming rules for enterprises of a Contracting State that perform services in the other Contracting State. The first rule applies if services are provided through an individual who is present in the other State during a period or periods exceeding in the aggregate 183 days in any twelve month period, and more than 50 percent of the gross revenue attributable to active business activities of the enterprise during this period or periods are derived from the services performed in that other State through that individual. The second rule applies if during a period or periods exceeding in the aggregate 183 days in any twelve month period, services are performed for the same project or for connected projects through one or more individuals who are performing such services in that other State or are present in that other State for the purpose of performing such services. In either case the activities carried on in the other State in performing these services are deemed to be carried on through a permanent establishment of that enterprise in the other Contracting State, unless these services are of a preparatory or ancillary nature.<sup>60</sup> The suggested wording in the Commentary is clear that these rules apply notwithstanding the requirements in Article 5(1).

The UN Model Tax Treaty suggested provision for services was added to Article 5 in the 2011 update to the Treaty for the benefit of those Contracting States that preferred to eliminate the independent personal services article. It varies from the OECD provision to reflect the fact that the UN Model Tax Treaty version of Article 14 explicitly applies to individuals. The UN version eliminates the language in the OECD Commentaries that requires that the services provided under the 183 day time test be for the same or connected project. The underlying logic for eliminating the “connected” requirement is that no similar limitation was imposed in Article 14.

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<sup>59</sup>This has been the subject of discussion by the OECD and the following revisions were released in the Draft Commentary in October 2011: “Whilst the practices followed by Member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months).” It would appear therefore, that even if the provision exceeds six months that will not necessarily lead to a permanent establishment if the tax treaty does not include a time test.

<sup>60</sup>These activities are limited to those mentioned in Article 5(4) of the OECD Model Tax Treaty which, if performed through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.



The concern was that if the “connected” language was included in the proposed services permanent establishment provision in Article 5 it would serve to limit the source country taxation rights otherwise applied to income subject to the independent personal services article.

### Independent Personal Services

Article 14 of the UN Model Tax Treaty provides that income from professional and other independent services performed by a resident of one country in the other country may be taxed in the other country if the resident has a “fixed base” in the other country or if the resident’s “stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned.” As discussed above, Article 14 of the OECD Model Tax Treaty was deleted in 2000 but before its deletion it applied to income from services if the services were provided through a fixed base in the host country. Variations of Article 14 of the OECD Model Tax Treaty exist in many of the tax treaties entered into before the article was deleted. Some tax treaties also include a time test similar to the 183-day test found in the UN Model Tax Treaty.

Income from services under former Article 24 of the OECD Model Tax Treaty and under the current version of Article 14 of the UN Model Tax Treaty is broadly defined as income from professional services or other services of an independent nature.<sup>61</sup> A number of interpretative issues plagued the provision. Among these were questions about what services were included under Article 14 and not Article 7, the business profits article. There were also questions about whether Article 14 applied only to individuals and not to other legal entities and about how host country taxation should be levied under Article 14. The answers to these questions could be important.

For example, in contrast to the business profits article in Article 7, Article 14 refers to income from independent personal services, not profit, and does not include rules for how income is to be computed.<sup>62</sup> This may prove significant in the tax treatment of the non-resident. Unlike the tax treatment of business profits, which is subject to a tax treaty non-discrimination obligation if the services are attributable to a permanent establishment in the host country, there is no equivalent non-discrimination obligation that applies if the independent personal services

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<sup>61</sup>In Article 14 of the OECD Model Tax Treaty, the term “professional services” included especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

<sup>62</sup>The OECD (2008) [2008 OECD Commentary] on Article 14 at para 10 indicates that reference may be made to the computational rules in Article 7.

article applies and the services are provided through a fixed base.<sup>63</sup> Any method of net or gross based taxation could be applied to the income generated by a non-resident. This issue is discussed further below.

