CHAPTER 1
Introduction

1.1 OBJECTIVES OF THIS PRIMER

This Primer on international taxation provides the reader with an introductory analysis of the major issues that a country must confront in designing its international tax rules and in coordinating those rules with the tax systems of its trading partners. At one time, international tax issues were important to a small circle of tax specialists, primarily the tax advisers of large multinational corporations and their counterparts in the tax departments of developed countries. As the countries of the world have become increasingly integrated economically, the importance of these issues has mushroomed. Many small- and medium-sized firms, as well as individuals, now engage in **cross-border transactions** that cause them and their tax advisers to confront international tax issues on a regular basis; and most national governments must care about international tax, both to present a hospitable environment for foreign investment and to protect their revenue base.

Although this Primer is intended mainly for students, government officials and tax practitioners who are confronting international tax for the first time, I fondly hope that those with considerable experience in international tax may also find it useful. Many times in my work, I have been forced to return to fundamental principles in analyzing complicated tax issues. In essence, the objective of this Primer is to articulate these fundamental principles.

International tax planning is firmly grounded, if not mired, in the technical minutiae of a particular country's tax rules. Thus, in this Primer it has been necessary to provide some level of detail on some issues in order for the discussion of these issues to have any practical significance. However, the objectives of a primer would be lost if it did not focus on general principles and fundamental structure. I have tried to balance the need for both the specific and the general by illustrating general principles with frequent references to the actual practices of a variety of developed and developing countries.

The many examples provided throughout this Primer are given for illustrative purposes only and are not meant to be definitive statements about the laws of particular countries. No attempt is made to survey the practices of all countries. I have avoided writing from the perspective of any particular country, including the countries with which I am most familiar. Instead, I have tried to identify and discuss issues of international tax that are relevant and important to many countries.

Section 1.2 of this introductory chapter describes the meaning of the term "international tax". Section 1.3 identifies the most important goals that should guide countries in designing their international income tax rules. Section 1.4 describes the role of the tax adviser in planning international transactions and offers a few examples of typical international tax planning techniques.

Chapter 2 describes the rules that countries have adopted for defining the scope of their jurisdiction to tax. Most countries tax residents and nonresidents differently. Chapter 3 examines the issues involved in taxing residents of a country on their worldwide income. If one country taxes its residents on their worldwide income and another country taxes the same income because it arises, is earned, or has its source in that country, the income will inevitably be subject to double taxation. The mechanisms used to mitigate the risks to taxpayers of this and other forms of **international double taxation** are addressed in Chapter 4. As a counterpart to Chapter 3, Chapter 5 examines the issues involved in a country taxing nonresidents on their income earned in or sourced in the country. Chapter 6 examines the controversial issue of **transfer pricing rules** for adjusting intercompany transfer prices to prevent the avoidance of tax by multinational corporations. Chapter 7 discusses a variety of anti-avoidance rules dealing with international transactions, such as controlled foreign company (CFC) rules and thin capitalization or earnings-stripping rules. Chapter 8 provides an overview and analysis of the provisions of bilateral tax treaties and the **OECD (Organisation for Economic Co-operation and Development)** and **United Nations (UN) Model Treaties** on which they are generally based. Several important emerging issues that cut across the issues addressed in the prior chapters are addressed in Chapter 9. Those issues include the OECD's initiative against **base erosion and profit shifting (BEPS)**, the tax aspects of **hybrid entities and financial instruments**, the taxation of fees for technical services under the UN Model Treaty, the use of arbitration to resolve international tax disputes, and the challenges posed by taxation of income derived from the digital economy.

There is an extensive glossary of international tax terms after Chapter 9. The first time a term included in the glossary is used in the text, it is shown in bold-face type. The meanings of the terms in the glossary reflect their meanings in an international context; some of the terms may have a slightly different meaning in a domestic context.

1.2 WHAT IS INTERNATIONAL TAX?

The term "international tax" is used in this Primer for convenience because international tax law is more correctly referred to as the international aspects of the income tax laws of particular countries. With minor exceptions, tax laws are not "international" –

they are creations of sovereign states. Arguably at least, there is no overriding international law of taxation, arising either from the customary practice of sovereign states or from the actions of some international body such as the UN or the OECD.

