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PERMANENT ESTABLISHMENTS UNDER THE NONDISCRIMINATION CLAUSE IN INCOME TAX TREATIES*

William C. Gifford†

A standard provision in bilateral income tax treaties between the United States and its treaty partners is the nondiscrimination clause.¹ Under this provision, each treaty country agrees not to discriminate

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1. Twenty-four of the twenty-seven income tax treaties which are currently in force between the United States and its treaty partners contain a nondiscrimination clause. [For ease of reference, each convention for the avoidance of double taxation on income between the United States and each of its treaty partners is cited in this Article by the name of the treaty partner.] *Austria*, Oct. 25, 1956, art. XVIII(3), 8 U.S.T. 1699, T.I.A.S. No. 3923; *Belgium*, July 9, 1970, art. 24, 23 U.S.T. 2687, T.I.A.S. No. 7463; *Burundi, Kinshasa, and Rwanda*, Oct. 28, 1948, art. XX(3), 4 U.S.T. 1647, T.I.A.S. No. 2833, *extended by Supplementary Convention*, Aug. 22, 1957, art. IV, 10 U.S.T. 1358, T.I.A.S. No. 4280; *Canada*, March 4, 1942, Protocol para. 12, 56 Stat. 1399, T.S. No. 983, *amended by Supplementary Convention*, Aug. 8, 1956, art. I(d), 8 U.S.T. 1619, T.I.A.S. No. 3916; *Denmark*, May 6, 1948, art. XVI(1), 62 Stat. 1730, T.I.A.S. No. 1854; *Federal Republic of Germany*, July 22, 1954, art. XVIII(3), 5 U.S.T. 2768, T.I.A.S. No. 3133; *Finland*, March 6, 1970, art. 7, 22 U.S.T. 40, T.I.A.S. No. 7042; *France*, July 28, 1967, art. 24, 19 U.S.T. 5280, T.I.A.S. No. 6518; *Greece*, Feb. 20, 1950, art. XVI(3), 5 U.S.T. 47, T.I.A.S. No. 2902; *Iceland*, May 7, 1975, art. 7, 26 U.S.T. 2004, T.I.A.S. No. 8151; *Ireland*, Sept. 13, 1949, art. XXI, 2 U.S.T. 2303, T.I.A.S. No. 2356; *Japan*, March 8, 1971, art. 7, 23 U.S.T. 967, T.I.A.S. No. 7365; *Luxembourg*, Dec. 18, 1962, art. XX(3), 15 U.S.T. 2355, T.I.A.S. No. 5726; *Netherlands*, April 29, 1948, art. XXV(3), 62 Stat. 1757, T.I.A.S. No. 1855, *modified by Supplementary Convention*, Dec. 30, 1965, art. XIV, 17 U.S.T. 896, T.I.A.S. No. 6051; *Norway*, Dec. 3, 1971, art. 25(1)-(3), 23 U.S.T. 2832, T.I.A.S. No. 7474; *Pakistan*, July 1, 1957, art. XVII, 10 U.S.T. 984, T.I.A.S. No. 4232; *Poland*, Oct. 8, 1974, art. 21, T.I.A.S. No. 8486; *Romania*, Dec. 4, 1973, art. 22, T.I.A.S. No. 8228; *Sweden*, March 23, 1939, Protocol para. 7, 54 Stat. 1759, T.S. No. 958, *modified by Supplementary Convention*, Oct. 22, 1963, art. II(c), 15 U.S.T. 1824, T.I.A.S. No. 5656; *Switzerland*, May 24, 1951, art. XVIII(3), 2 U.S.T. 1751, T.I.A.S. No. 2316; *Trinidad and Tobago*, Jan. 9, 1970, art. 6, 22 U.S.T. 164, T.I.A.S. No. 7047; *Union of South Africa*, Dec. 13, 1946, art. III(1), 3 U.S.T. 3821, T.I.A.S. No. 2510; *U.S.S.R.*, June 20, 1973, art. X, T.I.A.S. No. 8225; *United Kingdom*, April 26, 1945, art. XXI, 60 Stat. 1377, T.I.A.S. No. 1546, *amended by Supplementary Protocol*, March 17, 1966, art. 16, 17 U.S.T. 1254, T.I.A.S. No. 6089 (also in force in its original form with *Barbados, Jamaica, Nigeria, and Sierra Leone*, see 2 TAX TREATIES (CCH) ¶ 8103 (1971)). The clause also appears in several income tax conventions which have not entered into

against the nationals² of the other country resident in its territory by taxing them more severely than its own nationals.³ Designed to assure

force. *Brazil*, March 13, 1967, art. 6, 1 *id.* ¶ 809 (1967); *India*, Nov. 10, 1959, art. XVI, *id.* ¶ 3819 (1960) (treaty withdrawn by United States before becoming effective); *Israel*, Nov. 20, 1975, art. 27, 2 *id.* ¶ 4230 (1976); *Morocco*, Aug. 1, 1977, art. 22, *id.* ¶ 9741 (1977); *Philippines*, Oct. 1, 1976, art. 24(1)-(3), *id.* ¶ 6627 (1976); *Republic of Korea*, June 4, 1976, art. 7, 1 *id.* ¶ 4810 (1976); *Thailand*, March 1, 1965, art. 23, 2 *id.* ¶ 7526 (1965); *United Arab Republic*, Oct. 28, 1975, art. 26, *id.* ¶ 8031 (1976); *United Kingdom*, Dec. 31, 1975, art. 24(1), (2), (5), *id.* ¶ 8103X (1977). In addition, both the Treasury Department's Model Income Tax Convention of May 17, 1977, art. 24, *reprinted in* 1 TAX TREATIES (CCH) ¶ 153 (1977), and the Organisation for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, art. 24, in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL 41 (1977) [hereinafter cited as OECD], contain nondiscrimination provisions. The three United States income tax treaties which do not contain a nondiscrimination clause are: *Australia*, May 14, 1953, 4 U.S.T. 2274, T.I.A.S. No. 2880; *Italy*, March 30, 1955, 7 U.S.T. 2999, T.I.A.S. No. 3679, *extended by* Exchange of Letters, Dec. 13, 1974, 26 U.S.T. 1088, T.I.A.S. No. 8097; *New Zealand*, March 16, 1948, 2 U.S.T. 2378, T.I.A.S. No. 2360. *Cf. Honduras*, June 25, 1956, 8 U.S.T. 219, T.I.A.S. No. 3766 (treaty lacking nondiscrimination clause was terminated). None of the estate or gift tax conventions to which the United States is a party contains a nondiscrimination clause, although a nondiscrimination clause does appear in Article 11 of the Treasury Department's Model Estate and Gift Tax Convention, *reprinted in* 1 TAX TREATIES (CCH) ¶ 154 (1977).

Some commentators also refer to the nondiscrimination clause as the "equal treatment" clause, *see, e.g.*, S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS at IX-109 (1970), and the "national treatment" clause, *see, e.g.*, R. WILSON, UNITED STATES COMMERCIAL TREATIES AND INTERNATIONAL LAW 179-80 (1960).