### 2.2.2.2 Non-discrimination Obligations

The previous sections addressed the general provisions under which a tax treaty partner is allocated the right to tax income from the provision of services earned by a non-resident in a treaty partner's country under the OECD and UN Model Tax Treaties. The following section describes the tax treaty non-discrimination obligations in respect of a non-resident with a focus on the OECD Model Tax Treaty.

#### Overview

The non-discrimination obligations in both the OECD and UN Model Tax Treaties take the form of prohibitions designed to prevent source countries from discriminating against 'foreigners' with sufficient nexus to the source country.<sup>64</sup> The goal of these provisions is to ensure no less favourable tax treatment for "similarly situated" persons and businesses. Specifically, the principle of non-discrimination as expressed in Article 24 of the OECD Model Tax Treaty prohibits differences in tax treatment in four major areas as follows.

A state shall not:<sup>65</sup>

- Subject non-nationals to "other or more burdensome taxation" than nationals who are "in the same circumstances" [Article 24(1)].
- Levy tax on a permanent establishment of a foreign enterprise "less favourably" than a domestic enterprise of carrying on the same activities [Article 24(3)].
- Prevent the deduction of interest, rents, royalties or other disbursements paid to a treaty partner if "paid under the same circumstances" and a deduction is available if paid to a resident [Article 24(4)].
- Subject "foreign-owned enterprises" to taxation that is "other or more burdensome" than the taxation and connected requirements applicable to "similar" domestic enterprises [Article 24(5)].

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<sup>63</sup>If the non-resident service provider is subject to tax under the business profits article, the applicable non-discrimination article provides that the source State cannot levy tax less favourably than that levied on a domestic enterprise carrying on the same activities. See Article 24(4) of the OECD Model Tax Treaty.

<sup>64</sup>Depending on the context, the non-discrimination principles found in trade agreements may apply to determine if the host country is guilty of discrimination in the area of taxation.

<sup>65</sup>The obligation applies to taxes of every kind and description (that is, to all direct and indirect taxes) levied by, or on behalf of, the State, its political subdivisions or local authorities. OECD Model Tax Treaty Article 24(6).

These prohibitions are negotiated on a bilateral basis, thus negating any obligation with respect to most-favoured nation treatment.<sup>66</sup> The OECD Commentary is also clear that unless the specific listed criteria are met, the non-discrimination clause does not become operative. If unequal or arbitrary treatment results from matters not mentioned in Article 24, there is no tax treaty non-discrimination obligation. The narrow scope of the non-discrimination article in the tax treaty results in a wide range of permitted differences in the tax treatment between foreign and domestic-source income and foreign (non-resident) and domestic (resident) taxpayers.<sup>67</sup> The discussion begins with the non-discrimination obligations currently included in the OECD Model Tax Treaty.

### Non-discrimination and the Taxation of Tax Resident but Foreign-Owned Corporations

Foreign-owned resident corporations, including those providing services, potentially benefit from three non-discrimination provisions:

- Article 24(1) with respect to nationality,<sup>68</sup>
- Article 24(5) with respect to foreign ownership, and
- Article 24(4) with respect to the deductibility of expenses paid to non-residents.

The practical effect of this provision is that the source state must provide a form of equal or national treatment to resident nationals including corporations but may provide tax concessions or preferences that are not available to its own nationals. Article 24(1) prohibits discrimination based on nationality. It is framed in the negative. Nationals of a Contracting State may not be subjected in the other Contracting State to “any taxation or any connected requirements that are other or more burdensome” than those to which nationals of the other Contracting State in the same circumstances are subjected.

Article 24(5) addresses non-discrimination in the context of foreign ownership of resident corporations and obligates the source state not to subject such corporations to “other or more burdensome taxation requirements” than domestically owned corporations. This obligation to provide equal treatment is subject to a number of important limitations. For example, as discussed further below, differences in treatment in related party transactions are permitted to prevent foreign-owned or

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<sup>66</sup>The 2014 OECD Commentary confirms that Article 24 cannot be interpreted to require most favoured nation and should not be unduly extended to encompass indirect discrimination, e.g. discrimination that occurs where a provision of law indirectly favours residents over non-residents. OECD (2014), Commentary on Article 24 at para 2.