Tax treaties are perhaps the most obvious "international" aspect of a country's income tax system. Most developed countries have entered into tax treaties with their major trading partners, and often with their minor trading partners as well. Many developing countries also have extensive treaty networks. The growth in the number of tax treaties over the past decade has been exponential - there are now over 3,000 bilateral tax treaties in existence. These treaties impose significant limitations on the taxing powers of the signatories to the treaty (often referred to as the **contracting states**). Tax treaties, however, do not generally impose tax; in most countries, they are exclusively relieving in nature. Although tax treaties are binding agreements between sovereign states, in many countries they do not have any effect on taxpayers unless they are specifically incorporated into a country's tax law.

The scope of what is called international tax in this Primer is extremely broad. It encompasses all tax issues arising under a country's income tax laws that include some foreign element: for example, cross-border trade in goods and services, cross-border manufacturing, production, and resource development by a multinational enterprise, cross-border investment by individuals or investment funds, and individuals working outside the country where they usually reside. These activities usually present international tax issues under the tax laws of at least two countries.

Some international tax issues arise out of extremely complex situations. The reorganization of a multinational corporation with foreign **subsidiaries** in several countries is an example. Other situations may be quite simple. For example, an international tax issue may arise under some countries' tax laws if a **resident** individual attempts to claim a deduction for the support of a dependent spouse or child residing in a foreign country.

The international tax law of a country has two broad dimensions:

(1) the taxation of resident individuals and legal entities on income arising in foreign countries; and
(2) the taxation of **nonresidents** on domestic income (i.e., income arising or sourced in the country).

The first dimension is referred to in this Primer as the "taxation of residents on foreign income", and the second dimension as the "taxation of nonresidents on domestic income". Obviously, what is the taxation of residents on foreign income for one country (generally referred to as the **residence country**) is the taxation of nonresidents on domestic source income for another country (generally referred to as the **source country**).

A transaction that involves the export of capital or other resources from a country is often referred to by tax analysts as an **outward-bound** or "outbound" transaction. Conversely, the term **inward-bound** or "inbound" transaction is commonly used to refer to a transaction involving the import of capital or other resources from a foreign country. A transaction that a country considers to be an outward-bound transaction

typically involves its rules for taxing the foreign income of resident taxpayers. In contrast, inward-bound transactions typically involve a country's rules for taxing nonresidents on domestic income. In some circumstances, a single transaction may have consequences under both sets of rules. An example is the liquidation of a **foreign affiliate** into a domestic **parent corporation**.

International tax extends beyond income tax. It may include estate taxes, gift taxes, inheritance taxes, general wealth taxes, value-added taxes, customs duties, and a variety of special levies. The international aspects of estate and gift taxes are particularly important. For example, such wealth-transfer taxes have important international implications when a resident receives a bequest or gift from a nonresident or non-domiciled individual or when a person dies owning property in a foreign country. These important issues are beyond the scope of this book, which is restricted to international aspects of income tax law.

1.3 GOALS OF INTERNATIONAL TAX RULES

In designing its international tax rules, a country should generally seek to advance the four major goals described below. Often these goals conflict, so that a country must try to achieve a balance between them. Some of the policy goals of international tax can be pursued effectively through unilateral action; however, other goals can be achieved only through cooperation with other countries.

Revenue considerations. Governments raise tax revenues to fund public goods and services. From a purely national perspective, every country wants to maximize its tax revenues. However, this goal conflicts with other goals, such as the need to attract foreign investment and other countries' revenue-raising goals. From an international perspective, each country should obtain its fair share of the tax revenues from income generated by transnational activities. To achieve this goal of **inter-nation equity**, a country must protect its domestic tax base - that is, it must develop a good domestic tax system and an effective tax administration to enforce its tax rules, and it must avoid entering into tax treaties that inappropriately limit its right to tax the domestic source income of residents and nonresidents.

Fairness. The primary advantage of an income tax over other potential taxes is fairness. In general, fairness is achieved by imposing equal tax burdens on individuals with equal income, without reference to the source or type of the income (so-called horizontal equity), and by making those burdens commensurate with the ability to pay of individuals (so-called vertical equity - the more you make, the more you pay). Fairness is not a relevant consideration with respect to taxes imposed on corporations and other legal entities because such entities are legal fictions created by the law that, unlike natural persons, do not have any tangible existence in the real world. Although corporations and other legal entities may pay tax, that tax must ultimately be borne by natural persons - the shareholders, employees, or customers of a corporation. It is unclear to what extent the corporate tax is passed on to its shareholders, employees, or customers; this lack of solid information as to the incidence of the corporate tax makes it difficult for countries to implement good tax policies for taxing resident corporations

on their foreign source income and nonresident corporations on their domestic source income.