2. Some treaties' nondiscrimination clauses expressly protect both the individuals and corporations of each treaty state. *E.g., France*, July 28, 1967, art. 24, 19 U.S.T. 5280, T.I.A.S. No. 6518; *United Kingdom*, April 26, 1945, art. XXI, 60 Stat. 1377, T.I.A.S. No. 1546, *amended by* Supplementary Protocol, March 17, 1966, art. 16, 17 U.S.T. 1254, T.I.A.S. No. 6089. Other treaties state that the clause covers "citizens" but do not indicate whether the clause protects corporate entities as well as individuals. *E.g., Canada*, March 4, 1942, Protocol para. 12, 56 Stat. 1399, T.S. No. 983, *amended by* Supplementary Protocol, Aug. 8, 1956, art. I(d), 8 U.S.T. 1619, T.I.A.S. No. 3916.

3. S. ROBERTS & W. WARREN, *supra* note 1, at IX-109. The historical roots of the nondiscrimination clause lie in the "most favored nation" and national treatment protections contained in the Friendship, Commerce and Navigation Treaties which originated in the 17th century within the Western Hemisphere trading community. The "most favored nation" clause provides that treaty partner nationals will be subjected to no other or greater tax and customs burdens than are imposed on the nationals of any third country. This clause first appeared in the 1642 treaty between Portugal and Great Britain and was contained in the first American commercial treaty, Treaty of Amity and Commerce, Feb. 6, 1778, France-United States, arts. II-IV, 8 Stat. 12, T.S. No. 83. Lidstone, *Liberal Construction of Tax Treaties—An Analysis of Congressional and Administrative Limitations of an Old Doctrine*, 47 CORNELL L.Q. 529, 537-38 (1962). Provisions similar to the "most favored nation" clause today are contained in the bilateral income tax conventions between the United States and Romania, and the United States and the U.S.S.R. *Romania*, Dec. 4, 1973, art. 22(2), T.I.A.S. No. 8228; *U.S.S.R.*, June 20, 1973, art. X(2), T.I.A.S. No. 8225. These provisions, however, only require that treaty partner citizens shall not be subjected to more burdensome taxes than are generally imposed on the citizens of a third country; a treaty country is not required to afford to a treaty partner citizen national tax benefits granted by

equal tax treatment in each treaty country for its own citizens and the citizens of its treaty partner,⁴ the nondiscrimination clause protects the nationals of both countries from differential tax treatment abroad.⁵ As applied to the United States taxation of treaty partner nationals and residents, the nondiscrimination clause supplements the constitutional,⁶

special agreement to citizens of a third country. *Cf. Poland*, Oct. 8, 1974, art. 21(2), (3), T.I.A.S. No. 8486 (similar provisions applicable to "permanent establishments" and "companies"); *Romania*, Dec. 4, 1973, art. 22(2), (3), T.I.A.S. No. 8228 (similar provisions applicable to "citizens" and "corporations").

The "most favored nation" provision, which merely secures for foreign nationals treatment equal to that afforded all other similarly situated foreigners, differs from the national treatment clause which requires that all foreigners receive the same treatment as domestic nationals. Wurzel, *Trade Agreements And Tax Privileges*, 18 TAXES 484, 486 (1940). The national treatment clause first appeared in the 1654 treaty between Portugal and Great Britain and provided that the subjects of Great Britain "shall enjoy the same liberties, privileges and exemptions as the Portugese [*sic*] themselves." Lidstone, *supra* at 538. Article X of that treaty granted to the English the right to transport their goods into Portuguese ports "without paying any other or further custom, duty or sum of money besides what the Portugese [*sic*] merchants should pay, if the goods and merchandise belonged to them." *Id.* The 1660-61 Treaty of Peace and Commerce between Great Britain and Denmark, the 1667 Treaty of Peace and Friendship between Spain and Great Britain, and all early British commercial treaties included a national treatment clause. *Id.*

The first American treaty to contain a national treatment clause was the Jay Treaty, Nov. 19, 1794, Great Britain-United States, 8 Stat. 116, T.S. No. 105. Article III of that treaty required that Americans pay "no higher or other duties than would be payable by His Majesty's subjects" and "[n]o higher or other tolls or rates of ferriage than what are or shall be payable by [Englishmen]." Throughout the 1800's, the United States actively sought treaties providing for reciprocal national treatment; because these treaties were aimed primarily at securing protection for American trade abroad, they often "assumed a very nautical cast." Lidstone, *supra* at 539; see R. WILSON, *supra* note 1, at 163. The first American treaty to contain a national treatment clause specifically applicable to taxes was the Treaty of Amity, Commerce, and Navigation, April 5, 1831, Mexico-United States, art. IX, 8 Stat. 410, T.S. No. 203. R. WILSON, *supra* note 1, at 163.

4. Bilateral income tax treaties to which the United States is not a partner typically contain a nondiscrimination clause. *E.g.*, Convention for the Avoidance of Double Taxation, Sept. 9, 1966, France-Switzerland, art. 26, [1967] Journal Officiel de la Republique Française [J.O.] 9972, 772 U.N.T.S. 275; Convention for the Avoidance of Double Taxation, May 22, 1968, France-United Kingdom, art. 25, [1970] Gr. Brit. T.S. No. 6 (Cmd. 4253), 725 U.N.T.S. 3; Convention for the Avoidance of Double Taxation, Aug. 11, 1971, Federal Republic of Germany-Switzerland, art. 25, [1972] Bundesgesetzblatt II (Ger.) 1022; Convention for the Avoidance of Double Taxation, Nov. 26, 1964, Federal Republic of Germany-United Kingdom, art. XX, [1967] Gr. Brit. T.S. No. 17 (Cmd. 3249), 603 U.N.T.S. 183. Nevertheless, the Committee on Fiscal Affairs of the Organization for Economic Co-operation and Development has again rejected the feasibility of implementing a multilateral treaty among its 24 members, although the Committee has suggested that groups of members might experiment in this direction. OECD, *supra* note 1, at 15, para. 32.

5. See Wurzel, *supra* note 3, at 486. One commentator has stated that considerable precedent supports the proposition that unfair discriminatory taxation of aliens is inconsistent with principles of international law grounded in custom and usage. R. WILSON, *supra* note 1, at 157. Recent international practice, however, appears too contradictory to permit acceptance of this proposition as a clearly established rule. *Id.*

6. The due process clauses of the fifth and fourteenth amendments as well as the equal protection clause of the fourteenth amendment protect aliens. *E.g.*, *Mathews v. Diaz*, 426

statutory,⁷ and administrative⁸ safeguards against discrimination.

Modern income tax conventions⁹ typically express the nondiscrimination principle in three specific provisions, each designed to protect a distinct class of treaty partner nationals: foreign individuals and enterprises; domestic enterprises owned or controlled by foreigners; and domestic permanent establishments of foreign enterprises.¹⁰ As to the first

U.S. 67, 77 (1976); *In re Griffiths*, 413 U.S. 717 (1973). A taxing statute which discriminates against aliens is not unconstitutional under the due process clause if the classification of taxpayers is reasonable. *Barr v. Commissioner*, 51 U.S. Tax Ct. 693, 695 (1969) (resident United States citizen held ineligible for dependency deduction for his nonresident alien son); *cf. Barclay & Co. v. Edwards*, 267 U.S. 442, 450 (1924) (no fifth amendment violation when tax is greater on domestic corporations than on foreign corporations).