<sup>67</sup>The 2014 OECD Commentary clarifies 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. OECD (2014), Commentary on Article 24 at para 1.

<sup>68</sup>See the definition of ‘national’ in the OECD Model Tax Treaty Article 3(1)(g), which includes a corporation.

controlled corporations from narrowing their tax base (i.e. thin capitalization rules).<sup>69</sup> The requirement of equality at source under the OECD Model Tax Treaty is also restricted to the activities of the corporation itself. As a result, it does not apply to issues relating to a group to which the enterprise belongs. For example, it does not extend to rules that allow consolidation, the transfer of losses or the tax-free transfer of property between companies under common ownership. It also does not extend to corporate distributions. This means that distributions to resident and non-resident investors may and generally are treated differently in particular respect to withholding taxes and imputation systems.

Article 24(4) prohibits the source State from discriminating against non-residents by restricting the deductibility of payments made to them. This non-discrimination obligation ensures that a foreign-owned resident corporation, for example, may deduct amounts paid to its parent corporation head office if a deduction would be available if paid to a resident in the source country. This obligation is also subject to a number of limitations that are set out in other tax treaty provisions, specifically the arm's length rule in Article 9(1) and the provisions in Articles 11(6) and 12(4) with respect to the deduction of interest and royalty payments where there is a special relationship between the parties.

### Non-discrimination and the Taxation of Permanent Establishments

Services may also be provided through a permanent establishment in the host country. The non-discrimination obligation with respect to permanent establishments in the OECD Model Tax Treaty requires that the source state not "levy tax less favourably" than that levied on a domestic enterprise carrying on the same activities. This obligation does not extend to personal allowances and benefits based on civil status or family responsibilities. The OECD Commentaries also make clear that this principle of equal treatment applies only to the taxation of the permanent establishment's own activities and 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. This means that the requirement of equal treatment does not extend to rules that take into account of the relationship between an enterprise and other enterprises, for example rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership. Transfer pricing restrictions may also be applied between a permanent establishment and its head office notwithstanding that such provisions are not applicable in a domestic context.<sup>70</sup> The obligation not to levy tax less favourably also does not extend to the

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<sup>69</sup>See the OECD Model Tax Treaty Articles 7(2) and 24(4).

<sup>70</sup>See OECD (2014), Article 7(2). This provision forms part of the context in which Article 24(3) must be read. OECD (2014), Commentary on Article 24 at para 42.

distribution of profits by a resident enterprise to a permanent establishment.<sup>71</sup> It clearly has no application if there is no permanent establishment. This non-discrimination obligation does prevent a Contracting State from subjecting the income of the permanent establishment to different tax treatment than a resident. The OECD Commentary is clear that a difference in treatment for practical reasons is not of itself discriminatory provided it does not result in more burdensome taxation.<sup>72</sup>

### Non-discrimination and the Taxation of Non-residents (Including Foreign-Owned Enterprises)

The non-discrimination rules in Article 24 of the OECD Model Tax Treaty do not forbid all forms of source-based discrimination.<sup>73</sup> Much latitude is permitted based on perceived differences. For example, there is no general non-discrimination obligation that applies to non-residents, including non-resident service providers. However, like corporations, individual service providers potentially benefit directly from the non-discrimination obligations included in Article 24(1) with respect to nationality and indirectly through the non-discrimination obligation in Article 24(4) with respect to the deductibility of expenses paid to a non-resident.

To determine whether a tax measure in the source State is discriminatory for purposes of Article 24(1) the applicable non-discrimination principle is based on comparability. The ‘national’ of the other state must be “in the same circumstances as the national of the source State, in particular with respect to residence.”<sup>74</sup>

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<sup>71</sup>The tax treatment of profits distributed to a permanent establishment has been a matter of recent controversy, particularly when shares form part of the holdings of the permanent establishment and are effectively connected with its activity. Member States disagree about whether the special rules that exist for the taxation of dividends distributed between companies should be extended to permanent establishments in these circumstances. See OECD (2014), Commentary on Article 24 at para 50.