Often when commentators talk about fairness with respect to corporations, they are really referring to considerations of economic efficiency and neutrality, which are discussed below.

For resident individuals, fairness requires the full taxation of both domestic and foreign source income; moreover, foreign source income must be taxed whether the income is earned directly or through some foreign entity. However, no country has the power to impose a fairness standard on nonresidents earning domestic source income because no country can tax all the income of nonresidents arising outside its borders. For example, an individual resident in Country A may earn income in Country A, Country B and Country C. In general, Country B has jurisdiction to tax only the individual's income arising in Country B. It will not have any information about, and cannot take into account, the individual's income earned in countries A and C. Countries can promote fairness, however, by contributing to the development of fair and appropriate international tax standards, by imposing tax burdens that are consistent with these standards, and by otherwise cooperating with other countries in the assessment and collection of tax on their residents.

Competitiveness considerations. Every country should care about the welfare of nonresidents. Nevertheless, each country has a primary duty to advance the economic interests of its own citizens and residents. To this end, a country should avoid tax measures that undermine its competitive position in the global economy.

In the international context, countries compete; tax competition is one way in which countries compete for jobs and investment. Some countries try to attract jobs and investment by reducing or eliminating taxes generally or on income from certain activities. However, a particular country's competitiveness depends on a wide variety of other factors, including an educated labor force, modern infrastructure, political stability and an established legal system with protection for investors, and natural resources. Countries can enhance their competitiveness by removing provisions of their tax law that tend to encourage the movement of investment and jobs out of the country or that discourage the importation of capital and jobs. In the medium and long run, a country's competitiveness is not enhanced by **tax incentives**; these and other beggar-thy-neighbor policies invite a retaliatory response by foreign governments and a "race to the bottom", to the detriment of all countries. Such policies erode the ability of all governments to impose fair and effective taxes on income from movable capital.

Capital-export and capital-import neutrality. The principles of **capital-export neutrality** or **capital-import neutrality** usually figure prominently in discussions of international tax policy. Readers should be aware of these concepts, although their importance is doubtful.

The principle of capital-export neutrality is that a country's international tax rules should neither encourage nor discourage outflows of capital. Capital-export neutrality would be achieved if a country taxes its residents, including its resident corporations, on their worldwide income, including income earned by their foreign subsidiaries. In practice, policymakers typically treat capital-export neutrality as at best a secondary goal with respect to corporations. In virtually every country, capital inflows are

generally considered to be desirable and are encouraged through tax and other economic policies. In contrast, capital outflows are generally thought to diminish a country's national wealth. Many countries adopt measures designed to discourage capital outflows, although their tax laws may also contain provisions that have the unintended effect of encouraging outflows. Prudent policymakers exercise caution in discouraging outflows because limitations on capital outflows may discourage capital inflows. For example, a country that imposes excessively high **withholding taxes** on dividends, interest and royalties paid to nonresidents is likely to discourage nonresidents from investing in that country.

According to the principle of capital-import neutrality, taxpayers doing business in a country should be subject to the same tax burden irrespective of where they are resident. Capital-import neutrality is generally achieved to the extent that a country exempts its residents, including its resident corporations, from tax on their foreign source income, including income earned by their foreign subsidiaries. Thus, if Country A does not tax corporations resident in Country A on the income earned by their foreign subsidiaries, the subsidiaries will be subject to tax only by the countries in which they are resident, and in the same way as other corporations resident in those countries.

Most countries have adopted international tax rules that contain some features that are consistent with both capital-export neutrality and capital-import neutrality. For example, most countries tax resident individuals on their worldwide income, which reflects capital-export neutrality. In contrast, most countries do not tax foreign source income earned by foreign corporations that are controlled by residents (except in special circumstances), which reflects capital-import neutrality. Capital-import neutrality is widely accepted with respect to foreign business income earned by corporations, so that such income is taxable only by the country in which it is earned. Further, such income is either exempt from tax by the country in which the corporation is resident or that country's tax is deferred until it is repatriated, usually in the form of dividends.