7. I.R.C. § 894(a) provides that income of any kind shall not be included in gross income to the extent required by any treaty obligation. *See* Treas. Reg. § 1.894-1(a), T.D. 7293, 1973-2 C.B. 228, 242. The section requires that any Code section that discriminates against treaty partner nationals by including in their gross income items which are not included in the gross income of United States citizens must yield to a treaty nondiscrimination clause. This provision, however, does not prevent discrimination against treaty partner nationals in the form of the denial of exemptions, deductions, credits, or other allowances available to United States citizens. Since the former kind of discrimination does not exist under the Code, I.R.C. § 894(a) has no practical application. *See also* I.R.C. § 7852(d) (IRS provisions must yield to treaty obligations); I.R.C. §§ 891, 896 (President may proclaim retaliatory tax on foreign citizens and corporations).

8. The IRS "cannot tax one and not tax another without some rational basis for the difference." *United States v. Kaiser*, 363 U.S. 299, 308 (1960) (Frankfurter, J., concurring). This rule prohibits one taxpayer from receiving less favorable tax treatment than that accorded another "similarly situated" taxpayer. *See International Business Machines Corp. v. United States*, 343 F.2d 914 (Ct. Cl. 1965) (member of a two-firm industry entitled to the same favorable tax treatment afforded his sole competitor by a prior IRS ruling). A body of case law defining the parameters of administrative tax discrimination has begun to develop and will probably expand more rapidly in light of the provisions of the Tax Reform Act allowing taxpayers access to private IRS rulings. Tax Reform Act of 1976, Pub. L. No. 94-455, § 1201(a), 90 Stat. 1520 (codified at I.R.C. § 6110). *See generally* Gifford, *Taxpayer Discrimination: Some Speculations*, CORNELL L.F., Feb. 1977, at 8.

9. Modern income tax conventions originated with the Convention on Double Taxation, April 27, 1932, France-United States, 49 Stat. 3145, T.S. No. 885; the Convention for the Avoidance of Double Taxation, Dec. 24, 1936, France-Sweden, 181 L.N.T.S. 315; and the Convention on Double Taxation, March 23, 1939, Sweden-United States, 54 Stat. 1759, T.S. No. 958. *See Wurzel, A Tax Agreement with Sweden*, 17 TAXES 460, 460 (1939).

10. *E.g.*, Treasury Department's Model Income Tax Convention of May 17, 1977, art. 24, reprinted in 1 TAX TREATIES (CCH) ¶ 153 (1977). Article 24(1) provides:

Nationals of a Contracting State shall not be subjected in the other 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 are or may be subjected. For purposes of the preceding sentence, nationals who are subject to tax by a Contracting State on worldwide income are not in the same circumstances as nationals who are not so subject. This provision shall, notwithstanding the provisions of Article 1 (Personal Scope), also apply to persons who are not residents of one or both of the Contracting States.

two classes the Internal Revenue Code is generally consistent with the nondiscrimination clause; although there is little decisional authority interpreting the extent of protection the treaty affords these taxpayers, the Code contains only limited instances of potential discrimination.¹¹

A permanent establishment of a foreign corporation, however, would seem to be subject to extensive discrimination under the Internal Revenue Code with respect to taxation of dividends it receives, losses suffered by its American subsidiary corporations, and credits for foreign taxes imposed on its income. To date, no court or administrative decision has recognized the Code's discriminatory treatment of permanent establishments of foreign enterprises.¹² Moreover, the commentary interpreting the typical permanent establishment clause, such as Article 24(3) of the United States Model Treaty, sheds little light on the extent to which these establishments are protected from discriminatory taxation.¹³

Article 24(3) of that Treaty provides:

The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

Article 24(5) provides:

Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

The United States Model Treaty also contains a provision which specifically requires each country to allow domestic enterprises the same deduction for interest, royalties, debts, and other disbursements whether these payments are made to its own residents or residents of the other country. Because this provision concerns the tax treatment which each country affords its own domestic enterprises, it does not properly fall within the nondiscrimination principle. Treasury Department's Model Income Tax Convention of May 17, 1977, *supra*, art. 24(4).

11. The IRS has recognized and eliminated some instances of discrimination. Rev. Rul. 72-330, 1972-2 C.B. 444; Rev. Rul. 72-598, 1972-2 C.B. 451.

12. Experience in other countries also seems limited. *Cf.* Judgment of Dec. 19, 1976, Nos. 84,774 and 91,895, Conseil d'état, France, *noted in* 16 EUROPEAN TAX. 312 (1976) (court decided French municipal law issue and avoided the issue of discrimination against a permanent establishment of a foreign corporation). *But see* Judgment of April 30, 1975, Supreme Tax Court, W. Ger., [1975] Bundessteuerblatt II 706, *noted in* 16 EUROPEAN TAX. 164 (1976) (court found no violation of treaty's nondiscrimination clause since nationals of the taxing country would receive identical tax treatment).

13. The only in-depth commentary which has addressed the permanent establishment clause of any treaty appears to be that contained in the OECD, *supra* note 1, at 165-73, paras. 21-55, and Oliver, *Discrimination*, 1977 BRIT. TAX REV. 148. The only official comment on a permanent establishment clause is the official explanation of the United Kingdom-United States treaty that is not yet in force, *United Kingdom*, Dec. 31, 1975, art. 24(1), (2), (5), 2 TAX TREATIES (CCH) ¶ 8103X (1977). This commentary merely states that

This Article will focus on the interpretive problems of the permanent establishment clause of the Model Treaty and illustrate these problems by reference to the specific circumstances in which they arise. The tax principles and policies underlying the nondiscrimination clause will be examined in an effort to formulate a consistent analytic framework which resolves these interpretive difficulties. Finally, the Article suggests a revised formulation of the permanent establishment clause designed to avoid the present interpretive problems and effectuate the policies behind the nondiscrimination clause.

I

THE PERMANENT ESTABLISHMENT CLAUSE

The early tax treaties between the United States and its treaty partners did not contain a provision which specifically addressed discriminatory tax treatment of permanent establishments of treaty country enterprises.¹⁴ Permanent establishments of a foreign enterprise could only claim the protection afforded the foreign enterprise itself under the simple formulation of the nondiscrimination clause, which typically provided that "the citizens of one [treaty country] residing within the other [treaty country] shall not be subjected to the payment of more burdensome taxes than the citizens of the other [treaty country]."¹⁵ Because this early formulation did not make clear the extent of protection afforded permanent establishments,¹⁶ modern treaties have expanded the earlier nondis-

the clause "provides that a permanent establishment which an enterprise of one Contracting State has in the other Contracting State will not be subject in that other Contracting State to less favorable taxation than an enterprise of that other Contracting State carrying on the same activities." Internal Revenue Service, U.S. Dep't of the Treasury, Technical Explanation of the Convention between the United States and the United Kingdom for the Avoidance of Double Taxation Signed on December 31, 1973, Treasury Department News Release (March 19, 1977), reprinted in 2 TAX TREATIES (CCH) ¶ 8103DD, at 8107-55 (1977). This "explanation" wholly fails to address the difficult interpretive issues surrounding the clause.