<sup>72</sup>OECD (2014), Commentary on Article 24 at para 34; United Nations (2013) at para 2, which quotes para 34 of the OECD Model Tax Convention.

<sup>73</sup>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. Commentary to the article also clarifies that what is expressly mandated or authorized by other provisions of the Treaty cannot constitute a violation of the provisions of Article 24.

<sup>74</sup>This means differences in withholding taxes on dividend and interest income, for example, paid to a non-resident as compared to a resident are not considered discriminatory under the OECD or UN Model Tax Treaties. Non-resident investors are protected from discriminatory tax treatment only in so far as a maximum is set on withholding tax under other provisions in the OECD Model Tax Treaty. This more limited non-discrimination obligation is generally justified on the basis that withholding at source is necessary to ensure revenue collection. Withholding is also based on gross, not net, income. No attempt is made to rationalize gross taxation with the effective tax rates imposed on residents, a reality that is often loosely justified based on the practical difficulties of finding an accurate comparison. This issue is discussed further in Chap. 7 at Sect. 7.2.

Non-resident service providers are not viewed as being in the same circumstances as resident service providers. They cannot claim the protection of Article 24 (1). Unlike enterprises with a permanent establishment in the source State they are not directly protected from discriminatory tax treatment. The only non-discrimination obligation provided under the OECD and UN Model Tax Treaties with respect to this group of non-residents operates indirectly through Article 24(4). The source State may not prohibit a deduction to its taxpayers for disbursements paid to a service provider of a treaty partner if a deduction is permitted when paid under the “same circumstances” to a resident.<sup>75</sup> Notwithstanding, a source State may impose more or different compliance requirements before permitting the deduction of payments made to non-residents.<sup>76</sup>

The application of the above noted tax treaty non-discrimination obligations to the four Modes of supplying services under the GATS can be seen in Table 2.1.

### 2.3 Non-discrimination and Non-resident Service Providers—The Bottom Line

According to the preamble to the GATS the vision of the Members was “to establish a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization and as a means of promoting the economic growth of all trading partners and the development of developing countries.” In some respects the vision was achieved. The goals of national treatment, most favoured nation treatment and transparency remain the cornerstone principles of the GATS. However, these goals do not extend to tax measures which were largely excepted from the non-discrimination obligations in the agreement.

Thus although the national treatment obligation must be accorded to the service providers of other Member States in all sectors in which commitments were made, there is an exception for tax measures aimed at ensuring the equitable or efficient imposition or collection of direct taxes. There is also an exception from the requirement to provide most favoured nation treatment to the service providers of other Member States if the difference in tax treatment is the result of an agreement

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<sup>75</sup>OECD (2014), Article 24 and Commentary on Article 24 at para 75. “[Article 24(4)] does not prohibit additional information requirements from being imposed with respect to payments made to non-residents, since such requirements are only intended to ensure similar levels of compliance between payments to residents and payments to non-residents.”

<sup>76</sup>*Ibid.*

**Table 2.1** Summary of modes of supply in the GATS and OECD non-discrimination obligations

| GATS mode (1–4)   | OECD non-discrimination obligation (Article 24)  | Tax measure affected   |
|---|--|--|
| <b>Mode 1—cross-border trade:</b> from the territory of one member into the territory of any other member;<br>E.g. a user in country A receives services from Country B via internet          | <b>Indirect</b> ... for the purpose of determining the taxable profits of such enterprise, amounts must be deductible under the same conditions as if they had been paid to a resident of the first-mentioned state [Article 24(4)]  | Requires resident state to permit deduction of payment for services under same conditions as if paid to a resident   |
| <b>Mode 2—consumption abroad:</b> in the territory of one member to the service consumer of any other member;<br>E.g. a user in Country A travels to Country B to receive services in country | <b>Indirect</b> ... for the purpose of determining the taxable profits of such enterprise, amounts must be deductible under the same conditions as if they had been paid to a resident of the first-mentioned state [Article 25(4)]  | Requires resident state to permit deduction of payment for services under same conditions as if paid to a resident   |
| <b>Mode 3—commercial presence:</b> by a service supplier of one member, through commercial presence, in the territory of any other member   | <b>Direct</b> ... the taxation on a permanent establishment of an enterprise of a contracting state in the other contracting state shall not be less favourably levied in that other state than the taxation levied on enterprises of that other state carrying on the same activities   | Tax shall not be levied less favourably. Does not oblige a contracting state to grant to residents of the other contracting state any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents |
| <b>Mode 4—presence of natural persons:</b> by a service supplier of one member, through the presence of natural persons of a member in the territory of any other member                      | <b>Direct if service provider is a tax resident</b> ... 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 | There is no OECD non-discrimination obligation in respect of a non-resident service supplier without a permanent establishment in the source country   |