More recently, several tax analysts have referred to another concept of neutrality – **capital-ownership neutrality**. Whereas capital-export neutrality and capital-import neutrality focus on the location of capital, capital-ownership neutrality also focuses on the ownership of capital. Under an ideal tax system based on capital-ownership neutrality, tax would not distort the ownership of assets by taxpayers. Capital-ownership neutrality is achieved if all countries tax on either a worldwide or territorial basis.

The fairness and efficiency of income taxation ultimately depends not on the income tax laws of any one country but on the cumulative effects of the income tax laws of all countries. Countries have little to lose and much to gain by coordinating their income tax systems with the tax systems of their trading partners. Tax treaties are the primary means for achieving such coordination.

Income tax treaties have two primary operational goals – to reduce the risk of double taxation of taxpayers engaged in cross-border transactions and to ensure that income from cross-border transactions does not escape tax entirely (sometimes referred to as double non-taxation or stateless income). Both of these goals are advanced by measures that promote the harmonization of international tax rules

through the adoption of income tax treaties that follow the same general pattern. Other ancillary objectives of tax treaties include the prevention of discrimination against nonresidents and foreign nationals and administrative cooperation in exchanging information, collecting tax, and resolving disputes. Virtually all modern income tax treaties are based in substantial part on the OECD and UN Model Treaties. The UN Model Treaty is based heavily on the OECD Model Treaty, although it contains some alternative and additional provisions that allow developing countries to tax more income than is permitted under the OECD Model Treaty. Tax treaties are discussed in Chapter 8.

1.4 THE ROLE OF THE TAX ADVISER IN PLANNING INTERNATIONAL TRANSACTIONS

The tax adviser's role with respect to international transactions is similar to his or her role with respect to domestic transactions. Probably the tax adviser's most important obligation is to ensure that clients do not fall into any traps or anomalies that result in levels of taxation beyond what might reasonably be expected. Such defensive tax planning should not ordinarily put the tax adviser in an adversarial role with a country's tax officials, who should also be seeking to impose appropriate tax burdens on taxpayers. Domestic and international tax advisers are also expected to be acquainted with international tax strategies that might be used to minimize taxes. These schemes often involve the use of countries with low or no taxes, either generally or on certain types of income; these countries are commonly referred to as **tax havens**.

International tax advisers are likely to spend more of their time engaging in defensive tax planning than their domestic counterparts, since taxpayers engaged in international transactions frequently confront serious risks of paying excessive levels of tax. These risks typically arise when two or more countries claim the right to impose tax on the same items of income. Many important international tax rules are designed to mitigate or eliminate such double taxation. The measures commonly used to relieve double taxation are discussed in Chapter 4.

Although visible and newsworthy, offensive tax planning activities occupy a relatively modest part of the practice of most international tax advisers. However, these activities may constitute a major part of the practice of some large law and accounting firms and have caused governments to respond with increasingly complex anti-avoidance legislation. The most important of the rules designed to combat international **tax avoidance** are discussed in Chapters 6, 7, and 8. These rules have not driven the tax havens out of business - opportunities for international tax avoidance are still widely available to individual investors and multinational enterprises.

The role of the tax adviser depends on whether the transaction involved is an outward-bound or an inward-bound transaction or investment. In the case of an outward-bound investment by a resident taxpayer, the tax adviser often has an ongoing relationship with the client and is familiar with the client's total affairs. Consequently, the client usually looks primarily to the domestic tax adviser for advice concerning both the domestic and foreign tax consequences of a transaction. Although the domestic tax

adviser is not generally qualified to provide advice concerning foreign tax law, the client often expects the tax adviser to act as a filter with respect to foreign tax advice. It is not unusual for foreign tax advisers to deal with the domestic tax adviser rather than with the client directly. In contrast, when the tax adviser is providing advice concerning an inward-bound investment by a nonresident, the role is often more restricted. Usually the advice is limited to the tax consequences in the tax adviser's particular country, and the adviser may not be involved in the overall tax planning for the nonresident on an ongoing basis. Also, as indicated earlier, in this situation the tax adviser may deal with the foreign tax advisers rather than directly with the client.

Whether an inward-bound or an outward-bound investment is involved, domestic tax advisers consulting on an international transaction invariably deal with foreign lawyers, accountants, or business persons. The role of tax advisers in this regard may often be difficult because of differences in basic legal concepts, tax laws, and accounting practices. These differences may be exacerbated by language and cultural differences.