14. For example, the Canadian treaty, *Canada*, March 4, 1942, Protocol para. 12, 56 Stat. 1399, T.S. No. 983, amended by Supplementary Convention, Aug. 8, 1956, art. I(d), 8 U.S.T. 1619, T.I.A.S. No. 3916, prohibits discrimination against all foreign "citizens" without defining the term "citizen" and guarantees those foreign "citizens" tax treatment equal to that afforded to all United States "citizens" residing both home and abroad. A number of later tax treaties also prohibit discrimination against all foreign "citizens" (or "nationals"), but those treaties both define the term "citizens" as including legal persons, partnerships, and associations, and limit the guarantee to tax treatment equal to that afforded to United States "citizens" residing only in the United States. *E.g.*, *Austria*, Oct. 25, 1956, art. XVIII(3), 8 U.S.T. 1699, T.I.A.S. No. 3923 ("citizens"); *Ireland*, Sept. 13, 1949, art. XXI, 2 U.S.T. 2303, T.I.A.S. No. 2356 ("nationals").

15. *Canada*, March 4, 1942, Protocol para. 12, 56 Stat. 1399, T.S. No. 983, amended by Supplementary Convention, Aug. 8, 1956, art. I(d), 8 U.S.T. 1619, T.I.A.S. No. 3916.

16. Under the simple formulation of the older treaties, a permanent establishment of a foreign corporation must satisfy two requirements to receive protection against discrimina-

crimination principle and now include a separate provision which focuses upon permanent establishments. Typical of the modern formulation is Article 24(3) of the Treasury Department's Model Income Tax Treaty of May 17, 1977, which provides:

The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in the other State than the taxation levied on enterprises of that other State carrying on the same activities.¹⁷

This rule is followed by a provision which limits its application by permitting a contracting state to deny to residents of the treaty partner country "any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which [are granted] to its own residents."¹⁸

tory taxation: first, the corporation and its permanent establishment must qualify as a "citizen" of the foreign country; second, the permanent establishment must qualify as a "resident" of the country imposing the tax. See, e.g., *Federal Republic of Germany*, July 22, 1954, art. XVIII(3), 5 U.S.T. 2768, T.I.A.S. No. 3133; *Switzerland*, May 24, 1951, art. XVIII(3), 2 U.S.T. 1751, T.I.A.S. No. 2316.

17. Treasury Department's Model Income Tax Convention of May 17, 1977, art. 24(3), reprinted in 1 TAX TREATIES (CCH) ¶ 153 (1977) [hereinafter cited as the United States Model Treaty]. The 1977 OECD Model Treaty as well as at least 14 treaties between the United States and its treaty partners contain similar expanded nondiscrimination provisions. Organisation for Economic Co-operation and Development Model Convention for the Avoidance of Double Taxation with Respect to Taxes on Income and on Capital, art. 24(4) [hereinafter cited as the OECD Model Treaty], in ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL 41 (1977) [hereinafter cited as OECD]; *Belgium*, July 9, 1970, art. 24(2), 23 U.S.T. 2687, T.I.A.S. No. 7463; *Brazil*, March 13, 1967, art. 6(2), 1 TAX TREATIES (CCH) ¶ 809 (1967) (not yet in force); *Finland*, March 6, 1970, art. 7(2), 22 U.S.T. 40, T.I.A.S. No. 7042; *France*, July 28, 1967, art. 24(2), 19 U.S.T. 5280, T.I.A.S. No. 6518; *Israel*, Nov. 20, 1975, art. 27(2), 2 TAX TREATIES (CCH) ¶ 4230 (1976) (not yet in force); *Japan*, March 8, 1971, art. 7(2), 23 U.S.T. 967, T.I.A.S. No. 7365; *Morocco*, Aug. 1, 1977, art. 22(2), 2 TAX TREATIES (CCH) ¶ 9741 (1977) (not yet in force); *Netherlands*, April 29, 1948, art. XXV(3), 62 Stat. 1757, T.I.A.S. No. 1855, modified by Supplementary Convention, Dec. 30, 1965, art. XIV, 17 U.S.T. 896, T.I.A.S. No. 6051; *Norway*, Dec. 3, 1971, art. 25(2), 23 U.S.T. 2832, T.I.A.S. No. 7474; *Philippines*, Oct. 1, 1976, art. 24(2), 2 TAX TREATIES (CCH) ¶ 6627 (1976) (not yet in force); *Republic of Korea*, June 4, 1976, art. 7(2), 1 *id.* ¶ 4810 (1976) (not yet in force); *Trinidad and Tobago*, Jan. 9, 1970, art. 6(2), 22 U.S.T. 164, T.I.A.S. No. 7047; *United Arab Republic*, Oct. 28, 1975, art. 26(2), 2 TAX TREATIES (CCH) ¶ 8031 (1976) (not yet in force); *United Kingdom*, April 26, 1945, art. XXI(2), 60 Stat. 1377, T.I.A.S. No. 1546, amended by Supplementary Protocol, March 17, 1966, art. 16, 17 U.S.T. 1254, T.I.A.S. No. 6089; see *United Kingdom*, Dec. 31, 1975, art. 24(2), 2 TAX TREATIES (CCH) ¶ 8103X (1977) (not yet in force). The treaties with Poland and Romania also focus specifically on permanent establishments of residents of the treaty countries. But, unlike the United States Model Treaty, *supra*, these treaties only prohibit taxes on permanent establishments of residents of the treaty countries that are more burdensome than the taxes imposed on permanent establishments of residents of third countries carrying on the same activities. *Poland*, Oct. 8, 1974, art. 21(2), T.I.A.S. No. 8486; *Romania*, Dec. 4, 1973, art. 22(2), T.I.A.S. No. 8228.

18. United States Model Treaty, *supra* note 17, art. 24(3). For the full text of Article 24(3) of the United States Model Treaty, see note 10 *supra*.

The definitional provisions of the Model Treaty clarify the range of taxpayers eligible for protection under Article 24(3). The permanent establishment clause itself extends protection to a permanent establishment maintained in a contracting state by an enterprise of the other contracting state. Article 5(1) defines a permanent establishment as a "fixed place of business through which the business of an enterprise is wholly or partly carried on."¹⁹ Article 3(1)(c) in turn characterizes the enterprise of a contracting state as "an enterprise carried on by" a resident of that contracting state.²⁰ A resident of a contracting state is defined as any person who, under the laws of that state, is subject to tax because of his domicile, residence, citizenship, place of management, place of incorporation, or similar criteria.²¹ This definition is sufficiently broad to include individuals, partnerships, companies, estates, trusts, and any other group of persons.²² However, the Model Treaty nowhere explains the critical term "enterprise." Presumably, this term includes a broad range of legal entities actively conducting business operations. In the absence of a definition of "enterprise," a treaty country will presumably resort to its own domestic law for guidance or request negotiations with its treaty partner under the mutual agreement procedure of Article 25 to establish this term's meaning.²³

II

INTERPRETIVE PROBLEMS

The Model Treaty eliminates several interpretive difficulties in the current income tax conventions between the United States and its treaty partners. For example, most current United States tax treaties contain a clause similar to Article 1(3) of the Model Treaty, which provides that "a Contracting State may tax its residents . . . and by reason of citizenship may tax its citizens, as if this Convention had not come into effect."²⁴ Without more, the question would immediately arise whether this "savings clause" overrides the nondiscrimination principle of Article 24(3), since a United States permanent establishment of a foreign corporation is

19. United States Model Treaty, *supra* note 17, art. 5(1).

20. *Id.* art. 3(1)(c).

21. *Id.* art. 4(1).

22. *See id.* art. 3(1)(a).