on the avoidance of double taxation.<sup>77</sup> Further, no challenge to the national treatment obligation in respect of a direct tax measure is permitted under the consultation provisions in the GATS or under the GATS dispute resolution procedures if the matter falls within the scope of a tax treaty. A similar restriction may apply to indirect tax measures depending on the specific wording of the applicable tax treaty between the Member States. The result is that the non-discrimination obligations that apply generally to a non-resident service provider under the GATS are very different from those that apply to taxation measures if there is a tax treaty between the Member States.

### ***2.3.1 Tax and Trade Agreements: Non-discrimination Obligations Compared***

Table 2.2 provides a snapshot of the non-discrimination obligations owed to a non-resident service provider under the GATS and under the OECD and UN Model Tax Treaties in respect of direct taxes. In the case of the GATS the chart includes both the general non-discrimination obligations (national treatment<sup>78</sup> and most favoured nation treatment) and the more limited non-discrimination obligations in respect of tax measures. Indirect tax measures are also subject to the GATS non-discrimination obligations.

The GATS generally excludes the national treatment obligation for measures directed at ensuring the effective imposition and collection of direct tax in respect of services or service suppliers in other Member States were excluded from the national treatment obligation.<sup>79</sup> The GATS revised non-discrimination obligation as it applies to measures in Article XIV(d) is that the measure must not constitute “arbitrary or unjustifiable discrimination between countries where like conditions

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<sup>77</sup>The language in Article XIV(e) is ambiguous about whether all matters that are included in an agreement for the avoidance of double taxation are exempted from the most favoured nation obligation under the GATS. For example while it is obvious that differences in withholding tax rates would fall within the exception, do differences in the imposition of indirect taxes fall within the exception if indirect taxes are included in a tax treaty? It would appear the answer to that question is yes based on the wording of the provision.

<sup>78</sup>This assumes that resident and non-resident service providers are “like service providers” for purposes of the GATS. See Cossy (2006).

<sup>79</sup>The GATS, Article XIV(d). But for this carve-out, the national treatment obligation under the GATS otherwise requires that in the sectors listed in a Member’s schedule of commitments “like” service providers of other Members are to be treated no less favourably than domestic ones. This treatment could be formally identical or formally different, but it would be considered less favourable if it modified the conditions of competition in favour of services or service suppliers of the Member compared to like services or service suppliers of any other Member. This standard was one that many Member States hoped would apply to direct tax measures under the GATS.



**Table 2.2** Non-discrimination obligations under the GATS and OECD and UN model tax treaties and their application a non-resident service provider

| Measure under review   | GATS   | OECD/UN model tax treaty   |
|------------------------|--|--|
|                        | No commercial presence   | No permanent establishment   |
| General trade measures | NT/MFN   | None   |
| – Tax measures (NT)    | NT-unless the measure is to ensure the equitable of effective imposition or collection of DIRECT taxes of services or service suppliers of other member states. BUT the measure must not be arbitrary or unjustified ... or a disguised restriction on trade in services | Measure may be arbitrary, unjustified ... or a disguised restriction of trade if the matter falls within the scope of a tax treaty |
| – Tax measure (MFN)    | No MFN obligation if difference in tax treatment is the result of a tax treaty BUT measure must not be arbitrary or unjustified ... or a disguised restriction on trade in services  | None   |
|                        | Commercial presence  | Permanent establishment  |
| General trade measures | NT/MFN   | None   |
| – Tax measures (NT)    | NT—(see above)   | The source state may not “levy tax less favourably” than that levied on a domestic enterprise carrying on the same activities      |
| – Tax measures (MFN)   | (see above)  | None   |