Although a tax adviser may not be legally qualified to provide advice concerning foreign tax law, knowledge of foreign tax systems is an important asset. This knowledge enables an adviser to deal more effectively with foreign tax advisers and to suggest alternative methods for structuring transactions to provide desirable tax results under the laws of both countries.

From the taxpayer's viewpoint, the foreign tax consequences of any investment or transaction are often as important as, or even more important than, the domestic tax consequences. Consider, for example, an individual, T, who is resident in one country and who plans to make a **portfolio investment** in another country. Obviously, T is concerned about how her country of residence will tax the foreign source income and the provisions available for relieving double taxation. T is also concerned, however, about the level of the foreign tax. If her residence country relieves double taxation by exempting foreign source income, the foreign tax is the only tax she needs to be concerned about.

If T's country of residence provides a **foreign tax credit**, the situation is more complex, for reasons explained in detail in Chapter 4. In brief, countries that grant a credit for foreign taxes typically limit the credit to the amount of the domestic tax imposed on the foreign income – they do not allow a refund for any foreign tax in excess of the domestic tax on the foreign income. If T expects to obtain a credit for foreign taxes imposed on her foreign income, she needs to be concerned about the foreign tax only if it exceeds the domestic tax, in which case T will be subject to an effective rate of tax equal to the foreign tax rate.

To take a more complicated example of the importance of foreign tax law to the tax adviser, suppose that a multinational corporation wants to reorganize its multinational group of corporations for business reasons. In the absence of special relief provisions, such a reorganization might result in significant adverse tax consequences under the tax laws of many countries. Many countries, however, provide for certain corporate reorganizations to occur on a tax-free (or, more accurately, tax-deferred) basis. In deciding whether to undertake the reorganization, therefore, the multinational corporation will look to its tax advisers for advice on the tax consequences of the

reorganization under the tax laws of the country in which the parent corporation is resident, and also under the tax laws of the foreign countries in which the foreign subsidiaries of the parent corporation are located or carry on business. Providing this advice is no easy matter because the tax rules governing corporate reorganizations vary widely and often interrelate in complex ways.

This intersection of domestic tax law and foreign tax law is one of the most challenging features of the study and practice of international tax. Although tax advisers are usually qualified only to give advice on their domestic tax law, they must be sufficiently familiar with foreign tax laws to be able to recognize potential problems and to deal efficiently with foreign tax advisers. Further, the intersection of foreign and domestic law extends beyond tax. Tax consequences of transactions often depend on the underlying legal results of the transactions. For example, the tax consequences may differ if income is earned by an individual, a **trust**, a partnership, or a corporation. Similarly, the tax consequences may differ if a taxpayer is considered to have transferred property or know-how, or to have rendered services to another person.

The problem of determining the tax consequences of a proposed transaction on the basis of the underlying legal situation is exacerbated in the foreign context because domestic tax consequences often must be determined on the basis of foreign legal concepts. For example, if a resident of one country holds an interest in a *limitada* or limited liability company (which is in essence an entity that provides limited liability for its investors and flow-through treatment for income tax purposes) organized in another country, are the ownership rights characterized as an interest in a partnership, as shares in a corporation, or as something else? And is the characterization the same in both countries? If the entity is characterized differently by the two countries, it is known as a **hybrid entity**. The issues raised by hybrid entities are addressed in Chapter 9, section 9.2.

Tax is often not a major factor in the initial decision of an enterprise to make a **direct investment** abroad. Other factors, such as the return on investment, political stability, labor costs, and access to foreign markets, are much more important as far as the original investment is concerned. The tax "tail" should not wag the commercial "dog". Once the decision to invest has been made, however, tax is an important factor in determining the way in which the investment is structured and financed. Further, tax remains an important factor in determining whether to reinvest or repatriate the profits from the investment. Tax advisers are expected to provide advice concerning the tax consequences of the various ways in which the profits of a foreign enterprise might be repatriated to the domestic corporation. Similarly, they are expected to provide advice concerning the tax consequences of providing the foreign enterprise with additional capital to finance its activities.

One important point about tax planning in general that must be kept in mind is that the client's organization must be able to live with the operational implications of the tax plan. If the tax plan is too complex from an operating viewpoint, any tax savings may be offset by additional administrative costs. Moreover, if the business is unable to operate, in fact, in accordance with the tax plan, the effectiveness of the plan for tax purposes may be jeopardized. For example, a tax plan might involve the establishment of a foreign subsidiary in a tax haven to purchase goods from the domestic parent

corporation and resell them to customers abroad. Such a tax plan might be conditional on the delivery of the goods to the tax haven subsidiary. Therefore, if the goods are shipped by the parent corporation directly to the ultimate customers because that is the sensible thing to do from a commercial perspective, the success of the tax plan may be jeopardized, and indeed, significant penalties may be imposed on the taxpayer.