23. *Id.* art. 25(3)(e). The term "enterprise" is not defined in the Internal Revenue Code but will presumably be defined in consultations held pursuant to the mutual agreement procedure recently set forth in Rev. Proc. 77-16, 1977-19 I.R.B. 35. That procedure, formulated to resolve issues arising under any income tax treaty to which the United States is a signatory nation, appears to be unnecessarily cumbersome and time consuming.

24. United States Model Treaty, *supra* note 17, art. 1(3).

arguably a "resident" of the United States under Article 4(1).²⁵ The Model Treaty, unlike some current United States tax treaties, answers this question by providing in Article 1(4)(a) that the savings clause will not affect benefits conferred by Article 24. Any other result, of course, would nullify the nondiscrimination clause.

Another interpretive difficulty eliminated by the Model Treaty concerns the range of taxes covered by the nondiscrimination clause. The provisions of several income tax conventions apply only to the United States federal income tax and its foreign equivalent—no mention is made of taxes imposed by political subdivisions.²⁶ Without more, the nondiscrimination clause in these treaties would appear to prohibit only discriminatory federal income taxation. The IRS, however, has indicated that it may interpret the clause as covering all federal, state, and local taxes.²⁷ The Model Treaty and many recent treaties expressly provide that the range of taxes covered includes "taxes of every kind and description imposed by each Contracting State, or its political subdivisions or local authorities."²⁸

25. *Id.* art. 4(1). *But cf.* Rev. Rul. 74-239, 1974-1 C.B. 372 (although nondiscrimination clause and savings clause were listed by the IRS as among the provisions bearing on the computation of a Canadian citizen's United States income tax, the Service considered only the nondiscrimination clause in reaching its decision).

26. *Burundi, Kinshasa, and Rwanda*, Oct. 28, 1948, arts. I, XX(3), 4 U.S.T. 1647, T.I.A.S. No. 2833, *extended by* Supplementary Convention, Aug. 22, 1957, art. IV, 10 U.S.T. 1358, T.I.A.S. No. 4280; *Canada*, March 4, 1942, Protocol paras. 1, 12, 56 Stat. 1399, T.S. No. 983, *amended by* Supplementary Convention, Aug. 8, 1956, art. I(d), 8 U.S.T. 1619, T.I.A.S. No. 3916; *India*, Nov. 10, 1959, arts. I, XVI, 1 TAX TREATIES (CCH) ¶¶ 3804, 3819 (1960) (treaty withdrawn by United States before becoming effective); *Ireland*, Sept. 13, 1949, arts. I, XXI, 2 U.S.T. 2303, T.I.A.S. No. 2356; *Israel*, Nov. 20, 1975, arts. 1, 27, 2 TAX TREATIES (CCH) ¶¶ 4204, 4230 (1976) (not yet in effect); *Pakistan*, July 1, 1957, arts. I, XVII, 10 U.S.T. 984, T.I.A.S. No. 4232; *Union of South Africa*, Dec. 13, 1946, arts. I, III(1), 3 U.S.T. 3821, T.I.A.S. No. 2510.

27. The IRS apparently adopted this position when it explained the amendments made to the Swedish-American treaty in 1963. The original treaty, *Sweden*, March 23, 1939, art. I, 54 Stat. 1759, T.S. No. 958, explicitly applied to the United States federal income tax and its Swedish equivalent but did not contain a specific definition of "taxes" for the purpose of the nondiscrimination clause. *Id.* Protocol para. 7. The 1963 Supplementary Convention, *Sweden*, Oct. 22, 1963, art. II(c), 15 U.S.T. 1824, T.I.A.S. No. 5656, amended the nondiscrimination clause of the original Protocol to define "taxes" for the purpose of the original clause as including all federal, state, and municipal taxes. Although the amendment by its terms appeared to expand the scope of the nondiscrimination clause, the IRS characterized the amendment as merely adding a definition "for the sake of clarity," thus implying that the scope of the nondiscrimination clause before the amendment was identical to its scope after the amendment. *See* Statement of the Treasury Department, in S. EXEC. REP. NO. 10, 88th Cong., 2d Sess. 65 (1964); S. ROBERTS & W. WARREN, *supra* note 1, at IX-113. In other words, the IRS suggested that the language found in the 1939 Swedish treaty, which is similar to the language found in the treaties cited in note 26 *supra*, prohibits all discriminatory federal, state, and local taxation.

28. United States Model Treaty, *supra* note 17, art. 24(6); *e.g.*, *Federal Republic of Germany*, July 22, 1954, art. XVIII(3), 5 U.S.T. 2768, T.I.A.S. No. 3133; *France*, July 28,

Although the Treasury Department's model formulation eliminates several problems contained in the current treaties, some interpretive difficulties remain. The two principal interpretive problems in the Model Treaty's permanent establishment provision are: (1) the meaning of "enterprises . . . carrying on the same activities"; and (2) the criteria for determining what constitutes "taxation . . . not . . . less favorably levied."²⁹

A. "CARRYING ON THE SAME ACTIVITIES"

Discrimination under Article 24(3) is measured by comparing the taxation of the permanent establishment of the foreign treaty partner enterprise with the taxation of enterprises of the situs country "carrying on the

1967, art. 1(4), 19 U.S.T. 5280, T.I.A.S. No. 6518; *U.S.S.R.*, June 20, 1973, art. X(3), T.I.A.S. No. 8225. .

The general application of the nondiscrimination clause to all "taxes" levied by each signatory country raises two distinct problems not resolved by the Model Treaty. First, the existing conventions do not define the range of levies which can be considered "taxes" for purposes of the nondiscrimination clause. Although the clause in many of the treaties is not confined to income taxes but extends to property, inheritance, gift, and similar taxes, *cf. Scandinavian Airlines System, Inc. v. County of Los Angeles*, 56 Cal. 2d 11, 37-42, 363 P.2d 25, 40-44, 14 Cal. Rptr. 25, 40-44, *cert. denied*, 368 U.S. 899 (1961) (nondiscrimination clause prohibits state personal property tax on airplanes unless the state is the airplanes' home port); *Trott v. State*, 41 N.D. 614, 171 N.W. 827 (1919) (under estate tax treaty's nondiscrimination clause aliens may not be charged a greater state inheritance tax than residents), income tax conventions are not designed to afford protection against levies, such as tariff duties or certain license fees, which can not properly be characterized as "taxes." *Cf. McCready v. Virginia*, 94 U.S. 391 (1876) (privileges and immunities clause, U.S. CONST. art. IV, § 2, does not protect noncitizen from criminal penalty). Case law, administrative pronouncements, and treaty commentaries offer little guidance in determining whether certain levies are "taxes." For example, in Rev. Rul. 72-579, 1972-2 C.B. 441, United States citizens employed in Great Britain made payments pursuant to the National Insurance Act of Great Britain. The IRS ruled that the insurance payments made by the American taxpayers constituted an income tax for foreign tax credit purposes. This ruling suggests that the capacity in which a foreign country exacts a levy, for example as an "insurer," does not bear on whether the levy is a "tax" for the purposes of the nondiscrimination clause; unfortunately, the ruling does not set forth criteria which govern the characterization of a levy as a "tax" or non-"tax" exaction. *See* Rev. Rul. 76-215, 1976-23 I.R.B. 6 (single Indonesian production-sharing levy possessing both tax and royalty portions not allocated into tax and royalty components but rather characterized as a tax in its entirety). *See generally* Note, *The Foreign Tax Credit for American Oil Contractors in Indonesia: An Allocation Approach*, 10 CORNELL INT'L L.J. 307, 318-27 (1977).