prevail, or a disguised restriction on trade in services.” However, even this obligation is effectively negated if the measure falls within the scope of a tax treaty between the GATS Member States.<sup>80</sup>

Indirect taxes remain subject to the GATS national treatment obligation but access to the GATS consultation and dispute resolution process may be limited if the tax treaty non-discrimination provisions include indirect taxes.<sup>81</sup> Article 24(6) of the OECD Model Tax Treaty for example, includes “taxes of every kind and description.” If the applicable tax treaty includes similar language or specific language related to indirect taxes, an indirect tax measure would fall within the scope of the tax treaty and the Member State would be subject to the restriction in the GATS Article XXII(3).

<sup>80</sup>Tax treaties have primacy over the GATS national treatment obligation in resolving disputes involving the taxation of services and service suppliers.

<sup>81</sup>See OECD and UN Model Tax Treaties, Article 24(6).

There is no most favoured national obligation under the OECD and UN Model Tax Treaties for tax measures. The GATS requires that any differences in treatment among Member States that violate the most favoured nation obligation must be the result of a tax treaty.<sup>82</sup>

### 2.3.1.1 The Interaction of the GATS and Tax Treaties

It is clear from the discussion thus far that the non-discrimination obligations in the OECD and UN Model Tax Treaties are significantly more limited in scope than those under the GATS and provide little or no protection to a non-resident service provider who does not take up tax residence or have a permanent establishment in the country where the income or profit is earned. This is of no surprise. It is widely accepted that for tax purposes, and in particular tax treaty purposes, that non-residents may be treated differently than tax residents. The question is how differently and on what basis.

Let us take withholding tax as an example. The imposition of withholding tax on a non-resident service provider is typically justified as a way to protect the source country's revenue base. Withholding tax ensures that the non-resident earning income in the source country cannot avoid paying applicable taxes. The use of withholding tax is further rationalized on the basis that amounts withheld are either fully credited against income taxes due or refunded. In principle, this ensures withholding taxes are non-distortionary. But is this true?

The argument that withholding taxes are non-distortionary ignores the compliance costs associated with the imposition of withholding taxes. It also ignores the reality that withholding taxes often apply to gross rather than net income and may add a significant tax cost to doing business. The end result is that a tax measure, including a withholding tax, may affect the conditions of competition and may effectively serve as a barrier to trade.<sup>83</sup> It was this potential for the negative impact that tax measures could have on trade in services that was recognized in the negotiations under the GATS and has since been acknowledged in negotiating other trade agreements.<sup>84</sup>

Although measures aimed at ensuring the equitable or effective imposition or collection of direct tax were excepted from the national treatment obligation in the GATS, a minimum non-discrimination obligation remained—that is the measure

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<sup>82</sup>The GATS, Article XIV(e).

<sup>83</sup>This issue is discussed further in Chap. 7 at Sect. 7.2.

<sup>84</sup>“In the context of the negotiation of the GATS, the European Energy Charter and of a draft multilateral investment on agreement, the Committee on Fiscal Affairs has done considerable work on the issue of the application of such agreements to taxation. This work has revealed that whilst there are good reasons for preventing, or at least limiting, the application of such agreements to tax measures, there is a concern that taxation may be used as a form of disguised discrimination and that the non-discrimination article of tax treaties, in its present form, is not considered by trade or investment experts as an appropriate way to address this concern.” From OECD (2005).

could not constitute “arbitrary or unjustifiable discrimination between countries where like conditions prevail, or a disguised restriction on trade in services.” This non-discrimination obligation may potentially serve a very important role.