There are many different ways of structuring foreign investments. For example, a manufacturing enterprise might sell its goods in a foreign country in one or more of the following ways:

- selling its manufactured goods directly to customers in the foreign country through, for example, mail-order sales, sales over the Internet, or sales by itinerant sales agents;
- selling its goods to an unrelated foreign distributor for resale to customers;
- establishing a **branch** in the foreign country consisting of a warehouse and sales employees or agents to sell its goods there;
- establishing a foreign sales subsidiary in the foreign country to sell the goods;
- establishing a foreign holding company, which establishes a foreign sales subsidiary in the country to sell the goods; or
- licensing an unrelated foreign corporation to manufacture and sell its goods in the foreign country.

The tax consequences of these various alternatives may vary considerably under the tax laws of a particular country (and from country to country).

One of the fundamental choices that a corporation resident in one country faces in structuring a foreign investment in another country is the choice between a foreign branch and a foreign subsidiary. The essential difference between a branch and a subsidiary is that a subsidiary is a separate legal entity, whereas a branch is a part or division of the resident corporation. As a result, when a resident corporation sells its products through a foreign branch, the resident corporation may be taxed on the profits of the branch because the branch is not a legal entity separate from the corporation. Further, for general law purposes, the resident corporation is responsible for any legal obligations (e.g., with respect to product defects) arising out of its foreign sales activities. In contrast, if the foreign sales are made by a foreign subsidiary corporation, that corporation, as a separate legal entity, is taxable on its profits and is responsible for its own legal obligations. There are, of course, exceptions to this general rule.

In summary, a tax adviser is expected to perform two functions with respect to tax planning for international transactions. First, tax advisers must, within a reasonable range, quantify the tax costs and benefits of carrying out transactions, and assess the tax risks of obtaining the tax benefits. Second, tax advisers are expected to provide advice for minimizing the amount of tax payable. Often, this tax-minimization aspect of international tax planning involves identifying various methods of structuring a transaction and recommending one method over others in light of the tax consequences and the compatibility of the proposed structure with the overall operating plan of the enterprise.

Although tax planning for international transactions must be tailored to each client's particular situation, certain common types of tax planning can be identified. Three types of international tax planning are described below to give some flavor of the nature of the exercise. The following examples have been simplified drastically.

Double-dip leases. Some cross-border transactions are structured to exploit differences in the tax treatment of transactions by two countries. Cross-border leasing provides an example of this type of international tax planning.

Assume that an airline company resident in Country A wishes to acquire, on credit, some new aircraft for use in its business. It can take out a commercial loan and purchase the aircraft directly, or it can acquire the aircraft by utilizing a so-called financial lease. In general, a financial lease is a financing arrangement under which the lessee acquires substantially all ownership rights to the leased property. In effect, the lessor sells its ownership rights in the property and finances the acquisition of the property by the lessee. Instead of receiving interest and repayments of principal as a conventional lender would, the lessor receives "rental" payments that reflect both the sale price of the property and the financing aspect of the transaction.

Assume that under the tax laws of Country A, a financial lease is treated as a sale. Accordingly, if the airline company resident in Country A leases the aircraft, it will be treated as the owner of the aircraft for purposes of Country A's tax and will be entitled to deduct depreciation in respect of the aircraft and the interest element of the lease payments. The depreciation deductions may be quite large, since many countries provide accelerated depreciation deductions as a tax incentive for investment in substantial equipment. The airline company will also be permitted to claim any investment tax credits that Country A provides for purchases of aircraft.

If the lessor is also a resident of Country A, it will be treated as having sold the aircraft, with the appropriate gain or loss recognized on the sale and the interest element of the lease payment included in its income. Assume, however, that the lessor is a resident of Country B and Country B treats financial leases for tax purposes as genuine leases. Under these assumptions, the lessor will be treated as the owner of the aircraft by Country B and will be entitled to take depreciation deductions and claim any investment tax credits offered by Country B to owners of aircraft. The lessor will be taxable in Country B on the payments of rent received from the airline company. However, Country A treats the financial lease as a sale so that the airline company is considered to be the owner of the aircraft. Thus, the payments considered to be rent by Country B will be treated as payments of the purchase price and interest by Country A.