A second problem left unresolved by the Model Treaty is whether a treaty provision limiting a state's power to tax is unconstitutional in the United States and other countries where there is a division of power and function between federal and state governments. Relying on the supremacy clause, U.S. CONST. art. VI, § 2, a number of American courts have held that state taxes must yield to treaty provisions requiring equal treatment between citizens and foreigners. *Scandinavian Airlines System, Inc. v. County of Los Angeles*, 56 Cal. 2d 11, 363 P.2d 25, 14 Cal. Rptr. 25, *cert. denied*, 368 U.S. 899 (1961); *Trott v. State*, 41 N.D. 614, 171 N.W. 827 (1919).

29. United States Model Treaty, *supra* note 17, art. 24(3).

same activities." The truncated language of Article 24(3) unfortunately gives rise to an elliptical comparison—the same activities as what? Presumably, the object of comparison is the permanent establishment, although the enterprise of which the permanent establishment is a part is also a possible candidate. The former reading is consistent with the purposes of the provision as stated in the 1977 commentary to the OECD Model Treaty, namely, to end discrimination in the treatment of permanent establishments as compared with resident enterprises involved in similar operations.³⁰

An additional ambiguity lies in the reference to "activities." At a minimum, this term protects a permanent establishment from discrimination vis-à-vis an enterprise of the situs country in the same sector of the economy. However, "activities" might be interpreted to include not only the conduct of business operations but also incidental conduct such as the payment of taxes on profits derived from these or other operations.

These problems are illustrated by the tax treatment afforded the "pseudo-parent" permanent establishment. Consider the case of a foreign enterprise's permanent establishment in the United States which owns stock in one or more United States subsidiary corporations and controls them in the same manner as the parent corporation of an affiliated group of corporations.³¹ If the permanent establishment were a domestic corporation it would be allowed a deduction for at least 85 percent—and for 80 percent or more owned subsidiaries, most likely 100 percent—of the amount received as dividends.³² The effective United States tax rate on such dividends would thus range from 7.2 to 0 percent. Alternatively, the hypothetical United States corporation might join with the 80 percent or more owned subsidiary corporations and file a consolidated return, with the result that dividends from the subsidiary would be excluded from the income of the hypothetical American parent.³³

By its terms, Article 24(3) of the Model Treaty would seem to entitle a United States permanent establishment of a foreign corporation to claim the dividends-received deduction of section 243(a) of the Code³⁴ or to join in the consolidated return with the subsidiaries.³⁵ However, the IRS has

30. OECD Model Treaty, Commentary on Article 24, para. 23, in OECD, *supra* note 17, at 165.

31. The question of when shares are effectively connected with a permanent establishment within the meaning of Article 10 of the Model Treaty is outside the scope of this Article. See generally Treas. Reg. § 1.864-4(c) (1972).

32. I.R.C. §§ 243-246.

33. Treas. Reg. § 1.1502-14(a)(1) (1966).

34. I.R.C. § 243(a).

35. Many current treaties as well as the United States Model Treaty and the OECD Model Treaty contain a separate provision which determines the extent to which each treaty country may tax dividends received by enterprises of the other treaty country. United

allowed the permanent establishment neither the dividends-received deduction nor consolidation.³⁶ Although the IRS has not made clear the reasons for its position, several possible arguments against affording the permanent establishment the benefit of Article 24(3) may be posited. The Treasury may consider it inappropriate to extend the substantial benefits of the dividends-received deduction or consolidation because the larger foreign enterprise of which the permanent establishment is a part is not subject to tax by the United States. Without Article 24(3), this argument is particularly persuasive as to the dividends-received deduction. When a domestic enterprise receives this deduction, a loss of tax revenue occurs, but this loss is partly offset by the withholding tax on dividends when the profits of the enterprise are redistributed at the shareholder level.³⁷ No corresponding offset occurs in the case of a permanent establishment since its profits are distributed by the foreign enterprise to its shareholders, who would generally not be subject to the United States withholding tax.³⁸

Regardless of its equitable merits, the Treasury position cannot be justified in the absence of textual support from Article 24(3). This support can be found only by reading "same activities" as requiring examination of the circumstances not only of the permanent establishment but also of the entire foreign enterprise. This interpretation would involve a two-stage comparison between the taxation of a permanent establishment and its hypothetical domestic counterpart as well as the taxation of the foreign enterprise and a hypothetical domestic parent. Under this analysis, the imposition of a withholding tax upon shareholders of the domestic parent is considered an "activity" which the foreign enterprise does not carry on; consequently, the permanent establishment is not eligible for Article 24(3)'s protection against differential tax treatment.

This reading of Article 24(3) would in substance impose upon permanent establishments and their foreign enterprises the same requirement which is contained in Article 24(1) which governs the treatment of nationals—that the foreign taxpayer must be "in the same circumstances" as his domestic counterpart.³⁹ Article 24(1) has been interpreted as requiring

States Model Treaty, *supra* note 17, art. 10; OECD Model Treaty, art. 10, in OECD, *supra* note 17, at 31; *e.g.*, Sweden, March 23, 1939, art. VII, 54 Stat. 1759, T.S. No. 958, *modified* by Supplementary Convention, Oct. 22, 1963, art. I(a), 15 U.S.T. 1824, T.I.A.S. No. 5656.

36. Schlumberger v. United States, No. 195-75 (Ct. Cl., petition filed June 27, 1975).

37. I.R.C. §§ 1441-1464.

38. See OECD Model Treaty, Commentary on Article 24, para. 33, in OECD, *supra* note 17, at 168.

39. United States Model Treaty, *supra* note 17, art. 24(1). For the complete text of Article 24(1), see note 10 *supra*.

that the foreign taxpayer and the hypothetical domestic counterpart be similarly situated in all respects. The IRS has held that this "same circumstances" test includes the payment of United States tax and is not satisfied where the foreign taxpayer, unlike a United States citizen, is not subject to United States tax on his worldwide income.⁴⁰ Under this approach, Article 24(3) would protect only those permanent establishments whose home enterprises are subject to United States tax on their worldwide income on the same basis as their hypothetical domestic counterparts.

This reasoning would also justify the denial of consolidation for a permanent establishment and its domestic subsidiaries. A hypothetical domestic counterpart to the foreign enterprise of the permanent establishment would be included in a consolidation. However, the foreign enterprise would be included in a consolidation only to the extent of the profits or losses of its permanent establishment. Moreover, since a foreign enterprise's income from operations elsewhere in the world escapes taxation, the Treasury Department might maintain that it does not engage in an "activity" in which a hypothetical domestic counterpart with similar worldwide operations participates—payment of United States tax on income earned abroad.