A preliminary consideration of the GATS exception for direct taxes against a list of common tax measures reveals that at least five broad categories of tax measures could violate the GATS national obligation if applied by a host country to the income earned by a non-resident.

First, the domestic legislation of the host country may fall under the exception in Article XIV of the GATS because the measure is arguably aimed at the effective imposition of direct taxes in respect of income from services or of service suppliers of another Member States. Nonetheless the measure may operate as a disguised restriction on trade in services. For example, the host country may impose an excessive and arbitrary gross withholding tax.

Second, the domestic legislation in the host country may meet the exception in Article XIV of the GATS but be administered in a manner that is a disguised restriction on trade. For example, the requirements of the host country to obtain an exemption from or a refund of withholding tax on income that is exempt under the tax treaty may be arbitrary or unduly onerous.

Third, the measure may fall outside the permitted list of exceptions in Article XIV of the GATS and may not be listed as a qualification in the Member’s schedule of commitments. For example, the host country could provide an additional tax credit to a tax resident that purchases services from a resident service provider but not from a non-resident service provider.

Fourth, the tax measure may be disguised in the form of a penalty, fee or charge. For example, there may be additional fees associated with non-resident filings or claims for refunds.

Finally, the measure may be in respect of indirect taxes. For example, the host country may impose different and discriminatory indirect taxes such as sales taxes, excise taxes, value added taxes-and tariffs or other similar charges on the services provided by a non-resident service provider.

Each of these measures is potentially subject to scrutiny under the GATS minimum non-discrimination obligation. If the measure violates the national treatment obligation, the measure is subject to the additional requirement that it must not be arbitrary or unjustifiable discrimination between countries where like conditions prevail or a disguised restriction on trade in services.

Each of these measures may also fall within the scope of a tax treaty. A tax treaty between two Member States may operate to prevent a challenge under the GATS that the national treatment obligation has been violated and will negate the GATS requirement that any differences based on the effective enforcement and collection of direct taxes must not be arbitrary or a disguised restriction on trade.<sup>85</sup> The

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<sup>85</sup>At present, there are also few limitations on a country’s tax practices. Customary international law provides virtually no protection against tax discrimination and constitutional or national limitations on tax discrimination against non-residents are rare. The primary restraint against egregious tax practices is international goodwill or limitations imposed in integrated agreements.

non-discrimination articles in the OECD and UN Model Tax Treaties and the tax treaties that are based on them do not provide protection against differences in tax treatment to a non-resident service provider in any of these circumstances.

The interaction of the GATS with tax treaties may also result in the application of different non-discrimination obligations by a member State to the non-resident service providers of other Member State. This is illustrated in the summary below.

If there is no tax treaty between the Member States, the GATS non-discrimination obligations and applicable exclusions apply. A measure that violates the national treatment obligation and is directed at ensuring the equitable or efficient collection of taxes cannot be arbitrary or a disguised restriction on trade in service.

If there is a tax treaty between the Member States that is based on the OECD or UN Model, the non-discrimination obligations in the tax treaty will prevail if the matter falls within the scope of the tax treaty and a non-resident service provider can anticipate that no non-discrimination obligation will apply.

The outcome is less clear if there is a tax treaty between the Member States, the measure *prima facie* violates the national treatment obligation and the exception but the tax treaty does not include a non-discrimination article.<sup>86</sup> One view is that the matter of non-discrimination falls within the scope of a tax treaty but by inference no non-discrimination obligation applies. An alternate view is that absent a non-discrimination article, the matter does not fall within the scope of a tax treaty and therefore the measure remains subject to the GATS limited non-discrimination obligation.