This type of structure is often referred to as a **double-dip lease** because the tax benefits of ownership of the aircraft are claimed in both countries as a result of the inconsistent characterization of the transaction by the two countries.

Tax haven entities. International tax planning focuses heavily on the use of countries that levy little or no tax. Such tax havens can be used in a wide variety of ways to reduce taxes of residents of high-tax countries. One common way is to establish a controlled foreign corporation in a tax haven.

For example, assume that ACo is resident in and manufactures goods in Country A, which levies corporate tax at a rate of 40 percent. ACo sells its manufactured goods not only in Country A but also in several other countries. ACo is taxable in Country A

on its worldwide profits. ACo incorporates a wholly owned subsidiary, THCo, in Country TH, which does not impose any income taxes. THCo purchases manufactured goods from ACo at their **arm's-length price** and resells them to clients outside Country A. As a result, the sales profits attributable to sales outside Country A will be earned by THCo, not by ACo. Because THCo is a separate legal entity and because the tax advisers will ensure that it is not resident in Country A, the sales profits derived by THCo are not usually taxable by either Country A or Country TH. Thus, assuming that the sales profits are 2 million, this transaction will reduce the taxes payable to Country A by 800,000 (40 percent of 2 million).

If THCo does not have any employees and never takes delivery of the goods acquired from ACo, Country A may disregard THCo as a sham and consider the sales profits to be derived by ACo. Even if THCo actually performs the sales function, some countries have rules to attribute the income derived by THCo to ACo. These "controlled foreign corporation" (CFC) rules are discussed in section 7.3 of Chapter 7 dealing with international tax avoidance.

Most countries that market themselves as tax havens have traditionally provided broad protection against disclosure to foreign governments of the particulars of the transactions involving resident corporations and financial intermediaries located within their borders. These secrecy regimes made it difficult for the tax authorities of high-tax countries to discover attempts at tax avoidance and evasion by their residents. This situation changed drastically in the early 2000s as a result of a series of high-profile cases of widespread tax evasion facilitated by large banks in tax havens such as Liechtenstein and Switzerland . These incidents led to the elimination of bank secrecy and the adoption of a common international standard for the exchange of information between tax authorities, on request and automatically. The significant improvements in exchange of information to prevent tax avoidance and evasion are discussed in Chapter 8, section 8.8.4.

Treaty shopping. Another type of international tax planning involves the use of tax treaties to reduce tax. One common example involves the establishment by a resident of one country of a "conduit" company in another country in order to take advantage of that country's tax treaty network.

Assume that ACo, resident in Country A, has developed valuable intangible property and intends to license the property for use by manufacturers in several other countries. Country A does not have treaties with some of the countries where the potential licensees are resident, and the treaties that Country A has with the other countries provide for withholding taxes on royalties of 15 percent. Country A provides an exemption for dividends received by a corporation resident in Country A from foreign corporations in which it has a substantial participation. ACo transfers its intangible property to a wholly owned subsidiary, BCo, established in Country B. Country B has tax treaties with all the countries where potential licensees are resident, and those treaties provide an exemption from any withholding tax on royalties.

The result of the above arrangement is that no tax will be imposed on the royalties by the countries where the royalties arise. Country B may not tax the royalties derived by BCo (or may tax them at a low rate), either because it is a traditional tax haven or because it provides a special low-tax regime for royalties in respect of

intangible property. When BCo distributes dividends to ACo, Country A will not tax the dividends because of its **participation exemption** for dividends from foreign corporations. Even if Country A treats the transfer of the intangible property by ACo to BCo as a taxable transaction, it may have significant difficulty in taxing the appropriate amount of gain on the transfer because of the problem of accurately establishing the fair market value of the intangible property at the time of the transfer.

This example illustrates the problem of *treaty shopping*. In effect, ACo has taken advantage of Country B's treaty network by the simple expedient of establishing a corporation as a resident of Country B. BCo functions as a conduit to convert the royalties into tax-exempt dividends to ACo. BCo may have no employees and no place of business in Country B. The overall effect of the arrangement is that the withholding taxes of the countries in which the royalties arise are avoided. Treaty shopping is dealt with in Chapter 8, section 8.8.2.2.