An additional illustration involves the foreign tax credit. Both Article 23 of the Model Treaty and section 906 of the Internal Revenue Code⁴¹ allow a United States permanent establishment of a foreign corporation a credit against its United States tax on foreign-source income for any foreign taxes imposed thereon. The foreign tax credit allowed by section 906, however, is somewhat narrower than that allowed to a United States corporation by section 901.⁴² Section 906 restricts the credit to foreign income taxes paid "with respect to income effectively connected with the conduct of a trade or business within the United States,"⁴³ while section 901 contains no such limitation. Section 906(b) imposes the additional limitation that foreign taxes are not to be taken into account to the extent that they are imposed on income from sources within the United States which is taxable solely because the foreign corporation was created or organized under the laws of the taxing country or because it was domiciled there.⁴⁴

Here the language of Article 24(3) arguably mandates that the United States allow a permanent establishment of a foreign corporation the full

40. Rev. Rul. 74-239, 1974-1 C.B. 372.

41. I.R.C. § 906.

42. I.R.C. § 901.

43. I.R.C. § 906(a).

44. I.R.C. § 906(b)(1).

foreign tax credit under section 901, to the extent that a domestic corporation carrying on the activities of the permanent establishment would be entitled to the credit, and subject only to the limitation of section 904 of the Code.⁴⁵ Perhaps the Treasury could justify retaining the section 906(b) limitation on the credit despite the nondiscrimination clause on the "same activities" grounds; the hypothetical United States corporation would presumably not be subject to tax by any foreign country on account of being incorporated or domiciled there. In any event, the restriction on taxes imposed on income effectively connected with the conduct of a United States trade or business does not seem justifiable.

B. "TAXATION . . . NOT . . . LESS FAVORABLY LEVIED"

Article 24(3) shields a permanent establishment only from less favorably levied taxation. This language differs from the separate nondiscrimination provisions which apply to foreign nationals and foreign-controlled domestic enterprises which are protected from "other or more burdensome . . . taxation and connected requirements."⁴⁶ The vagueness of the language in Article 24(3) and its variation from the language in Articles 24(1) and 24(5) present three interpretive problems. First, the focus on less favorable rather than other or more burdensome taxation and the absence of a reference to "connected requirements" suggests that Article 24(3) prohibits only differential tax treatment whose net effect upon the permanent establishment is discriminatory. This emphasis on the end result means that taxation under Article 24(3), unlike that under Articles 24(1) and 24(5), need not be in the same form and impose the same rate of taxation and connected formalities on domestic enterprises and permanent establishments of foreign enterprises and their domestic counterparts.⁴⁷ Consequently, Article 24(3) would appear to permit a different method of taxation for permanent establishments in situations where the imposition of the same mode of taxation would be impracticable.⁴⁸ However, where the different mode of taxation or connected requirements, such as election, compliance, and audit examinations, were unduly burdensome relative to that imposed on domestic enterprises, Article 24(3) would prohibit such disparate tax treatment.⁴⁹

45. I.R.C. § 904.

46. United States Model Treaty, *supra* note 17, art. 24(1), (5).

47. *Cf.* OECD Model Treaty, Commentary on Article 24, para. 10, in OECD, *supra* note 17, at 163 (suggesting rate of taxation and connected formalities must be the same for nationals and foreigners under Article 24(1) and 24(5) of the United States Model Treaty).

48. *See* Barr v. Commissioner, 51 U.S. Tax Ct. 693, 695 (1969); OECD Model Treaty, Commentary on Article 24, para. 22, in OECD, *supra* note 17, at 165.

49. For example, Article 24(3) arguably prohibits the unusual penalty of I.R.C. § 882(c), the disallowance of all deductions and credits, imposed on foreign corporations which fail to file a true and correct return.

Second, some authority indicates that the nondiscrimination clause prohibits only discrimination against foreign nationals as a class.⁵⁰ In a 1943 estate tax case, *Watson v. Hoey*,⁵¹ a statute denying nonresident aliens the estate tax exemption afforded citizens and residents was upheld despite a treaty providing for nondiscrimination because the statute did not unfairly discriminate against nonresident aliens generally. On the other hand, the OECD commentary suggests that the clause protects every taxpayer who is subject to heavier taxation because of his particular circumstances, even though foreign nationals, including permanent establishments, are not discriminated against as a class.⁵²

Third, the treaty appears to focus on the taxes imposed by each treaty country alone and to prohibit each country from levying a higher tax on a permanent establishment than on a hypothetical domestic enterprise carrying on the same activities. On the other hand, the treaty language admits of an interpretation which for nondiscrimination purposes compares the total taxes paid by a permanent establishment to both treaty partners with the total taxes paid by its hypothetical domestic counterpart to both countries.

III

ANALYTIC FRAMEWORK

The dearth of decisional authority and commentary on these interpretive problems calls for an analytic framework to guide the application of the clause in the future and to assist the reformulation of the permanent establishment clause in unambiguous terms. This analytic framework must be formulated with an eye to the tax policies and principles underlying the nondiscrimination clause as well as the practical application of the clause in specific situations.

The tax treaties between the United States and its treaty partners are intended to secure tax equality and reciprocity between the treaty countries.⁵³ This aim is reflected not only in the specific treaty provisions which address particular items of income, deductions, and credits, but also in the nondiscrimination clause, which applies generally to the entire

50. See R. WILSON, *supra* note 1, at 161-62.

51. 59 F. Supp. 197 (S.D.N.Y. 1943).

52. See OECD Model Treaty, Commentary on Article 24, para. 24, in OECD, *supra* note 17, at 165.

53. See *Jordan v. Tashiro*, 278 U.S. 123, 127 (1928); *Geofroy v. Riggs*, 133 U.S. 258, 271 (1890); *Aerovias Interamericanas de Panama, S.A. v. Board of County Commissioners*, 197 F. Supp. 230, 240-41 (S.D. Fla. 1961), *rev'd on other grounds sub nom. Board of County Commissioners v. Aerolineas Peruanas, S.A.*, 307 F.2d 802 (5th Cir. 1962), *cert. denied*, 371 U.S. 961 (1963).

range of tax treatment afforded individuals, enterprises, and permanent establishments. In interpreting the permanent establishment clause, the United States courts and the IRS should construe its provisions liberally in order to carry out the apparent intention of the treaty partners to secure the goals of tax equality and reciprocity.⁵⁴ This principle of liberal interpretation would serve to evidence to treaty countries the United States commitment to honor its treaty obligations and encourage these countries likewise to construe liberally not only the nondiscrimination clause but also the provisions of the treaty generally.⁵⁵ The resulting full tax equality between treaty countries would help to secure a further goal of tax conventions: the elimination of a form of nontariff barrier to free international trade and commercial activity.⁵⁶

The policies underlying tax treaties suggest that an interpretation of the permanent establishment clause as requiring an examination of the circumstances not only of the permanent establishment but also the entire foreign enterprise is too restrictive. A country entering into a tax convention with the United States would typically expect that the permanent establishment clause requires a comparison of only the two entities mentioned in the language of the clause—the permanent establishment and a hypothetical domestic equivalent enterprise. In addition, the interpretation of the term “activities” as including the payment of taxes so as to read into the clause a “similarly situated” requirement goes well beyond the parties’ normal expectation. The combination of both of these restrictive interpretations cannot but help to give treaty partners the feeling that the United States is giving them less than they bargained for.

Moreover, such an analysis in effect nullifies the permanent establishment clause’s protection of permanent establishments. The hypothetical United States counterpart of the foreign enterprise is always subject to United States tax on its foreign operations, but a foreign enterprise is typically insulated from United States tax on similar operations; consequently, the absence of this tax upon the foreign enterprise will almost always cause the permanent establishment to fail the “same activities” requirement. In fact, this restrictive approach would limit the application of the permanent establishment clause to a permanent establishment of a foreign enterprise which had no operations other than the United States permanent establishment.