Resolution of the issue may depend on the tax treaty itself. For example, in the case of the Canada-US Tax Treaty, the tax treaty addresses the potential role of the WTO in resolving tax matters. Specifically, the Third Protocol amended Article XXIX of the tax treaty to include new provisions for purposes of the application of Article XXII(3) of the GATS. The amendment provides that for the purposes of GATS, Canada and the US agree that a tax measure will fall under the tax treaty if it relates to Article XXV (Non-Discrimination) or, if it does not relate to non-discrimination, it falls within another tax treaty provision, but only to the extent that the measure relates to a matter dealt with in that tax treaty provision.<sup>87</sup> The tax treaty also clarifies that notwithstanding Article XXII of the GATS,

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<sup>86</sup>See for example the Australian treaties with Canada, Malaysia, Mexico, Singapore and the discussion in Chap. 4 at Sect. 4.3.10.

<sup>87</sup>See the Canada-Tax Treaty Article XXIX at para 6. This clarification of the role of the tax treaty was considered necessary, notwithstanding that the Protocol was grandfathered under the GATS provisions, as the Third Protocol also extends the non-discrimination article of the Treaty to “all taxes imposed by either contracting state.” Apparently, the negotiators wanted to ensure that these new taxes (including the GST) would be subject to the Tax Treaty dispute resolution mechanism. The amendment to Article XXIX of the Canada-US Tax Treaty to limit the role of the WTO was of no surprise given the very strong position taken by the US during the Uruguay Round.

**Table 2.3** Summary of applicable non-discrimination obligations under the GATS and the OECD/UN model tax treaties in respect of non-resident service providers with no permanent establishment

| Agreements in place              | GATS/tax treaty  | GATS  | GATS Tax treaty (no Art 24)   | No GATS Tax treaty   | No GATS No tax treaty? |
|----------------------------------|--|---|---|--|------------------------|
| Non-discrimination obligation(s) | Tax treaty (none) other than indirect through Article 24 (4) | GATS measures cannot be “arbitrary or a disguised restriction on trade” | GATS measures cannot be “arbitrary or a disguised restriction on trade” | Tax treaty (none) other than indirect through Article 24 (1) | (None)                 |

any doubt as to the interpretation of the scope of a treaty provision, and specifically whether the tax treaty applies, will be resolved under the mutual agreement procedure of the tax treaty.<sup>88</sup>

Other tax treaties may be silent on the role of the GATS. If the tax treaty is silent and was in existence prior to the entry into force of the GATS, the parties are subject to the GATS requirement that both parties must consent to have the issue of the treaties scope settled by the Council for Trade in Services.<sup>89</sup> For subsequent tax agreements, the GATS provides that either Member may bring the jurisdictional matter before the Council for Trade in Services, which will refer the matter to arbitration for a decision that will be final and binding on the Members (Table 2.3).

## 2.4 Conclusions

An examination of the GATS agreement and the OECD and UN Model Tax Treaties reveals few limits on the tax measures that a country may impose on a non-resident service provider.<sup>90</sup> During the GATS negotiations it became clear that tax treaties were to assume primacy in tax matters. Tax treaties provide little protection for a non-resident against discriminatory tax practices.

<sup>88</sup>*Ibid.*

<sup>89</sup>The GATS, Article XXII(3) specifically provides that there will be no access to GATS procedures to settle a national treatment dispute concerning a measure that falls within the scope of a tax agreement. In the event of a disagreement between Members as to whether a measure falls within the scope of a tax agreement that existed at the time of the entry into force of the Agreement establishing the World Trade Organization, Article XXII(2), footnote 11, of GATS reserves the resolution of the dispute to the Contracting States under the tax agreement. In such a case, the issue of the scope of a tax agreement may be resolved under GATS procedures (rather than tax treaty procedures) only if both parties to the existing tax agreement consent.

<sup>90</sup>The precise scope of the non-discrimination obligations that may apply to non-residents under the GATS and with what effect at best remains unclear. See Farrell (2013).

Is this important? What impact, if any, will the failure to provide adequate protection from discriminatory tax measures have on a non-resident service provider? These questions have not been the subject of extensive study. There is significant evidence, however, that the manner in which many countries employ their domestic laws to tax income from the provision of services earned by a non-resident, especially the manner in which withholding taxes are imposed, can result in a significant and unpredictable tax burden for a non-resident.<sup>91</sup>

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