A further difficulty with the Treasury Department’s analysis is that it raises reciprocity and tax inequality problems between the United States and treaty partners who do not tax domestic enterprises on worldwide

54. See note 53 *supra*.

55. See Lidstone, *supra* note 3, at 548.

56. See R. WILSON, *supra* note 1, at 180; Lidstone, *supra* note 3, at 545-48.

income. Consider the case of an Italian permanent establishment of a United States enterprise subject to tax by Italy. If Italy taxes some domestic enterprises only on income from Italian sources,⁵⁷ a hypothetical Italian equivalent of the United States enterprise would only be subject to Italian tax upon its Italian operations which correspond with the operations of the Italian permanent establishment of the United States enterprise. Because neither the United States enterprise nor its hypothetical counterpart are subject to Italian tax on their American operations, the United States permanent establishment and its domestic equivalent enterprise carry on the "same activities." Consequently, the Italian permanent establishment of a United States enterprise would be protected against discriminatory tax treatment by the Model Treaty, but, in the reverse situation, a United States permanent establishment of an Italian enterprise would not be covered by Article 24(3).

To avoid these interpretive difficulties, the term "activities" should be read to refer only to the business operations which a permanent establishment conducts in the country in which it is situated. No consideration should be given to obligations incurred incidentally to the conduct of business operations, such as the payment of taxes. This approach allows a relatively simple application of the nondiscrimination clause on the basis of a comparison of business operations and avoids complex tax analysis which, in most cases, would nullify the protection afforded by the permanent establishment clause.

The same principle of liberal construction should guide the courts and the IRS in formulating standards for determining whether a foreign permanent establishment suffers "taxation . . . less favorably levied." The permanent establishment clause should be interpreted to protect every United States permanent establishment of a treaty partner enterprise who is subject to heavier taxation because of its particular circumstances, even though permanent establishments as a class receive equal treatment. This interpretation avoids the more restrictive approach of the "class" standard, which would deny protection to a particular permanent establishment that actually pays higher United States taxes and thus falls outside the norm of the typical permanent establishment, which does not suffer more burdensome taxation. By extending protection to a broader

57. Although the current tax convention between the United States and Italy does not contain a permanent establishment clause, *Italy*, March 30, 1955, 7 U.S.T. 2999, T.I.A.S. No. 3679, extended by Exchange of Letters, Dec. 13, 1974, 26 U.S.T. 1088, T.I.A.S. No. 8097, current negotiations between the two countries may produce a treaty containing a provision similar to Article 24(3) of the United States Model Treaty. See U.S. Dep't of the Treasury, Treasury Department News Release WS-1271 (Jan. 19, 1977), reprinted in 2 TAX TREATIES (CCH) ¶ 9755 (1977).

range of taxpayers, the "particular circumstances" approach is consistent with the treaties' goals of full tax equality and reciprocity and avoids retaliatory tax discrimination by treaty partners who view the nondiscrimination clause as mandating a "particular circumstances" analysis. Moreover, this approach offers a relatively simple objective standard of discrimination and does not involve the evidentiary tangles and subjective analysis which the "class" approach would entail.⁵⁸

As to the range of taxes relevant to the discrimination determination, however, tax equality and reciprocity do not help to resolve the question of whether the courts and the IRS should examine only the United States taxes paid by a permanent establishment and its domestic counterpart or the total taxes paid to both treaty partners. A permanent establishment which pays the same or a lower amount of total taxes to both countries than its hypothetical United States counterpart is not placed in a less favorable position vis-à-vis its counterpart even though the permanent establishment may pay higher United States taxes. Thus a comparison of the taxes paid to both countries is not inconsistent with the goals of tax equality and reciprocity. However, this approach cannot be reconciled with the literal language of the treaty provision which expressly protects a permanent establishment that an enterprise of one treaty country has in the other treaty country from less favorable taxation *in that other treaty country*.⁵⁹ This language focuses only upon the taxation levied by the country in which the permanent establishment is situated and suggests that taxes levied by the country of the foreign enterprise are irrelevant for nondiscrimination purposes. Even assuming that this language admits the "total taxes" approach, the principle of liberal construction of treaty provisions would require the interpretation which examines only the United States taxation, since this interpretation affords greater protection to a permanent establishment of a treaty partner enterprise.

IV

A PROPOSED DRAFT

The current interpretive difficulties in the permanent establishment clause stem partly from cryptic draftsmanship. As in the OECD Model Treaty, the permanent establishment clause in the United States Model Treaty appears to be drafted in a manner designed to accommodate

58. Taxpayers might encounter substantial practical and legal obstacles in obtaining the data about the taxation of others necessary to prove discrimination against the class of, say, all Italian enterprises with permanent establishments in the United States. A further difficulty would be defining the appropriate "class."

59. United States Model Treaty, *supra* note 17, art. 24(3).

competing viewpoints on the interpretive problems which have been unearthed.⁶⁰ Such draftsmanship may serve initially to encourage countries to agree to the treaty terms by obfuscating potential areas of disagreement; however, the danger that subsequent inconsistent interpretations by treaty countries may lead to retaliatory tax discrimination offsets the initial benefit.

Alerted to the interpretive difficulties contained in the current permanent establishment clause, countries entering into an income tax treaty should negotiate an expanded permanent establishment clause which is mutually acceptable to both countries. Negotiation of the permanent establishment clause should prove no more difficult than negotiation of any other term in the treaty, for the negotiation of all tax treaty terms involves the same essential problem: the sorting out between countries of residence and countries of source the right to tax certain types of income.

Ideally, a treaty should specifically address all major areas of possible discrimination against permanent establishments. For instance, detailed provisions could be established for the treatment of dividends received, consolidation, and foreign tax credit problems. However, demanding such precision would, in many cases, make treaty negotiation too cumbersome and impede international efforts to end tax discrimination. A more feasible alternative is a revised model draft that expressly provides several rules of interpretation which resolve the problems encountered in the current version of the permanent establishment clause. Such a draft could be written as follows:

The taxation of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favorably levied in the other State than the taxation levied on an enterprise of the other State carrying on the same activities as the permanent establishment. For the purposes of the preceding sentence: (1) "activities" refers only to the business operations conducted by the permanent establishment and does not include incidentally incurred obligations, such as the payment of taxes; and (2) "taxation" refers only to the taxes levied by the Contracting State in which the permanent establishment is located, without regard for the taxes levied by the other Contracting State. This clause is intended to protect each particular permanent establishment of a Contracting State from less favorable taxation vis-à-vis equivalent enterprises of the other Contracting State, regardless of the tax treatment permanent establishments receive as a class.

60. See OECD Model Treaty, Commentary on Article 24, paras. 38-50, in OECD, *supra* note 17, at 169-72 (paragraphs 45 and 50 specifically encourage the contracting states to settle interpretive difficulties "in bilateral negotiations in the light of their peculiar circumstances").

Although some countries may not wish to adopt a treaty provision which extends protection as broadly as the proposed draft, this draft at least isolates the problems which confront countries negotiating an income tax convention and provides countries with some basis for negotiating a mutually acceptable permanent establishment clause.